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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 Investments Proposed Regulation

Re: RIN 1210-AB95; Financial Factors in Selecting Plan Investments Proposed  
Regulation

Dear Sir or Madam:

The Investment Company Institute<sup>1</sup> appreciates the opportunity to provide comments to the Department of Labor (the Department) on its proposed rule on *Financial Factors in Selecting Plan Investments* (the Proposed Rule).<sup>2</sup> The Proposed Rule would amend the existing regulation<sup>3</sup> on fiduciaries' investment duties under Title I of the Employee Retirement Income Security Act of 1974, as amended (ERISA). As a trade association representing mutual funds, ICI is especially attuned to the needs of retirement savers because mutual funds play an important role in US retirement saving through defined contribution (DC) plans and individual retirement accounts (IRAs). At year-end 2019, more than 60 percent of private-sector 401(k) plan assets were invested in mutual funds.<sup>4</sup>

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<sup>1</sup> The [Investment Company Institute](http://www.ici.org) (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US\$24.8 trillion in the United States, serving more than 100 million US shareholders, and US\$6.5 trillion in assets in other jurisdictions. ICI carries out its international work through [ICI Global](http://www.ici.org), with offices in London, Hong Kong, and Washington, DC.

<sup>2</sup> 85 Fed. Reg. 39113 (June 30, 2020).

<sup>3</sup> 29 CFR section 2550.404a-1.

<sup>4</sup> At year-end 2019, Americans had \$6.4 trillion in 401(k) plans, with \$4.0 trillion invested in mutual funds. See "The US Retirement Market, First Quarter 2020" (June 2020), available at <https://www.ici.org/research/stats/retirement>.

The ICI and its members support the long-understood ERISA tenet that, when making decisions on investments and investment courses of action on behalf of a retirement plan, ERISA plan fiduciaries must be focused on the *financial* rather than *non-pecuniary* interests of the plan's participants and beneficiaries. Despite this sentiment, we cannot support the Proposed Rule because we are deeply concerned that it will have significant unintended consequences. It is premised on an incorrect assumption that integrating environmental, social, and corporate governance (ESG) considerations into an investment management strategy is, by nature, non-pecuniary and inconsistent with the essential goal of plan fiduciaries to be focused solely on the plan's financial returns and the interests of plan participants and beneficiaries in their plan benefits.

The Proposed Rule singles out a particular investment focus—investments informed by ESG considerations—for special scrutiny and restrictions. The unique conditions of the Proposed Rule would include:

- To the extent ESG investments are selected for their economic benefits, the plan would be required to conclude that a “qualified investment professional” would treat the specific ESG considerations as “material economic considerations under generally accepted investment theories” to confirm that such ESG factors are indeed pecuniary factors.<sup>5</sup>
- To the extent ESG investments are “economically indistinguishable” from competing investments and the ESG investments are selected for non-pecuniary reasons, a fiduciary must document why the investment is “economically indistinguishable” from other investments and why the investment was chosen based on the purpose of the plan, diversification of investments, and the interests of the plan's participants and beneficiaries.<sup>6</sup>
- To the extent ESG investments are selected as alternatives in an individual account plan, a fiduciary must document its selection and monitoring of the investment option (as well as all other investment options in the plan) based on a number of factors.<sup>7</sup>
- ESG or similar mandate-driven investment alternatives may not be used as the plan's qualified default investment alternative (QDIA) or as any component of the QDIA.<sup>8</sup>

We are concerned that the above requirements, both individually and combined, would apply heightened fiduciary requirements or prescriptions to the use of any investment strategy that incorporates ESG considerations. As described below, this sudden shift departs from more than 45

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<sup>5</sup> Proposed Rule § (c)(1).

<sup>6</sup> Proposed Rule § (c)(2).

<sup>7</sup> Proposed Rule § (c)(3)(i), (ii).

<sup>8</sup> Proposed Rule § (c)(3)(iii).

years of precedent dating from the adoption of ERISA and appears to be based on an inaccurate or incomplete understanding of ESG. It suggests, without evidence, that a growing emphasis on ESG considerations 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. However, the Department provides no evidence to support such a conclusion, and seemingly ignores that professional investment managers increasingly analyze ESG criteria precisely because of risk, return, and fiduciary considerations. Further, the Department ignores the adverse consequences that the Proposed Rule would have, including that it would set a dangerous precedent extending beyond ESG investments. The Proposed Rule's creation of heightened fiduciary requirements for a particular investment strategy could lead to more stringent restrictions on other investments and investment strategies the Department may disfavor in the future—contravening ERISA's prescription against the creation of "legal lists" of permissible investments.<sup>9</sup> In addition to the heightened standards applicable to ESG investments, the Proposed Rule would add a troubling new requirement applicable to all plan investments—an unclear and potentially unattainable requirement to compare each plan investment to all "available alternative investments or investment courses of action" with regard to certain specified factors.

A decision to move forward with this rulemaking will impose additional new costs on ERISA plans and have a chilling effect on the willingness of plan sponsors to consider *any* investment that incorporates ESG criteria—even when such factors are pecuniary and part of the investment's risk assessment. Such a result would be detrimental to the very plan participants and beneficiaries the Proposed Rule is intended to protect. Therefore, and for the reasons explained in more detail below, we respectfully urge the Department to withdraw the Proposed Rule.

### **I. The Proposed Rule Ignores the Role of ESG Considerations in Modern Portfolio Management and Is Not Supported by Evidence of a Problem.**

The Proposed Rule broadly treats any fund that includes environmental, social, corporate governance, and/or "any similarly oriented assessments or judgments in their investment mandates" as "ESG investments" that are subject to heightened scrutiny and increased administrative burden.<sup>10</sup> The Department acknowledges that "some investing takes account of environmental factors and corporate governance in a manner that focuses exclusively on the financial aspects of those considerations."<sup>11</sup> Yet,

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<sup>9</sup> See discussion accompanying notes 49 to 55.

<sup>10</sup> Proposed Rule § (c)(3).

<sup>11</sup> 85 Fed. Reg. 39122. Additionally, the Department states that:

As the Department has recognized in its prior guidance, there may be instances where factors that sometimes are considered without regard to their pecuniary import—such as environmental considerations—will present an economic business risk or opportunity that corporate officers, directors, and qualified investment professionals would appropriately treat as material economic considerations under generally accepted investment theories. For example, a company's improper disposal of hazardous waste would likely implicate business risks and opportunities, litigation exposure, and regulatory obligations. These would be appropriate

the Proposed Rule does not reflect this understanding, but instead implies that most investing that takes account of ESG considerations does not do so. An investment alternative that includes any one of the ESG considerations (or similarly oriented assessments) in its investment mandates becomes subject to this heightened scrutiny, even if considered *precisely because of risk*, return and fiduciary considerations, as is often the case. This contradiction belies the purpose of the Proposed Rule and demonstrates a misunderstanding of how investment managers incorporate ESG considerations.

#### **A. The Proposed Rule Reflects an Imprecise Application of ESG Considerations.**

The Department states several times in the preamble to the Proposed Rule that ESG criteria may be considered if “qualified investment professionals would treat [them] as material economic considerations under generally accepted investment theories.”<sup>12</sup> We agree with this principle in so far as any qualified investment professional using sound investment theories can utilize ESG factors in their investment analysis and selection. Yet, as noted below, many of our members, who are certainly “qualified investment professionals,” do consider ESG criteria “as material economic considerations under generally accepted investment theories.” Despite this, the Proposed Rule broadly puts ESG considerations under a single lens and subjects them to special analytical treatment. Instead, the focus of the Department’s concern and call for increased scrutiny should be on ESG considerations that expressly sacrifice investment returns or assume greater investment risks as a means of promoting collateral social policy goals.

##### **1. ESG Considerations Are Often Pecuniary in Nature.**

When it comes to the use of ESG considerations in mutual funds, in many cases, ESG simply represents one of the many considerations that go into the active management process as part of the overall risk and return analysis. Mutual funds’ portfolio managers and analysts—even those of funds that do not include ESG-related terms in their names or market themselves as “ESG funds”—routinely, and to an extent inextricably, include ESG considerations in their decision making to enhance performance, manage investment risks, and identify emerging investment risks and opportunities, much as they would consider macroeconomic or interest rate risks, idiosyncratic business risks, and investment exposures to particular companies, industries, or geographical regions.<sup>13</sup> In determining whether ESG information is material to a particular investment, an asset manager analyzes its potential long-term impact on the financial health of the investment in the context of a fund’s investment strategy.

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economic considerations that qualified investment professionals would treat as material under generally accepted investment theories. Dysfunctional corporate governance can likewise present pecuniary risk that a qualified investment professional would appropriately consider on a fact-specific basis. *Id.* at 39116.

