American Federation of Labor and Congress of Industrial Organizations

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AFL-CIO

AMERICA'S UNIONS

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Office of Regulations and Interpretations
Employee Benefits Security Administration
Room N-5655
U.S. Department of Labor
200 Constitution Avenue, N.W.
Washington, D.C. 20210

Re: Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights Proposed Regulation (RIN 1210-AC03)

Ladies and Gentlemen:

On behalf of the American Federation of Labor and Congress of Industrial Organizations (the "AFL-CIO"), we are writing to provide comments on the U.S. Department of Labor's (the "Department") Notice of Proposed Rulemaking ("NPRM" or the "Proposal") entitled "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights," published in the Federal Register on October 13, 2021.[1] The AFL-CIO welcomes the NPRM as furthering the important goal of securing the pension, retirement savings, and other employee benefits of America's workers and their families. The NPRM corrects deficiencies in two rules that were hastily adopted by the Department in late 2020, "Financial Factors in Selecting Plan Investments"[2] and "Fiduciary Duties Regarding Proxy Voting and Shareholder Rights;"[3] these rules have created confusion and uncertainty for plan fiduciaries.

The AFL-CIO is a voluntary democratic federation of 57 national and international labor unions that together represent some 12.5 million working people. Members of AFL-CIO affiliated unions participate in collectively

[1] 86 Fed. Reg. 57272, *available at* https://www.govinfo.gov/content/pkg/FR-2021-10-14/pdf/2021-22263.pdf.

[2] 85 Fed. Reg. 72846, *available at* https://www.govinfo.gov/content/pkg/FR-2020-11-13/pdf/2020-24515.pdf.

[3] 85 Fed. Reg. 81658, *available at* https://www.govinfo.gov/content/pkg/FR-2020-12-16/pdf/2020-27465.pdf.

bargained private-sector pension, retirement savings, and employee benefit plans that will be affected by the NPRM. In particular, many of these plans have a long history of making prudent investments that generate competitive risk-adjusted returns to pay promised benefits, while, at the same time, creating jobs and providing other collateral benefits for local communities. Further, for more than three decades, the fiduciaries for these pension and employee benefit plans have been voting proxies consistent with the duties of prudence and loyalty enshrined in the Employee Retirement Income Security Act of 1974 ("ERISA") and the Department's long-standing interpretive guidance.

The AFL-CIO was among the many commentators on the Department's 2020 rulemakings who made the case that the previously adopted rules did not properly reflect the scope of fiduciaries' duties under ERISA to act prudently and solely in the interest of plan participants and beneficiaries. We also pointed to the 2020 rulemakings' procedural deficiencies: the Department rushed both rulemakings without adequate consideration of the substantial body of evidence on the use of environmental, social, and governance ("ESG") considerations for improving long-term investment returns.[4] The NPRM properly clarifies the application of ERISA's duty of prudence and loyalty to plan fiduciaries' selection of investments and investment courses of action including the selection of qualified default investment alternatives ("QDIAs"), as well as its application to the exercise of shareholder rights, such as proxy voting.

Financial Factors in Selecting Plan Investments, Including QDIAs

In its proposed amendments to the 2020 rule titled "Financial Factors in Selecting Plan Investments," the Department provides important clarification for private sector employee benefit plan fiduciaries. We share the Department's assessment that this 2020 rule was an unproductive departure from the Department's long-standing view that ESG factors may be relevant to investment decision-making and portfolio construction,[5] and resulted in uncertainty and confusion as to whether plan fiduciaries could continue to consider ESG, or other similar factors, when making investment decisions.

The NPRM makes clear that a fiduciary's duty under ERISA requires "appropriate consideration" of relevant facts and circumstances "which may often require an evaluation of the economic effects of . . . environmental, social, or governance factors on the particular

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[4] *See* AFL-CIO Comment Letter to the U.S. Department of Labor on Financial Factors in Selecting Plan Investments, July 30, 2020, *available at* https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AB95/00637.pdf; AFL-CIO Comment Letter to the U.S. Department of Labor on Fiduciary Duties Regarding Proxy Voting and Shareholder Rights, October 5, 2020, *available at* https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AB91/00259.pdf.

