US SIF

The Forum for Sustainable and Responsible Investment

Submitted via regulations.gov

July 30, 2020

Joe Canary
Office of Regulations and Interpretations
US Department of Labor
Room N-5655
200 Constitution Avenue NW
Washington, DC 20210

RE: Proposed rule on Financial Factors in Selecting Plan Investments (RIN 1210-AB95)

Dear Mr. Canary:

On behalf of US SIF: The Forum for Sustainable and Responsible Investment, I write to provide comments in response to the Department of Labor's (the "Department" or "DOL") proposed rule, "Financial Factors in Selecting Plan Investments" (RIN 1210-AB95) (the "Proposal").

US SIF is the leading voice advancing sustainable investing across all asset classes. Our mission is to rapidly shift investment practices toward sustainability, focusing on long-term investment and the generation of positive social and environmental impacts. Our members, comprised of investment management and advisory firms, mutual fund companies, asset owners, research and data firms, financial planners, advisors and broker-dealers, represent more than $3 trillion in assets under management or advisement. US SIF members integrate environmental, social and governance factors ("ESG") into their investment decisions and take their responsibilities seriously as shareowners, including voting proxies and engaging with companies.

Summary

On June 23rd, the US Department of Labor announced the Proposal to revise the fiduciary standard for ERISA-governed retirement plans. In 2015, the DOL carefully considered this issue and released an Interpretive Bulletin clarifying that fiduciaries of ERISA-governed retirement "need not treat commercially reasonable investments as inherently suspect or in need of special scrutiny merely because they take into consideration environmental, social, or other such factors."[1] This established clear guidelines for fiduciaries who previously may have been reluctant to incorporate ESG or select an ESG mutual fund as a qualified default investment alternative (QDIA) out of fear of regulatory enforcement actions or litigation.

[1] Interpretive Bulletin Relating to the Fiduciary Standard Under ERISA in Considering Economically Targeted Investments, Employee Benefits Security Administration, Department of Labor IB-2015-01.

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The new Proposal attempts to isolate financially material environmental, social and governance (ESG) criteria from other financially material information in investments covered under ERISA. The Proposal implies—without ever providing a framework—that nearly all ESG criteria are non-financial. The Proposal is out of step with professional investment managers who increasingly analyze ESG factors precisely because of risk, return and fiduciary considerations.

The Proposal will put a substantial burden on fiduciaries who consider ESG factors or offer ESG investment options in their retirement plans. The proposed changes require additional documentation to justify why ESG factors are financially material. The Proposal would effectively prohibit ESG considerations in default investment options for plans (Qualified Default Investment Alternatives, or QDIA).

The DOL has suggested that investments that consider ESG factors underperform. To advance this specious claim, the DOL cites limited, cherry-picked data, ignoring the multitude of studies demonstrating that investment strategies that take ESG factors into account offer comparable or better financial performance when compared with conventional investments.

If the new regulation is adopted, fiduciaries would be allowed to consider an ESG factor only if it could be demonstrated that that factor improved forecasted performance – a nearly impossible task and an assessment that not asked of other investment criteria.

Most importantly, this Proposal is a significant change to decades of DOL precedent that, at a minimum, allowed fiduciaries to consider ESG factors so long as doing so did not diminish expected financial performance. This change would increase the burden of proof that fiduciaries must meet in order to include an ESG focused investment, increasing regulatory and litigation risk. Most importantly, it would penalize plan participants who will not be able to benefit from investments that assess ESG criteria.

Yet, the Department does not present any examples of an ERISA fiduciary selecting investments based on "non-pecuniary" factors, the purported problem the Proposal is intended to solve. The Department also offers a wholly inadequate economic analysis, which underestimates the actual costs to fiduciaries if this Proposal becomes a regulation.

To date, the Department has appropriately focused on the process used by fiduciaries to ensure that decisions are undertaken with due diligence and prudence, based on objective expertise with no conflicts of interest and for the sole interest of the plan participant. By targeting ESG considerations for special consideration, this Proposal is a radical departure from that focus.

Last, the proposal puts the US out of step with the European Union and several other countries who have or are in the process of integrating sustainability consideration into financial policy frameworks in order to finance sustainable growth.[2]

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[2] The The Australian Sustainable Finance Initiative, https://www.sustainablefinance.org.au/. Canada's Expert Panel on Sustainable Finance - Mobilizing Finance for Sustainable Growth, http://publications.gc.ca/collections/collection_2019/eccc/En4-350-2-2019-eng.pdf. The European Union's Suustainable Finance Action Plan, https://ec.europa.eu/info/business-economy-euro/banking-and-

For these reasons, expanded upon below, we respectfully request that the Proposal be withdrawn from consideration.

