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December 13, 2021

Fred Wong
Acting Chief of the Division of Regulations
Office of Regulations and Interpretations
Employee Benefits Security Administration
Department of Labor
200 Constitution Ave NW
Washington, DC 20210

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

Dear Acting Chief Wong:

Dimensional Fund Advisors LP ("Dimensional") appreciates the opportunity to comment on the Department of Labor's (the "Department") proposed amendments regarding the fiduciary duties of prudence and loyalty under the Employee Retirement Income Security Act of 1974, as amended ("ERISA")[1]. We generally support the Department's proposal and its goal of clarifying how fiduciaries may consider environmental, social and governance ("ESG") factors in investment decisions. At the same time, we are concerned by the proposal's suggestion that an evaluation of ESG factors is *required*, and we encourage the Department to remove references to ESG in the final rule text. Finally, we appreciate that the Department has reiterated its longstanding view that fiduciaries should vote proxies, unless the fiduciary has determined that voting proxies may not be in the plan's best interest.

I. ***Fiduciaries should be permitted, but not required, to consider ESG factors.***

A. Financial materiality is the appropriate standard.

As the Department acknowledges, climate change is already having an economic effect on a wide variety of businesses.[2] While companies vary in their exposure to climate change, many are subject to physical risks, such as increased severity of extreme weather events, higher temperatures, and rising sea levels, as well as to transitional risks, such as shifts in government regulation and taxation and in consumer demand. Companies that face these physical and transitional risks are increasingly disclosing them in their public filings so that investors can assess

1 86 FR 57272 (Oct. 14, 2021).
2 *Id.* at 57276.

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the potential impact of climate change on a company's valuation.[3] It should go without saying that plan fiduciaries, too, should be permitted to assess ESG factors, if material to the plan's risk-return analysis.

Thus, we strongly support the Department's proposal to clarify that "a prudent fiduciary may consider any factor…that…is *material* to the risk-return analysis (emphasis added)."[4] Not only is this standard consistent with the duty of prudence under Section 404(a)(1)(B) of ERISA and the Department's longstanding position that ERISA fiduciaries may not sacrifice investment returns or assume greater investment risks as a means of promoting collateral social policy goals, but in our view, it is also the appropriate standard to apply in the investment context more broadly. The US federal securities laws are based on a materiality framework that requires public companies to disclose information about their financial condition that is material to an investment decision, and we believe this framework has served investors well over many decades. Market portfolios—*i.e.*, those that hold a broad representation of the market at individual security weights approximating their relative market capitalization—have been very competitive and difficult for most investment managers to consistently outperform.[5] This strongly suggests that the US securities market, which relies on a disclosure framework rooted in materiality, functions very well.

B. Fiduciaries should not be **required** *to consider ESG factors.*

While we agree that fiduciaries should be *permitted* to consider any factor material to the risk-return analysis, including ESG factors, we are concerned by language in the proposal suggesting that a fiduciary's duty of prudence "may often *require* an evaluation of the economic effects of climate change and other environmental, social, or governance factors on the particular investment or investment course of action (emphasis added)."[6] This language suggests that fiduciaries may have an affirmative obligation to consider ESG factors and may compel fiduciaries to evaluate ESG as a separate and distinct consideration when assessing competing investment choices. Our concern is that encouraging fiduciaries to evaluate the economic effects of climate change or other ESG factors in an effort to achieve greater returns with less risk could add increased costs, risks, and complexity to the investment decision process, without any corresponding benefit. Therefore, we urge caution in suggesting that consideration of ESG factors

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3 Bloomberg Law found that the number of companies in the S&P 500 that cited climate change or greenhouse gas under risk factors in their annual 10-K filings almost quadrupled, from roughly 60 companies in 2019 to at least 220 companies in 2020. Bloomberg Law, Climate Change Risks Surge in Companies' Annual Reports to SEC (March 25, 2021), available at https://news.bloomberglaw.com/securities-law/climate-change-risks-surge-in-companies-annual-reports-to-sec.

4 Proposed rule 404a-(1)(b)(4).

5 See, for example, Dimensional Fund Advisors, *Mutual Fund Landscape 2021: A Study of US-Based Mutual Fund Performance*, available at https://my.dimensional.com/xlink/6JZObWgaeCzj5SzFFo5UbD5C80mkJedkb2VDvzK8bL-gxa2PTLFYXzmiPd4CwYpMktavv6eiHAc3_JwtZkwhmY6UOniRqE63jicnLLZNd4xvcF58-SyRbJYZy3HYeZunN9snpwET40lrG7ynsg-gQfTSxqLQdPQLIX2cn4rbXMY1.

6 Proposed rule 404a-1(b)(2)(ii)(C).

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is required when making an investment decision.