[5] For decades, the Department recognized that ERISA allows plan fiduciaries to make economically targeted investments ("ETIs"), so long as the investments do not sacrifice investment returns or incur greater risk, formalizing this guidance in 1994. *See* ERISA Interpretive Bulletin 94-1, 59 Fed. Reg. 32607, June 23, 1994 (the "fiduciary standards applicable to ETIs are no different than the standards applicable to plan investments generally."). *See also* Interpretative Bulletin 2015-01, 80 Fed. Reg. 63135 (October 26, 2015).

investment or investment course of action." That is, a fiduciary may reasonably determine that such consideration will benefit the plan, its participants, and beneficiaries. The removal in the NPRM of the unclear terms "pecuniary" or "non-pecuniary," that made their first appearance in the 2020 financial factors rule, to characterize plan investments is constructive. Their use resulted in confusion by suggesting there was a new "pecuniary" test, an undefined concept that is not widely understood by employee benefit plans or institutional investors more generally.

To promote further clarity for plan fiduciaries, we also suggest that the final rule employ the term "relevant factors," rather than "material factors" when describing when ESG factors may be considered; this change would be consistent with the Department's pre-2020 guidance.[6] "Materiality" is an accounting and securities law concept that has not previously been used in the Department's interpretive guidance regarding ERISA. The concept of "materiality" derives from case law regarding securities fraud,[7] and it is a subjective standard.[8] According to the Financial Accounting Standards Board ("FASB"):

> Relevance and materiality are defined by what influences or makes a difference to an investor or other decision maker; however, the two concepts can be distinguished from each other. Relevance is a general notion about what type of information is useful to investors. Materiality is entity specific. The omission or misstatement of an item in a financial report is material if, in light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.[9]

Using the term "material factors" in the final rule will create regulatory uncertainty for plan fiduciaries when exercising their judgment as to whether and how to consider ESG factors. In some cases, relevant ESG factors may not necessarily be material to investors, but such a nuanced determination cannot be easily reduced to a regulatory requirement. It is best made by

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[6] The 1994 interpretive guidance stated: "The regulation provides that the prudence requirements of section 404(a)(1)(B) are satisfied if (1) the fiduciary making an investment or engaging in an investment course of action has given appropriate consideration to those facts and circumstances that, given the scope of the fiduciary's investment duties, the fiduciary knows or should know are *relevant* . . . ." ERISA Interpretive Bulletin 94-1. [Emphasis Added.]

[7] *See TSC Industries, Inc. v. Northway, Inc*., 426 U.S. 438, 449 (1977) ("[A]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote… Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."); *Basic Inc. v. Levinson*, 485 U.S. 224, 240 (1988) ("[M]ateriality depends on the significance the reasonable investor would place on the withheld or misrepresented information.").

[8] *See, e.g.* Oesterle, Dale A., *The Overused and Under-defined Notion of "Material" in Federal Securities Law*, University of Pennsylvania Journal of Business Law, Fall 2011, *available at* https://www.law.upenn.edu/live/files/157-oesterle14upajbusl1672011pdf.

[9] Financial Accounting Standards Board, Statement of Financial Accounting Concepts No. 8: Conceptual Framework for Financial Reporting, August 2018, p. 17, *available at* https://www.incp.org.co/Site/publicaciones/info/archivos/Chapter3-04092018.pdf.

plan fiduciaries as part of a prudent investment process. As stated by FASB, "No general standards of materiality could be formulated to take into account all the considerations that enter into judgments made by an experienced, reasonable provider of financial information."[10] Nor can such a general materiality standard be formulated for plan fiduciaries.

