Bernard S. Sharfman
Senior Corporate Governance Fellow

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

Submitted By: Bernard S. Sharfman[*]

Ladies and Gentlemen,

The Department of Labor ("DOL"), through its administration of ERISA,[1] has a critical role to play in the regulation of "employee pension benefit plans."[2] Most importantly, the DOL is tasked with enforcing the fiduciary duties of ERISA plan managers (trustees who retain investment and voting authority or "investment managers"[3] that receive such authority through delegation by the trustees). Under ERISA, plan managers owe the strictest duties of loyalty and care to their participants[4] and beneficiaries.[5] They are to be constantly guided by the fiduciary principles of "*solely* in the interest of the participants and beneficiaries" and for the *exclusive purpose* of providing financial benefits to them.

Given this understanding of fiduciary duty under ERISA, it is easy for me to strongly support the approach taken by the DOL in its recently proposed rule, *Financial Factors in Selecting Plan Investments*.[6] I agree with the DOL when it states that "ERISA requires plan fiduciaries to select investments and investment courses of action based *solely* on financial considerations relevant to the *risk-adjusted economic value* [**risk-adjusted financial return**][7] of a particular investment or

[*] Bernard S. Sharfman is a Senior Corporate Governance Fellow at the RealClearFoundation. The opinions expressed here are the author's alone and do not represent the official position of RealClearFoundation or any other organization with which he is currently affiliated.
[1] Pub. L. No. 93-406, 88 Stat. 829; Title 1 of the Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1001 *et seq.*
[2] *See id.* § 1002(2) ("The terms 'employee pension benefit plan' and 'pension plan' mean any plan, fund, or program which was heretofore or is hereafter established or maintained by an employer or by an employee organization, or by both, to the extent that by its express terms or as a result of surrounding circumstances such plan, fund, or program—(i) provides retirement income to employees, or (ii) results in a deferral of income by employees for periods extending to the termination of covered employment or beyond").
[3] *See* ERISA § 1002(8).
[4] *See id.* § 1002(7) ("The term 'participant' means any employee or former employee of an employer, or any member or former member of an employee organization, who is or may become eligible to receive a benefit of any type from an employee benefit plan which covers employees of such employer or members of such organization, or whose beneficiaries may be eligible to receive any such benefit").
[5] *See id.* § 1002(8) ("The term 'beneficiary' means a person designated by a participant, or by the terms of an employee benefit plan, who is or may become entitled to a benefit thereunder").
[6] 85 Fed. Reg. 39113 (June 30, 2020).
[7] **Please note:** I suggest replacing "risk-adjusted economic value" with "risk-adjusted financial return." The latter is more precise; the former, a term that appears to be rarely used in finance, suggests the possibility that under ERISA, nonfinancial or third-party benefits may be recognized as part of the value generated by a particular investment.

investment course of action,"[8] "plan assets may not be enlisted in pursuit of other social or environmental objectives,"[9] and "ERISA plan fiduciaries may not invest in ESG [Environmental, Social, and Governance] vehicles when they understand an underlying investment strategy of the vehicle is to subordinate return or increase risk for the purpose of *non-pecuniary objectives*."[10] I also find the proposed rule to be consistent with federal court cases that have subsequently interpreted ERISA.

This comment letter is divided into four Parts. Each Part provides different observations and recommendations that I believe will enhance the proposed rule.

Part I focuses on the specific legal issue that is addressed in the proposed rule. I believe that an understanding of this legal issue would be enhanced if the proposed rule were to adopt the Max Schanzenbach and Robert Sitkoff approach of dividing ESG investing into two types: "collateral benefits ESG" and "risk-return ESG."[11] Collateral benefits ESG is investing based on nonfinancial objectives, including moral or ethical reasons, or to benefit a third party (non-beneficiary or non-participant in a pension fund), such as one or more stakeholders in a public company. Risk-return ESG is investing by utilizing ESG factors only as a means to enhance the manager's evaluation of the risk-adjusted returns of an investment without regard to collateral benefits.

Because collateral benefits ESG comes into direct conflict with the fiduciary duties of a plan manager, it creates an issue that requires DOL scrutiny. On the other hand, because risk-return ESG focuses only on using ESG factors as a means of optimizing the financial analysis of an investment, it does not conflict with the fiduciary duties of the plan manager. Therefore, I agree with the DOL that risk-return ESG does not create a legal issue that needs to be addressed.

