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Comment on the Employee Benefits Security Administration proposed rule "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights" RIN 1210-AC03

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Assistant Secretary Khawar:

Thank you for the opportunity to comment on the Employee Benefits Security Administration's recently proposed rule on the Investment Duties regulation under Title I of the Employee Retirement Income Security Act (ERISA) of 1974. Safeguarding the retirement security of working Americans is a vital societal goal, and key to how Americans understand their part in the American dream. The legitimacy of our economic system rests in no small part on the idea that a lifetime of savings and investment, whether in the context of a pension plan or an individual retirement account, will generally yield a reliable nest egg of capital allowing for a dignified and enjoyable retirement. This is why Congress

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[2] The Competitive Enterprise Institute (CEI) is a nonprofit public policy organization dedicated to advancing the principles of limited government, free enterprise, and individual liberty. Founded in 1984, CEI has a long history of research and advocacy on a wide variety of federal regulatory topics, including finance, labor, pensions, corporate governance, and environmental policy: https://cei.org/about.

passed ERISA nearly half a century ago, and why we must defend its guarantees today with the greatest strength and fidelity.[3]

ESG-Themed Investing or Investing-Themed Activism?

The first question, when we consider the application of environmental, social, and governance (ESG) considerations to investing, needs to be which of those two components is primary, the investing part or the ESG part. Is ESG investing primarily about securing long-term financial rewards or about advancing the non-financial policy agendas frequently associated with ESG frameworks? The requirements of ERISA clearly permit only the former, and the current rule, published in 2020, attempts to reinforce this obligation.[4] The proposed rule currently under consideration would normalize the latter, however.

The preamble to the proposed rule clearly signals this shift in emphasis by citing Executive Order 13990, which has "tackle the climate crisis" as its primary goal.[5] Section 1 of E.O. 13990 lays out how the administration seeks to confront climate change and champion environmental justice. It also seeks to promote, as the notice of proposed rulemaking puts it, "the creation of the well-paying union jobs." While those may be laudable goals, they have nothing to do with securing the retirement future of Americans workers. Worse, to the extent that they distract pension fiduciaries from that primary goal, they actually threaten it.

Like most executive orders, E.O. 13990 contains boilerplate phrasing calling for the heads of agencies to "promptly take steps" to implement the goals of the order and to repeal previously published policy documents inconsistent with those goals. No doubt the Department considers reversing the "Prudence and Loyalty in Selecting Plan Investments" rule to be consistent with that directive. But E.O. 13990 also contains other boilerplate language that applies to the current question. Section 8(b) states that the order "shall be implemented in a manner consistent with applicable law." Demoting the interests of pension beneficiaries in order to advance climate change policy and offer preferment to labor unions is not consistent with ERISA, and any rule being promulgated under those auspices is therefore illegitimate.

The Department's own conclusions in Section D, "Regulatory Impact Analysis," reinforce this conflict. The analysis first suggests that there could be a negative impact on plans' financial performance if plan

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[3] In his signing statement on ERISA, President Gerald Ford specifically mentioned that the new law would seek to address the problem of "pension funds have been invested primarily for the benefit of the companies or plan administrators, not for the workers." Gerald R. Ford, "President Ford Signing ERISA of 1974," September 2, 1974, Pension Benefit Guaranty Corporation, https://www.pbgc.gov/about/who-we-are/pg/president-ford-signing-erisa-of-1974.

[4] "Financial Factors in Selecting Plan Investments," *Federal Register*, Vol. 85, No. 220 (November 13, 2020), https://www.federalregister.gov/documents/2020/11/13/2020-24515/financial-factors-in-selecting-plan-investments.

[5] Joseph R. Biden, Jr., Executive Order, "Protecting Public Health and the Environment and Restoring Science to Tackle the Climate Crisis," *Federal Register*, Vol. 86 No. 15 (January 25, 2021), pp. 7037-7043, https://www.federalregister.gov/documents/2021/01/25/2021-01765/protecting-public-health-and-the-environment-and-restoring-science-to-tackle-the-climate-crisis.

mangers are scared off from considering ESG-themed criteria, in investments or proxy voting, that turn out to be financially material. But the analysis also justifies the proposal based on concerns about "broader negative economic/societal impacts (e.g., negative impacts on climate change, on workers' productivity and engagement, and on corporate managers' accountability)." In other words, the proposal is justified, in part, on considerations that are beyond the purview of ERISA and the Employee Benefits Security Administration in general, and that are in conflict with ERISA's central goal.