The underlying premise of the Proposal is flawed

The Proposal suggests that considering ESG criteria in investments is largely an invalid investment approach. Abundant data debunks this premise.

Investors consider ESG criteria because they are material to financial performance. The Department, throughout the Proposal, treats the use of ESG criteria for assessing potential performance as a different data set than traditional GAAP-reported financial criteria.[3] In fact, the only difference between ESG criteria and financial factors is that financial factors are required reporting for companies; most ESG data, unfortunately, are not yet required. Both, however, affect financial performance.

There is now ample literature that makes clear that ESG criteria are material. For example, the CFA Institute, the leading investment professional standards organization, identifies ESG criteria as financially material. "CFA Institute encourages all investment professionals to consider ESG factors, where relevant, as an important part of the analytical and investment decision-making process, regardless of investment style, asset class, or investment approach."[4]

Independent research firm ISS studied the relationship of ESG performance and the economic value added (EVA) margin of US companies with a market capitalization above $250 million between 2013 and 2019.[5] Their findings show that "high ESG performance is generally positively related to valuation and profitability and negatively correlated with volatility." It also found "high ESG performance/high-EVA margin stocks tend to outperform."

Two meta-studies arrive at the same conclusion. The first, published by The *Journal of Sustainable Finance & Investment* considered 2,200 individual studies and reported that 90 percent of the studies found a non-negative relationship between ESG considerations and corporate financial performance with a clear majority showing a positive relationship.[6] The second, by Oxford University and Arabesque Partners, considered 200 sources and concluded, "88 percent of reviewed sources find that companies with robust sustainability practices demonstrate better operational performance, which ultimately translates into cash flow," and "80

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finance/sustainable-finance_en. The United Kingdom's Green Finance Strategy, https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance_en

[3] Proposal, page 17, "one of the investments is selected on the basis of a non-pecuniary factor or factors such as environmental, social, and corporate governance considerations." See also page 38 "It is also difficult to estimate the degree to which the use of non-pecuniary factors by ERISA fiduciaries, ESG or otherwise, would expand in the future."

[4] Positions on Environmental, Social, and Governance Integration, CFA Institute (2018) https://www.cfainstitute.org/-/media/documents/article/position-paper/cfa-institute-position-statement-esg.ashx

[5] ESG Matters, Dr. G. Kevin Spellman, CFA, David O. Nicholas. (2019) https://www.issgovernance.com/file/publications/ISS_EVA_ESG_Matters.pdf

[6] ESG And Financial Performance: Aggregated Evidence from More Than 2000 Empirical Studies, Gunnar Friede, Timo Busch, Alexander Bassen, *Journal of Sustainable Finance & Investment* (Volume 5, 2015 – Issue 4) https://www.tandfonline.com/doi/full/10.1080/20430795.2015.1118917

percent of the reviewed studies demonstrate that prudent sustainability practices have a positive influence on investment performance."[7]

The Morgan Stanley Institute for Sustainable Investing "compared the return and risk performance of ESG-focused mutual and exchange-traded funds (ETFs), as defined by Morningstar, against traditional counterparts from 2004 to 2018, using total returns and downside deviation."[8] It found that that there is "no financial trade-off in the returns of sustainable funds compared to traditional funds, and they demonstrate lower downside risk." Moreover, during a period of extreme volatility, the study found "strong statistical evidence that sustainable funds are more stable."

In fact, much work over the past decade has established materiality standards for ESG issues. The Sustainability Accounting Standards Board (SASB) and the Global Reporting Initiative (GRI), through multi-stakeholder processes that include corporations, investors and other market participants, have created corporate sustainability reporting standards for ESG issues.

SASB's Materiality Map is a summary of sustainability issues that are "likely to affect the financial condition or operating performance of companies within an industry."[9] At the end of 2019, 120 companies were using the SASB standard in their reporting; investors representing more than $35 trillion in assets under management participate in SASB's investor advisory group.[10] [11]

The Proposal also suggests that the lack of a single definition for an ESG fund makes these investments nearly always questionable for retirement plans-- and always unsuitable for QDIAs. Investment professionals use various strategies to complement traditional, quantitative techniques of analyzing financial risk and return with qualitative and quantitative analyses of ESG policies, performance, practices and impacts. Some may actively seek to include companies that have more robust ESG policies and practices in their portfolios or to exclude or avoid companies with poor ESG track records. Others may incorporate ESG factors to benchmark corporations to peers or to identify "best-in-class" investment opportunities based on ESG issues. Still, other responsible investors integrate ESG factors into the investment process as part of a more extensive evaluation of risk and return.[12]

Currently, other investment styles lacking specific definitions, such as “growth” or “value” funds, do not require the kind of additional documentation required for ESG funds, but the Proposal does not draw a valid distinction as to why this is so.

