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Mr. Ali Khawar
Acting Chief of the Division of Regulations
Office of Regulations and Interpretations
Employee Benefits Security Administration
Room N-5655
U.S. Department of Labor
200 Constitution Avenue NW
Washington, DC 20210

December 13, 2021

Subject: RIN 1210-AC03 Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights

Dear Acting Chief Khawar,

On behalf of the California Public Employees' Retirement System (CalPERS), we write to comment on the U.S. Department of Labor's (DOL) proposed rule entitled "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights" (Proposed Rule). The Proposed Rule would modify, in part and rescind in part, DOL's "Financial Factors in Selecting Plan Investments" rule, which adopted amendments to the investment duties regulation (Investment Duties Regulation), and the "Fiduciary Duties Regarding Proxy Voting and Shareholder Rights" rule, which impacted voting proxies and exercising shareholder rights (Shareholder Rights Reduction Regulation). We refer to the Investment Duties Regulation and the Shareholder Rights Reduction Regulation collectively as the "2020 Amendments."

As the largest public defined-benefit pension fund in the United States, we manage approximately $495 billion in global assets on behalf of more than 2.1 million public employees, retirees, and beneficiaries. Our duty to pay benefits decades into the future requires that we take a long-term view when assessing whether the companies we hold in our portfolio are managed effectively. We believe that the integration of environmental, social, and governance (ESG) considerations is necessary in this process.[1]

[1] See, CalPERS Investment Beliefs, https://www.calpers.ca.gov/docs/board-agendas/201702/pension/item7-01.pdf, (Investment Belief 2: A long time investment horizon is a responsibility and an advantage; Investment Belief 3: CalPERS' investment decisions may reflect wider stakeholder views, provided they are consistent with its fiduciary duty to members and beneficiaries; Investment Belief 4: Long-term value creation requires effective management of three forms of capital: financial, physical and human; Investment Belief 7: CalPERS will take risk only where we have a strong belief we will be rewarded for it.); CalPERS Sustainable Investment Research Initiative Library,

As a public defined-benefit pension plan, CalPERS is not subject to the Employee Retirement Income Security Act of 1974, as amended (ERISA). However, we are subject to common law principles of fiduciary duty and have noted that many of DOL's prior modifications of common law fiduciary duty for ERISA fiduciaries have weakened the power of ERISA fiduciaries and have made them more likely to be subjected to private suits without providing any apparent benefits. Given the effects of DOL's rulemaking on common law fiduciary duty, we welcome the positive moves made in the Proposed Rule but wish to raise concerns about various aspects of DOL's framework for regulating ERISA fiduciaries' investments.

RECOMMENDATIONS

We applaud DOL for reversing the direction of the 2020 Amendments, but we encourage DOL to take further action to improve the framework. To do so, DOL should choose to more closely apply common law concepts of fiduciary duty and update its approach to align with modern investing. Doing so would comport with DOL's mission by empowering workers in corporate governance affairs.[2]

DISCUSSION

I. THE APPLICATION OF ECONOMICALLY TARGETED INVESTMENT (ETI) ANALYSIS TO ESG IS FUNDAMENTALLY FLAWED.

The Proposed Rule continues using the ETI framework and does not address its misapplication to ESG investments. As a result, DOL should make its views on index construction clearer. ESG is embedded in investing, including index investing. Consider the fact that the Investment Duties Regulation promotes the use of index investing while simultaneously prohibiting the most basic index investing, such as using the S&P 500 Index. This happened because the S&P 500 Index excludes certain multiple class structures.[3] The Proposed Rule would not change this operational aspect, despite including some constructive language regarding ESG investments. As a result, we believe that unfortunate consequences would still arise. For example, an ERISA fiduciary investing in an index fund that excludes Zoom may still be subject to suit because Zoom would be excluded for governance reasons. Providing more clarity on index construction to take these ESG-related effects into account would be welcome.