Beyond the current proposed rule, the administration has shown an aggressive tendency to reposition legal powers from other realms to address climate policy as part of President Biden's "all of government" approach.[6] John Kerry, the U.S. special envoy for climate, has disclosed his efforts to lobby major financial firms to direct more capital to renewable energy projects and, by implication, to restrict financing to traditional hydrocarbon resource development.[7] This effort was widely perceived by critics as an attempt to pressure banks into making politically motivated investment decisions that they would have otherwise avoided.

Kerry's effort has proved controversial with elected officials as well, with Republican members of the Senate Banking Committee publicly writing in opposition: "Beyond the poor track record associated with central economic planning, this apparent attempt to prevent energy companies from obtaining capital disturbingly resembles the Obama administration's notorious 'Operation Choke Point' scandal, in which financial regulators attempted to coerce banks into denying services to legal yet politically-disfavored businesses."[8] Prominent Republican members of the House of Representatives also criticized Kerry's efforts, writing that "American banks should not be exploited as political pawns and bullied into being enlisted as instruments of the Biden Administration's misguided and controversial climate policies."[9] Treasurers of fifteen states weighed in with similar criticism.[10]

This effort to turn every federal activity into climate change activism, absent any specific grant of authority, can also be seen in recent policy decisions at the Federal Reserve. Introducing climate-related "stress tests" on banks and endorsing the agenda of the Network for Greening the Financial System, for example, have generated strong push-back from dozens of members of Congress, who warned against

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[6] Meredith Compton, Douglas Hastings, and Duke McCall III, "Biden-Harris Administration's 'All of Government' Approach to Addressing Climate Change and Environmental Justice," JD Supra, April 23, 2021, https://www.jdsupra.com/legalnews/biden-harris-administration-s-all-of-2462046/.

[7] Hannah Miao, "Biden climate envoy John Kerry talking to banks, asset managers about mobilizing capital for clean energy," CNBC, March 4, 2021, https://www.cnbc.com/2021/03/04/climate-change-john-kerry-talking-to-banks-asset-managers-about-clean-energy.html.

[8] "Toomey, GOP Banking Members Demand Kerry, Biden Administration Stop Trying to De-Bank Energy Companies," U.S. Senate Committee on Banking, Housing, and Urban Affairs, April 21, 2021, https://www.banking.senate.gov/newsroom/minority/toomey-gop-banking-members-demand-kerry-biden-administration-stop-trying-to-de-bank-energy-companies. For background on Operation Choke Point, see Iain Murray, "Operation Choke Point: What It Is and Why It Matters," *Issue Analysis 2014* No. 1, Competitive Enterprise Institute, July 2014, https://cei.org/studies/operation-choke-point/.

[9] Rep. Andy Barr, et al., Letter to Special Presidential Envoy for Climate Kerry, U.S. House of Representatives, April 21, 2021, https://twitter.com/RepAndyBarr/status/1384979747084587015.

[10] Riley Moore, et al., Letter to John Kerry, State of West Virginia, Office of the State Treasurer, May 25, 2021, https://www.wvtreasury.com/Portals/wvtreasury/content/Press%20Releases/State%20Treasurers%20Letter%20to%20John%20Kerry%20on%20Fossil%20Fuel%20Lending%20w-%20signatures.pdf.

adopting such plans, stating that they are "are plagued with speculation, inconsistencies, and reliance on long-term projections that may not adequately account for shifting market dynamics."[11] In the case of the Federal Reserve, there is significant question as to whether incorporating climate responsibilities into the agency's portfolio is even legal, much less smart policy. Two leading law professors, Joshua Kleinfeld and Christina Parajon Skinner, recently wrote of the effort: "It is democratically illegitimate for the Fed to engage in freelance activism. The Fed has no legal right to do so."[12] Prof. Skinner also recently noted that "the U.S. Federal Reserve presently has relatively limited legal authority to address [climate change] head-on," concluding that "many aspects of climate change sit outside the Fed's legal remit today."[13]