Part II focuses on identifying collateral benefits ESG. Even though Part I defines collateral benefits ESG, it still may not be easily recognizable when presented to a plan manager as an investment option. If the DOL does not want plan managers to unknowingly violate their fiduciary duties, the proposed rule should provide guidance on how to recognize collateral benefits ESG. For example, if "portfolio screening" is used in an investment approach or in an investment fund such as a mutual fund or an Exchange Traded Fund ("ETF"), then you most likely have collateral benefits ESG. Portfolio screening is defined in this comment letter as *a process by which a plan manager reduces its universe of eligible investments based on non-pecuniary factors*. Another indicator is that the investment approach or fund yields lower risk-adjusted returns relative to an appropriate benchmark.

Moreover, if screening criteria based on non-pecuniary factors are used in the creation of an index, this should create a presumption that those investment funds that use such an index are collateral benefits ESG. For example, by screening out newly issued dual-class shares, investment funds that track some of the most familiar benchmark indexes, such as the S&P 500 index, are now collateral benefits ESG and therefore no longer eligible to be included in an ERISA plan's investment portfolio. Of course, this also means that an investment fund that uses such indexes can no longer serve as a "qualified default investment alternative" ("QDIA") under the proposed rule. This result is probably a surprise to the DOL, plan managers, participants, and beneficiaries. But it is true.

Part III focuses on the fiduciary duties of plan managers under ERISA. This Part argues that *collateral benefits ESG, in whatever form, is not compatible with ERISA*. Second, the combination of the *sole purpose rule* and the *common investor purpose* puts significant limits on how a plan manager can operate under ERISA. The only alternative for a plan manager that wants to be in compliance with

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[8] 85 Fed. Reg. 39113, 39113.
[9] *Id.* at 39116.
[10] *Id*.
[11] Max M. Schanzenbach & Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*, 72 STAN. L. REV. 381 (2020).

its fiduciary duties is to have the sole focus of pursuing *the highest risk-adjusted return possible* for its participants and beneficiaries. If the pursuit of this maximization does not occur, the plan manager must be in breach of its fiduciary duties.

Part IV will discuss the DOL's current plan of continuing with its "all things being equal" test or "tie-breaker" standard. This guidance, which essentially creates a safe harbor for collateral benefits ESG to enter the investment portfolio of an ERISA plan, should not be allowed to continue. Even if its occurrence were rare, the tiebreaker is a violation of ERISA because it introduces a non-pecuniary objective into a plan manager's investment decision-making process. As will be discussed, it should be clear that the combination of the *sole purpose rule* and the *common investor purpose* does not allow for non-pecuniary objectives to be considered in a plan manager's investment decision making, even in a tiebreaker situation.

Alternatively, if the DOL decides to continue with the "tie-breaker" standard, it must do more than just acknowledge that the "test could invite fiduciaries to find ties without a proper analysis, in order to justify the use of non-pecuniary factors in making an investment decision."[12] My recommendation is to start with the assumption that plan managers will try "to find ties without a proper analysis, in order to justify the use of non-pecuniary factors in making an investment decision."[13] This simply reflects the reality that when there is money to be made, opportunistic behavior will follow.

If this assumption is accepted, the DOL must determine what procedures and documentation are required to minimize this opportunistic behavior. In sum, if the DOL does not take up-front steps to minimize opportunistic behavior, the DOL should not be surprised to be confronted with numerous claims that economically indistinguishable investments exist.

This comment letter has at its foundation two recent law review articles: *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*, by Max Schanzenbach and Robert Sitkoff;[14] and *Now Is the Time to Designate Proxy Advisors as Fiduciaries under ERISA*, by Bernard Sharfman.[15] The latter owes much to the former in its approach to fiduciary duties under ERISA.

I. Defining ESG Investing and the Issue at Hand

The proposed rule tackles the issue of whether some or all ESG investing violates the fiduciary duties of plan managers. To begin to address this issue and to add specificity, it is important to define what is meant by ESG investing, both in general terms and in the context of ERISA. Unfortunately, that is not easily done. ESG investing has, at its roots, the practice of avoiding investment in firms that make antisocial products[16]—for example, screening out from an investment portfolio securities that are involved in the production and distribution of tobacco, guns, and alcohol. This can be referred to as "ethical-factor investing."[17] Albert Feuer defines this term as "using ethics as a factor to determine whether to acquire, dispose of, or how to exercise ownership rights in an equity or debt interest in a business enterprise."[18]

However, as SEC Commissioner Hester Peirce has observed, ESG investing has evolved to target a multitude of non-pecuniary objectives:

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[12] 85 Fed. Reg. 39113, 39117.
[13] *Id*.
[14] Schanzenbach & Sitkoff, *supra* note 11.
[15] Bernard S. Sharfman, *Now Is the Time to Designate Proxy Advisors as Fiduciaries under ERISA*, 25 STAN. J.L. BUS. & FIN. 1 (2020).
[16] Schanzenbach & Sitkoff, *supra* note 11, at 6.
[17] Albert Feuer, *Ethics, ESG, and ERISA: Ethical-Factor Investing of Savings and Retirement Benefits*, TAX MGT. COMP. PLANNING J. 212, 212 (2019).
[18] *Id*.