Another issue is the lack of definition of the proposed materiality threshold. The International Limited Partners Association recently published its revised due diligence questionnaire (ILPA DDQ).[4] It serves as an industry guide but is used broadly by institutional investors to assist in examining managers and making decisions among managers. The ILPA DDQ asks many questions, including ESG and diversity questions. DOL appears to allow such considerations but uses a materiality

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https://www.calpers.ca.gov/page/investments/sustainable-investments-program/esg-integration/siri-library, and CalPERS Total Fund Governance & Sustainability Strategic Plan, https://www.calpers.ca.gov/docs/governance-sustainability-strategic-plan-update.pdf.

[2] The mission of the DOL is "t**o foster, promote, and develop the welfare of the wage earners, job seekers, and retirees of the United States; improve working conditions; advance opportunities for profitable employment; and assure work-related benefits and rights." See** https://www.dol.gov/general/aboutdol.

[3] Albert Feur, *How an ERISA Fiduciary May Try to Save the World*, Tax Management Compensation Planning Journal (2020), referencing the comment letter of Bernard Sharfman, *Comment Letter re DOL ESG Proposal at 9* (July 22, 2020).

[4] ILPA Due Diligence Questionnaire and Diversity Metrics. See https://ilpa.org/due-diligence-questionnaire/.

threshold without ever defining materiality in the Proposed Rule. DOL should clarify its view on the application of broad-based due diligence.

Additionally, the continuing enhanced private right of action is problematic. A recently written article by Quinn Curtis, Jill Fisch, and Adriana Robertson highlights that the private right of action against ERISA fiduciaries for use of ESG has no empirical basis.[5]

In short, DOL remains solidly behind the times in considering ESG by applying an ETI framework to ERISA fiduciaries' investments, refraining from defining its materiality threshold, and enhancing litigation risk against ERISA fiduciaries. The Proposed Rule would continue this trajectory, but we believe DOL can revise the Proposed Rule to address these concerns.

II. THE SUPREME COURT HAS MADE CLEAR THAT NONPECUNIARY FACTORS ARE APPROPRIATE EVEN UNDER ERISA.

DOL's continued focus on financial matters appears to be misplaced and inconsistent with Supreme Court precedent. In *Fifth Third Bancorp v. Dudenhoeffer*[6] (*Fifth Third*), the Supreme Court actually made clear that nonpecuniary considerations are a part of investing. This is critical because this case is the basis of the "pecuniary" versus nonpecuniary interest dichotomy argument in the Investor Duties Regulation. In *Fifth Third*, the Supreme Court went to great lengths in analyzing Fifth Third Bank's Employee Stock Ownership Plan (ESOP), which contained a congressionally mandated, nonpecuniary benefit (ownership based on employment, not a company's financial performance). The Supreme Court upheld the existence of such nonpecuniary benefit under ERISA. Despite this ruling, DOL's has imposed broad-based prohibitions that do not comport with modern investment needs or common law fiduciary duty. These prohibitions have had the adverse impact of reducing the availability of ESG funds in 401(k) plans despite empirical evidence demonstrating that workers would have benefited from having access to such plans.[7] The Proposed Rule makes a positive move to correct this deficiency, but there is room to go further and provide ERISA participants better access to ESG mutual funds.

DOL's proposal to apply a value maximizing approach for each investment is also at odds with the Supreme Court's precedent. In *Fifth Third*, the Supreme Court did not adopt a "maximize returns" approach to fiduciary duty because no such duty exists in common law. The fiduciary standard applied in *Fifth Third* was simply whether the stock was purchased at the public market price.[8] DOL should address how purchasing public securities at the market price applies within ERISA.

Greater focus on the diversification element in the Proposed Rule may yield an outcome more consistent with common law fiduciary duty. The *Fifth Third* case highlights the three areas of fiduciary duty: Diversification, Prudence and Loyalty. As written, the Proposed Rule would de-

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[5] Quinn Curtis, Jill E. Fisch, and Adriana Z. Robertson, *Do ESG Mutual Funds Deliver on Their Promises?* Working Paper N 586/2021, (June 2021) ((i)"We interrogate the empirical basis for these concerns and find it lacking."; (ii) "When focusing on the ESG market as it currently stands, many of the critiques of ESG lack empirical support." 53).