<sup>12</sup> *Id.* at 39116.

<sup>13</sup> See, e.g., NYSE Corporate Governance Guide at pp. iii to iv (“boards are expected to . . . Set high standards of social responsibility for the company, including human rights, and monitor performance and compliance with those standards.”) and case studies at Chapters 7B (Annie’s) and 7C (Hershey Company).

Today, ESG matters vary widely, and materiality may depend on sector, capitalization, and regional contextualization, but generally are considered to include:

- Environmental or “E” matters, such as climate change, resource depletion, waste, pollution, inefficient resource use, drinking water contamination, water stress, or deforestation;
- Social or “S” matters, such as companies’ relationships with their employees and suppliers, including labor standards, diversity, worker safety practices, cyber safety and data security, and human rights issues; and
- Governance or “G” matters, such as shareholder rights, bribery and corruption, executive pay, transparency, accountability, and decision-making structures, and board composition.

The approaches used to incorporate these issues can vary from the purely qualitative to the purely quantitative, and it is common for funds to use a mix of qualitative and quantitative approaches.<sup>14</sup> Qualitative factors, while less concrete in nature, are no less pecuniary than quantitative factors. Warren Buffett, known for pursuing value investing, has touted the importance of deeply analyzing a business’s qualitative characteristics, including the quality of corporate management.<sup>15</sup> SEC Chairman Clayton has also confirmed that a reasonable investor considers both financial and non-financial metrics.<sup>16</sup>

Corporate governance is the most commonly used of ESG considerations. According to a 2015 CFA Institute survey of portfolio managers and research analysts, 64 percent of respondents said they take corporate governance into account in their investment analysis or decisions.<sup>17</sup> The Department noted that dysfunctional corporate governance can present a pecuniary risk.<sup>18</sup> Audit standards, board

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<sup>14</sup> See Lee Gremillion, *Mutual Fund Industry Handbook: A Comprehensive Guide for Investment Professionals*, Boston Institute of Finance and The National Investment Company Services Association (2005), at p. 86.

<sup>15</sup> See Gary Mishuris, “What You Can Learn From How Warren Buffett's Investment Process Evolved,” *Forbes* (December 7, 2018), available at <https://www.forbes.com/sites/garymishuris/2018/12/07/what-you-can-learn-from-how-warren-buffetts-investment-process-evolved/#3c59e48dc5f7>.

<sup>16</sup> Clarifying what a “reasonable investor” means, Clayton indicated: “People sometimes think that when I say that, that just means financial. Let me be clear. The reasonable investor looks at qualitative, quantitative, non-financial, and financial metrics.” See A Conversation with SEC Chairman Jay Clayton: Long-term Investing, Sustainability, and the Role of Disclosures (June 23, 2020), available at <https://www.fcltglobal.org/resource/jay-clayton-sec-webinar/>.

<sup>17</sup> See “Environmental, Social, and Governance Issues in Investing: A Guide for Investment Professionals,” CFA Institute (2015), available at <https://www.cfainstitute.org/-/media/documents/article/position-paper/esg-issues-in-investing-a-guide-for-investment-professionals.ashx>. Fifty percent of respondents said they take environmental considerations into account, and 49 percent said they take social issues into account. *Id.* According to a 2019 survey, a rough estimate of the asset managers, using qualitative and/or quantitative ESG information, suggests that approximately 90 percent of actively invested asset managers incorporate ESG as an investment consideration. See *2019 Annual ESG Manager Survey* by Yoshie Phillips, available at <https://russellinvestments.com/-/media/files/us/insights/institutions/governance/2019-annual-esg-manager-survey-results.pdf?la=en&hash=B25D3B7BA44EFD9B1611C74DC5650815BB7D2C66>.

<sup>18</sup> Specifically, the Department states “[d]ysfunctional corporate governance can likewise present pecuniary risk that a qualified investment professional would appropriately consider on a fact-specific basis.” 85 Fed. Reg. 39116.

composition, and executive compensation are other aspects of corporate governance that can be financially material and whose consideration often results in better outcomes.

Regarding environmental considerations, SEC Chairman Clayton recently noted that climate change can be a material consideration, giving as an example an investor in a property and casualty company.<sup>19</sup> Likewise, water stress is likely to be a material factor for certain sectors, such as extractives, food and beverage, and agricultural companies.<sup>20</sup>

Regarding social considerations, Chairman Clayton has explained that the area of human capital is an ESG area that can be a material consideration, stating “[t]oday, human capital represents an essential driver of performance for many companies albeit in different ways. It is clear that, in certain cases, such as a growth-oriented data sciences company, understanding a company’s approach to human capital may be material to an investment or voting decision.”<sup>21</sup> Similarly, employee health and safety issues can be economically material for companies in the extractives and minerals processing industry.<sup>22</sup>

Fund managers consider ESG criteria to varying degrees, and these approaches coexist on a broad investing spectrum. Not every fund manager incorporates ESG considerations in the same manner; in fact, there is a range of qualitative and quantitative approaches for embedding ESG analysis across investing strategies, spanning asset classes and active-to-passive strategies. ESG-related investing strategies exist along a continuum. Some funds integrate analysis of ESG considerations, others use one or more sustainable investing strategies,<sup>23</sup> and some integrate ESG considerations and use one or more sustainable investing strategies.

## **2. ESG Considerations Can Be Solely Incidental to a Fund’s Management.**

The consideration of ESG matters for investing is not new. Going back to the 1950’s, some funds have excluded “sin” stocks (for example, stocks of issuers that derive the majority of their revenues from alcohol and tobacco products) from their holdings. Typically, these funds do not reflect these restrictions in their names, the restrictions are not part of the funds’ investment objectives or strategy

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<sup>19</sup> A Conversation with SEC Chairman Clayton: Long-term Investing, Sustainability, and the Role of Disclosures, (23 June 2020), available at <https://www.fcltglobal.org/resource/jay-clayton-sec-webinar/>.

<sup>20</sup> A joint World Bank/GPIF report noted that water stress is likely to be a material factor for certain sectors, such as extractives, food and beverage, and agricultural companies. See Georg Inderst and Fiona Stewart, *Incorporating Environmental, Social and Governance (ESG) Factors into Fixed Income Investment*, World Bank Group publication (April 2018) at p. 11, available at <http://documents.worldbank.org/curated/en/913961524150628959/pdf/125442-REPL-PUBLIC-Incorporating-ESG-Factors-into-Fixed-Income-Investment-Final-April26-LowRes.pdf>.

<sup>21</sup> Eve Tahmincioglu, “SEC Chief Takes on Short-Termism and ESG,” *Directors & Boards*, available at <https://www.directorsandboards.com/articles/singlesec-chief-takes-short-termism-and-esg>.

<sup>22</sup> See Sustainability Accounting Standards Board Materiality Map, available at <https://materiality.sasb.org/>.

<sup>23</sup> Such strategies can include ESG exclusionary investing, ESG inclusionary investing, impact investing, or any combination of these three approaches.

and the funds are not marketed as ESG funds. Moreover, the restrictions have no impact on the fund manager's ability to find suitable investments for the fund consistent with its investment objectives and therefore have no financial impact on the fund.<sup>24</sup> Nonetheless, the Proposed Rule's broad definition of ESG would sweep in many such funds and subject them to heightened fiduciary scrutiny.

Alcohol and tobacco restrictions of this type have a long history in investment funds and are qualitatively different from the types of restrictions that have been embraced by the emerging universe of ESG funds. Such funds have been (and still are) used by faith-based organizations that operate under Title I (ERISA-electing church plans) and use faith-based filters that eliminate certain categories. While the motivation arose from church plan sponsors, the concern was more fundamentally with the possibility of discouraging participation if the only investment options available to participants with strong religious convictions permitted investments in companies that derived a majority of their revenues from alcohol and tobacco products. These restrictions may also fairly be viewed by some as relevant to an analysis about the likely long-term value of an issuer that derives the majority of their revenues from products whose continued use could be impacted by societal changes.

### **3. The Proposed Rule Treats QDIAs Inconsistently.**

The Proposed Rule's prohibition of ESG-integrated investments in a Qualified Default Investment Alternative (QDIA) is inconsistent. On the one hand, the Department says that ESG criteria may generally be considered if "qualified investment professionals would treat [them] as material economic considerations under generally accepted investment theories." On the other, we are concerned that the Proposed Rule would explicitly prohibit the use of ESG-integrated investments as a QDIA regardless of whether such ESG criteria would constitute material economic considerations. This prescriptive policy will serve to prohibit the use of these funds as component investments in a QDIA regardless of the merit of the fund in the creation of the QDIA's overall investment strategy. Because, as discussed above, ESG-criteria are widely used in investment management, this prescription would be very disruptive and result in QDIA portfolio creation to be limited by regulatory as opposed to investment management considerations. Moreover, it is difficult to square this outright prohibition with the Department's recent private equity information letter.<sup>25</sup> While we support the private equity information letter, there appears to be no justification for disparate treatment of investments that include ESG strategies compared to private equity investments when it comes to QDIAs. In addition to the newly confirmed ability to hold private equity, target date funds already can hold asset classes such as commodities and high-yield debt. This is permissible based on the notion that investment managers are capable of appropriately balancing the risk and reward and understanding the benefits of diversification. The same logic should hold true for the inclusion of ESG strategies.