The NPRM reflects institutional investors' increasing integration of ESG considerations into their evaluation of long-term investment risks.[11] Indeed, the world's largest asset managers including BlackRock,[12] Vanguard,[13] and State Street[14] recognize the importance of ESG factors to investment decisions. At the beginning of 2020, asset managers using ESG criteria held $17.1 trillion in U.S. domiciled assets under management.[15] According to a 2021 survey by the Callan Institute, 49 percent of surveyed U.S. institutional investors (including 20 percent of surveyed corporate plans) have incorporated ESG factors into their investment decision-making process, up 7 percentage points from last year's level and more than double the share in 2013.[16]

As the Department properly reaffirms, consideration of ESG factors can provide superior risk-adjusted investment returns compared to traditional financial analysis alone. According to a recent McKinsey Global Survey, 57 percent of corporate executives and investment professionals believe that ESG programs create shareholder value, compared with just 3 percent

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[10] *Id.*

[11] "Public Companies: Disclosure of Environmental, Social and Governance Factors and Options to Enhance Them, GAO-20-530 (July 2, 2020*), available at* https://www.gao.gov/products/gao-20-530.

[12] BlackRock, Inc., "BlackRock ESG Integration Statement," Effective 27 July 2018; Revised 19 May 19, 2021, *available at* https://www.blackrock.com/corporate/literature/publication/blk-esg-investment-statement-web.pdf ("As long-term investors . . . accounting for environmental social and governance (ESG) risks and opportunities helps us provide sustainable value to our clients.").

[13] The Vanguard Group, "Thinking through the challenges of ESG investing," June 3, 2021, *available at* https://institutional.vanguard.com/VGApp/iip/site/institutional/researchcommentary/article/InvComESGinvestingChallenges ("Vanguard has a fiduciary duty to maximize long-term investment returns for our clients. We believe that material ESG risks can impact long-term value creation for the companies in which our funds invest. Therefore, ESG matters are relevant to all Vanguard investors worldwide.").

[14] State Street Global Advisors, ESG Integration, *available at* https://www.ssga.com/us/en/institutional/ic/capabilities/esg/investment-solutions/esg-integration (*accessed on 11/8/2021*) ("It is not about achieving particular environmental, social, or governance goals. It's about looking at the whole investment picture and considering material ESG components as a driver of risk and/or return.").

[15] "2020 Report on US Sustainable and Impact Investing Trends," US/SIF Foundation, *available at* https://www.ussif.org/files/Trends/2020_Trends_Highlights_OnePager.pdf ("This [amount] represents 33 percent -- or 1 in 3 dollars -- of the total US assets under professional management.").

[16] Callan Institute, "2021 ESG Survey," *available at* https://www.callan.com/research/2021-esg-survey/.

who believe that ESG programs reduce shareholder value.[17] According to Morningstar, a majority of U.S. mutual funds self-identifying as sustainable using ESG factors outperformed their conventional peers in 2019.[18] According to Standard and Poor's, ESG fund performance has out-performed the S&P 500 even during the COVID-19-related stock market volatility.[19]

We appreciate that, consistent with its prior interpretive guidance on proxy voting, the Department expressly characterizes the examples of relevant ESG factors contained in the NPRM as "not exclusive." We also strongly support the inclusion of "workforce practices" as a relevant financial factor in any not-exclusive list of factors as the Department previously has done in its interpretive guidance on proxy voting dating back to 1994.[20] In fact, some legal experts have suggested that the concept of "ESG" should be expanded to expressly include "employees" as a fourth and separate factor as important as environmental, social, and governance factors.[21] We prefer the term "WESG" for "workforce" as a more comprehensive term than "employees" so as to include independent contractors, misclassified workers, as well as other workers in a company's upstream and downstream value chains.

[17]McKinsey & Company, "The ESG premium: New perspectives on value and performance," Feb. 12, 2020, *available at* https://www.mcKinsey.com/business-functions/sustainability/our-insights/the-esg-premium-new-perspectives-on-value-and-performance.

[18] Gunnar Friedea, Timo Busch and Alexander Bassen, "ESG and financial performance: aggregated evidence from more than 2000 empirical studies," Journal of Sustainable Finance & Investment, 2015, Vol 5, No. 4, 210-33, *available at* http://dx.doi.org/10.1080/204306795.2015.1118917.