[6] *Fifth Third Bancorp v. Dudenhoeffer*, 573 U.S. 409 (2014).

[7] Curtis, Fisch and Robertson at 25-26. (On the other hand, plan sponsors might be sufficiently risk averse, particularly in light of the threat of private litigation, to simply avoid funds that foreground ESG goals. To date, ESG funds are rarely included as an investment option in 401(k) plans.").

[8] *Fifth Third* at 17; ("ERISA fiduciaries, who likewise could reasonably see 'little hope of outperforming the market…based solely on their analysis of publicly available information,' ibid., may, as a general matter, likewise prudently rely on the market price.").

emphasize the diversification requirement, using diversification primarily as a subset of the prudence requirement. When fiduciary duty is considered fully, including diversification, much of DOL's ERISA rules miss the mark. There are important reasons to invest in different types of non-correlated investments, but DOL continues to apply special scrutiny to one type—ESG—without recognizing that other types of investments present similar issues.[9]

III. THE PROPOSED RULE DOES NOT TREAT ESG AS OTHER TYPES OF ACTIVE INVESTING STRATEGIES.

DOL introduced *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*[10] (*Reconciling Fiduciary Duty*) in footnote 5 of the proposal for the Investment Duties Regulation[11] stating that the article provides a "concise history of the current ESG movement and the evolving terminology."[12] The article does much more than provide an ESG history. Rather, it analyzes whether ESG investing meets the prudence standard, a central issue in creating the Investment Duties Regulation and the Proposed Rule. For emphasis, we highlight the following six quotes from *Reconciling Fiduciary Duty.*

> **It follows, therefore, that an ESG investing strategy that involves picking and choosing investments based on ESG factors, or that involves exercising shareholder control rights in light of those factors, could satisfy the prudent investor rule.[13]**
>
> **An active investing strategy based on ESG factors, in other words, is conceptually no different than any other active investing strategy that purports to identify stocks or other securities that are mispriced, and to generate risk-adjusted excess returns by placing bets for or against those stocks or securities.[14]**
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> **As a matter of law, the explicit doctrinal underpinning of the prudent investor rule is that "[s]pecific investments or techniques are not per se prudent or imprudent." Instead, "[a] trustee may invest in any kind of property or type of investment" so long as the investment is "part of an overall investment strategy having risk and return objectives reasonably suited to the trust." Under the prudent investor rule, therefore, there are no categorical rules of permissible or impermissible investments.[15]**
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> **The prudent investor rule permits a trustee to undertake any type or kind of investment so long as the resulting overall portfolio is diversified, and its overall risk and return align with the terms and purposes of the trust.[16]**

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[9] Curtis, Fisch, and Robertson at 54-55, explaining that ESG disclosures about potential underperformance are not unique. Value funds which have underperformed for a decade make similar disclosures.
[10] 72 Stan. L. Rev. 381 (2020).
[11] Proposed Investment Duties Regulation 2020.
[12] Proposed Investment Duties Regulation 2020, 4.
[13] 72 Stan. L. Rev. 427-28.
[14] 437 referencing 3 Restatement (Third) of Trusts ch.17, introductory note (Am.Law Inst. 2007).
[15] 449 referencing 3 Restatement (Third) of Trusts ch.17, introductory note (Am.Law Inst. 2007) and Unif. Prudent Inv'r Act 2(b), (e) (Unif. Law Comm'n 1994).
[16] 449 referencing UNIF. PRUDENT INV'R ACT, prefatory note ("All categoric restrictions on types of

Ironically, it is the flexibility of the prudent investor rule that allows a trustee to consider ESG factors. The prudent investor rule was meant to get courts and legislatures out of the business of prescribing by category or method per se rules on what investments would and would not be prudent.[17]