> E, S, and G tend to travel in a pack these days, which makes it hard to establish reliable metrics for affixing scarlet letters. Governance [G] at least offers some concrete markers, such as whether there are different share classes with different voting rights, the ease of proxy access, or whether the CEO and Chairman of the Board roles are held by two people. Even with these examples, however, people do not agree on which way they cut, and they may not cut the same way at every company. In comparison to governance, the environmental and social categories tend to be much more nebulous. The environmental category [E] can include, for example, water usage, carbon footprint, emissions, what industry the company is in, and the quantity of packing materials the company uses. The social category [S] can include how well a company treats its workers, what a company's diversity policy looks like, its customer privacy practices, whether there is community opposition to any of its operations, and whether the company sells guns or tobacco. Not only is it difficult to define what should be included in ESG, but, once you do, it is difficult to figure out how to measure success or failure.[19]

A. ESG and Stakeholders

The benefiting of stakeholders seems to be the current concern of ESG investing. As stated by Peirce, "ESG stands for 'environmental, social, governance,' but the 'S' in ESG could just as well stand for 'stakeholder.' "[20]

The stakeholders in a public company "represent an enormous number of entities and individuals, including shareholders, directors, managers, employees, independent contractors, consultants, consumers, creditors, vendors, distributors, communities affected by the company's operations, federal, state, and local governments, and society in general, when it is positively affected by the social value created by the company or negatively affected when the company generates third-party costs such as air or water pollution. The management of these relationships is complex and is usually placed in the hands of those who have the knowledge and expertise to manage them: the company's management team, up and down the line."[21]

In its broadest sense, stakeholders include all those who transact with the company internally and externally and all third parties who do not necessarily transact with the company but are both positively and negatively affected by its activities. For example, think about the stakeholders covered by ESG in the context of the environmental category—that is, all those who are affected by the environmental policies of a company may be stakeholders. Of course, this may mean most people in this world, if not everyone.

Arguably, this broader understanding of ESG investing being consistent with a stakeholder model is what Larry Fink, CEO of BlackRock, was discussing in his 2018 Letter to CEOs:

> We also see many governments failing to prepare for the future, on issues ranging from retirement and infrastructure to automation and worker retraining. As a result, society increasingly is turning to the private sector and asking that companies respond to broader

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[19] Hester M. Peirce, *Scarlet Letters: Remarks before the American Enterprise Institute*, SEC. & EXCHANGE COMMISSION (June 18, 2019), https://www.sec.gov/news/speech/speech-peirce-061819.

[20] Hester M. Peirce, *My Beef with Stakeholders: Remarks at the 17th Annual SEC Conference, Center for Corporate Reporting and Governance*, SEC. & EXCHANGE COMMISSION (Sept. 21, 2018), https://www.sec.gov/news/speech/speech-peirce-092118.

[21] Bernard S. Sharfman, *Why BlackRock's Stakeholder Approach Won't Work*, RealClearMarkets (May 18, 2020), https://www.realclearmarkets.com/articles/2020/05/18/why_blackrocks_stakeholder_approach_wont_work_491618.html. For a good explanation of why management needs to be in charge of stakeholder relationships, *see* Emily Winston, *Managerial Fixation and the Limitations of Shareholder Oversight*, 71 HASTINGS L.J. 699, 699 (2020) ("[W]hile corporate attention to non-shareholder stakeholders can improve firm value, shareholder oversight of these stakeholder relationships will not succeed in having this effect").

> societal challenges. Indeed, the public expectations of your company have never been greater. Society is demanding that companies, both public and private, *serve a social purpose*. To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. *Companies must benefit all of their stakeholders*, including shareholders, employees, customers, and the communities in which they operate.[22]

B. The Issue: Collateral Benefits ESG

Schanzenbach and Sitkoff refer to this type of ESG investing, "investing for moral or ethical reasons or to benefit a third party [non-participant or non-beneficiary]," by pension fund trustees, including ERISA plans managers, as "collateral benefits ESG."[23] However, consistent with the proposed rule, I would include *all* nonfinancial objectives, not just investing for moral or ethical reasons or for the benefit of third parties, within the definition of collateral benefits ESG. For example, focusing on the "G" in ESG, some ESG funds may exclude companies with dual-class shares, such as Alphabet, Facebook, Zoom, Snap, Nike, and Comcast, from their investment portfolios. Having such stocks in their portfolios, no matter how financially beneficial, may offend some investors who are strong advocates of shareholder democracy/empowerment.[24]

As discussed in Part II, collateral benefits ESG, at its worst, results in excluding those investments that would be expected to help maximize the risk-adjusted returns of an ERISA investment portfolio. At its best, it would underweight certain investments that may help maximize risk-adjusted returns. Because collateral benefits ESG necessarily means that other interests, besides the financial interests of beneficiaries and participants, are being considered in the investment decision-making process, I agree with the DOL that this creates a legal issue that must be addressed.