[19] Esther Whieldon, Robert Clark and Michael Copley, "ESG funds outperform S&P 500 amid COVID-19 helped by tech stock boom," "S&P Global Market Intelligence, Aug. 13, 2020*, available at* https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/esg-funds-outperform-s-p-500-amid-covid-19-helped-by-tech-stock-boom-59850808.

[20] *See* Interpretive Bulletin 94-02, 59 Fed. Reg. 38863 (July 29, 1994), ("Other issues may include such matters as consideration of the appropriateness of executive compensation, the corporation's policy regarding mergers and acquisitions, the extent of debt financing and capitalization, the nature of long-term business plans, **the corporation's investment in training to develop its work force, other workplace practices** and financial and non-financial measures of corporate performance") [Emphasis added]. *See also* Interpretive Bulletin 2016-1, 81 Fed. Reg. 95879 (December 29, 2016) ("Other issues may include such matters as governance structures and practices, particularly those involving board composition, executive compensation, transparency and accountability in corporate decision-making, responsiveness to shareholders, the corporation's policy regarding mergers and acquisitions, the extent of debt financing and capitalization, the nature of long-term business plans including plans on climate change preparedness and sustainability, governance and compliance policies and practices for avoiding criminal liability and ensuring employees comply with applicable laws and regulations, **the corporation's workforce practices (e.g., investment in training to develop its work force, diversity, equal employment opportunity),** policies and practices to address environmental or social factors that have an impact on shareholder value, and other financial and non-financial measures of corporate performance") [Emphasis added].

[21] Leo E. Strine, Jr., Kirby M. Smith, and Reilly S. Steel, "Caremark and ESG, Perfect Together: A Practical Approach to Implementing an Integrated, Efficient, And Effective Caremark and EESG Strategy," 106 Iowa L. Rev. 1885 (2021) *available at* https://scholarship.law.upenn.edu/faculty_scholarship/2196/ ("We will use the term "EESG" to incorporate the interests of employees into the ESG framework instead of just "burying them in the S.").

For simplicity, we suggest that the Department consider referencing "workforce, environmental, social, and governance factors" in the final rule rather than try to provide a lengthy list of examples of ESG factors that may be relevant to a risk-return analysis. If needed, a more complete list of examples could be provided to plan fiduciaries through sub-regulatory guidance that the Department could update periodically as best practices in ESG investing evolve over time. In any case, it is important for the final rule to expressly state that any listed ESG factors are only for illustrative purposes, and that the regulation does not limit plan fiduciaries from considering other relevant ESG factors when making investment decisions.

We strongly support the proposed changes to the "all things being equal" or "tiebreaker standard" which are aligned with the Department's original 1994 interpretive guidance[22] so as to allow an ERISA fiduciary to consider collateral benefits, i.e. benefits beyond investment returns, when choosing between investments that, as the NPRM provides, would "equally serve the financial interests of the plan."[23] This standard is an improvement over the 2020 financial factors rule requirement that "competing investments must be indistinguishable based on consideration of risk and return" because, as the Department correctly observes in the NPRM, "two investments may differ on a wide range of attributes, yet when considered in their totality, can serve the financial interests of the plan equally well."

The language "equally serve the financial interests of the plan" is sufficiently clear for plan fiduciaries to understand their ERISA obligations when considering collateral benefits. While we agree that the Proposal should not place parameters on the collateral benefits that a fiduciary may consider to break a tie, we believe that the final rule should expressly affirm that an appropriate collateral benefit could include an investment's potential impact on the plan's financial health by, for example, generating increased plan contributions through the creation of jobs for plan participants. Of course, consideration of such collateral benefits always must be subject to the fiduciary duties of prudence, loyalty, diversification, and to act according to plan documents.

