

CONSULTATION RESPONSE

U.S. DEPARTMENT OF LABOR: PRUDENCE AND LOYALTY IN SELECTING PLAN INVESTMENTS AND EXERCISING SHAREHOLDER RIGHTS (FILE NUMBER RIN 1210-AC03)

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THE PRINCIPLES FOR RESPONSIBLE INVESTMENT

The United Nations-supported Principles for Responsible Investment (PRI) is the world's leading initiative on responsible investment. The PRI has over 4,500 signatories (pension funds, insurers, investment managers and service providers) globally with approximately US \$121 trillion in assets under management.¹

The PRI works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole. The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

ABOUT THIS CONSULTATION

The PRI welcomes the opportunity to submit comments on the Department of Labor's (the "Department's") Notice of Proposed Rulemaking (NPRM) entitled, "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights" (the "Proposed Rule").² The Proposed Rule would clarify the duties of fiduciaries regulated under the Employee Retirement Income Security Act of 1974 (ERISA) in their consideration of ESG and climate-related factors throughout the investment decision-making process and in the exercising of shareholder rights.

¹ See PRI signatories, available at: <https://www.unpri.org/signatories/signatory-resources/signatory-directory>.

² See <https://www.federalregister.gov/documents/2021/10/14/2021-22263/prudence-and-loyalty-in-selecting-plan-investments-and-exercising-shareholder-rights>.

SUMMARY OF PRI'S RESPONSE

The PRI strongly supports adoption of the Proposed Rule and recommends follow-on guidance to provide additional clarification to market participants on the growing use cases of ESG factors. The Proposed Rule would amend numerous confusing, contradictory and burdensome provisions of the rulemakings finalized last year, “Financial Factors in Selecting Plan Investments” and “Fiduciary Duties Regarding Proxy Voting and Shareholder Rights” (the “current rules”) that created uncertainty and unnecessary complexity for investors looking to consider ESG factors in their investment process. The Proposed Rule further provides fiduciaries the clarity and autonomy necessary to appropriately consider climate-related and other ESG factors in their investment decisions and to exercise shareholder rights in line with their fiduciary duties and overarching investment strategy.

The current rules, adopted in late 2020, were approved despite overwhelming opposition from affected market participants and a lack of evidence that prior guidance was ineffective. They deter fiduciaries from executing their duties of prudence and loyalty by making it more time-consuming and costly to consider potentially economically relevant ESG factors and by signaling that using ESG factors in investment decision-making and stewardship will subject fiduciaries to increased scrutiny and enforcement risk. The current rules’ negative effect is amplified by the fact that the Department, under the prior Administration, issued document requests focused on plans’ use of ESG factors.³ The clear prejudice against this potentially relevant information is outside the investment mainstream, and could force fiduciaries to fail to consider, or act in spite of knowledge of, information potentially providing for lower risk and/or higher returns.

As a result, while global investors continue to further incorporate climate and other ESG factors in their investment and stewardship activities and decision-making processes,⁴ ERISA-regulated fiduciaries lag behind market practice. We consistently hear from market participants that the current regulatory environment discourages ERISA-regulated fiduciaries, and those that follow DOL guidance as best-practice, from considering ESG factors, potentially limiting their ability to systematically and explicitly incorporate all economically relevant investment factors.

The current barriers were erected despite abundant evidence that ESG factors and effective stewardship can improve risk-adjusted returns. The current rules, then, place ERISA funds at a disadvantage relative to other investors and encourage fiduciaries to go against their duties. If adopted, the Proposed Rule would remove the obstacles established by the current rules and provide necessary clarification for ERISA-regulated fiduciaries in their consideration of ESG factors. Importantly, the Proposed Rule would restore trust in fiduciaries to use their professional judgement in exercising their duties of prudence and loyalty when considering all value drivers, including ESG factors, on behalf of plan participants and beneficiaries.

³ Morgan Lewis, “More to Come from Department of Labor on ESG Factors? Executive Order, DOL Document Requests Suggest Yes,” (March 11, 2020), available at: <https://www.morganlewis.com/blogs/mlbenebits/2020/03/more-to-come-from-department-of-labor-on-esg-factors-executive-order-dol-document-requests-suggest-yes>.