C. Nonissue: Risk-Return ESG

Schanzenbach and Sitkoff also identified a second type of ESG investing that is intended to improve the risk-adjusted returns of an investment portfolio. They call this "risk-return ESG."[25] In this type of ESG investing, ESG factors are to be incorporated into the investment analysis of a plan manager if those factors are purely used to enhance the manager's evaluation of the risk and/or return of the investment without regard to collateral benefits or the plan manager's own preferences—for example, the financial markets not properly taking into consideration the risk of a nuclear reactor meltdown when

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[22] Larry Fink, *Larry Fink's 2018 Letter to CEOs: A Sense of Purpose*, BLACKROCK, https://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter.
[23] Schanzenbach & Sitkoff, *supra* note 11, at 389–90.
[24] Shareholder democracy and empowerment are two intertwined concepts. Shareholder democracy was a term coined in the 1940s that "carried the normative message that greater shareholder participation in corporate governance was both possible and desirable." Harwell Wells, *A Long View of Shareholder Power: From the Antebellum Corporation to the Twenty-First Century*, 67 FLA. L. REV. 1033, 1069 (2015). It is currently associated with the idea of "one share, one vote." *See* Usha Rodrigues, *The Seductive Comparison of Shareholder and Civic Democracy*, 63 WASH. & LEE L. REV. 1389, 1390 (2006). Shareholder empowerment is essentially the leveraging of shareholder democracy by certain institutional investors. How this concept is to be understood in practice has been powerfully articulated by Delaware Supreme Court Chief Justice Leo Strine:

> [T]here is only one set of agents who must be constrained—corporate managers—and the world will be made a better place when corporations become direct democracies subject to immediate influence on many levels from a stockholder majority comprised not of those whose money is ultimately at stake, but of the money manager agents who wield the end-users' money to buy and sell stocks for their benefit.

Leo E. Strine, Jr., *Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law*, 114 COLUM. L. REV. 449, 451 (2014).
[25] Schanzenbach & Sitkoff, *supra* note 11, at 390.

pricing the securities of a power company that is dependent on nuclear power.[26] In sum, the purpose of utilizing ESG factors in the context of risk-return ESG is "to take into account . . . financially material risks and opportunities that arise out of environmental, social and governance information; it is not about achieving particular environmental, social or governance goals."[27]

This type of evaluation will take into consideration the additional costs involved in utilizing ESG factors in the financial analysis. These costs include the additional research required to reasonably conclude that the market is not being efficient in properly reflecting ESG factors in the price of a company's stock or debt securities.[28] This may result in an ERISA plan's underweight or overweight position in these securities and therefore a lack of diversification. This is another cost—taking on additional risk above market risk (unsystematic risk)—that must be taken into consideration when using ESG factors. Such costs will require higher financial returns as compensation.[29]

Because risk-return ESG focuses only on using ESG factors as a means of optimizing the financial analysis of an investment, I agree with the DOL that this type of ESG investing does not create a legal issue that needs to be addressed in the proposed rule. Nevertheless, the DOL should be on the lookout for collateral benefits ESG being misrepresented as risk-return ESG.

II. Identifying Collateral Benefits ESG

Even though Part I provides a definition of collateral benefits ESG, it still may not be easily recognizable when presented to a plan manager as an investment option. If the DOL does not want plan managers to unknowingly violate their fiduciary duties, the proposed rule should provide guidance on how to recognize collateral benefits ESG. For example, if "portfolio screening" is used in an investment approach or in an investment fund such as a mutual fund or an ETF, you most likely have collateral benefits ESG. Portfolio screening is defined as *a process by which a plan manager reduces its universe of eligible investments based on non-pecuniary factors*. Portfolio screening may not be the only way to identify collateral benefits ESG, but it is probably the primary way. As discussed below, portfolio screening leads to the potential exclusion or underweighting of those big winners necessary to earn portfolio returns over Treasuries and increases the potential for unsystematic risk entering the portfolio. Another indicator is that the investment approach or fund yields lower risk-adjusted returns relative to an appropriate benchmark.