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<sup>24</sup> These restrictions typically have only incidental or de minimis impact on a fund's management. For example, alcohol and tobacco stocks currently represent less than 1 percent of the S&P 500 Index. Tabulated from Bloomberg data.

<sup>25</sup> See note 59.

#### 4. Risk Disclosure Is Fundamental to Asset Management.

The disclosure of risk is fundamental to protecting all investors, including, of course, those investing on behalf of retirement plans.<sup>26</sup> The Department cautions that plan fiduciaries should scrutinize fund risk disclosures in considering the impact of ESG considerations and suggests that the identification of any additional risk added by ESG considerations is unacceptable, regardless of the reason for the risk or the effect on returns. The Department expresses concern that some ESG investment funds being offered through ERISA DC plans acknowledge in their “disclosure materials that the fund may perform differently or forgo certain opportunities, *or accept different investment risks*, in order to pursue the ESG objectives” [emphasis added].<sup>27</sup>

As described above, however, ESG considerations are used in a variety of ways in fund portfolios. They can be pecuniary in nature or, in some cases, solely an incidental component of the fund’s investment strategy. When funds take ESG considerations into account, they are pursuing an investment strategy (much like a value, growth, tax-sensitive, or income fund). Because each strategy is different, each will perform differently and have different risks. If the ESG consideration is used to enhance the overall value of the investment, and the risk and return are appropriately balanced, then the fact that the investment risks are “different” should not be the focus of the analysis. While ESG considerations can serve a role in portfolio construction under modern portfolio management, fund managers are not prescient and cannot foresee how their investment strategies, including efforts to manage risk through the construction of a diverse portfolio that includes ESG considerations, will ultimately perform.

Singling out risk disclosures relating to ESG considerations sends a signal to plan fiduciaries that these funds (any fund that includes this risk in its prospectus) should not be considered, even if their construction is supported “under generally accepted investment theories.” We urge the Department to be more precise in its cautionary language. The mere disclosure of risk related to ESG considerations should not be disqualifying. Rather, the focus should be on risk disclosures that suggest the fund is sacrificing investment returns or assuming greater investment risks as a means of promoting collateral social policy goals. Such an approach would be consistent with the principles-based approach taken by the SEC to date with respect to ESG.<sup>28</sup>

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<sup>26</sup> Speaking on the topic of risk disclosure associated with ESG, SEC Chairman Clayton explains, “what is important is that investors have full and fair disclosure of the material facts about the investment strategy their fiduciary is following so that they are in a position to make informed investment choices.” See Jay Clayton, Chairman, SEC, Remarks to the SEC Investor Advisory Committee (December 13, 2018), available at <https://www.sec.gov/news/public-statement/clayton-remarks-investor-advisory-committee-meeting-121318>.

<sup>27</sup> 85 Fed. Reg. 39116.

<sup>28</sup> The SEC, recognizing that ESG is an evolving area, has avoided defining ESG. Chairman Jay Clayton has emphasized that the SEC does not regulate the merits of any particular investment strategy. See Jay Clayton, Chairman, SEC, Remarks to the SEC Investor Advisory Committee (December 13, 2018), available at <https://www.sec.gov/news/public-statement/clayton-remarks-investor-advisory-committee-meeting-121318>. In a March 2019 speech, Division of Corporation Finance Director William Hinman explained the staff view regarding the SEC’s principles-based and market-driven view to operating company disclosure of ESG-related information:



## **B. The Department Is Proposing a Solution to a Problem That Even It Is Unsure Exists and Ignoring the Adverse Consequences of Doing So.**

The Department admits that there is little evidence supporting the need for the Proposed Rule, but proposes to move forward regardless of this fact, in contravention of the Administration’s stated de-regulatory agenda and basic prerequisites of administrative rulemaking.

### **1. The Proposed Rule Is Not Supported by Evidence of a Problem.**

By its own admission, the Department does not have sufficient data to estimate the number of plan fiduciaries that are currently not following or misinterpreting the Department’s existing sub-regulatory guidance on ESG investment.<sup>29</sup> Indeed, the Department believes it is small. The Department is equally “unclear [about] how many plans use ESG and similar factors when selecting investments. . . [or] the total asset value of investments that were selected in [disregard of its sub-regulatory guidance]. . .,” but acknowledges this number to be small as well.<sup>30</sup>

The Department also is not clear whether survey information about ESG investing accurately represents the prevalence of investing that incorporates non-pecuniary factors.<sup>31</sup> Rather, the Department speculates that the growing emphasis on ESG investing and other non-pecuniary factors—particularly in Europe—“*may be*” prompting ERISA plan fiduciaries to make investment decisions for purposes distinct from their responsibility to provide benefits to participants and beneficiaries and defraying reasonable plan administration expenses.<sup>32</sup> The Department further speculates that some

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The marketplace evolution of sustainability disclosures is ongoing ... and allowing this evolution to continue should provide market participants with a continued opportunity to sort out the types of information they find useful. Had we leapt into action and issued prescriptive sustainability disclosure requirements when people first began calling for them, I believe we would have stymied that evolution and stifled efforts to develop useful disclosure frameworks. Substituting regulatory prescriptions for market-driven solutions, especially while those solutions are evolving, ... is something we need to manage with utmost care.

See William Hinman, Director, Division of Corporation Finance, SEC, Applying a Principles-Based Approach to Disclosing Complex, Uncertain and Evolving Risks: Remarks at the 18th Annual Institute on Securities Regulation in Europe (March 15, 2019), available at <https://www.sec.gov/news/speech/hinman-applying-principles-based-approach-disclosure-031519>.

<sup>29</sup> 85 Fed. Reg. 39120.

<sup>30</sup> *Id.* at 39122. The Department further acknowledges that “a small share of individual account plans offer at least one ESG-themed option among their investment alternatives” and that “about 0.01 percent of total DC plan assets are invested in ESG funds.” *Id.* at 39121.

<sup>31</sup> *Id.* at 39122-3.

<sup>32</sup> In making this assessment, the Department appears to be influenced by “trends in other countries,” citing to research on Europe, but even then it suggests that pressure for such expansion will only continue to increase moderately (it “believes that the use of non-pecuniary factors by ERISA plans is likely to increase moderately in the future without this rulemaking, and thus on a forward basis the benefits of the proposed rule will be appreciable”). *Id.* at 39123.

investment products “*may be*” marketed to ERISA fiduciaries on the basis of purported benefits and goals unrelated to financial performance.<sup>33</sup>

In attempting to substantiate its position that the Proposed Rule will result in benefits, the Department speculates that “if some portion of the increased returns would be associated with ESG investments generating lower pre-fee returns than non-ESG investments ... then the new returns qualify as benefits of the rule...”<sup>34</sup> Also, the Department speculates that as plans invest less in actively managed ESG mutual funds, they may instead select mutual funds with lower fees or passive index funds.

The Department seeks comments regarding its assumptions and additional information describing the prevalence of ESG investing or ESG investment options among ERISA plans. In fact, even a cursory review of the applicable data shows the fallacy of the Department’s assumptions.

- **First, relying on trends in other countries, particularly countries in Europe, is irrelevant to what to anticipate in the United States.** The Department’s assumption that ESG trends in the United States will follow those in Europe is flawed. Pension plan fiduciaries in Europe are subject to different legal requirements than in the United States, including a requirement to take ESG investment risks into account in governance and risk management,<sup>35</sup> and a forthcoming legal obligation to provide extensive disclosure about both ESG risks to investments and also sustainability impact of those investments.<sup>36</sup> In addition, there are meaningful cultural and social differences between most European countries and the United States, which limits the applicability of analogies to current trends there given the likely differences in both participant and plan sponsor viewpoints on investing and ESG issues. Given the differences in the US and European Union legal frameworks and obligations for retirement plan fiduciaries, as well as underlying social and cultural differences, the Department should not

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<sup>33</sup> *Id.* at 39120.

<sup>34</sup> *Id.* at 39121. The Department further explains that “[t]o the extent that ESG investing sacrifices return to achieve non-pecuniary goals, it reduces participant beneficiaries’ retirement investment returns, thereby compromising a central purpose of ERISA.” *Id.*

<sup>35</sup> See Directive (EU) 2016/2341 of the European Parliament and of the Council of 14 December 2016 on the activities and supervision of institutions for occupational retirement provision (IORPs), available at <https://eur-lex.europa.eu/eli/dir/2016/2341/oj>.