A prudent trustee could opt for an opposite, anti-ESG bet. "[18]

Reconciling Fiduciary Duty makes clear that consideration of ESG factors is consistent with fiduciary duty and similar to other active investment, legal support for its conclusions, including Restatement (Third) of Trusts. It also addresses the dual nature of ESG investments. DOL continues to specially scrutinize only investments that move from the status quo without acknowledging that ESG investments can be made in each direction. For example, if an ERISA fiduciary decides to favor all white male boards, it has made an ESG decision. The Proposed Rule, however, would not require special scrutiny of this decision because it is consistent with the status quo. Investments in oil and gas companies would not be scrutinized, but investments in clean energy could spur litigation if those investments underperform.

A variety of studies demonstrate ESG investing lowers volatility of returns, boosting their desirability for risk-adjusted returns and diversification (*see* Kaiser, 2020;[19] Kumar, et al, 2016;[20] Verheyden & Feiner, 2016[21]). These factors further show that ESG fits soundly in what a fiduciary must consider. Unless DOL's goal is to eliminate active investing, it is not practical to differentiate between ESG investing and other forms of active investing.[22]

IV. DOL SHOULD USE A COMMON LAW FIDUCIARY DUTY BASELINE TO DETERMINE THE COSTS OF THE PROPOSED RULE ON ERISA FIDUCIARIES.

The U.S. Chamber of Commerce described the Investment Duties Regulation as a litigation "road map."[23] It appears that if a chosen investment fund underperforms and includes mention of an ESG factor, the Proposed Rule would continue the process for a potential private right of action against an ERISA fiduciary for choosing such investment. The ESG examples that DOL adds in the Proposed Rule do not change this outcome given that the operating portions remain the same and includes a materiality qualifier. DOL also adds language regarding comparing competing investment or competing courses of action that needs to be enhanced to make sense. It should be made clear that the ESG investment or course of action would compete with the weakest existing investment as opposed to the best or close alternative. The added wording suggesting consideration of certain ESG factors does not reduce the scrutiny placed on pro ESG investments. In order to provide a safe

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investments have been abrogated; the trustee can invest in anything that plays an appropriate role in achieving the risk/return objectives of the trust and that meets the other requirements of prudent investing.").

17 449-50.

18 453 referencing *Fifth Third Bancorp v. Dudenhoeffer*, 134 S. Ct. 2459, 2471 (2014) (quoting *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398, 2411 (2014)).

19 Kaiser, L., ESG integration: value, growth and momentum, *Journal of Asset Management* (Jan. 2020), 21, 32-51.

20 Kumar, N. C. A., Smith, C., Badis, L., Wang, N., Ambrosy, P. & Tavares, R. (2016) ESG factors and risk-adjusted performance: a new quantitative model, *Journal of Sustainable Finance and Investment*, 6(4), 292-300.

21 Veheyden, T., Eccles, R. G. & Feiner, A. (2016) ESG for all: The impact of ESG screening on return, risk and diversification, *Journal of Applied Corporate Finance*, 28(2), 47-55, Spring.

22 See, Reconciling Fiduciary Duty at 427-53.

23 *Legal Battles Likely Over Trump's ESG Crackdown, Advisers Say,* https://news.bloomberglaw.com/corporate-governance/legal-battles-likely-over-trumps-esg-crackdown-advisers-say/ ("The added documentation requirements are a road map for the plaintiffs' bar," Chantel Sheaks, Retirement Policy Director, US Chamber of Commerce).

harbor, DOL must state without qualification that no private right of action will exist when such ESG matters are considered. Otherwise, a plaintiff will argue, in light of the actual returns in stock drop cases, that the pursuit of ESG or the collateral benefit was a breach of loyalty causing harm to the ERISA fund or the participant.[24] Ironically, there will not be lawsuits for a fiduciary's failure to invest in ESG if it is found that diversity, energy sustainability, and good governance outperforms, and the fiduciary failed to consider such factors. Continuing a one-sided private right of action is problematic. The broader market is embracing ESG, but the Proposed Rule continues to limit ERISA plan beneficiaries and participants. The empirical evidence does not support continuing to limit ESG (see Curtis, Fisch and Robertson in footnote 5, as well as others).