⁴ See, e.g., Brian Croce, “DOL proposal could chill prospects for ESG in ERISA plans,” *Pensions & Investments*, (June 26, 2020), available at: <https://www.pionline.com/regulation/dol-proposal-could-chill-prospects-esg-erisa-plans>.

ESG FACTORS ARE POTENTIALLY RELEVANT ECONOMIC FACTORS

The PRI supports the Proposed Rule's statements that ESG factors are to be considered across the investment process in the same way as any other potentially relevant economic factors and further supports general efforts to remove the unsupported bias against this established investment approach. As an increasing number of investors place ESG analysis at the core of their investment processes, the current rules are out of step with market realities and place limitations on fiduciaries' ability to prudently consider ESG factors as potentially economically relevant to their investment decisions.³

Growing evidence shows that climate change presents new challenges to global economies, local markets and companies around the world. The COVID-19 global pandemic has highlighted the importance of risks related to worker health and safety and human capital management more generally, and many empirical studies have found links between ESG factors and company performance.⁵ It therefore falls directly within the duty of prudence for fiduciaries to consider the possible risks and opportunities created by climate change and other ESG factors for investments, portfolios and long-term returns.

The Department's long-standing guidance holds that fiduciary duty includes consideration of all relevant information that could affect risk and return and long-term plan success. Though prior Department guidance recognizes "ESG funds" as a separate category of fund, as ESG-related risk factors become better understood, it could be argued that any fund not considering ESG factors is ignoring economically relevant risk-return information.

Therefore, we support the clarifying language in the Proposed Rule's safe harbor around "appropriate consideration" of relevant facts and circumstances in Paragraphs (b)(1) and (b)(2) as we believe prior sub-regulatory guidance, including FAB 2018-01, like the current rules, suggested that fiduciaries have heightened duties when considering ESG factors. Because it is understood that fiduciary duties include consideration of all factors relevant to risk and return, additional language emphasizing this point with respect to ESG creates an impression that fiduciaries either are currently violating their duties, or are at greater risk of doing so when considering ESG information. Both perceptions discourage consideration of ESG factors. The Proposed Rule's use of a reasonableness standard ensures that fiduciaries will take into account relevant factors while avoiding more stringent language that could create excessive litigation and/or enforcement risk.

Further, focusing on "the purposes of the plan" as a whole more accurately reflects the ways in which fiduciaries and their service providers try to maximize plan returns. The NPRM's preamble recognizes this, stating: "... a fiduciary may prudently choose an investment as a hedge against specific risk to the portfolio, even though the investment, when considered in isolation from the portfolio as a whole, is riskier or less likely to generate a significant positive return....". This clarification, while not

⁵ See PRI's database of academic research on ESG topics, available here: <https://www.unpri.org/research/academic-esg-review/5024.article>.

necessarily representing a new idea,⁶ appropriately illustrates the complexity of investment decision-making and further works to protect fiduciaries from undo scrutiny in their regular activities.

A plan-centered approach, as opposed to one focused on each investment individually, is also better suited to considering and mitigating the impacts of systematic ESG-related risks, which is particularly important for the many ERISA-governed plans whose investments are broadly diversified. The PRI's landmark report, *A Legal Framework for Impact* provides detailed explanation of the "interdependence between financial and economic activity" and the implications for investment managers and asset owners.⁷ Recent academic work has similarly explained that modern portfolio theory dictates that diversified investors, whose idiosyncratic risks are diversified away, are compensated only for bearing systematic risk.⁸ In fact, academic literature found that non-diversifiable or systematic risk, often caused by systemic risks to the environmental, social and financial systems in the real world, actually matter much more to returns than do risks associated with any individual firm or security.⁹ Thus, diversified investors should endeavor to reduce systematic risks.¹⁰

Engagement designed to reduce systematic risks, such as that called for by PRI in our Active Ownership 2.0 project,¹¹ is growing.¹² As Professor Jeffrey Gordon has noted, "engagements aimed at reducing systematic risk do not run afoul of the 'exclusive benefit' criterion [of ERISA]; rather they are in service to it. Indeed, pension fund managers who are not thinking about the systematic dimension in their engagements are falling short of the objective of maximizing risk-adjusted returns."¹³ As such, while the Proposed Rule can be read as providing for fiduciary consideration of systematic risks, it would be useful for the Department to promptly issue sub-regulatory guidance providing a safe harbor for fiduciaries to incorporate systematic risks into their investment and stewardship decisions.