<sup>36</sup> See Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector, available at <https://eurlex.europa.eu/eli/reg/2019/2088/oj>. The EU pensions authority, EIOPA, has further recommended that national pension fund supervisors “should encourage” [workplace pension schemes] to take into account the potential long-term sustainability impact of investment decisions “in order to support society’s sustainability goals.” See Paragraph 3.18 of EIOPA Opinion of the management of environmental, social and governance risks faced by IORPs (10 July 2019), available at [https://www.eiopa.europa.eu/newsroom/speeches-presentations\\_en](https://www.eiopa.europa.eu/newsroom/speeches-presentations_en) (stating in the opinion that national supervisors “should encourage IORPs to take into account the potential long-term impact of investment decisions on ESG factors in order to support society’s sustainability goals.”)

assume that European pension trends around ESG investing are relevant to US ERISA plan fiduciaries' commitment to meeting their legal obligations to plan beneficiaries.

- **Second, the same surveys cited by the Department in support of the need for the Proposed Rule show that ESG investing by ERISA-covered plans in the United States is very small.** While ESG represents a growing trend, the number of 401(k) plans that offer a specifically ESG-designated offering remains very small. In plan year 2018, 2.9 percent of plans in the Plan Sponsor Council of America (PSCA) survey offered “ESG (Socially Responsible)” investment funds, and 0.1 percent of plan assets were invested in these funds.<sup>37</sup> In plan year 2019, 9 percent of DC plans in Vanguard’s recordkeeping system offered “socially responsible” funds; overall, 25 percent of participants were offered socially responsible funds; and among those offered, 4 percent were using them.<sup>38</sup>
- **Third, the range of fees for funds that invest according to ESG criteria is similar to funds industrywide.** The Department claims that “ESG funds often come with higher fees”<sup>39</sup> and suggests throughout the preamble that they may have higher risks and lower returns. The Department seems to assume that funds that pursue ESG strategies are willing to sacrifice return and the Proposed Rule appears based on the assumption that an “ESG fund” is by definition equal to or worse performing than a “non-ESG fund.” The evidence does not support this position.

Mutual funds that invest according to ESG criteria are predominantly actively managed equity mutual funds (Figure 1 in Exhibit A), and these funds’ fees compare favorably to funds industrywide.<sup>40</sup> Half of all actively managed equity mutual funds have expense ratios below 1.16 percent (median), while half of actively managed equity mutual funds that invest according to ESG criteria have expense ratios below 1.02 percent (Figure 2 in Exhibit A, top panel). Eighty percent of all actively managed equity mutual funds have expense ratios between 0.70 percent (10th percentile) and 2.00 percent (90th percentile), while 80 percent of all actively managed

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<sup>37</sup> See Plan Sponsor Council of America, *62nd Annual Survey of Profit Sharing and 401(k) Plans: Reflecting 2018 Plan Experience*, Arlington, VA: Plan Sponsor Council of America (2019).

<sup>38</sup> See Figures 64 and 73 in *How America Saves 2020*, Valley Forge, PA: The Vanguard Group, Vanguard Center for Retirement Research (2020), available at <https://institutional.vanguard.com/ngiam/assets/pdf/has/how-america-saves-report-2020.pdf>.

<sup>39</sup> The Department states: “Moreover, ESG funds often come with higher fees, because additional investigation and monitoring are necessary to assess an investment from an ESG perspective.” 85 Fed. Reg. 39115.

<sup>40</sup> Mutual fund expenses cover portfolio management, fund administration and compliance, shareholder services, recordkeeping, certain kinds of distribution charges (known as 12b-1 fees), and other operating costs. A fund’s expense ratio, which is shown in the fund’s prospectus and shareholder reports, is the fund’s total annual expenses expressed as a percentage of its net assets. It is possible to analyze the range of mutual fund fees across the entire market, or on an asset-weighted basis, which takes into account where fund assets are invested.

equity mutual funds that invest according to ESG criteria have expense ratios between 0.60 percent (10th percentile) and 1.94 percent (90th percentile). Whether investing in actively managed equity mutual funds in general, or actively managed equity mutual funds that invest according to ESG criteria more specifically, investors have concentrated their assets in lower-cost funds. In 2019, fund investors in actively managed equity mutual funds paid 0.74 percent on average, while fund investors in actively managed equity mutual funds that invest according to ESG criteria paid 0.79 percent (asset-weighted average).

A similar pattern emerges for actively managed bond mutual funds and bond mutual funds that invest according to ESG criteria. In this case, in 2019, fund investors in actively managed bond mutual funds paid 0.56 percent on average, while investors in bond mutual funds that invest according to ESG criteria paid 0.64 percent (asset-weighted average) (Figure 2 in Exhibit A, bottom panel). It should be noted that net assets in bond mutual funds that invest according to ESG criteria are more concentrated in world bond funds. World bond funds tend to cost more to manage because portfolio managers spend more time doing research, which increases the cost of managing the fund.

- **Finally, taken as a whole, empirical studies to date cannot be taken as supporting the Department’s suggestion that ESG funds tend to underperform.**<sup>41</sup> Recent analysis by Morningstar indicates that ESG funds’ returns occurred across the return distribution in 2019.<sup>42</sup> Earlier Morningstar analysis, completing a review of academic studies, concluded there was no performance penalty to ESG investing.<sup>43</sup> In addition, the International Monetary Fund (IMF) concludes: “There is no consistent evidence that sustainable funds regularly over- or under-perform.”<sup>44</sup>

## 2. The Proposed Rule Is Inconsistent with the Administration’s Deregulatory Agenda.

In one of the first acts of his presidency, on January 30, 2017, President Trump signed Executive Order 13771 —entitled “Reducing Regulation and Controlling Regulatory Costs” — directing agencies to

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<sup>41</sup> 85 Fed. Reg. 39121.

<sup>42</sup> Specifically, 35 percent of sustainable funds had returns in the top quartile of their respective investment categories, another 30 percent fell in the second-highest quartile, 21 percent were in the third quartile of returns, and the returns of 14 percent of sustainable funds placed in the bottom quartile. See Jon Hale, “US ESG Funds Outperformed Conventional Funds in 2019” (April 16, 2020), available at <https://www.morningstar.com/articles/973590/us-esg-funds-outperformed-conventional-funds-in-2019>.

<sup>43</sup> See Jon Hale, “Sustainable Investing Research Suggests No Performance Penalty” (November 10, 2016), available at <https://www.morningstar.com/articles/779758/sustainable-investing-research-suggests-no-performance-penalty>.

<sup>44</sup> See “Chapter 6: Sustainable Finance: Looking Farther” in *Global Financial Stability Report*, Washington, DC: International Monetary Fund (October 2019), available at <https://www.imf.org/en/Publications/GFSR/Issues/2019/10/01/global-financial-stability-report-october-2019#Chapter6>.

repeal two existing regulations for every new regulation, and to do so in such a way that the total cost of regulations does not increase.<sup>45</sup> Executive Order 13771 requires any executive department or agency that plans to publicly announce a new regulation to propose at least two regulations which will in turn be repealed. The cost of the implementation of these new regulations must be less than or equal to 0 dollars. If costs above 0 dollars are accrued, the payment of these costs shall be funded through the elimination of more regulations. The order states, “it is essential to manage the costs associated with the governmental imposition of private expenditures required to comply with Federal regulations.”

The practical effects of the Proposed Rule would clearly be inconsistent with the purpose behind Executive Order 13771. The Proposed Rule singles out a particular investment strategy—investments informed by ESG considerations—for special scrutiny and restrictions. Despite the Department’s assertions to the contrary, the unique and unprecedented conditions of the Proposed Rule would require a plan fiduciary to apply heightened fiduciary requirements to the use of an ESG-inclusive investment strategy. As described below, this sudden shift departs from more than 45 years of precedent dating from the adoption of ERISA and raises troubling implications for future administrations to use regulatory authority to eventually narrow the field to a “legal list” of investments and investment strategies for which heightened standards of care apply. The Proposed Rule will have a chilling effect on plan fiduciaries. When faced with the prospect of personal liability under ERISA, it is reasonable to expect that a fiduciary’s natural reaction would be to avoid pursuing an investment or investment strategy that the Department has singled out for enhanced scrutiny. Indeed, the Department acknowledges that the Proposed Rule will lead to decreased ESG investment and uses this to support its cost assessment of the Proposed Rule.<sup>46</sup> Clearly the implications of the Proposed Rule suggest that it is not deregulatory in scope.