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[7] From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance,” Gordon Clark, Andreas Feiner, Michael Viehs. University of Oxford and Arabesque Partners. (March 2015) https://arabesque.com/research/From_the_stockholder_to_the_stakeholder_web.pdf
[8] Sustainable Reality: Analyzing Risk and Returns of Sustainable Funds, Morgan Stanley Institute for Sustainable Investing. (2019) https://www.morganstanley.com/pub/content/dam/msdotcom/ideas/sustainable-investing-offers-financial-performance-lowered-risk/Sustainable_Reality_Analyzing_Risk_and_Returns_of_Sustainable_Funds.pdf
[9] Materiality Map, Sustainability Accounting Standards Board. https://materiality.sasb.org/
[10] “More than 100 companies using SASB” IR Magazine. (December 12, 2019) https://www.irmagazine.com/reporting/more-100-companies-using-sasb-standards
[11] Global Reporting Initiative, http://www.globalreporting.org/standards
[12] ESG Incorporation, US SIF: The Forum for Sustainable and Responsible Investment. https://www.ussif.org/esg

The Proposal does not present a problem that needs fixing

The Proposal never establishes that the Department's 2015 guidance is a roadblock for fiduciaries. The proposed rule suggests, without evidence, that fiduciaries considering ESG options for a retirement plan may result in ERISA plan fiduciaries making investment decisions for purposes that do not align with providing benefits to participants and beneficiaries.[13] In support of this claim, the Proposal cites two newspaper columns but provides no empirical data from the Department, enforcement actions, academia or the financial services industry.

To justify the Proposal's claim that "ESG investing approaches may consider non-pecuniary matters," the Department cites a study of Dutch individual investors' perceptions about sustainable investments between 2006 and 2012.[14] The study, reporting on the motivations of retail investors, has no bearing on the financial materiality of the sustainable funds they are considering.

The Proposal is out of step with professional finance managers

The DOL proposal is out of step with professional investment managers who increasingly analyze ESG factors precisely because of long-term risk, return and fiduciary considerations.

Investor interest in companies' ESG practices has never been higher. Since 1995, when the US SIF Foundation first measured the size of the US sustainable investment universe at $639 billion, these assets have increased more than 18-fold to $12 trillion in 2018, a compound annual growth rate of 13.6 percent.[15] Investors consider ESG issues both when they make decisions about their portfolios and when they engage in the shareholder process.

In the US SIF Foundation's 2018 survey of sustainable investment trends in the United States, 141 money managers with aggregated assets of more than $4 trillion responded to a question on their motivations for incorporating ESG criteria into their investment process.[16] Three-quarters of these managers cited the desire to improve returns and to minimize risk over time. Fifty-eight percent cited their fiduciary duty obligations as a motivation.

A 2020 survey of company executives and investment professionals by McKinsey & Co. showed even stronger agreement about the financial benefit to considering ESG factors.[17] The study found "83 percent of C-suite leaders and investment professionals say they expect that ESG programs will contribute more shareholder value in five years than today."

Performance of ESG focused investments also indicates the financial relevance of these criteria. One of the most explicit findings on the performance question comes from the 2017

[13] Proposal, page 10 "The Department is concerned, however, that the growing emphasis on ESG may be prompting ERISA plan fiduciaries to make investment decisions for purposes distinct from providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan."
[14] Proposal, page 29.
[15] Report on US Sustainable, Responsible and Impact Investing Trends 2018: http://www.ussif.org/trends.
[16] See footnote 13.
[17] The ESG premium: New perspectives on value and performance, McKinsey & Co. (February 12, 2020) https://www.mckinsey.com/business-functions/sustainability/our-insights/the-esg-premium-new-perspectives-on-value-and-performance

DOL-commissioned review of the ESG field.[18] Meta-analyses reviewed for the study show that ESG factors do not have a negative impact on investment performance and may have a positive impact.

The Proposal singles out ESG for burdensome analysis and documentation

The Proposal will put a substantial additional burden on fiduciaries who wish to utilize ESG investments by requiring further investment analysis and documentation requirements. It imposes these conditions to solve no known problem.

The Department fails to justify why ESG funds have to be compared to other fund options controlling for diversification, liquidity, return, and comparison[19], but other fund types like US and international equity, small-, mid- and large-cap and value and growth do not. Investment professionals know that ESG criteria impact risk and return. It's thus unclear why ESG issues are treated entirely differently.

In discussing the "all things being equal" tie-breaker test, the Proposal adds two additional requirements for fiduciaries who want to include one or more ESG options in the plan line-up.[20] The first requires a fiduciary to prove something does not exist: "the fiduciary must document the basis for concluding that a distinguishing factor could not be found." The second requirement, again, establishes a burden for ESG alternatives but not for any other investment type: [the fiduciary must document] why the selected investment was chosen based on the purposes of the plan, diversification of investments, and the financial interests of plan participants and beneficiaries in receiving benefits from the plan." This is an unfair and unjustified burden on an investment style that has proven it can deliver competitive or better risk-adjusted returns. It should also be noted that it is at least as common for a non-ESG stock pick to underperform as it is for an ESG stock pick.