To further counter prior bias and clarify the importance of ESG factors, we support the inclusion in Paragraph (b)(4) of specific factors that a fiduciary may consider; however, we recommend the Department edit the list to reflect a more holistic understanding of environmental, social and

⁶ See 29 USC §1104(a)(1)(C)

⁷ Principles for Responsible Investment, "A Legal Framework for Impact" (July 2021), available at: <https://www.unpri.org/policy/a-legal-framework-for-impact>.

⁸ Jeffrey N. Gordon, "Systematic Stewardship", Columbia Law and Economics Working Paper No. 640, European Corporate Governance Institute - Law Working Paper No. 566/2021 (February 14, 2021), available at: <https://ssrn.com/abstract=3782814>; Madison Condon, "Externalities and the Common Owner," Washington Law Review, Vol. 95, No. 1 (March 2020), available at: <https://digitalcommons.law.uw.edu/cgi/viewcontent.cgi?article=5103&context=wlr>.

⁹ Roger G Ibbotson, "The Importance of Asset Allocation." Financial Analysts Journal, vol. 66, no. 2, CFA Institute, 2010, pp. 18–20, (March 2010), available at: <http://www.jstor.org/stable/27809175>.

¹⁰ Jon Lukomnik and James P. Hawley, *Moving Beyond Modern Portfolio Theory: Investing That Matters*, (April 2021).

¹¹ See PRI's report "Active Ownership 2.0", available at: <https://www.unpri.org/stewardship/active-ownership-20-the-evolution-stewardship-urgently-needs/5124.article>.

¹² Hazel Bradford, "Majority Action issues proxy guide on companies' climate-change actions," *Pensions & Investments*, (March 30, 2021), available at: <https://www.pionline.com/esg/majority-action-issues-proxy-guide-companies-climate-change-actions>. (Describing campaign to vote against directors based on systemically important companies' contributions to climate change and failure to implement plans consistent with limiting warming to 1.5 degrees); Frederick Alexander and Sara E. Murphy, "Beta Activism: Benefit Corporations and External Cost Disclosure," *Proxy Preview*, (March 16, 2021), available at: www.proxypreview.org/2021/contributor-articles-blog/beta-activism-benefit-corporations-and-external-cost-disclosure; James P. Hawley and Jon Lukomnik, "The Third Stage of Corporate Governance," *The CLS Blue Sky Blog*, (May 22, 2018), available at: clsbluesky.law.columbia.edu/2018/05/22/the-third-stage-of-corporate-governance/.

¹³ Jeffrey N. Gordon, "Systematic Stewardship", Columbia Law and Economics Working Paper No. 640, European Corporate Governance Institute - Law Working Paper No. 566/2021 (February 14, 2021), available at: <https://ssrn.com/abstract=3782814>

governance issues.¹⁴ Specifically, Paragraph (b)(4)(i) should include a broader understanding of relevant “environmental” factors, such as resource depletion, that may contribute to environmental degradation, or activities to promote a more sustainable economy and society. Paragraph (b)(4)(iii) should include a broader enumeration of “social” issues to appropriately align with market practice. Social issues include broader considerations of human rights throughout the value chain, as well as impact on communities in which companies operate, including any efforts to address contributions to systemic racism. While a definite list of “ESG” issues does not exist, fiduciaries would be served well by a broader list of examples for consideration.¹⁵

INVESTMENT LOYALTY DUTIES

The PRI supports the amendments made to “investment loyalty duties” regarding decisions to make investments based on collateral benefits. The current rule permitting fiduciaries to select an investment based on collateral benefits only if it is “economically indistinguishable” from other investment options sets an exceedingly high bar that is in practice impossible for fiduciaries to achieve, given the existence of differences among even very similar investments. The Proposed Rule’s requirement that the investments “equally serve the financial interests of the plan” to support selection of an investment with collateral benefits would allow fiduciaries to make decisions that do not sacrifice risk-adjusted returns without having to satisfy a standard that is more stringent than necessary to protect plan participants and beneficiaries. As discussed above, considering the plan as a whole is more consistent with market practice.

