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Office of Regulations and Interpretations, Employee Benefits Security Administration
Room N-5655, U.S. Department of Labor
200 Constitution Avenue NW, Washington, DC 20210
Attention: Financial Factors in Selecting Plan Investment Proposed Regulation

RE: RIN 1210-AB95

To Whom It May Concern:

We are writing in respect of Proposed Rule RIN 1210-AB95, 85 FR 39113 (the "Proposed Rule") and the accompanying supplementary information (the "Release.")

The Shareholder Commons is a nonprofit organization focused on ensuring that companies act in a manner that promotes the best interests of their investors and that asset owners and managers act in the best interests of their beneficiaries. B Lab USA/CAN is a nonprofit that serves a movement of people using business as a force for good. We write today on behalf of long-term, diversified shareholders and businesses who rely on healthy social and environmental systems to promote broad economic value and businesses.

Stewardship and ESG

We write because we believe the Proposed Rule and the Release may create confusion as to the obligations of plan fiduciaries with respect to stewardship of the assets held by their plan. The term "stewardship" refers to the actions that a plan fiduciary or other investor takes with respect to securities in its portfolio, in contrast to decisions as to what securities to hold. Stewardship activities include proxy voting, issuer engagement and policy leadership.[1] As discussed below, appropriate stewardship relating

[1] We do not comment on the more direct effect of the Proposed Rule on decisions whether to purchase or sell securities because we believe other commenters have provided thorough analysis of the shortcomings of the

to the impacts that companies have on society and the environment increases the overall financial returns of investors.[2]

A. *Diversification and the Importance of Overall Market Return*

Sound investing practice mandates that fiduciaries adequately diversify their portfolios.[3] This allows investors to reap the increased returns available from risky securities, which greatly reduces that risk—it is this insight that defines Modern Portfolio Theory.[4] This core principle is reflected in ERISA itself, which requires plan fiduciaries to act prudently "by diversifying the investments of the plan."[5] The wisdom of a diversified investment strategy can be summarized through the philosophy of the late John Bogle, founder of Vanguard, one of the largest mutual funds companies in the world, "Don't look for the needle in the haystack; instead, buy the haystack."[6]

Thus, adequate diversification is required of plans by accepted investing theory and ERISA itself. However, once a portfolio is diversified, the most important factor determining return will not be how the companies in that portfolio perform relative to other companies ("alpha"), but rather how the market performs as a whole ("beta"). As one work describes this, "[a]ccording to widely accepted research, alpha is about one-tenth as important as beta [and] drives some 91 percent of the average portfolio's return."[7]

B. *Beta and ESG*

This distinction between individual company return and overall market return is critical because shareholder return at an individual company does not reflect "externalized" costs, i.e., those costs it generates but does not pay. Externalized costs include harmful emissions, resource depletion, and the instability and lost opportunities caused by inequality. The collective costs of such externalities are absorbed by diversified shareholders (including benefit plans) because they degrade and endanger the stable, healthy systems that corporate financial returns depend upon. Thus, while individual companies can "efficiently" externalize costs from their own narrow perspective (and the perspective of a shareholder of just that company), benefit plans pay these costs through a lowered return on their diversified portfolios.[8] Stewardship of the externalizing companies provides an opportunity to increase return at the portfolio level.

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proposal with respect to such activity. *See, e.g.*, Comment of Jon Lukomnik, et al, *filed at regulation.gov*. To be clear, we endorse the Lukomnik letter.

2 We note that beneficiaries share common interests in matters beyond a plan's financial returns, such as the preservation of the ecosystem in which those returns are to be used, and the maintenance of basic ethical standards in the use of funds. *See, e.g.*, Frederick Alexander, *The Benefit Stance: Responsible Ownership in the Twenty-First Century*, OXFORD REVIEW OF ECONOMIC POLICY, Volume 36, Issue 2, Summer 2020. While we believe that ERISA should be interpreted and applied in a manner that honors these common interests as influenced by ESG, we focus in this comment only on the common interest that plan beneficiaries and participants share in overall market returns as reflected in their benefits.