First, identifying relevant risks associated with climate change is not an easy task. The impact of climate change is far reaching and its implications on individual businesses and the broader economy are complex and uncertain. For example, climate change's impact on the physical environment may damage existing investments, lead to higher costs of capital and a decrease in productivity, and result in negative societal costs, such as increases in mortality and morbidity. However, the extent of climate change's impact depends on many factors, such as the development of mitigating technologies (or lack thereof), geographic location, and the ability of economies and businesses to adapt. In addition, companies vary in their exposure to the indirect effects of climate change, such as shifts in government regulation, taxation, and consumer demand, all of which are difficult to assess and change over time. Second, even if we assume such risks can be accurately assessed, avoiding such risks in an effort to improve portfolio performance implies that markets systematically underappreciate risks relating to climate change. We know of no compelling evidence that this is likely to be the case.[7] Positioning plan investments to avoid climate change-related risks in an effort to enhance investor returns is unlikely to yield positive results.

The Department argues that if left unchanged, the rule could expose plans' investments and portfolios to avoidable climate change-related risks which negatively impact performance, particularly over long-time horizons.[8] We strongly disagree that ESG factors must be considered in order to protect plans' investments. Dimensional's core investment philosophy is based on the belief that in liquid capital markets, security prices reflect available information about fundamental values and the aggregate expectations of market participants. Since the effects of climate change are uncertain and potentially long lasting, some worry that markets might struggle to incorporate information about climate risk. However, financial markets process complex information every day, and ample academic research has shown that financial markets are remarkably good at processing new information.[9] We believe that climate change is no exception—to the extent that climate change risks are material to a company, this will be reflected in the company's price.[10] Generally speaking, this means that investors receive fair prices at the time they buy and sell

7 *See* Chi, Joseph, Mathieu Pellerin, and Jacobo Rodriguez, *The Economics of Climate Change* (Oct. 2020), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3715848.

8 86 FR 57277.

9 *See*, for example, Fama, Eugene F., Lawrence Fisher, Michael C. Jensen, and Richard Roll, *The Adjustment of Stock Prices to New Information*, International Economic Review 10, no. 1, 1-21 (1969); Fama, Eugene F., *Two Pillars of Asset Pricing*, American Economic Review 104, no. 6, 1467-1485 (2014); Busse, Jeffrey A., and T. Clifton Green, *Market Efficiency in Real Time*, Journal of Financial Economics 65, no. 3, 415-437 (2002); Hasbrouck, Joel, *Intraday Price Formation in US Equity Index Markets*, Journal of Finance 58, no. 6, 2375-2400 (2003); Chordia, Tarun, Richard Roll, and Avanidhar Suburahmanyam, *Evidence on the Speed of Convergence to Market Efficiency*, Journal of Financial Economics 76, no. 2, 271-292 (2005); Kelley, Eric K. and Paul C. Tetlock, *How Wise Are Crowds? Insights from Retail Orders and Stock Returns*, Journal of Finance 68, no. 3, 1229-1265 (2013); Brogaard, Jonathan, Terrence Hendershott, and Ryan Riordan, *High-Frequency Trading and Price Discovery*, Review of Financial Studies 27, no. 8, 2267-2306 (2014); and Hendershott, Terrence, Dmitry Livdan, and Norman Schurhoff, *Are Institutions Informed About News?*, Journal of Financial Economics 117, no. 2, 249-287 (2015).

10 *See*, for example, Pellerin, Mathieu, et al., *Climate Change and Asset Prices* (March 2021), available at https://www.dimensional.com/us-en/insights/climate-change-and-asset-prices.

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securities, including securities of companies that may be exposed to climate change and other risks.

As support for its position, the Department argues that "a growing body of evidence suggests a generally positive relationship between the financial performance of investments that address or account for climate change."[11] Results of these studies should be interpreted with caution. If a positive relationship were to hold in the future, it would imply the presence of a free lunch for investors, who could make more money by taking less risk. Empirical findings that contradict the link between risk and returns may be driven by statistical noise and short sample periods. We therefore urge caution when extrapolating results suggesting that higher returns can be obtained by taking less risk.

At Dimensional, we have conducted extensive research on how a company's greenhouse gas ("GHG") emissions have been related to company financials as well as the returns of stocks and bonds. Our research has not shown that there is a reliable relation between the returns of stocks or bonds and GHG emissions.[12] Our findings suggest that the impact of climate change on the expected returns of high-emissions firms, for example, is already captured by prices and proxies for expected future cash flows, and is consistent with the broader literature, which observes that ESG variables are largely subsumed by known drivers of expected returns.[13] This research also supports our view that markets already incorporate climate risk into prices.

For these reasons, we do not believe fiduciaries should be required or even encouraged to explicitly consider ESG factors in their investment decision process, and we recommend removing all references to ESG in the text of the final rule. Specifically calling out and defining ESG in the rule text is both unnecessary and unprecedented; the proposed rule would already allow fiduciaries to consider any material factor, and existing rules under ERISA do not currently require or encourage the consideration of any specific factors. The inclusion of ESG in the text of the rule could be interpreted as differentiating—and indeed, elevating—ESG factors from other investment considerations. Furthermore, as the Investment Company Institute argues in its comment letter to the Department, the inclusion of ESG factors in the text of the rule will increase the risk that the rule will be amended once again by a future administration.[14] We strongly urge the Department to remove all references to ESG from the final rule and promulgate a more neutral rule that will be less likely to be challenged in the future.