The Proposed Rule appropriately eliminates the specific documentation requirements imposed by the current rule, which, as discussed above, create a stigma around considering collateral benefits in investment decision-making. Fiduciaries require autonomy to set strategy and execute investment decisions in line with that strategy without excessive regulatory scrutiny spurred by bias against ESG or any other kind of potentially relevant considerations.

We believe Paragraph (c)(2) can be further clarified to ensure protection for fiduciaries in their consideration of economically relevant information. The NPRM refers several times to “collateral benefits” and “other objectives” as distinct from “risk-return” factors. However, these categorizations are subjective, which we believe can create risk for fiduciaries. Prudent fiduciaries may draw different conclusions about whether a factor affects risk-return or involves a collateral benefit because, for example, they assume different time horizons or likelihood that a risk factor materializes.

Further, an investment choice may both provide collateral benefits and affect risk-adjusted returns. For example, many funds screen out tobacco companies because investors don’t want to contribute to a harmful industry. Beyond this “collateral benefit,” however, investing in tobacco companies can affect risk-adjusted returns by harming overall human health, increasing healthcare costs and decreasing economic productivity. An investment may confer collateral benefits in the short term,

¹⁴ See <https://www.unpri.org/sustainability-issues/environmental-social-and-governance-issues>.

¹⁵ See “PRI Reporting Framework Main definitions”, specifically page 3, (November 2018), available at: https://www.unpri.org/Uploads/x/l/g/maindefinitionstoprireportingframework_971173.pdf.

then, and also affect risk-adjusted returns on the longer time horizon appropriate for most ERISA-governed funds.

While current regulation and the Proposed Rule can be read to allow fiduciaries to make this determination, we recommend that the Department make clear that the distinction between these two categories relies on analytical assumptions and methodologies and that categorization should be decided by the fiduciary with appropriate protections from hindsight bias. Without such protections, fiduciaries risk undue scrutiny from those hostile to the notion that ESG factors are relevant to risk and/or return. The threat of this scrutiny alone, and a lack of surety of protections for fiduciaries, can limit willingness to utilize certain types of information that has a bias against it.

The PRI supports removing all references to the recently added term “pecuniary.” Rather than providing clarity, this term creates confusion by layering an additional standard onto the existing fiduciary framework requiring fiduciaries to consider all economically relevant factors. Language such as that in the preamble to the final “Financial Factors” rule cautioning fiduciaries against “too hastily” selecting an ESG fund based on pecuniary factors reinforces the inhibiting effect of this terminology. This terminology is also unhelpful because, as discussed above, a factor may have both pecuniary and non-pecuniary aspects and a fiduciary should have the ability to determine how to treat that factor.

RELEVANT CONSIDERATIONS

The PRI encourages the Department to consider the distinction between the terms “relevant” and “material” factors. While some may use these interchangeably, we see these phrases as having different meanings for the duties of an ERISA fiduciary. While “material” can be read as limiting considerations to those directly affecting the finances of a company or individual investment, or having a financial impact of a particular magnitude, we see “relevant” as providing a more appropriate lens through which fiduciaries can consider any factors that may affect risk-adjusted returns. As investors with a more specific set of duties, on multi-decadal timelines, we believe ERISA fiduciaries should have the broadest possible lens with which to view and determine relevant information. The underlying ERISA statute does not exclusively utilize the term “material” when identifying the information that falls within fiduciary considerations and the Department’s sub-regulatory guidance has consistently utilized the phrase “relevant”. Further, the term “material” is a construct of corporate and securities law and its usage may be read as importing the associated regulatory law into the Proposed Rule. We encourage the Department to limit its usage of the term “material” in order to minimize confusion and avoid overly constraining fiduciaries’ considerations in their standard practices.

QUALIFIED DEFAULT INVESTMENT ALTERNATIVES (QDIAs)

Qualified Default Investment Alternatives (QDIAs) are an important means for plans to ensure that participants’ and beneficiaries’ retirement savings are consistently being invested in a sound way whether or not they declare a preferred investment vehicle or risk-return profile. To accomplish this goal, fiduciaries must be able to offer a variety of financially prudent options as QDIAs. The current

rule unnecessarily prevents fiduciaries from selecting a QDIA that considers non-pecuniary (presumably targeting ESG) factors, regardless of their economic relevance.

