COMMENTS OF THE CENTER FOR CLIMATE AND ENERGY SOLUTIONS

This document constitutes the comments of the Center for Climate and Energy Solutions (C2ES) on Department's proposed rule, Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights ("the Proposed Rule.")

C2ES is an independent, nonprofit, nonpartisan organization dedicated to advancing strong policy and action to reduce greenhouse gas emissions, promote clean energy, and strengthen resilience to climate impacts. We have extensive experience engaging stakeholders on climate-related financial disclosures and have released several publications and hosted public webinars on the subject.

- In September 2017 we issued a report, *Beyond the Horizon: Corporate Reporting on Climate Change*, in which we identified areas where additional support was needed for companies implementing the Taskforce on Climate-related Financial Disclosure's (TCFD) recommendations.
- Based on the findings of that report, C2ES released a brief in August 2018, *Best Practices and Challenges: Using Scenarios to Assess and Report Climate-Related Financial Risk*.
- In April 2020, C2ES released a brief, *Implementing TCFD: Strategies for Enhancing Disclosure*, that describes the themes, lessons, and best practices from two workshops that we held in 2019 on TCFD implementation challenges.
- In April 2021, C2ES launched a new initiative examining how companies in high greenhouse gas emitting sectors can improve their disclosure of transition and physical risks and their strategies for strengthening resilience against these risks. C2ES will host two workshops this summer and release a report in early 2022.

Through working with its Business Environmental Leadership Council (BELC), C2ES has also worked closely with leading companies to understand their internal and public-facing efforts to mitigate climate change and build climate resilience, and how they are communicating their climate-related initiatives to investors and to the public. The views expressed here are those of C2ES alone and do not necessarily reflect the views of members of the C2ES Business Environmental Leadership Council (BELC).

Summary

The Center for Climate and Energy Solutions supports the Department's proposed rule, *Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights* ("the Proposed Rule"), 86 Fed. Reg. 57272 (Oct 14, 2021). The Proposed Rule allows fiduciaries to consider all available information, including climate-related financial risk and opportunities, in seeking to best serve the interests of employer retirement plans' participants and beneficiaries. The Proposed Rule restores the authority to exercise shareholder rights in the beneficiaries' best interests and allow savings plans to better account for climate-related financial and other environmental, social, and governance risks and opportunities.

Background

Employee Retirement Income Security Act (ERISA) plans help create retirement security for working Americans. In 2020, under the prior administration, the Department enacted new rules that effectively prohibited, or limited, ERISA plans from considering climate or other ESG factors in their investment selection and proxy voting. The Proposed Rule would reverse the provisions in two rules adopted in late 2020, *Financial Factors in Selecting Plan Investments* and *Fiduciary Duties Regarding Proxy Voting and Shareholder Rights*. These 2020 rules left retirement plans less able to direct their investments to factor important issues of corporate governance and would limit retirement fund managers from considering the increasing negative financial impacts of climate change in selecting retirement plans. The Proposed Rule would restore fiduciary authority to consider all relevant, financially material factors, including, where appropriate, climate-related financial risk; clarify that investment options incorporating financially material climate and other ESG factors are eligible as defaults (QDIAs); clarify that ERISA plans may continue to make prudent investments that provide collateral benefits for workers, communities, and the environment (the "tie-breaker" rule), and restore fiduciary authority to make prudent decisions in proxy voting.

Institutional investors recognize the relevance of climate risks and opportunities in their investments

Over 700 investors with $51 trillion in assets under management are asking governments to mandate climate risk disclosure by companies.[1] Moreover, hundreds of asset managers, such as those participating in the Net Zero Asset Managers Initiative, and asset owners, such as those participating in the Paris Aligned Investment Initiative, with a combined $57 trillion in assets under management, are committing to decarbonize their portfolios for a net zero economy. As such, stakeholders across the investor community consider that climate concerns and other ESG risks will be a significant driver of investment risk and return for the foreseeable future.