### **3. The Proposed Rule Disregards Basic Administrative Rulemaking Prerequisites.**

In issuing the Proposed Rule, the Department disregards fundamental prerequisites of agency rulemaking required under the Administrative Procedure Act (APA),<sup>47</sup> by relying solely on unsubstantiated assumptions about plan fiduciary behavior regarding ESG investing and failing to reflect evidence that ESG considerations can be pecuniary in nature.<sup>48</sup>

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<sup>45</sup> The White House, Office of the Press Secretary (January 30, 2017), [Presidential Executive Order on Reducing Regulation and Controlling Regulatory Costs](#), 82 Fed. Reg. 9339, (February 3, 2017).

<sup>46</sup> 85 Fed. Reg. 39122.

<sup>47</sup> Public Law 79-404, 60 Stat. 237 (June 11, 1946).

<sup>48</sup> *Motor Veh. Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983) (“Normally, an agency rule would be arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise.”)

## **II. The Department’s Proposed Changes to the Investment Duties Regulation Singling Out One Investment Category for Special Scrutiny Are Inconsistent with Long-Standing Department Precedent and Will Have Far-Reaching Impact on the Selection of All Plan Investment Options—Going Well Beyond Just ESG Funds.**

### **A. The Proposed Rule Contradicts Congressional Intent and Decades of Precedent by Applying a Heightened Standard of Care to a Particular Investment Strategy.**

The Proposed Rule singles out a particular investment strategy—investments informed by some level of ESG considerations—for special scrutiny and restrictions. The unique and unprecedented conditions the Proposed Rule would require a plan fiduciary to apply heightened fiduciary requirements to the use of an ESG-driven investment strategy. This sudden shift departs from more than 45 years of precedent dating from the adoption of ERISA and raises troubling implications for future administrations to use regulatory authority to eventually narrow the field to a “legal list” of investments and investment strategies for which heightened standards of care apply.

#### **1. Until Now, the Same Fiduciary Standard Has Applied to Every Kind of Investment and Investment Strategy.**

Trusts were at one time limited to investment in certain statutorily-prescribed investments, known as a “legal list.” However, ERISA was adopted at a time of modernization in trust law, when it was recognized that investments could not be classified as prudent or imprudent “in the abstract” but rather based on the facts and circumstances.<sup>49</sup> ERISA’s statutory language, therefore, does not define whether any type of investment or investment strategy may be consistent with its fiduciary standard. Congress explained that it did not intend for ERISA to contain a legal list of investments.<sup>50</sup> When it originally issued the investment prudence regulation in 1979, the Department also recognized that ERISA did not create a legal list of permissible investments.<sup>51</sup>

The Department’s original investment prudence regulation reflects that no investment may be “per se prudent or per se imprudent. . .”<sup>52</sup> Accordingly, the Department has repeatedly stated over the years that the same fiduciary duties apply to each type of investment.<sup>53</sup> The Department has also rejected

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<sup>49</sup> Restatement (Third) of Trusts, § 90 cmt. e(1).

<sup>50</sup> S. Rep. No. 93-383, 1974 U.S.C.C.A.N. 4889, 4984 (Aug. 21, 1973).

<sup>51</sup> Preamble to ERISA Section 404 Regulation, 44 Fed. Reg. 37221, 37225 (June 26, 1979).

<sup>52</sup> *Id.*

<sup>53</sup> Testimony of Louis Campagna, Chief of the Division of Fiduciary Interpretations, Office of Regulations and Interpretations, Advisory Council on Employee Welfare and Pension Benefit Plans, Hedge Funds and Private Equity Investments (November 2011), at p. 27, available at <https://www.dol.gov/sites/dolgov/files/EBSA/about-cbsa/about-us/erisa-advisory-council/2011-hedge-funds-and-private-equity-investments.pdf>; DOL Information Letter to Eugene Ludwig (March 21, 1996); see also DOL Information Letter to Jon W. Breyfogle (June 3, 2020), applying ERISA

attempts to change ERISA to favor or disfavor particular investments and investment strategies. For example, the Department opposed the proposed 401(k) Fair Disclosure for Retirement Security Act of 2007, which would have required 401(k) plans to offer at least one index fund as an investment option. The Department expressed concern with proposals “that would mandate specific investment options — limiting the ability of employers and workers together to design plans that best serve their mutual needs.”<sup>54</sup> The Department has never suggested or taken the position before that heightened fiduciary requirements may apply to specific investments or investment strategies.<sup>55</sup>

## 2. The Proposed Rule Is Not a Mere Codification of the Department’s Prior Guidance.

The Department has previously addressed ESG investments in sub-regulatory guidance. But the Proposed Rule goes much further. In the prior guidance, the Department made clear that it was not requiring that ESG-themed investments meet a higher fiduciary standard than other types of investments or investment strategies. For instance, in Advisory Opinion 98-04, when addressing the selection of a “socially-responsible fund” in an individual account plan, the Department explained that, “[w]hether a particular fund or investment alternative satisfies [ERISA’s prudence] requirement[ ] . . . is an inherently factual question, and . . . [t]he appropriate plan fiduciaries must make this determination, based on all the facts and circumstances of the individual situation.”<sup>56</sup> As recently as 2015, the Department stated that it did not believe ESG investments “presumptively requir[e] additional documentation or evaluation beyond that required by fiduciary standards applicable to plan investments generally.”<sup>57</sup>

Similarly, while pecuniary factors are the *primary* factors to consider, it is not clear that they should be the *only* factors considered. The requirement to evaluate investments “based *solely* on pecuniary factors” does not align with current law. The Proposed Rule’s mandate that only “pecuniary” factors may be considered for ERISA plans when considering investment courses of action calls into question many important practices by fiduciaries today, such as giving consideration to participant preferences, making available plan investment in company stock, ensuring a diverse plan lineup—just to name a few of the many considerations involved in plan sponsorship.

We believe that the prior guidance thus conforms with a long line of Department efforts to address the application of ERISA’s fiduciary standard to different investments and investment strategies.<sup>58</sup> For example, the Department recently issued an information letter addressing a fiduciary’s responsibility

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Sections 403-04 to plan investments in private equity funds, available at <https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/information-letters/06-03-2020>.

<sup>54</sup> DOL Testimony to the Committee on Ways and Means, U.S. House of Representatives (October 30, 2007).

<sup>55</sup> See text accompanying notes 58 to 59 and note 70.

<sup>56</sup> DOL Advisory Opinion 98-04A (May 28, 1998).

<sup>57</sup> Preamble to Interpretive Bulletin 2015-01, 80 Fed. Reg. 65135, 65136 (October 26, 2015).

<sup>58</sup> See, e.g., DOL Adv. Op. 2006-08 (Oct. 3, 2006); DOL Information Letter to Eugene Ludwig (March 21, 1996).

when considering allocating a portion of a managed asset allocation fund to private equity investments.<sup>59</sup> The information letter describes that a fiduciary must consider specific risks and benefits attendant to private equity but does not create enhanced diligence or documentation requirements. The Proposed Rule is distinct from the information letter and the Department's prior ESG guidance in that it applies specific diligence and documentation requirements to ESG investments, as outlined above.

While we support the Department's recent private equity information letter, the Department's act of prohibiting the inclusion of ESG investment strategies mere weeks after confirming that default investment vehicles may invest in the private equity asset class would create a legal list of permitted investments that may be used to populate qualified default investment alternatives.

### **3. The Proposed Rule Could Open the Door to More Investments Being Singled Out for Special Scrutiny.**

The Proposed Rule's creation of heightened fiduciary requirements for a particular investment strategy could lead to more stringent restrictions on other investments and investment strategies the Department may disfavor in the future.

When faced with the prospect of personal liability under ERISA, a fiduciary's natural reaction would be to avoid pursuing an investment or investment strategy that the Department has singled out for enhanced scrutiny. The Department recognizes, for instance, that the Proposed Rule will lead to decreased ESG investment.<sup>60</sup> Combined with initiatives to single out other types of investments and investment strategies that the Department may pursue, the Proposed Rule could therefore lead to the creation of a legal list, by negative implication, of investments that do not require fulfillment of additional diligence and documentation requirements. Many, if not most, ERISA plan participants will not have access to the investments and investment strategies that the Department has singled out, regardless of their potential merit. But Congress did not intend for ERISA to contain a legal list of permissible or impermissible investments, but instead left investment decisions to fiduciaries who must act prudently and in the best interests of participants. Moreover, a requirement that suggests fiduciaries somehow have an even more heightened standard of care with respect to specific investments and investment strategies contradicts the Department's guidance over the past 45 or more years.<sup>61</sup> We caution the Department against taking a step in this troubling direction.

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<sup>59</sup> See DOL Information Letter to Jon W. Breyfogle (June 3, 2020), available at <https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/information-letters/06-03-2020>.