3 *See generally*, Burton G. Malkiel, A Random Walk Down Wall Street (2015)

4 *Id.*

5 29 USC Section 404(a)(1)(C).

6 John C. Bogle, The Little Book of Common Sense Investing: The Only Way to Guarantee your Fair Share of the Stock Market, 86 (2007).

7 Stephen Davis, Jon Lukomnik and David Pitt-Watson, *What They Do with Your Money* (2016).

8 *Externalities and Corporate Objectives in a World with Diversified Shareholder/Consumers*, Robert G. Hansen and John R. Lott, JOURNAL OF FINANCIAL AND QUANTITATIVE ANALYSIS, 1996, vol. 31, issue 1, 43-68 (abstract)("If shareholders own diversified portfolios, and if companies impose externalities on one another, shareholders do not

Thus, if a plan fiduciary focuses only on individual company performance, and not on the external environmental and social costs created by those companies, the fiduciary may be sacrificing the 91% of potential return attributed to market return in order to optimize the 9% that comes from outperformance. Externalized social and environmental costs can play an outsized role in that 91%. A recent study by a major asset manager was able to discern that 55% of the profits attributed to publicly listed companies globally were consumed by external costs absorbed by the rest of the economy:

> *In total, the earnings listed companies generate for shareholders currently total US$4.1 trillion, which would fall by 55% to US$1.9 trillion if those social and environmental impacts crystallised as financial costs. One third of companies would become loss-making.*[9]

But those costs will crystalize: as the economy absorbs them, growth and productivity will fall, leading to decreasing overall market returns.[10] Asset owners and managers recognize that their responsibilities go beyond managing returns at individual companies and include ESG stewardship. For example, the PRI, an investor initiative whose members have $89 trillion in assets under management, recently explained how the pursuit of profit by an individual company can reduce the return of diversified owners even if the company is included in their portfolio:

- *A company strengthening its position by externalising costs onto others. The net result for the [diversified] investor can be negative when the costs across the rest of the portfolio (or market/economy) outweigh the gains to the company;*

- *A company or sector securing regulation that favours its interests over others. This can impair broader economic returns when such regulation hinders the development of other, more economic companies or sectors;*

- *A company or sector successfully exploiting common environmental, social or institutional assets. Notwithstanding greater harm to societies, economies, and markets on which investment returns depend, the benefits to the company or sector can be large enough to incentivise and enable them to overpower any defence of common assets by others.*[11]

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want value maximization to be corporate policy. Instead, shareholders want companies to maximize portfolio values. This occurs when firms internalize between-firm externalities.")

9 *Foresight*, Schroders, *available at* https://www.schroders.com/en/sysglobalassets/digital/insights/2019/pdfs/sustainability/sustainex/sustainex-short.pdf

10 On the economic cost of climate change, s*ee, e.g.*, Kahn, M., Mohaddes, K., Ng, R., Hashem Pesaran, M., Raissi, M, and Yang, J., *Long-Term Macroeconomic Effects of Climate Change: A Cross-Country Analysis*, IMF Working Paper (2019) (abstract)(" Our counterfactual analysis suggests that a persistent increase in average global temperature by 0.04°C per year, in the absence of mitigation policies, reduces world real GDP per capita by more than 7 percent by 2100. On the other hand, abiding by the Paris Agreement, thereby limiting the temperature increase to 0.01°C per annum, reduces the loss substantially to about 1 percent."); as to the economic cost of inequality, *see, e.g.,* Heather Boushey, Unbound: How Inequality Constricts Our Economy and What We Can Do about It (2019).

11PRI, *Active Ownership 2.0: The Evolution Stewardship Urgently Needs*, available at https://www.unpri.org/download?ac=9721. *See also Addressing Climate as a Systemic Risk: A call to action for U.S. financial regulators, available at* https://www.ceres.org/resources/reports/addressing-climate-systemic-risk ("The SEC should make clear

C. *The Need for ESG Stewardship*

Given the critical importance of overall market return, and the danger to that return from company activities the damage social and environmental systems, plan beneficiaries clearly need protection from individual companies that focus on their own performance in ways that damage overall market return. In order to protect the interest of plans and beneficiaries, plan fiduciaries must consider whether they can effectively engage with companies to limit or eliminate conduct that threatens the social and economic systems that diversified portfolios rely on over the long term.