A. Portfolio Screening

In general, all investment approaches and investment funds that utilize portfolio screening should be classified as collateral benefits ESG. For an example of portfolio screening, consider the selection criteria utilized in the MSCI KLD 400 Social Index, the index used by BlackRock's iShares MSCI KLD 400 Social ETF, an ESG ETF with approximately $2 billion in assets as of July 7, 2020:[30]

> The MSCI KLD 400 Social Index is maintained in two stages. First, securities of companies involved in Nuclear Power, Tobacco, Alcohol, Gambling, Military Weapons, Civilian Firearms, GMOs and Adult Entertainment are excluded. Then additions are made from the list of eligible companies based on considerations of ESG performance, sector alignment and size

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[26] *Id.* at 438.
[27] Randy Bauslaugh & Hendrik Garz, *Pension Fund Investment: Managing Environmental, Social and Governance (ESG) Factor Integration*, McCarthy Tétrault (May 1, 2019), https://www.mccarthy.ca/en/insights/articles/pension-fund-investment-managing-environmental-social-and-governance-esg-factor-integration.
[28] Schanzenbach & Sitkoff, *supra* note 11, at 437 ("Any active investment program, whether based on ESG factors or otherwise, can improve risk-adjusted returns only if those factors are not already reflected by market prices").
[29] *Id.* at 428.
[30] BlackRock, iShares MSCI KLD 400 Social ETF (July 7, 2020), https://www.ishares.com/us/products/239667/ishares-msci-kld-400-social-etf.

> representation. The MSCI KLD 400 Social Index is designed to maintain similar sector weights as the MSCI USA Index and targets a minimum of 200 large and mid-cap constituents. Companies that are not existing constituents of The MSCI KLD 400 Social Index must have an MSCI ESG Rating above "BB" and the MSCI ESG Controversies Score greater than 2 to be eligible. At each quarterly Index Review, constituents are deleted if they are deleted from the MSCI USA IMI Index, fail the exclusion screens, or if their ESG ratings or scores fall below minimum standards. Additions are made to restore the number of constituents to 400. All eligible securities of each issuer are included in the index, so the index may have more than 400 securities. The selection universe for the MSCI KLD 400 Social Index are large, mid and small cap companies in the MSCI USA IMI Index.[31]

Investment funds that use this index will have significantly reduced investment opportunities in two primary ways. First, there is an up-front screen to exclude a large number of investments based on moral and ethical reasons. Second, another round of exclusions is based on an investment not having a minimum ESG rating or score. However, additions are made from the list of eligible companies based on considerations of ESG performance, sector alignment and size representation. All qualified securities are included in the index. Even so, the result is a relatively small portfolio of roughly 400 stocks out of a universe of 2,344 stocks that make up the MSCI USA IMI Index.[32]

Some might argue that adding companies based on positive ESG attributes (inclusionary screen) needs to be distinguished from excluding investments based on moral and ethical grounds (exclusionary screen): "[A] key difference between ESG and its predecessor, 'socially conscious investing,' is that socially conscious managers implicitly admitted that their strategies might reduce their returns, while ESG investors do not. Socially conscious investors used *negative* screens to eliminate stocks that violated their *beliefs*. In contrast, ESG investors seek *positive* attributes, which they claim will make their companies better investments."[33] I disagree. It is simply another type of portfolio screening—but this time, the screen is based on the requirement of having certain positive ESG attributes. If investments don't have them, they are *excluded* from or underweighted in the portfolio.

B. Lower Risk-Adjusted Returns

The use of portfolio screening will necessarily produce lower risk-adjusted returns relative to a well-constructed benchmark index. Fund disclosures such as the following tell us why: "The CREF Social Choice Account returned 13.88 percent for the year [2017] compared with the 14.34 percent return of its composite benchmark…. Because of its ESG criteria, the Account *did not invest in a number of stocks and bonds*…. [T]he net effect was that the Account underperformed its benchmark."[34] Or, as observed by Mitch Goldberg, one reason that BlackRock's iShares MSCI USA ESG Select Social Index Fund, another large ESG ETF, has significantly trailed the S&P 500 Index over a recent ten-year period is that the fund did not invest in the stock of Amazon.[35]

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[31] MSCI, *MSCI KLD 400 Social Index (USD)* (June 30, 2020), https://www.msci.com/documents/10199/904492e6-527e-4d64-9904-c710bf1533c6. This index has as its foundation the MSCI USA Investable Market Index.

[32] The MSCI USA Investable Market Index is "designed to measure the performance of the large, mid and small cap segments of the US market. With 2,344 constituents, the index covers approximately 99% of the free float-adjusted market capitalization in the US." *See* MSCI, *MSCI USA IMI (USD)* (June 30, 2020), https://www.msci.com/documents/10199/3c4c8412-5d81-4aa9-a9c8-4490f9f5e04a.