<sup>60</sup> 85 Fed. Reg. 39122.

<sup>61</sup> See text accompanying notes 58 through 59 and note 70.



**B. The Proposed Rule’s Generally Applicable Requirement to Compare Investments Will Have Far-Reaching Consequences.**

In addition to including a new paragraph (c) to the Department’s regulation at 29 CFR 2550.404a-1 containing the heightened fiduciary requirements applicable to ESG investments described above, the Proposed Rule would amend paragraph (b) of the regulation. Paragraph (b) describes that a fiduciary’s responsibilities with respect to investment decisions are met if, among other things, the fiduciary has given “appropriate consideration to those facts and circumstances that . . . are relevant to the particular investment or investment course of action involved . . . .” The regulation further defines “appropriate consideration” to include consideration of specified factors, and the Proposed Regulation would add a new factor: “[h]ow the investment or investment course of action compares to available alternative investments or investment courses of action. . . .”<sup>62</sup> In the absence of clarification, this new requirement would seemingly apply to every investment decision made by an ERISA fiduciary, regardless of whether ESG investments are being considered.

**1. The Requirement to Compare Investments Is Unnecessary and Could Cause Needless Confusion.**

It is clear that the purpose of the Proposed Rule is to address ERISA plan investments informed by ESG considerations.<sup>63</sup> However, the Proposed Rule’s requirement to compare investments would apply to fiduciaries who have never and will never consider ESG investments. The only reason the Department provides for including the new requirement is that it would provide an “important reminder that fiduciaries must not let non-pecuniary considerations draw them away from an alternative option that would provide better financial results.”<sup>64</sup>

We do not believe that every investment decision must involve a comparison of different alternatives. There are many instances where a prudent, deliberative process will include consideration of some different investment courses of action or some culled universe of alternatives before making a decision. However, fiduciaries must only use a reasonably prudent process to do so. They do not have, and should not, have to perform an exhaustive comparison of every combination and permutation of investment courses of action or investment selections. Moreover, we believe the Department would agree that a fiduciary who has never incorporated ESG considerations into its investment decision-making should not be required to compare this approach with the alternative “investment course of action” of incorporating ESG considerations. Whether it is appropriate to consider different alternatives, as well as the depth and rigor of that consideration, should be based on the facts and circumstances of the decision under review in accordance with the standards under Sections 403 and 404 of ERISA.

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<sup>62</sup> Proposed Rule § (b)(2)(ii)(D).

<sup>63</sup> 85 Fed. Reg. 39114–16.

<sup>64</sup> *Id.* at 39117.

The requirement always to compare investments would lead to unnecessary confusion and would warrant detailed guidance from the Department. It is virtually impossible to catalog an exhaustive list of guidance to fit every reasonable pattern of facts and circumstances. Nonetheless, we will point out areas where guidance would be required just to provide some perspective. The first question fiduciaries would need to answer would be the minimum number of comparators that would need to be used to establish prudence. The requirement to identify appropriate comparators is also ambiguous. For example, when a fiduciary is considering the addition of an index fund, would the “alternative investments or investment courses of action” for purposes of comparison be (1) the same type of index funds offered by different investment managers, (2) funds that invest in a different index, or (3) funds that do not adhere to an index (i.e., actively managed funds)? Once the comparators are identified, what must be compared? How must that be compared? How must it be documented? How and when must the comparison be monitored? The requirement to compare investments would also apply to fiduciaries that carry out an investment strategy identified by other fiduciaries. For example, an investment manager engaged to invest a pool of assets pursuant to an index strategy may be concerned that it needs to consider whether each security included in the index should be purchased for the plan account, or on the other hand whether an “alternative investment” should be used to populate the portfolio, one-by-one. These deliberations are not only implausible, but they would add unneeded costs that plan participants would ultimately bear and would not promote the Department’s goal of increasing the scrutiny applied to non-pecuniary factors. Moreover, because of the Proposed Rule’s focus on ESG investments, we do not believe the Department has provided adequate notice to fiduciaries who do not consider ESG investments that the Proposed Rule contains requirements that are applicable to them.

Finally, the Department’s regulatory impact analysis, which assumes the Proposed Regulation only “would affect certain ERISA-covered plans whose fiduciaries consider non-pecuniary factors when selecting investments and the participants in those plans,” does not adequately account for the fact that the requirement to compare investments appears on its fact to be generally applicable.<sup>65</sup> In order to satisfy its responsibility to assess the costs and benefits of the Proposed Rule, the Department would need to calculate the costs arising from a requirement to compare investments whenever making an investment decision. In making these calculations, the Department would need to include each ERISA-covered plan with an investment component, not only those plans that include ESG investments. We strongly believe that an accurate cost-benefit analysis would not support these proposed changes.

## **2. The Department Should Clarify Which Aspects of the Proposed Rule Are Considered a Safe Harbor.**

When the Department originally issued the investment prudence regulation at 29 CFR 2550.404a-1, it made clear that the regulation was a safe harbor:

It should also be noted that the Department does not view compliance with the provisions of the regulation as necessarily constituting the exclusive method for satisfying the requirements of

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<sup>65</sup> *Id.* at 39120.

the “prudence” rule. Rather, the regulation is in the nature of a “safe harbor” provision; it is the opinion of the Department that fiduciaries who comply with the provisions of the regulation will have satisfied the requirements of the “prudence” rule, but no opinion is expressed in the regulation as to the status of activities undertaken or performed that do not so comply.<sup>66</sup>

It appears that the Department does not intend for the specific requirements applicable to ESG investments included in paragraph (c) of the Proposed Rule to constitute a safe harbor, but the preamble to the Proposed Rule does not address whether any aspect of the Proposed Rule may be considered a safe harbor. We respectfully request the Department clarify that paragraph (b) continues to be a safe harbor and not the exclusive means for satisfying a fiduciary’s duty of prudence in connection with investments. If—despite the clear need to withdraw the Proposed Rule—the Department’s intent is to transform paragraph (b) from a safe harbor into an affirmative requirement, then we believe that the Department must provide specific notice of this fact and solicit comments from the public while also assessing the costs and benefits of the change.

### **III. The Proposed Rule Would Actually Harm Those It Is Intended to Protect and Must Be Withdrawn.**

The Proposed Rule ignores the role of ESG considerations in modern portfolio management and will serve only to harm retirement plans and their participants and beneficiaries. Further, the Proposed Rule is unnecessary given the Department’s own findings that plan fiduciaries appear to be following its sub-regulatory guidance. The new requirements imposed by the rule are unnecessarily burdensome and unworkable.

The broad categorization used in the Proposed Rule could be read to implicate an extremely broad swath of funds, beyond those that market themselves as funds that invest according to ESG criteria. As explained above, many funds integrate some level of ESG analysis to help them better assess risk and return of investments or as part of the fund’s disclosed investment policy. Eliminating (or restricting) these products from the plan marketplace would work to the disadvantage of plan investors due to a massive reduction of potential investment products available to them.

By singling out all investments that incorporate ESG considerations for extra scrutiny, the Department not only shows a bias against ESG, but also seems to demonstrate more broadly an inappropriate bias against both active management<sup>67</sup> and qualitative approaches. The Proposed Rule disregards the

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<sup>66</sup> 44 Fed. Reg. 37221, 37222 (June 26, 1979).

<sup>67</sup> In the regulatory impact analysis, the Department notes, as a benefit of the Proposed Rule, that “as plans invest less in actively managed ESG mutual funds, they may instead select mutual funds with lower fees or passive index funds.” 85 Fed. Reg. 39121. Such a statement ignores the differences between actively managed investments and index funds as well as their differing benefits and fails to consider whether a participant would necessarily benefit from the substitution of passively managed funds for active ones no matter the circumstances. Plan fiduciaries can prudently determine that including actively managed funds as investment options is consistent with the purposes, terms, investment strategy, and risk/return objectives of the plan and its participants.

nuances of constructing an investment lineup that serves the best interests of a broad array of plan participants. Rather than safeguarding the interests of plan participants, the Proposed Rule could have the unintended result of compromising the ability of asset managers and plan fiduciaries to act in their best interests.

Not only would the Proposed Rule shrink the universe of investment options available to participants, but in the transition to implement the Proposed Rule, participants could incur significant transition costs in exiting strategies. Managers will be forced to buy and sell certain securities to meet the new requirements which will result in trading costs and possible challenges with best execution obligations.

For these reasons, we urge the Department to withdraw the Proposed Rule.