The Proposal's elimination of the extra unnecessary documentation required by the 2020 financial factors rule when applying the tiebreaker provision is also a positive step. Here, too, the NPRM more closely aligns with the Department's original interpretive guidance,[24] and since then, there has been no new justification for singling out and creating unique burdens for investments providing collateral benefits. As the Department correctly states, ERISA's obligation of general prudence is sufficiently protective in this context; fiduciaries well understand their obligations to include proper documentation of their decisions.

As to participant directed retirement savings plans, we are pleased that the NPRM eliminates the current prohibition on ESG funds from being used as a Qualified Default Investment Alternative

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[22] *See* Interpretive Bulletin 94-1, 59 Fed. Reg. 32606 (June 23, 1994).

[23] *See* Interpretative Bulletin 2008-01, 73 Fed. Reg. 61734 (Oct. 17, 2008) and Interpretative Bulletin 2015-01, 80 Fed. Reg. 65135 (Oct. 26, 2015) both of which provided for a similar "all things being equal" test.

[24] The Department first put forward this concept in its 1994 Interpretative Bulletin.

("QDIA").[25] As the preamble to the NPRM states, "there appears to be no apparent reason to foreclose plan fiduciaries from considering [such investment alternatives] as a QDIA," and there may be situations where ESG funds may be superior investments on a risk-return basis. We view the Proposal's requirement that a plan fiduciary disclose the consideration of collateral benefits for designated investment alternatives in individual account plans to be reasonable. However, we recommend that the Department provide plan fiduciaries with a model notice to assist compliance with this disclosure requirement.

Shareholder Rights Regarding Proxy Voting Procedures

In the NPRM's proposed amendments to the 2020 final rule titled "Fiduciary Duties Regarding Proxy Voting and Shareholder Rights," the Department affirms plan fiduciaries' obligations under ERISA when voting proxies in connection with the investment of plan assets. Proxy voting includes voting on a wide variety of corporate actions that are vital for ensuring corporate accountability and promoting long-term sustainable value creation, such as proxy votes on boards of directors, executive compensation, auditor ratification, shareholder resolutions, and mergers and acquisitions.

The AFL-CIO strongly supports the proposed changes to the 2020 proxy voting rule. Since the Reagan Administration, the Department has been of the view that ERISA's fiduciary duties of loyalty and prudence apply to proxy voting by pension and employee benefit plans[26] because the exercise of shareholder rights is key to ensuring management's accountability to the shareholders that own the company. Indeed, as shareholders of Enron and WorldCom learned years ago, monitoring a company's corporate governance is just as important as monitoring a company's financial performance. We, therefore, agree with the proposed elimination of any suggestion that plan fiduciaries should be indifferent to the exercise of their rights as shareholders.

The 2020 proxy voting rule placed an undue emphasis on the costs of proxy voting, and it inaccurately suggested that "existing sub-regulatory guidance may have inadvertently created the perception that fiduciaries must vote proxies on every shareholder proposal to fulfill their obligations under ERISA."[27] To the contrary, plan fiduciaries have long understood from the Department's interpretive guidance that proxy voting may be cost prohibitive in certain cases, such as when voting proxies of foreign issuers.[28] Moreover, thanks to advances in information

[25] The 2020 financial factors rule excludes a fund from being a QDIA if its investment objectives, goals or principal investment strategy includes or considers the use of one or more "non-pecuniary factors." As we previously said, we are pleased to see this vague term struck from the NPRM.

[26] Letter from US. Department of Labor to Mr. Helmuth Fandl, Chairman of the Retirement Board of Avon Products, Inc. (Feb. 23, 1988), 198 WL 897696 ("In general, the fiduciary act of managing plan assets which are shares of corporate stock would include the voting of proxies appurtenant to those shares of stock."). The Department subsequently restated this view in 1994 (Interpretive Bulletin 94-2); in 2008 (Interpretive Bulletin 2008-02); in 2016 (Interpretative Bulletin 2016-01); and in 2018 (Field Assistance Bulletin 2018-01).

[27] 85 Fed. Reg. 81658, *available at* https://www.govinfo.gov/content/pkg/FR-2020-12-16/pdf/2020-27465.pdf.