V. ERISA PARTICIPANTS SHOULD HAVE ACCESS TO ESG FUNDS, AND ESG FUNDS SHOULD BE ELIGIBLE TO BE QUALIFIED DEFAULT INVESTMENT ALTERNATIVES (QDIAs).

ESG funds should be allowed as QDIA funds and should be promoted as options within 401(k) plans, and DOL should trust ERISA fiduciaries to pick appropriate QDIA options and provide appropriate ESG offerings without the specialized scrutiny of ESG funds. Contrary to critics, ESG has earned a place in modern investing approaches and the data shows that investors do not give up returns or pay higher costs with ESG Funds.[25]

VI. DOL SHOULD ADOPT A PRO-WORKER STANCE ON PROXY VOTING.

Proxy voting is more than a right. It is a duty. ERISA fiduciaries are supposed to monitor investments and act in the best interest of participants. It is not clear how they can meet these obligations if they remain silent on the issues that impact workers the most. It is clear that ESG-oriented investors and ESG funds are most critical of management.[26] The Proposed Rule would remove some portions of the 2020 Amendments, but it would not go far enough in clarifying how important proxy voting is to protecting workers.

The language used in the Proposed Rule essentially assumes proxy voting should be free. In subsection (d)2(i), DOL uses the phrase "and defraying the reasonable expenses of administering the plan," and (d)3(i) states "and defraying reasonable expense of administering the plan." These phrases do not clearly express the requirement to vote which will include costs. The lack of clarity in Section (d) would make it more likely that ERISA funds will remain on the sidelines. Further, DOL continues to have a requirement to review whether a particular matter would have a material effect without recognizing that the time and money spent to conduct such review is similar to the time and money needed to actually vote. DOL should allow ERISA fiduciaries representing the interests of participants to make some decisions for themselves using their normal internal governance processes and promote the use of proxy voting to have worker views expressed in the market. Taking worker views out of the corporate governance process aligns more closely with management and has no practical foundation. This is concerning because over the past 40 years,

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[24] See, Reconciling Fiduciary Duty at 430. "In such circumstances, a claim that the policy was based on a risk-return analysis would be seen as pretextual."

[25] Curtis, Fisch and Robertson at 17, stating that ESG funds perform as well or better than non-ESG funds.

[26] Id. at 26 (stating that ESG funds "are more likely than other funds to oppose management in the proxy voting, particularly when votes are salient to ESG issues, and they do not cost more or perform worse than similar non-ESG funds.).

executive pay has increased by 1,322 percent and worker pay has increased by only 18 percent.[27] It appears clear that there are defensible reasons for ERISA fiduciaries to vote proxies.

CONCLUSION

We appreciate and commend DOL for reversing the direction of the 2020 Amendments. There is more progress to be made, however. So, to that end, we recommend that DOL fully rescind the 2020 Amendments and make changes more in line with modern investing, including clarifying that ESG investing is the same as other active investing.[28] We agree with the argument provided by Curtis, Fisch and Robertson that "regulators should adopt a presumption against ESG-specific interventions in the absence of clear evidence of ESG-specific problems."[29] We also believe that DOL should give more weight on the value of proxy voting allowing the expenditure of funds to exercise this important right and providing more weight behind making certain that worker voices are heard in the corporate governance process.

We welcome the opportunity to discuss this release in more detail. Please contact Anne Simpson, Managing Investment Director, at [redacted], or [redacted], if you have any questions or wish to discuss in more detail.

Sincerely,

Marcie Frost
Chief Executive Officer

[27] Economic Policy Institute. https://www.epi.org/publication/ceo-pay-in-2020/ .
[28] Reconciling Fiduciary Duty, 437.
[29] Curtis, Fisch and Robertson at 52.