This widely noticed and controversial tendency to put climate change ahead of other long-established and statutorily required policy goals is alarming. Given the Department's proffered justification for the current rule, it is difficult to see how this effort to loosen the discipline on fund fiduciaries is not simply a means of promoting climate activism (and other ESG goals), rather than a sincere attempt to safeguard the retirement savings of American workers, as ERISA requires. If members of the 117th Congress (or any future one) wants to amend the work of the 93rd Congress to explicitly allow pension fund fiduciaries to promote climate change and other ESG topics, they are free to do so. Until that time, however, the non-pension related political goals of the current administration are not a reasonable or proper basis for a new rule under the statute.

ESG Activism Is an Alternate Route for Failed Policies with a Democratic Deficit

The motivation for policymakers to greenlight greater ESG integration into pension fund management is more understandable when one realizes that many ESG proponents in the U.S. are policy advocates who have been frustrated by their inability to pass legislation through Congress. ESG activism is often an outlet for promoting a pre-existing agenda that has been grafted onto existing institutions and covered with a fig leaf of legal justification, rather a prudent way to discharge sound fiduciary responsibilities, as ESG advocates often claim.

Once again, the example of climate change activism provides an instructive example. Consulting firms and investment managers often refer to greater climate-centered investing as unstoppable or inevitable, and the United Nations-affiliated organization Principles for Responsible Investment insists that there will soon be an "Inevitable Policy Response" by governments around the world in the form of stricter climate regulations.[14]

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[11] Rep. Andy Barr, et al., Letter to Chairman Powell and Vice Chairman Quarles, U.S. House of Representative, December 9, 2020, https://www.politico.com/f/?id=00000176-4cfb-d52c-ad7e-dcff3d220000.

[12] Joshua Kleinfeld and Christina Parajon Skinner, "Hijacking the Fed," *National Review*, November 18, 2021, https://www.nationalreview.com/2021/11/dont-weaponize-the-fed/.

[13] Christina Parajon Skinner, "Central Banks and Climate Change," *Vanderbilt Law Review*, Vol. 45, No. 5 (October 2021), pp. 1301-1364, https://vanderbiltlawreview.org/lawreview/wp-content/uploads/sites/278/2021/10/Central-Banks-and-Climate-Change.pdf.

[14] Principles for Responsible Investment, "What is the Inevitable Policy Response?" United Nations Principles for Responsible Investment website, accessed July 2, 2020, https://www.unpri.org/inevitable-policy-response/what-is-the-inevitable-policyresponse/4787.article.

But despite this confident rhetoric, the kind of climate policies that firms and investors supposedly need to accommodate have been slow to materialize. In fact, Congress and American voters have repeatedly rejected, over the last quarter century, the type of policy "progress" that climate activists insist is inevitable. In 1997, the U.S. Senate unanimously approved the Byrd-Hagel resolution by a vote of 95-0, calling for the rejection of the Kyoto Protocol climate treaty, which President Bill Clinton signed but the Senate never ratified. Senators John McCain (R-AZ) and Joe Lieberman (D-CT) introduced three successive "Climate Stewardship" bills in 2003, 2005, and 2007. They all failed. A similar defeat greeted the Lieberman-Warner Climate Security Act in 2008 and the Waxman-Markey American Clean Energy and Security Act in 2010.[15]

Later, during the Obama administration, the Environmental Protection Agency proposed an ambitious program to regulate carbon emissions from the power sector, known as the Clean Power Plan (CPP). This was consistent with President Barack Obama's 2014 boast that, in the absence of congressional support for his agenda, he would pursue a program of unilateral executive policymaking via "pen and phone."[16] However, The CPP was replaced when the Environmental Protection Agency implemented the Affordable Clean Energy rule in 2019 (the final status of which is still being litigated).[17]