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11 86 FR 57277.

12 Dai, Wei and Philipp Meyer-Brauns, *Greenhouse Gas Emissions and Expected Returns* (Nov. 2020), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3714874.

13 *See*, for example, Polbennikov, Simon, et al., *ESG Ratings and Performance of Corporate Bonds*, Journal of Fixed Income 26, no. 1, 21-41 (2016); Blitz, David, and Frank J. Fabozzi, *Sin Stocks Revisited: Resolving the Sin Stock Anomaly*, Journal of Portfolio Management 44, no. 1, 105-111 (2017).

14 Comment letter of the Investment Company Institute (December 13, 2021) at 4-7.

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II. ***<u>Advocating for stronger governance practices through proxy voting can improve value for shareholders.</u>***

Finally, we support the Department's proposal to remove the language in the existing rule suggesting that fiduciaries need not vote proxies. We agree with the Department's longstanding position that proxies should be voted as part of the process of managing the plan's investment in company stock, unless a fiduciary determines that voting proxies may not be in the plan's best interests (*e.g.*, if there are significant costs or efforts associated with voting).[15]

Consistent with the Department's view that under ERISA, fiduciaries should take their rights as shareholders seriously and conscientiously exercise those rights to protect the interest of plan participants,[16] we believe that shareholders have a right to be heard by company management and that it is the responsibility of a fiduciary to exercise shareholder voting rights on behalf of the assets it manages. We are committed to advocating for stronger governance practices at the companies in which we invest because we believe it can improve returns for investors. Our stewardship priorities include protecting shareholder rights and encouraging strong and independent boards that represent shareholders' interests, oversee material risks (such as material environmental and social risks facing a company), and implement policies and procedures to manage conflicts of interest. Academic research shows that stronger governance practices, such as improved board oversight and alignment of management and shareholder risks, can have an impact on price through cash flow and discount rates.[17] If a company has weak governance practices, or if management is not adequately protecting shareholder interests, proxy voting is a way that shareholders can work to hold management accountable, for example, by voting against directors for failure to mitigate risk or for inappropriately transferring shareholder wealth through an executive compensation plan. In this way, shareholders are empowered to encourage changes that can have a positive economic impact on a company's value.

We also appreciate the Department's clarification that the proposed change "does not mean that fiduciaries must always vote proxies" and the Department's reiteration that "[p]rudent fiduciaries should take steps to ensure that the cost and effort associated with voting a proxy is commensurate with the significance of an issue to the plan's financial interests."[18] The Department appropriately recognizes that there can be significant costs or efforts associated with voting. For

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15 86 FR 57281.

16 *Id.*

17 Studies suggest that governance practices that insulate corporate officers from shareholder accountability result in lower valuations: *see*, for example, Bebchuk, Lucian A., et al. "What Matters in Corporate Governance?" *Review of Financial Studies* 22, no. 2, 783-827 (2009); Cuñat, Vicente, et al. "Price and Probability: Decomposing the Takeover Effects of Anti-Takeover Provisions," *Journal of Finance* 75, no. 5, 2591-2629 (2020). Other studies find that boards that lack independence from incumbent management reduce firm value: see Nguyen, Bang Dang, and Kasper Meisner Nielsen. "The Value of Independent Directors: Evidence from Sudden Deaths," *Journal of Financial Economics* 98, no. 3, 550-567 (2010); Coles, Jeffrey L., et al. "Co-opted Boards," *Review of Financial Studies* 27, no. 6, 1751-1796 (2014).

18 86 FR 57281.

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example, in certain countries outside of the US, there may be implicit costs associated with voting, such as trading restrictions or onerous paperwork requirements. Third party service providers, such as sub-custodians and proxy voting service providers, also typically charge fees to cast a vote.[19] Thus, while we believe it is important that fiduciaries exercise shareholder voting rights, we also believe that a fiduciary's obligation to vote proxies should be subject to an analysis of the costs and benefits to the plan of voting.

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If we could be of further assistance, please do not hesitate to contact Stephanie Hui, Vice President and Counsel, at (512) 306-2310 or at Stephanie.Hui@dimensional.com. We would welcome the opportunity to present an expanded discussion of our thoughts on these issues.

Sincerely,

Sincerely,

Gerard O Reilly

Gerard O'Reilly
Co-CEO and Chief Investment Officer

Jim Whittington
Head of Responsible Investment and Senior Portfolio Manager

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19 These fees can vary greatly. In our experience, the cost of voting is typically only a dollar per ballot in the US. However, in Sweden for example, we estimate that it would cost between $48 and $567 to vote a single ballot.