Moreover, individual investors are increasingly calling for ESG investment options. According to one study, more than half of investors surveyed believe that all things being equal, companies that demonstrate a higher level of integrity will outperform similar companies that do not, an important consideration, since half of investors say they are not willing to give up investment performance to align their assets with their values.[2] As with any factor, performance of ESG funds will vary, but an analysis of 11,000 mutual funds over 14 years showed that ESG funds had lower downside risk and equivalent returns to the broader market.[3] Nonetheless, fewer than 3% of organizations that offer retirement plans, or "plan sponsors," offer ESG funds in their investment menu.[4] The Proposed Rule removes uncertainty as to whether plan sponsors can consider climate risk and other ESG considerations, returning to fiduciaries their broad mandate to consider all relevant factors. Additionally, the Proposed Rule would enable retirement savings options to align with employee preferences; according to one survey, 7 in 10 retirement investors want to align their investments with their personal and ethical values.[5]

Climate change is a relevant factor that fiduciaries should be free to consider. The Proposed Rule restores fiduciary authority to consider all relevant factors.

Retirement (ERISA) fiduciaries must be empowered to evaluate *all* factors that impact risk and return, including climate change, which affects every sector of the economy. The Proposed Rule would restore fiduciary authority to consider all relevant, financially material factors, including climate change. Climate related disasters are increasingly frequent, with a record 22 events causing over $1 billion damage each in the US during 2020, for a total cost of $100 billion.[6] A 2019 analysis of 215 of the world's largest companies identified just under $1 trillion of potential risk to them from climate change – and noted that half of these losses are expected to materialize in the next five years.[7] Since climate-related financial risks are not yet fully reflected in asset prices, prudent fiduciaries are warranted in probing further to understand climate-related financial risks and vulnerabilities. Climate-related financial risks are especially relevant to retirement investors, who invest over decades, and are generally universal owners with exposure to many at-risk sectors. As society increasingly recognizes the importance of responding to the climate crisis, new regulation and changes in consumer demand are expected to create significant market and investment opportunities in new companies and industries[8] that fiduciaries may wish to consider.

Since 1978, Department regulations have required fiduciaries to consider all relevant factors when choosing among available investment options. The *Financial Factors* rule replaced this well-understood legal standard with a new and ill-defined "pecuniary" test, causing considerable confusion. The Proposed Rule appropriately eliminates this new term, restoring the traditional all-relevant-factors test.

We support the text in paragraph (b)(4) which, as the preamble states, "clarifies and confirms that a fiduciary may consider *any* factor material to the risk-return analysis, including climate change and other ESG factors." This reaffirms that "under ERISA, if a fiduciary prudently concludes that climate change or another ESG factor is material to an investment or investment course of action under consideration, the fiduciary can and should consider it and act accordingly, as would be the case with respect to any material risk-return factor." In our view, the Proposed Rule is consistent with, and encapsulates, the spirit and text of ERISA, as stated in the paragraph (c)(1), "A fiduciary may not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to other objectives, and may not sacrifice investment return or take on additional investment risk to promote benefits or goals unrelated to interests of the participants and beneficiaries in their retirement income or financial benefits under the plan."

The Proposed Rule clarifies that investment options incorporating relevant climate and other ESG factors are eligible as defaults

We endorse the Department's rescission of the prohibition on certain investment alternatives being used as a default investment: the Qualified Default Investment Alternative (QDIA). A fiduciary's responsibilities of prudence and loyalty are no different for a QDIA than for other plan investments, and if a participant does not wish to invest in the QDIA, they can select another investment vehicle. Any other approach would, as the Department observes in the preamble, "only serve to harm participants by depriving them of otherwise financially prudent options as QDIAs."

The Proposed Rule clarifies that ERISA plans may continue to make prudent investments that provide collateral benefits for workers, communities, and the environment

The *Financial Factors* rule provided that non-financial factors that offer collateral benefits to beneficiaries could be used to decide between funds only where the funds are economically "indistinguishable" (a provision known as the "tie-breaker rule"). This standard effectively prohibited the use of collateral benefits altogether, a departure from longstanding Department guidance. While the Proposed Rule's "equally serve the financial interests of the plan" language is an improvement on the term "indistinguishable," we suggest that the language be revised to reflect whether investments are equally prudent. We believe it is more appropriate for the collateral benefit provision in the final rule to focus on whether investments are equally prudent (i.e., the output of a prudent fiduciary process), rather than on an analysis of the equivalence of their financial characteristics. The issue is not how closely two or more investments resemble one another, but whether they are each the product of a prudent selection process. Fiduciaries should receive equal deference if their investment choice is the product of such a process. For example, those seeking to invest in funds that aim to be more climate resilient and, therefore, may have greater financial returns in the future, would be better served via a prudent fiduciary process, rather than assessing only financial characteristics, which could favor, in the short term, non-climate resilient investments.