If the Department continues to believe that rulemaking is necessary, it must issue a request for information (RFI), providing a generous comment period for the retirement community to develop a fulsome response, so that it can better inform itself before regulating in this area. An RFI broadly issued on plan investments would allow the Department to better understand how investment management has evolved over the last 40 years. Gathering information in this way prior to proceeding to rulemaking would help ensure that any future amendments: are actually needed; can be supported by a cost-benefit analysis; will not unnecessarily increase costs and burdens on fiduciaries for the selection of any plan investment; will not result in significant limitations on the investment choices of plan participants; will not increase risk of litigation against plans; and are based on a better understanding of the current state of modern investment theory/modern portfolio management.

If the Department opts to overlook the foregoing concerns and move forward with this rulemaking, its reference to ESG considerations to which the guidance is intended to apply must be limited to circumstances where non-pecuniary factors form the investment strategy of the investment. The Department should apply a principles-based rule (similar in spirit to the Department's recent letter on private equity investment)—not special requirements for ESG investments.<sup>68</sup> Significantly, the Department's own sub-regulatory guidance regarding ESG investments is also a good example of a principles-based application of ERISA to a category of investment—the most recent being the current administration's issuance of Field Assistance Bulletin (FAB) 2018-01.<sup>69</sup> Unlike the Proposed Rule, the FAB does not impose special fiduciary requirements for ESG considerations. Rather, it emphasizes,

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<sup>68</sup> As described above, the recent guidance regarding the use of private equity investment within DC plans does not create enhanced diligence or documentation requirements. Rather, the letter provides a framework of relevant factors for plan fiduciaries to consider if they choose to explore private equity as a component of a larger diversified, managed fund. See DOL Information Letter to Jon W. Breyfogle (June 3, 2020), available at <https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/information-letters/06-03-2020>.

<sup>69</sup> Field Assistance Bulletin No. 2018-01, issued April 23, 2018, available at <https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2018-01>.

importantly, that plan fiduciaries may not sacrifice investment returns or assume greater investment risks as a means of promoting collateral social policy goals.<sup>70</sup>

Additionally, the Department must remove the unnecessary generally applicable requirement to compare investments and clarify whether the changes form part of a safe harbor. As discussed in detail above,<sup>71</sup> a requirement to always compare investments would lead to unnecessary confusion and would necessitate detailed guidance from the Department. Such a requirement would also be superfluous in many circumstances—leading to unnecessary plan costs. As discussed above,<sup>72</sup> if the Department’s intent is to transform paragraph (b) of the investment prudence regulation from a safe harbor into an affirmative requirement, then we believe that the Department must provide specific notice of this fact and solicit comments from the public while also assessing the costs and benefits of the change.

If the Department moves forward with this rulemaking as proposed, it should include a generous transition period and grandfathering provisions. Plan fiduciaries who have complied with their fiduciary investment duties under ERISA in selecting the plan’s investment options could be concerned that they have not met the new heightened requirements under the Proposed Rule. For plans that, under this new standard, decide that a change to the plan lineup is needed, time is needed for the investment fiduciary to review the funds and make a determination, bring the issue to the board (or other deciding entity), make operational changes, and provide required notice to plan participants (governance, operations, compliance). These are not insignificant transactions, in particular if funds are liquidated and transferred. A grandfathering provision, allowing participants to remain invested in their current investment selections, would be warranted and would help to avoid negative outcomes.

Finally, we encourage the Department to include a more robust analysis of the costs and burdens that the Proposed Rule would impose. Satisfying the new conditions in the Proposed Rule would require well beyond the two hours the Department estimates,<sup>73</sup> and fiduciaries would need to review all plan investments, not only any ESG-themed investment options. The Proposed Rule, as drafted, would likely result in increased litigation against plan fiduciaries regarding their investment selection, due to

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<sup>70</sup> Similarly, in 2013, the Department issued a publication providing basic information on target date funds (TDFs) as well as guidance for fiduciaries in selecting TDFs as plan investment options. See “Target Date Retirement Funds - Tips for ERISA Plan Fiduciaries,” issued in February 2013, available at <https://www.dol.gov/sites/dolgov/files/EBSA/about-ebsa/our-activities/resource-center/fact-sheets/target-date-retirement-funds.pdf>. As the use of TDFs grew after the Department’s issuance of its QDIA regulation, the Department considered whether additional rules specific to TDFs were needed. Rather, than issue a regulation on TDFs, the Department ultimately issued this publication to educate plan fiduciaries on the types of information they should consider when selecting such funds. Because the Department did not issue prescriptive rules that lock in a precise definition of TDFs, TDFs have continued to evolve, improve and flourish to the point they are at today.

<sup>71</sup> See text accompanying notes 63 through 65 above.

<sup>72</sup> See text accompanying note 66.

<sup>73</sup> 85 Fed. Reg. 39125.

the addition of the new requirement to compare investments against available alternative investments.<sup>74</sup> There could also be costs in the form of lost contributions, because certain populations may contribute less if ESG options become unavailable. Plan fiduciaries are in the best position to assess the demand for and appropriateness of such products in their plan.

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Thank you for the opportunity to provide comments on this matter. The Institute is available to provide additional information and clarification regarding these issues and would welcome the opportunity to meet with the Department to discuss our comments. Please do not hesitate to contact the undersigned at 202-326-5901 or [paul.stevens@ici.org](mailto:paul.stevens@ici.org); David Abbey, Deputy General Counsel—Retirement Policy, at 202-326-5920 or [david.abbey@ici.org](mailto:david.abbey@ici.org); or Shannon Salinas, Assistant General Counsel—Retirement Policy, at 202-326-5809 or [shannon.salinas@ici.org](mailto:shannon.salinas@ici.org).

Sincerely,

A handwritten signature in black ink that reads "Paul Schott Stevens". The signature is written in a cursive style with a large initial "P" and a long horizontal stroke at the end.

Paul Schott Stevens  
President & CEO  
Investment Company Institute

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<sup>74</sup> Section (b)(2)(ii)(D). We note that the Department repeatedly mentions litigation risk, claiming that the new documentation requirement “is a best practice and a potential shield from litigation risk.” 85 Fed. Reg. 39122. However, the litigation risk added by the new provision appears to outweigh any benefit to requiring this documentation.

**I. Mutual Funds That Invest According to ESG Criteria Are Primarily Actively Managed Equity Funds**

***A. Environmental, Social, and Governance Investing***

ICI seeks to categorize funds as objectively as possible by applying predetermined rules and definitions to the prospectus language of mutual funds, ETFs, and closed-end funds, with a special focus on the “Investment Objective” and “Principal Investment Strategies” sections. For example, staff in ICI’s Research Department use prospectus language to determine in which of four broad categories to place a fund: equity, bond, hybrid, or money market. Funds are then placed in subcategories—for example, classifying equity funds as large-, mid-, or small-cap; or bond funds as investment grade or high-yield. To keep fund classifications up-to-date, ICI monitors funds’ prospectuses for material revisions. This approach produces fund classifications that are consistent and relatively stable, which is very helpful when monitoring current and historical trends in fund data.

ICI’s approach to classifying funds can be applied in a straightforward manner to all types of funds that invest according to ESG criteria. ICI Research staff reviewed the prospectuses for a vast number of mutual funds and ETFs, examining the investment objective and principal investment strategies sections for language indicating that a fund places an important and explicit emphasis on environmental, social, or governance criteria to achieve certain goals.<sup>1</sup>

***B. Investment Objectives of Mutual Funds That Invest According to ESG Criteria***

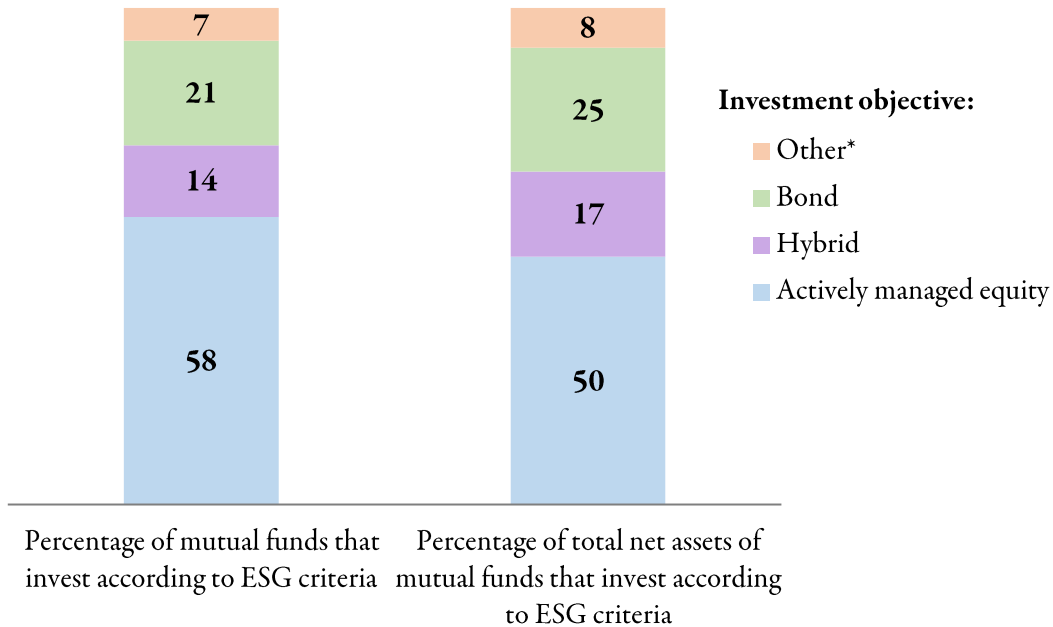
At year-end 2019, ICI finds that 423 mutual funds with \$301 billion in assets invested according to ESG criteria. Mutual funds that invest according to ESG criteria may invest in securities that follow environmental, social, and/or governance criteria, or some subset of them. Fifty-eight percent of these mutual funds holding 50 percent of these mutual funds’ assets were actively managed equity mutual funds, another 21 percent of these funds holding 25 percent of the assets were bond mutual funds, and 14 percent of these funds holding 17 percent of the assets were hybrid mutual funds (Figure 1).