This legislative and executive policymaking record is clearly not an example of inevitable triumph for climate proposals. And it is not just a case of the United States being an outlier. Australia implemented a national carbon tax in 2012, but it was gone by 2014. The yellow vest protests in France were sparked by rising fuel prices, largely driven by climate-focused energy taxes. That series of protests, some of the country' largest and most disruptive since the infamous civil unrest of "May '68" have already had an impact on energy policy throughout Europe.[18] When President Trump announced his plan to withdraw the U.S. from the Paris Climate Accord in 2017, it had been signed by 196 countries. Yet as of September 2021, not a single G20 nation had adopted a climate policy that is in line with the treaty's goals.[19]

These political reversals and refusals to accede to the demands of climate activists should give pause to anyone promoting ESG integration into investing. For many years, both industry analysts and federal policymakers have acknowledged that the most important "climate risks" that firms and asset managers need to be aware of are actually political, not physical. In 2010, when the Securities and Exchange

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[15] Richard Morrison, "Business can't rally around climate goals until politicians turn those goals into law," *Fortune*, November 1, 2021, https://fortune.com/2021/11/01/climate-change-esg-investing-congress-policy-business-cop26/.
[16] Tamara Keith, "Wielding A Pen And A Phone, Obama Goes It Alone," NPR, January 20, 2014, https://www.npr.org/2014/01/20/263766043/wielding-a-pen-and-a-phone-obama-goes-it-alone
[17] Marlo Lewis, Jr., "Comments on the Affordable Clean Energy Rule," Competitive Enterprise Institute, October 31, 2018, https://cei.org/regulatory_comments/cei-comments-on-epa-ace-rule/.
[18] Frédéric Simon, "'Yellow vests' spark EU debate about just transition to clean energy," *Euractiv*, November 27, 2018, https://www.euractiv.com/section/energy/news/yellow-vests-spark-eu-debate-about-just-transition-to-clean-energy/. Adam Nossiter, "The Question for France: Where Do the Yellow Vests Go From Here?," *The New York Times*, December 23, 2018, https://www.nytimes.com/2018/12/23/world/europe/france-yellow-vests-future.html.
[19] Ivana Kottasová, "Not a single G20 country is in line with the Paris Agreement on climate, analysis shows," CNN, September 16, 2021, https://www.cnn.com/2021/09/15/world/climate-pledges-insufficient-cat-intl/index.html.

Commission issued its first guidance on the topic, it listed four categories of risk, of which only the fourth had anything to do with changes in weather patterns resulting from a changing climate. The others involved potential new laws, treaties, and regulations that might intentionally disadvantage certain sectors and industries.[20] Assessing political risk is a legitimate calculation for investors to make, but many ESG proponents are trying to have it both ways—claiming that they are protecting shareholder value by raising these concerns, while engaging in policy advocacy that would create and amplify those same risks.[21] Allowing pension fund managers to participate in this activist bootstrapping is in direct conflict with the stated goals of ERISA.

ESG-themed Investment Criteria Are Inherently Less Rigorous

Unlike traditional financial concerns, ESG-related topics are less amenable to quantitative measurement and necessarily less rigorous in the context of calculating risk-adjusted returns; it is a major flaw of the proposed rule not to acknowledge that.[22] "Financial Factors in Selecting Plan Investments" made a clear and persuasive case that traditional risk/return calculations were not generally consistent with ESG considerations. Its provisions created reasonable guardrails to prevent motivated and wishful thinking among plan managers from redefining what constituted a reasonable investment risk.

The preamble to the current rule contains citations to several studies that document the inconsistent, vague, and confusing way in which ESG topics are rated and classified, even by the companies and consultants who are paid to interact with the relevant data on a daily basis.