The Proposed Rule restores fiduciary authority to make prudent decisions in proxy voting

We strongly support the ability of ERISA plan fiduciaries to exercise their judgment to vote proxies in the best interest of participants and beneficiaries. ERISA's fiduciary duties include active ownership, including informed proxy voting on shareholder proposals affecting companies owned by the plan. Fiduciaries must be given discretion to vote on these proposals, exercising critical oversight that has been shown to reduce downside risk.[9] C2ES supports the Proposed Rule's revisions to the current rule, restoring a fiduciary's ability to vote on a wide array of important issues, including climate change.

Climate-aligned investing will reduce currently unpriced climate risk and can generate wealth

Climate-aligned investing will manage climate-related financial risk with the potential to generate new wealth. Investors, banks, insurers and companies are increasingly announcing net-zero goals, and local, state, and national governments across the country and around the world are taking action to address climate change. The transition to a net-zero economy will involve innovation in technologies and production processes across a wide range of industries —resulting in job creation and wealth generating opportunities if managed well, and raising the risk of stranded assets if managed poorly. New government policies and changes in consumer demand will create significant market and investment opportunities. The Proposed Rule clears the way for fiduciaries to offer retirement investors access to these investment opportunities, that other institutional investors are pursuing and to which retirement savers say they want access. It is also consistent with Department policy in place in the nearly 50 years since ERISA became law.

[1] The Investor Agenda. "2021 Global Investor Statement to Governments on the Climate Crisis," 2021, https://theinvestoragenda.org/focus-areas/policy-advocacy-2021-gis/

[2] Natixis, "Investor Insights Series," 2019, https://www.im.natixis.com/us/resources/esg-investing-survey-2019

[3] Morgan Stanley, Institute for Sustainable Investing, "Sustainable Reality: Analyzing Risks and Returns of Sustainable Funds," 2019, https://www.morganstanley.com/content/dam/msdotcom/ideas/sustainable-investing-offers-financial-performance-lowered-risk/Sustainable_Reality_Analyzing_Risk_and_Returns_of_Sustainable_Funds.pdf

[4] National Association of Plan Advisors, "Could ESG Options Boost 401(k) Plan Participation?" May 13, 2021, https://www.napa-net.org/news-info/daily-news/could-esg-options-boost-401k-participation

[5] Natixis, "Investor Insights Series," 2019. https://www.im.natixis.com/us/resources/esg-investing-survey-2019

[6] "Billion Dollar Weather and Climate Disasters," National Oceanic and Atmospheric Administration, National Centers for Environmental Information, accessed December 12, 2021, https://www.ncdc.noaa.gov/billions/time-series

[7] CDP, "World's Biggest Companies Face $1 Trillion in Climate Change Risks," June 4, 2019, https://www.cdp.net/en/articles/media/worlds-biggest-companies-face-1-trillion-in-climate-change-risks

[8] Shead, Sam, "Climate tech start-ups have raised a record $32 billion globally so far in 2021," *CNBC,* October 26, 2021, https://www.cnbc.com/2021/10/26/dealroom-climate-tech-start-ups-have-raised-32-billion-this-year.html

[9] Hoepner, Andreas G. F. and Oikonomou, Ioannis and Sautner, Zacharias and Starks, Laura T. and Zhou, Xiaoyan, "ESG Shareholder Engagement and Downside Risk (April 30, 2021)," *AFA 2018 paper, European Corporate Governance Institute – Finance Working Paper* No. 671/2020, Available at SSRN: https://ssrn.com/abstract=2874252 or http://dx.doi.org/10.2139/ssrn.2874252