[33] John Rekenthaler, *The Department of Labor Attempts to Throttle ESG Investing*, Morningstar (July 2, 2020), https://www.morningstar.com/articles/990580/the-department-of-labor-attempts-to-throttle-esg-investing.

[34] Bradford Cornell & Aswath Damodaran, *Valuing ESG: Doing Good or Sounding Good?* (Mar. 20, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3557432 citing TIAA-CREF Annual Report, 2017, p. 34.

[35] Mitch Goldberg, *ESG Index Funds Are Hot: That May Be a Risky Thing for Investors*, cnbc.com (Nov. 17, 2019), https://www.cnbc.com/2019/11/17/esg-index-funds-are-hot-that-may-be-a-risky-thing-for-investors.html.

The problem should be apparent. Screening techniques based on non-pecuniary factors lead to an increased probability that the big winners in the stock market will be excluded from or underweighted in an investment portfolio.

Why it is critical to have as many big winners as possible in an investment fund's portfolio is explained by Hendrik Bessembinder in his recent pathbreaking article *Do Stocks Outperform Treasury Bills?*[36] Professor Bessembinder observed that there is a significant amount of positive skewness in the returns of individual public companies (common stock) that have made up the stock market from July 1926 to December 2016. He found that "in terms of lifetime dollar wealth creation" ("accumulated December 2016 value in *excess of* the outcome that would have been obtained if the invested capital had earned one-month Treasury bill returns"),[37] "the best-performing 4% of listed companies explain the net gain for the entire US stock market since 1926, as other stocks collectively matched Treasury bills."[38] His results also showed that the sum of the individual contributions to lifetime dollar wealth creation provided by the top 50 companies represented almost 40 percent of total lifetime dollar wealth creation.[39] Thus, the returns earned by a relatively small number of best-performing companies were critical to the stock market earning returns above short-term Treasuries.

The understanding that positive skewness exists in stock market returns means that investors are best served if those select few firms that are *expected* to be the best performers are given the maximum opportunity to show up in an investment fund's portfolio. If investment funds want to maximize risk-adjusted returns, weeding out investments based on non-pecuniary factors is not the way to accomplish this objective. It is simply an additional constraint on the ability to maximize. As stated by prominent finance professors Bradford Cornell and Aswath Damodaran, "[A] constrained optimum can, at best, match an unconstrained one, and most of the time, the constraint will create a cost."[40]

Another reason that portfolio screening may result in lower risk-adjusted returns relates to the *unsystematic risk* that it can create. The use of portfolio screening may result in the overweighting of certain industries. As Vincent Deluard observed, ESG funds are currently overweighted in the health-care and technology industries, the two best-performing sectors in the first part of 2020.[41] As pointed out by Goldberg, "there are two likely reasons why a fund could outperform its benchmark. Either by overweighting the outperforming sector, or by lowering the expense ratio. In the case of the recent strong run for some ESG funds, it looks like the answer is an overweight to the technology sector."[42]

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[36] *See* Hendrik Bessembinder, *Do Stocks Outperform Treasury Bills?* 129 J. FIN. ECON. 440, 440–41 (2018).
[37] *Id.* at 454 tbl.5.
[38] *Id.* at 440.
[39] *Id.* at 454 tbl.5.
[40] Cornell & Damodaran, *supra* note 34.
[41] Vincent Deluard, *ESG Investors Are Winning Their Unintended War on People*, StoneX Group Inc. (client memo; May 2020), https://www-test.intlfcstone.com/globalassets/featured-insights/v_deluard_0520_06302020.pdf. While outside the scope of this article, Deluard makes a very insightful observation about the unintended consequences of ESG investing:

> [T]he single most salient characteristics of these [ESG] funds is that they favor machines and intangible assets over humans. The average company in the ESG basket has 20% fewer employees than the median Russell 3,000 company. This tilt explains their success in a year which has rewarded biotech firms and tech platforms and punished employee-heavy sectors, such as airlines, retailers, and cruise lines. Companies with no employees do not have strikes or labor disputes. There is no gender pay gap when production is completed by robots and algorithms. Financial networks have no carbon footprint.
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> Despite its noble goal, ESG investing unintendedly spreads the greatest illnesses of post-industrial economies: winner-take-all capitalism, monopolistic concentration, and the disappearance of jobs for normal people. *Id.*

[42] Goldberg, *supra* note 35.