The lack of clarity around the definition of pecuniary and the new considerations for QDIA inclusion likely make fiduciaries more cautious, to the possible detriment of participants and beneficiaries. Even prior to the current rules being promulgated, 401(k) plans offered an average menu of 20 funds plus one or more target date fund. According to the Callan DC index, however, only 5% of corporate DC plans offered a standalone ESG option in 2018, compared to 43% of public and non-profit plans, while take-up overall was only 1.2%.¹⁶ We support rescission of this limitation and the maintenance of prior QDIA rules for all investment options being utilized as a default.

The Department should be cautious in requiring additional disclosure only for QDIAs that consider “collateral benefits” within the investment vehicle. Given the subjectivity involved in defining collateral benefits, reliance on this distinction could discourage fiduciaries from considering factors others may not consider risk-return, or encourage them to overly disclose these risk-return factors as collateral benefits in order to protect themselves from additional scrutiny. Both of those outcomes impose additional unwarranted burdens on the selection of investment options that consider ESG factors. Should the Department believe that additional disclosure is required for QDIAs providing collateral benefits, the PRI would encourage the Department to instead strengthen disclosure and reporting rules for all QDIAs, not only those listing collateral benefits, in sub-regulatory guidance. The Securities and Exchange Commission is considering changes to fund disclosure rules and the PRI would encourage the Department to coordinate enhanced disclosure requirements with SEC staff in order to ensure market alignment and regulatory consistency.

SHAREHOLDER RIGHTS AND RESPONSIBILITIES

The PRI filed extensive comments with the Department when the current rule was originally noticed, calling for the Department to withdraw the proposal entirely.¹⁷ We found the proposed changes to guidance on shareholder rights and responsibilities unjustified and adding confusion to fiduciary duties regarding shareholder rights, and warned the Department that the rule would inevitably interfere with fiduciaries appropriately exercising shareholder rights on behalf of their beneficiaries.

The PRI welcomes the Department’s effort to address the confusion created by the current rule regarding if and how fiduciaries may engage in the proxy voting process consistent with their fiduciary duties. Broadly, we support the Proposed Rule’s return to the standard set by previous sub-regulatory guidance, which provided that fiduciaries should exercise shareholder rights, including proxy voting rights, conscientiously, taking into account costs and benefits. Matters presented for a shareholder vote, including ESG reforms proposed in shareholder resolutions, can affect the value of a company’s shares.

¹⁶ See PRI’s analysis of private retirement systems, available at: <https://www.unpri.org/download?ac=11498>.

¹⁷ See https://dwtzyx6upklss.cloudfront.net/Uploads/d/h/r/pricomment_dolfiduciarydutiesreproxyvotingandshareholderrightsrin1210ab91_20956.pdf

Commenters on the 2020 rulemaking provided a great deal of evidence on this point, which the Department purported to acknowledge while adopting the current rule that effectively discouraged proxy voting. We agree with the Department's assertion in the NPRM that "[t]he exercise of shareholder rights is important to ensuring management accountability to the shareholders that own the company," a benefit that transcends the value of voting at any particular portfolio company.

The current rule imposes documentation requirements for the exercising of shareholder rights broadly, as well as the use of proxy voting firms, that have the potential to increase costs and deter participation in the proxy voting process. The Department's sub-regulatory guidance has consistently stated that fiduciaries must monitor service providers, and as such, singling out investment managers' and proxy advisors' proxy voting activities for special documentation requirements creates confusion in addition to imposing an unnecessary time and cost burden. We support the removal of these documentation requirements.

Finally, we support rescission of the two "safe harbor" provisions which added confusion on the proxy voting process and can be interpreted as broadly encouraging voting with company management. The two provisions could be interpreted as best-practice and encourage shareholders to follow those examples, instead of their established practices in line with stated investment policies and obligations under ERISA.

This consultation response represents the view of the PRI Association and not necessarily the views of its individual members. More information: www.unpri.org

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