[28] "The fiduciary obligations of prudence and loyalty to plan participants and beneficiaries require the responsible fiduciary to vote proxies on issues that may affect the value of the plan's investment. This principle applies broadly.

technology, the costs of proxy voting have declined dramatically since the Department issued its first interpretive guidance in 1994. For these reasons, the 2020 proxy voting rule lacked a sound basis for imposing new regulations on proxy voting by plan fiduciaries.

The NPRM correctly restores the presumption that proxies will be voted unless the fiduciary determines that the cost of voting outweighs the benefits. To this end, we agree with the proposed elimination of the two safe harbors that are contained in the 2020 proxy voting rule. The safe harbors set out in the 2020 proxy voting rule are 1) a policy of voting only on "particular types of proposals that . . . are substantially related to the issuer's business activities or are expected to have a material effect on the value of the investment;" and 2) a policy of not voting unless the plan's holdings of the company involved exceeds a threshold of the plan's holdings (the 2020 proxy voting rule's preamble suggested 5% as a possible threshold).[29] As the Department now correctly explains, these "safe harbors" inherently invite wide adoption, making it especially important that they serve plan participants' interests.

As we noted in our comments when the 2020 proxy voting rule was proposed, the Department provided no explanation whatsoever as to how the safe harbors are consistent with a fiduciary's general duties of prudence and loyalty to plan participants.[30] To the contrary, ERISA plans will be greatly harmed if they stop voting proxies because state corporate laws assume that shareholders will take an active role in the governance of companies by voting at shareholder meetings.[31] Without shareholder votes, corporate directors could not be elected and other corporate actions could not be approved by shareholders. And because a decision by an ERISA plan to not vote effectively cedes voting power to other shareholders, it should only be permitted on a case-by-case basis rather than pursuant to a general safe harbor to refrain from voting.

To provide further clarity to plan fiduciaries when deciding whether to exercise shareholder rights, we also suggest removing the phrase "or promote benefits or goals unrelated to those financial interests of the plan's participants and beneficiaries" from the proposed section 2550.404a-1(d)(2)(ii)(C) so that it simply reads "(C) Not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to any other objective." This simplified regulatory language will clarify that plan fiduciaries are not required to conduct a burdensome economic analysis before deciding whether to cast proxy votes. In certain cases, it may be simpler and cheaper for a plan fiduciary to cast a vote than to speculate whether the vote in question promotes "benefits or goals unrelated to those financial

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However, the Department recognizes that in some special cases, voting proxies may involve out of the ordinary costs or unusual requirements, for example in the case of voting proxies on shares of certain foreign corporations." Interpretive Bulletin 2016-01, 29 CFR §2509.2016-01.

[29] 85 Fed. Reg. 81658, *available at* https://www.govinfo.gov/content/pkg/FR-2020-12-16/pdf/2020-27465.pdf.

[30] AFL-CIO Comment Letter to the U.S. Department of Labor on Fiduciary Duties Regarding Proxy Voting and Shareholder Rights, October 5, 2020, *available at* https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AB91/00259.pdf.

[31] *See e.g.* Delaware General Corporation Law, § 211 - § 233.

interests of the plan's participants and beneficiaries." Moreover, consideration of such goals may be permitted under the NPRM's "all things being equal" tiebreaker test.

Last, we agree with the proposed elimination of the onerous recordkeeping requirements and monitoring obligations regarding the exercise of shareholder rights. They provide nothing more than the creation of new barriers and costs for proxy voting by ERISA plans. We note that the 2020 proxy voting rule did not provide a rationale for why proxy voting should be held to a higher documentation requirement than other investment decisions such as whether to buy or sell a particular security. As the Department states in the preamble to the NPRM, the exercise of these rights is no different from other fiduciary duty, so ERISA's general obligation of prudence and loyalty is sufficient to govern the proxy voting recordkeeping requirements.

Thank you for your consideration of our views. If we may be of further assistance regarding the NPRM, please feel free to contact us for more information.

Sincerely,

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