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<sup>1</sup> For a discussion of mutual funds and ETFs that invest according to ESG criteria at year-end 2019, see chapter 2 in the *2020 Investment Company Fact Book*, available at <https://www.icifactbook.org/>.

**Figure 1**  
**Mutual Funds That Invest According to ESG Criteria Tend to Be Actively Managed Equity Funds**

Percentage of funds and total net assets, year-end 2019



\*Other includes index equity mutual funds and money market funds.  
Source: Investment Company Institute

**II. Range of Fund Fees for Mutual Funds That Invest According to ESG Criteria Is Similar to Funds Industrywide**

**A. Mutual fund fees**

Mutual fund expenses cover portfolio management, fund administration and compliance, shareholder services, recordkeeping, certain kinds of distribution charges (known as 12b-1 fees), and other operating costs. A fund's expense ratio, which is shown in the fund's prospectus and shareholder reports, is the fund's total annual expenses expressed as a percentage of its net assets.<sup>2</sup> It is possible to analyze the range of mutual fund fees across the entire market, or on an asset-weighted basis, which takes into account where fund assets are invested.

Mutual funds that invest according to ESG criteria are predominantly actively managed equity mutual funds (Figure 1), and these funds' fees compare favorably to industrywide. In 2019, half of all actively

<sup>2</sup> For a full analysis of fund expenses and fees, see James Duvall, "Trends in the Expenses and Fees of Funds, 2019," *ICI Research Perspective* 26, no. 1 (March 2020); available at <https://www.ici.org/pdf/per26-01.pdf>.



managed equity mutual funds have expense ratios below 1.16 percent (median), while half of actively managed equity mutual funds that invest according to ESG criteria have expense ratios below 1.02 percent (Figure 2, top panel). Eighty percent of all actively managed equity mutual funds have expense ratios between 0.70 percent (10<sup>th</sup> percentile) and 2.00 percent (90<sup>th</sup> percentile), while 80 percent of all actively managed equity mutual funds that invest according to ESG criteria have expense ratios between 0.60 percent (10<sup>th</sup> percentile) and 1.94 percent (90<sup>th</sup> percentile). Whether investing in actively managed equity mutual funds in general, or actively managed equity mutual funds that invest according to ESG criteria more specifically, investors have concentrated their assets in lower-cost funds. In 2019, fund investors in actively managed equity mutual funds paid 0.74 percent on average, while fund investors in actively managed equity mutual funds that invest according to ESG criteria paid 0.79 percent (asset-weighted average).

A similar pattern emerges for actively managed bond mutual funds and bond mutual funds that invest according to ESG criteria. In this case, in 2019, fund investors in actively managed bond mutual funds paid 0.56 percent on average, while investors in bond mutual funds that invest according to ESG criteria paid 0.64 percent (asset-weighted average) (Figure 2, lower panel).<sup>3</sup> It should be noted that net assets in bond mutual funds that invest according to ESG criteria are more concentrated in world bond funds. World bond funds tend to cost more to manage because portfolio managers spend more time doing research, which increases the cost of managing the fund.

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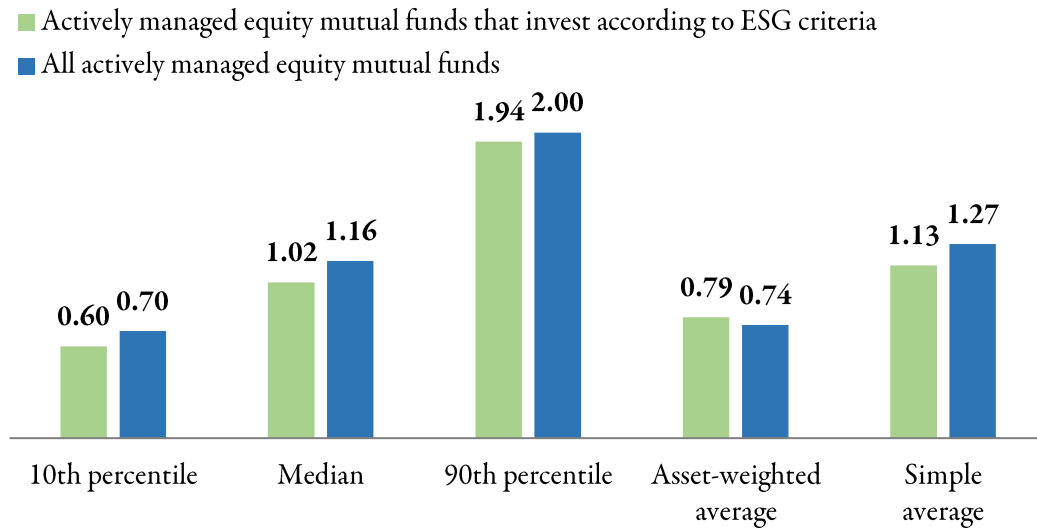
<sup>3</sup> Bond mutual funds that invest according to ESG criteria are essentially all actively managed bond mutual funds. The small number of index bond funds that invest according to ESG criteria prevents ICI from analyzing actively managed bond funds that invest according to ESG criteria and index bond mutual funds that invest according to ESG criteria separately.

**Figure 2**

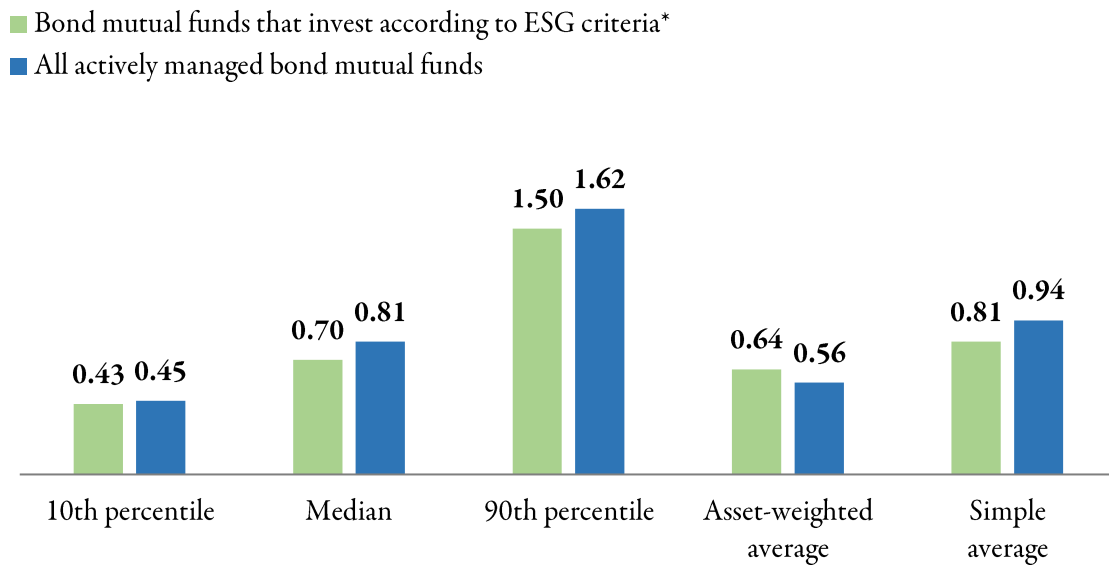
**Range of Fund Fees for Mutual Funds That Invest According to ESG Criteria Is Similar to Mutual Funds Generally**

Percent, 2019

*Actively managed equity mutual funds*



*Actively managed bond mutual funds*



\*Bond mutual funds that invest according to ESG criteria are essentially all actively managed bond mutual funds.

Sources: Investment Company Institute and Morningstar