There are also conflicting requirements laid out for fiduciaries considering ESG funds that will create confusion for fiduciaries. Fiduciaries face one obligation in section (c)(1) when the ESG criteria are material and treated as any other investment[21], and a different duty prescribed in section (2)(c) of the Proposal. The Proposal gives no guidance to fiduciaries to resolve these competing directives. This will lead to additional time and expense or avoidance of ESG alternatives altogether, which is perhaps the end goal of the Department.

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[18] Environmental, Social and Governance (ESG) Investment Tools: A Review of the Current Field, Ogechukwo Ezeokoli, et al. (December 2017) https://www.dol.gov/sites/dolgov/files/OASP/legacy/files/ESG-Investment-Tools-Review-of-the-Current-Field.pdf

[19] Proposal, Paragraph (c)(1) and "The paragraph further emphasizes that fiduciaries' consideration of ESG factors must be focused on their potential pecuniary elements by requiring fiduciaries to examine the level of diversification, degree of liquidity, and the potential risk-return profile of the investment in comparison with available alternative investments that would play a similar role in their plans' portfolios."

[20] Proposal, Paragraph (c)(2) and page 17.

[21] Proposal, page 16. "Paragraph (c)(1) is careful to acknowledge, however, that ESG factors and other similar considerations may be economic considerations, but only if they present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories."

In failing to acknowledge the new burdens on fiduciaries, the Department has not adequately completed the necessary cost-benefit analysis for the rule and trivializes the extra due diligence being prescribed. The Proposal casually assesses, "While the costs associated with the rule are small, its benefits could be significant for plans that are heavily invested in underperforming ESG investments."[22]. Yet, In the next sentence, the Proposal states, "The Department does not have sufficient data to estimate the number of such plans [containing ESG funds]." If the Department does not have sufficient data, how can it justify the cost-benefit analysis? It can't.

Excluding ESG Funds from QDIAs is a disservice to Plan Participants

The Proposal explicitly excludes the consideration of ESG funds in qualified default investment alternatives (QDIA), one of the fastest-growing options in the retirement space.[23] This deprives plan participants from the opportunity to benefit from the utilization of ESG criteria to manage long-term risks. If an investment meets the fiduciary criteria, it should be available for selection in a QDIA plan whether or not it includes ESG considerations.

Yet again, the Proposal makes conflicting statements that will cause confusion for fiduciaries. In paragraph (c)(1) of the Proposal states, "A fiduciary's evaluation of an investment must be focused solely on pecuniary factors."[24] The Department then states that even when based on pecuniary factors, ESG criteria must be excluded for a QDIA.[25]

As discussed above, investors consider ESG factors precisely because of long-term risk, return and fiduciary considerations. The provision barring ESG funds in default plans will arbitrarily exclude high-performing investments and potentially make their investments riskier. In fact, it would be prudent for the Department to mandate that QDIA investments consider long-term threats like climate change to protect the long-term interests of plan participants.[26]

Conclusion

The Proposal does not present a problem it is trying to solve, other than evidencing a deep distrust of investments that consider ESG criteria. The Proposal does not show instances of fiduciaries choosing investments that are likely to have lower returns in exchange for ESG criteria being considered. The Proposal provides no data on how plan participants have or are likely to suffer from having ESG options available to them. However, the Proposal does require a heightened level of scrutiny for fiduciaries who want to include ESG funds and mandates their exclusion from QDIAs.

[22] Proposal, section 3.3, page 51.
[23] Proposal, Paragraph (c)(3)(iii).
[24] Proposal, Paragraph (c)(1).
[25] Proposal, page 22. "The Department does not believe that investment funds whose objectives include non-pecuniary goals—even if selected by fiduciaries only on the basis of objective risk-return criteria consistent with paragraph (c)(3)—should be the default investment option in an ERISA plan."
[26] Decarbonizing Factors, Alex Cheema-Fox, Bridget R. LaPerla, George Serafeim, David Turkington and Hui Wang, Harvard Business School (October 23, 2019). "We consider several portfolio formation strategies and find strategies that lowered carbon emissions more aggressively performed better." https://hbswk.hbs.edu/item/decarbonization-factors

The unfortunate end result were this Proposal to become a regulation, is that it will limit plan participants' options and diversification opportunities. This should not be the role of the Department of Labor.

I respectfully request that the Proposal be withdrawn.

Thank you for your consideration of these comments.

Sincerely,

Lisa Woll
CEO