For instance, a 2020 study from investment strategy firm Research Affiliates found that ESG ratings vary significantly by provider and that ESG portfolios constructed using the ratings of two well-known providers yield large performance dispersion and low correlation of returns. The authors emphasize that even "well-known, well-established providers with robust methodologies" can provide very different scores to the same company being rated on ostensibly the same issue.[23]

Worse, ESG raters can disagree even on simple matters of fact. In the Research Affiliates study, whether a company is a member of the U.N. Global Compact has a correlation of 0.86 and whether the person holding the title of CEO is also the chairman of the board has a correlation of only 0.56. If two different

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[20] "SEC Issues Interpretive Guidance on Disclosure Related to Business or Legal Developments Regarding Climate Change," Securities and Exchange Commission, January 27, 2010, https://www.sec.gov/news/press/2010/2010-15.htm.

[21] Marlo Lewis, Jr., "Climate Risk Disclosure Proposal Would Destroy, Not Protect, Shareholder Value," *OpenMarket*, Competitive Enterprise Institute, July 12, 2019, https://cei.org/blog/climate-risk-disclosure-proposal-would-destroy-not-protect-shareholder-value/.

[22] Richard Morrison, "Environmental, Social, and Governance Theory: Defusing a Major Threat to Shareholder Rights," *Profiles in Capitalism* No. 6, Competitive Enterprise Institute, May 2021, pp. 27-42, https://cei.org/wpcontent/uploads/2021/05/Richard-Morrison-ESG-Theory.pdf.

[23] Feifei Li and Ari Polychronopoulos, "What a Difference an ESG Ratings Provider Makes!" Research Affiliates, January 2020, https://www.researchaffiliates.com/en_us/publications/articles/what-a-difference-an-esgratings-provider-makes.html.

rating firms can only agree half of the time on the identity of the chairman of a public company, the more detailed and qualitative assessments of ESG investing deserve a great deal more scrutiny.[24]

Researchers from MIT's Sloan School of Management reached similar conclusions last year when they found four different problems at work in inconsistent ESG ratings: measurement divergence, scope divergence, weights divergence, and rater effect. The authors of the MIT study suggest some circumstances in which divergent ratings might be acceptable, but conclude that, "Measurement divergence is problematic, however, if one accepts the view that ESG ratings should ultimately be based on objective observations that can be ascertained."[25] If we are expecting pension fund fiduciaries to be using ESG criteria to be maximizing risk-adjusted returns for beneficiaries, this is the very least we should be expecting.

Fund managers branching out into environmental and social topics are also unlikely to have the specialized training and expertise to evaluate fields that lie outside of traditional investment strategy. Even sophisticated investment professionals can make, for example, environmentally problematic choices because of reasonable, but ultimately incorrect, assumptions about which technologies and products have superior ESG attributes. For example, a biodiesel manufacturer that uses food crops to produce its fuel could easily have a larger carbon footprint per unit of production than a traditional oil company.[26] Evaluating the long-term climate impact of a particular firm is even more difficult. Fund managers will need to select the "correct" value from a range of possible values on multiple dimensions of climate science to generate any predictions of future risk, including climate sensitivity to increasing greenhouse gas (GHG) emissions, projected increase in GHG concentrations over several decades, effects of aerosol emissions on cloud formation, and other topics. The range of alternative assumptions in this process is too great for such calculations to be rigorous enough to guide even the most long-term investment decisions.[27]

Even when there are clear data, there will always be a temptation for fund managers to align investment choices they're supposed to make on behalf of their beneficiaries with their own social and political goals. The explosive growth of ESG-themed initiatives and investment products in recent years has been tied closely to the self-actualization goals of investment professionals themselves. News media reports, industry analyses, and academic studies on the intersection of "social responsibility" and business often emphasize the desire of corporate executives and investors to gain a greater sense of moral validity and

[24] Alex Edmans, "The Inconsistency of ESG Ratings: Implications for Investors," alexedmans.com, April 10, 2020, https://alexedmans.com/blog/responsible-business/the-inconsistency-of-esg-ratingsimplications-for-investors.
[25] Florian Berg, Julian F. Koelbel, and Roberto Rigobon, "Aggregate Confusion: The Divergence of ESG Ratings," MIT Sloan School Working Paper 5822-19, May 17, 2020, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3438533.
[26] Jon Sigurdsen, "Buyer beware: ESG screening has its faults," *Financial Times*, April 25, 2019, https://www.ft.com/content/682d4f63-23e3-3aaa-9283-b06de2de4589.
[27] Benjamin Zycher, "Testimony before the Senate Committee on Banking, Housing, and Urban Affairs: Climate 'risk' and the distortion of U.S. financial markets," American Enterprise Institute, March 18, 2021, https://www.aei.org/research-products/testimony/testimony-climate-risk-and-the-distortion-of-u-sfinancial-markets.