The result of this recent overweighting in the health-care and technology industries has led some advocates of ESG investing to claim that such investing leads to superior financial performance. However, this is not correct. As stated by James Mackintosh:

> Even where an ESG index did beat the market, it had little to do with environmental, social or governance issues. Instead, it came down to luck; did they happen to pick the stocks that best rode out coronavirus lockdowns? It is better to be lucky than right; but having, as some did, less exposure to cruise liners or long-haul airlines because of their carbon footprint was luck, not a well-thought-out way to avoid the stocks hurt most by Covid-19. There are several reasons why Microsoft tends to score well on ESG, but its cloud services being in demand because everyone is working from home isn't among them.[43]

Overweighting in certain sectors can certainly be a good thing, as the short-term performance of ESG funds demonstrates. Of course, depending on the luck of the draw, the opposite is always possible. That is, overweighting can result in poor financial performance. But the most important thing to understand is that overweighting, and its *resulting lack of portfolio diversification*, adds extra unsystematic risk to the ex-ante risk-adjusted return calculation. This extra risk cannot be ignored when an ESG fund is being evaluated for its risk-adjusted return.

C. Why Investment Funds Using the S&P 500 Index Are Now Collateral Benefits ESG

If screening techniques are used in the creation of an index, this should create a presumption that those investment funds that use such an index are collateral benefits ESG. For example, by screening out newly issued dual-class shares, investment funds that track some of the most familiar benchmark indexes, such as the S&P 500 Index, are now collateral benefits ESG and therefore no longer eligible to be included in an ERISA plan's investment portfolio. Of course, this also means that an investment fund that uses such indexes can no longer serve as a QDIA under the proposed rule. This result is probably a surprise to the DOL, plan managers, participants, and beneficiaries. But it is true.

The story of this result begins in 2017, when two leading index providers, S&P Dow Jones Indices and FTSE Russell, succumbed to pressure from the institutional investors that make up the shareholder empowerment movement and implemented changes to their indexes that limited the presence of dual-class shares. As I have previously observed, "the more public companies that utilize a dual-class share structure, the more controlled companies exist and the less power the movement has."[44] Therefore, a primary ESG objective of the shareholder empowerment movement, with a direct bulls-eye on the "G," is to get rid of all publicly traded dual-class shares. Focusing on index exclusion was one way the movement thought it could achieve its objective.

As a result, the FTSE Russell now bars companies from inclusion in its benchmark indexes unless more than 5 percent of the voting rights are in the hands of public shareholders. The S&P Dow Jones Indices went even further, excluding all *new* dual-class share offerings from the S&P Composite 1500 and its components, the S&P 500, S&P MidCap 400, and S&P SmallCap 600. This means that dual-class shares issued by dual-class share companies such as Snap, Lyft, Pinterest, and Zoom, among many other possible big winners, are no longer eligible to be included in these indexes.

These limitations on the inclusion of dual-class shares make no financial sense and are simply harmful to investors. In the past, the big stock market winners have been overrepresented by dual-class share companies such as Alphabet, Berkshire Hathaway, Facebook, Comcast, and Nike. This was

[43] James Mackintosh, "ESG Investing in the Pandemic Shows Power of Luck," *Wall Street Journal*, https://www-wsj-com.cdn.ampproject.org/c/s/www.wsj.com/amp/articles/esg-investing-in-the-pandemic-shows-power-of-luck-11594810802 (July 15, 2020).
[44] Bernard Sharfman, *Dual-Class Shares and the Shareholder Empowerment Movement,* R STREET INST. BLOG (June 12, 2017), https://www.rstreet.org/2017/06/12/dual-class-shares-and-the-shareholder-empowerment-movement.

confirmed in an MSCI research report that found "that unequal voting stocks in aggregate outperformed the market over the period from November 2007 to August 2017, and that excluding them from market indexes would have reduced the indexes' total returns by approximately 30 basis points per year over our sample period."[45] This should be no surprise. When a company is allowed by stock market participants to launch its IPO with a dual-class share structure, it is a signal to the market that the company is expected to be one of those best performers. These are companies that should be included in, not excluded from, an investment portfolio.

If the S&P Dow Jones Indices and FTSE Russell continue to maintain indexes that screen out certain dual-class shares, it should be expected that the funds that utilize these indexes will, over time, yield returns that move toward Treasuries and away from the stock market as a whole. Most important for purposes of this comment letter, the funds that utilize these indexes must now be considered collateral benefits ESG. Moreover, based on the proposed rule, they cannot serve as QDIAs.

III. An ERISA Plan Manager's Fiduciary Duties and Collateral Benefits ESG

ERISA Section 3(21)(A) provides that a "person is a fiduciary with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets."[46] Fiduciaries include trustees[47] who retain management control over plan assets and investment managers[48] who are commonly delegated such authority by the trustees. These fiduciaries must go about their work under the guidance of very strict fiduciary duties of loyalty and care.[49] These duties are very similar to what is found under the common law of trusts.[50] As described below, consistent with what is found in the proposed rule, collateral benefits ESG is incompatible with these duties.