Because investors collectively have the power to vote against the management at companies that endanger systems that are critical to all companies, they have the power—and the responsibility—to steward companies away from negative sum activities and towards authentically productive profits. Without considering such action, plan fiduciaries cannot completely satisfy their statutory obligations with respect to preserving plan benefits.

The PRI report cited above reaches precisely this conclusion: that collective investor action to manage social and environmental systems is needed in order to satisfy the fiduciary duties of investment trustees:

> *Systemic issues require a deliberate focus on and prioritisation of outcomes at the economy or society-wide scale. <u>This means stewardship that is less focused on the risks and returns of individual holdings, and more on addressing systemic or 'beta' issues such as climate change and corruption</u>. It means prioritising the long-term, absolute returns for universal owners, including real-term financial and welfare outcomes for beneficiaries more broadly.*[12]

II. The Proposed Rule, together with the Release, Will Limit the ESG Stewardship Mandated by ERISA

Given the importance of beta management, as well as the law and precedent supporting the need to protect participants and beneficiaries, the Proposed Rule violates ERISA to the extent that it limits the ability of plan fiduciaries to participate in environmental and social stewardship activities that they determine will protect plan benefits.

In part, the Proposed Rule does permit, and in fact compels, ESG stewardship because it is a critical "pecuniary factor" as defined, i.e., "a factor that has a material effect on the risk and/or return of an investment based on appropriate investment horizons consistent with the plan's investment objectives and funding policy . . . ."[13] For all of the reasons discussed in Part I, ESG stewardship falls squarely within that definition. However, much of the verbiage in the Proposed Rule and Release appears aimed at casting doubt on the efficacy of investment strategies that take environmental and social issues into consideration; moreover, the final clause of subparagraph (c)(1) creates particular confusion with respect

that consideration of material environmental, social and governance (ESG) risk factors, such as climate change, to portfolio value is consistent with investor fiduciary duty."). Ceres is a non-profit organization with a network of investors with over $29 trillion under management.

[12] Id. (emphasis added.)

[13] Proposed Rule Section 2550.404a-1(f)(2

to ESG stewardship. Thus, despite the literal mandate, the Proposed Rule may have the perverse effect of limiting the very fiduciary activity that is most likely to improve long-term, overall market returns and thus protect plan benefits.

A. The Proposed Rule and Release Create Barriers to ESG Stewardship

We recognize that the Proposed Rule does not directly mention stewardship and we further understand that there is an anticipation that such rulemaking may be made separately.[14] Nevertheless, the definitions of "investment duties"[15] and "investment course of action"[16] incorporated into the Proposed Rule literally encompass stewardship activity because the allocation of resources to voting, engagement and related activity is an "action related to" the investment of plan assets. In light of this broad definition, we are concerned that the Department's unsupported and unexplained animus towards a vague and undefined category of "environmental, social, corporate governance or other similarly oriented factors" might effectively preclude stewardship activity intended to mitigate risk to the social and environmental systems that support the pecuniary interests of plan participants and beneficiaries.

As an example of this hostility, the Release states that "the Department is concerned, however, that the growing emphasis on ESG investing may be prompting ERISA plan fiduciaries to make investment plan decisions for purposes distinct from providing benefits to participants and beneficiaries and defraying reasonable expenses . . . "[17] This "concern" is not accompanied by any evidence that plan fiduciaries have focused on ESG for any reason other than protection of participants and beneficiaries. Indeed, as other commenters have noted, the evidence is to the contrary.[18] Nevertheless, due to the Department's enforcement authority and the practical cost of investigations, the bald assertion of suspicion is likely to discourage plan fiduciaries even from undertaking ESG analysis, no matter how important such analysis may be to the financial goals of participants and beneficiaries.