emotional satisfaction by integrating ESG goals into their professional lives.[28] Those non-pecuniary rewards represent the kind of potential conflicts of interest that the documentation requirement of the current rule was meant to address.

Don't Assume That Federal Agencies Have ESG-Related Authority

Finally, the well-documented popularity of ESG funds and fund marketing is not, on its own, enough to justify any change in federal policy. As Prof. Skinner has written regarding the Federal Reserve, policymakers cannot simply decide that because a hot-button topic (like climate change) is acknowledged to be important, a given government agency automatically has the authority to address it. Absent a clear grant of authority from Congress, that may not be the case.[29]

The preamble to the proposed rule cites the concept that certain consideration of ESG criteria may be justified if investment professionals would normally treat the topic in question as material under "generally accepted investment theories." While it is reassuring that ESG integration isn't asserted to already be "generally accepted," the Department should be extremely wary of claims that it is. Large asset management firms and some investment professionals have hailed ESG investing as "mainstream," with supporting claims proliferating throughout the academic literature and mainstream business press.[30]

Law and regulation in the United States frequently makes use of subjective standards, such as what is considered "reasonable," "generally understood," or "commonly practiced." But such a shifting standard cannot become the basis for compliance (or defense against charges of non-compliance) with a rule that is supposed to be based on specifically prescribed statutory duties. Even if a manager of a private pension fund subject to ERISA's requirements were to provide persuasive evidence that her ESG-led investment decisions were "generally accepted" by her financial industry peers, it would not relieve her of the clearly stipulated fiduciary duty under the statute. General acceptance of prioritizing ESG goals over maximizing beneficiary returns can no more be validated by its alleged ubiquity than could outright fraud or theft. The Department's final rule should make that clear.

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[28] Tanja Hester, "Ethical investing is much easier than you think: 4 ways to fund your retirement and minimize harm to humanity," *MarketWatch*, November 15, 2021, https://www.marketwatch.com/story/4-ways-to-fund-your-retirement-ethically-11636997139. Lisa Lang, "When Passion Meets Purpose," *Above the Law*, November 30, 2021, https://abovethelaw.com/2021/11/when-passion-meets-purpose/. Jenny Gross, "Business Schools Respond to a Flood of Interest in E.S.G.," *The New York Times*, November 13, 2021, https://www.nytimes.com/2021/11/13/business/dealbook/business-schools-esg.html. Xiangshang Cai, Ning Gao, Ian Garrett, and Yan Xu, "Are CEOs Judged on Their Companies' Social Reputation?" *Journal of Corporate Finance*, Vol. 64 (October 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3571330.

[29] Sarah E. Light and Christina P. Skinner, "Banks and Climate Governance," *Columbia Law Review*, Vol. 121, No. 6 (October 2021), pp. 1896-1956, https://columbialawreview.org/content/banks-and-climate-governance/.

[30] Richard Morrison, "Comment on Employee Benefits Security Administration Proposed Rule 'Financial Factors in Selecting Plan Investments,'" Competitive Enterprise Institute, July 29, 2020, https://cei.org/regulatory_comments/comment-on-employee-benefits-security-administration-proposed-rule-financial-factors-in-selecting-plan-investments/.

Conclusion

While the Department has crafted a formally restrained proposal, the signal it would send to fund managers would be a dangerous one. The importance of protecting the retirement incomes of American workers is simply too important to loosen the reins on fiduciaries who have been rightly and successfully disciplined by ERISA for nearly half a century. The Department should retain the requirement that investment managers document cases in which they have employed ESG factors under the allowed "tie-breaker" standard, and enforce the current rule's view on the exclusion of non-pecuniary considerations.