The language of the Proposed Rule creates further confusion with respect to ESG stewardship. The gist of the Proposed Rule is that ESG activities must support "pecuniary factors." In particular:

> *A fiduciary's evaluation of an investment must be focused only on pecuniary factors. Plan fiduciaries are not permitted to sacrifice investment return or take on additional investment risk to promote non-pecuniary benefits or any other non-pecuniary goals. Environmental, social, corporate governance or other similarly oriented considerations are pecuniary factors only if they present economic risks or opportunities*

[14] See, e.g., Glass Lewis, *DOL Proposes Rule on ESG & Fiduciary Duties under ERISA: Call for Comment*, https://www.glasslewis.com/dol-proposes-rule-on-esg-fiduciary-duties-under-erisa-call-for-comment/

[15] See Proposed Rule Section 2550.404a-1(f)(1):
The term "investment duties" means any duties imposed upon, or assumed or undertaken by, a person in connection with the investment of plan assets which make or will make such person a fiduciary of an employee benefit plan or which are performed by such person as a fiduciary of an employee benefit plan as defined in section 3(21)(A)(i) or (ii) of the Act.

[16] See Proposed Rule Section 2550.404a-1(f)(2):
"The term "investment course of action" means any series or program of investments or actions related to a fiduciary's performance of the fiduciary's investment duties, and includes the selection of an investment fund as a plan investment, or in the case of an individual account plan, a designated alternative under the plan."

[17] Release at p. 9.

[18] *See supra*, n. 1.

> *that qualified investment professionals would treat as material economic considerations under generally accepted investment theories. The weight given to those factors should appropriately reflect a prudent assessment of their impact on risk and return. Fiduciaries considering environmental, social, corporate governance or other similarly oriented factors as pecuniary factors are also required to examine the level of diversification, degree of liquidity, and the potential risk-return* <u>*in comparison with other available alternative investments that would play a similar role in their plans' portfolios.*</u>[19]

As part of the Department's unexplained hostility toward a growing theory of investment, this provision subjects (without defining) ESG factors (and not any other investment rubric) to a highly ambiguous test: in order to be deemed pecuniary (and therefore permissible) they must present economic risks or opportunities that "qualified" professionals treat as "material" under "generally accepted" theories" and be "appropriately" weighed in a "prudent" assessment. These five vague factors create an unsettling opportunity for post hoc second-guessing by an apparently hostile agency such that the test is clearly intended to discourage the use of ESG strategies--not because they are bad for participants or beneficiaries, but because of the Department's unexplained animus. One wishes that the Department itself were required to follow a "generally accepted theory" that a "qualified" professional would follow in devising their own rules.

B. The Proposed Rule Encourages Free Riding Behavior That Violates the Overarching Purpose of ERISA

But as much of an obstacle as this test may be for ESG generally, the language of the Proposed Rule is even more troubling with respect to stewardship activity in particular. The underscored language at the end of the provision, pursuant to which the fiduciary is "required" to examine alternatives, does not fit with the type of beta stewardship described below. Such stewardship requires allocation of resources to proxy voting, issuer engagement and similar actions in order to preserve the social and environmental systems in which all portfolio companies are embedded, thereby raising the return of diversified investments overall. The benefits of such actions are shared by all diversified investors, and they must act collectively to be successful (because individual shareholders acting alone cannot change corporate behavior; joint efforts are required.) But this requires that the community of diversified shareholders must expend resources, and currently, any such expenditure is voluntary. Under these circumstances, there is a significant risk that some diversified investors will seek to "free ride" on the expenditures of others.[20]

In other words, any individual investor (including any single ERISA plan) could defray costs by reducing its contribution to the collective effort to limit externalities and letting the rest of the investor community spend the necessary resources. Paragraph (c)(1) exacerbates this problem by requiring plans to compare (1) the marginal return to their own portfolio of contributing additional resources towards collective beta stewardship with (2) a reduced use of plan resources. Of course, (2) seems favorable in

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[19] Proposed Rule Section 2550.404a-1(c)(1)(underscoring added).

[20] *See* PRI Report, n. 11, *supra* at p. 7 ("Challenges inherent in addressing collective systemic issues, such as the free-rider problem (i.e. where some avoid the costs of addressing collective problems, while reaping the benefits), result in weaker pursuit of collective goals relative to those where the distribution of costs and benefits is more equitable.")

isolation, since it allows other investors incur the expenditures that protect the plan in question, while the plan saves the stewardship costs. The mandate thus might be interpreted as a legal mandate to attempt to free ride on the efforts of others. But such a mandate, if applicable to all investment fiduciaries, would ensure that no beta stewardship would actually ever be accomplished, as each institutional investor looked to others to spend the resources necessary for effective ESG stewardship. If this is what the Department intended, it is surely contrary to ERISA itself, which is meant to increase the amount money available for retirees from their plan, not decrease it.

C. The Language of ERISA and Precedent Support ESG Stewardship

This conclusion—that the Proposed Rule violates ERISA itself—is supported by the very precedent cited in the Release.[21] In *Donovan*, The Secretary of Labor brought suit against plan trustees who bought shares of the publicly-traded employer in order to prevent a hostile bidder from acquiring a majority of the employer's shares. While the court found that the Secretary had made an adequate showing that the trustees had breached their duties by not carefully examining the circumstances surrounding the transaction, it specifically stated that the trustees could take into account the effect the purchase would have on the solvency of the plan *and not just on the shares as a financial asset:*

> *It is true that even if* [the bidder] *had been completely forthcoming <u>the trustees might still have been justified in concluding that its debtridden (sic) balance sheet was a sufficient basis for concern</u> [as to the continuing solvency of the plan], but they would have reached that conclusion after having made every reasonable effort to see how much protection [the bidder] would have afforded"*[22]

Thus, in *Donovan* (as well as the *Withers* case cited in the margin) the courts have recognized that trustees must sometimes take action with respect to securities in order to protect plan participants *even if those actions are not related to optimizing the value of those particular securities*. These cases make it clear that plan fiduciaries must be able to use plan resources to advance stewardship that protects portfolio value, whether through the protection of social and environmental systems or otherwise.

Ultimately, the analysis must begin with the statutory standard itself:

> *[A] fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and—*
>
> ***(A)*** *for the exclusive purpose of:*
>
> ***(i)*** *providing benefits to participants and their beneficiaries; and*
>
> ***(ii)*** *defraying reasonable expenses of administering the plan;*

[21] *Donovan v. Bierwirth*, 680 F.2d 263 (2d Cir. 1982).

[22] *Id. at 274 (emphasis added). Donavan* cited an earlier case, *Withers v. TRS, 447 F. Supp. 1248 (S.D.N.Y. 1978),* in which trustees of a retirement were permitted to purchase bonds for the purpose of maintaining the solvency of the city that employed the plan participants in order to increase the likelihood that the city would continue to fund the plan. Again, this case shows that fiduciaries must be able to look to systemic issues that support a plan, and not just the isolated performance of the individual securities within the plan's portfolio.

> ***(B)*** *with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;*
>
> ***(C)*** *by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and*
>
> ***(D)*** *in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this subchapter and subchapter II . . . .*[23]

As we have shown, "prudent" persons acting in the "capacity" of investment trustees must practice ESG stewardship in order reduce risk to the benefits needed for retirement from the costly externalities that individual portfolio companies may otherwise create in pursuit of individual gain.

*   *   *   *   *

For all of the reasons expressed above, we propose that the Rule be withdrawn or modified to clarify that ESG actions are not disfavored and that ESG stewardship that is designed to benefit the plan by protecting the systems in which portfolios are embedded is not disfavored but rather must be considered by plan fiduciaries in order to fulfill their statutory fiduciary duties. More specifically, we respectfully request that the final rule include assurance, in the form of safe harbors or other provisions, that plan fiduciaries will not be penalized for allocating plan resources to stewardship intended to protect social and environmental systems and to thereby increase long term overall market return and thus the return of the plan on its diversified portfolio.

We would be glad to discuss this further should the Department of Labor wish. Please contact Frederick Alexander at rick@theshareholdercommons.com.

Sincerely

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[23] 29 U.S. Code § 1104(a)