A. Duty of Loyalty (Solely in the Interest of Participants and Beneficiaries)

Under ERISA's duty of loyalty, a plan fiduciary shall discharge his duties with respect to a plan "'*solely* in the interest of the participants and beneficiaries' and for the '*exclusive* purpose' of benefitting them."[51] This *sole interest rule* is a codification of what is found in the common law of trusts.[52] It creates a very specific and narrow path for an ERISA plan manager when considering an investment strategy or providing mutual fund or ETF selections for self-directed individual accounts.

According to Schanzenbach and Sitkoff, "the trustee [ERISA plan manager] has a duty to the beneficiaries [and participants] not to be influenced by the interest of any third person or by motives other than the accomplishment of the purposes of the trust [ERISA plan]."[53] Moreover, a "trustee [ERISA plan manager] who is influenced by his own or a third party's interests is disloyal, because the trustee [ERISA plan manager] is no longer acting *solely* in the interest of the beneficiaries."[54] *Therefore, collateral benefits ESG is in breach of the sole interest rule if it is intentionally targeted to benefiting, in any degree, the interests of stakeholders or any other third party, including the interests of the plan manager.*

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[45] Dimitris Melas, *Putting the Spotlight on Spotify: Why Have Stocks with Unequal Voting Rights Outperformed?*, MSCI (Apr. 3, 2018), https://www.msci.com/www/blog-posts/putting-the-spotlight-on/0898078592.
[46] 29 U.S.C. § 1002(21)(A).
[47] *See id.* § 1105(c)(3).
[48] *See id.* § 1102(c)(3).
[49] Cent. States, Southeast & Southwest Areas Pension Fund v. Cent. Transp., Inc., 472 U.S. 559, 570–71 (1985).
[50] Tibble v. Edison International, 135 S. Ct. 1823, 1828 (2015) ("We have often noted that an ERISA fiduciary's duty is derived from the common law of trusts. In determining the contours of an ERISA fiduciary's duty, courts often must look to the law of trusts").
[51] *See* 29 U.S.C. § 1104(a)(1)(A)(i).
[52] Schanzenbach & Sitkoff, *supra* note 11, at 403.
[53] *Id.* (citing Restatement (Third) of Trusts § 78(1) cmt. f. (Am. Law Inst. 2007)).
[54] *Id.*

Regarding the latter, it must be recognized that an investment adviser that has been delegated the role of plan manager may be tempted, if allowed, to satisfy its own financial interests when it takes on an investment strategy or offers a selection of funds to self-directed individual accounts that utilize collateral benefits ESG. For example, mutual funds and ETFs that track the MSCI's KLD 400 Social Index[55] will typically charge significantly higher fees than funds and ETFs that track the more standardized and broadly based CRSP U.S. Total Market Index[56] or Fidelity U.S. Total Investable Market Index.[57] Therefore, the offering of ESG funds may be significantly more profitable for the investment adviser than lower-cost funds that use standardized indexes.

Or, as argued by Michal Barzuza, Quinn Curtis, and David Webber, an investment manager's strategy of increasing the offerings of ESG products may be motivated by a desire to attract the investment funds held by millennials and, at least while they are young, their perceived preference for less financial returns and more social activism.[58] Millennials will increasingly be the ones holding most of the wealth in the U.S., making it essential for investment advisers to start catering to their needs and developing their loyalty now, not later. [59]

In sum, it is not unreasonable to argue that the use of a collateral benefits ESG approach to investing, or an offering of a selection of funds to self-directed individual accounts that utilize collateral benefits ESG, if allowed, would create at least a presumption that the ERISA plan manager is not acting *solely* in the interests of these parties. That is, it is a presumption that the ERISA plan manager is breaching its duty of loyalty.

B. Duty of Loyalty (Pursuit of Financial Benefits)

What the *sole interest rule* does not forbid is collateral benefits ESG for the purpose of achieving nonfinancial benefits that do not involve third parties—for example, excluding investments that participants and beneficiaries may find objectionable on moral or ethical grounds, such as excluding those investments involving alcohol, guns, or tobacco. However, even if the beneficiaries and participants approve of such an investment approach, such an approach is also forbidden by ERISA. Based on the U.S. Supreme Court's interpretation of the statutory language, "providing benefits to participants and their beneficiaries," a fiduciary's duty of loyalty requires an exclusive focus on the pursuit of *financial benefits*:

> "providing benefits to participants and their beneficiaries" while "defraying reasonable expenses of administering the plan." Read in the context of ERISA as a whole, the term "benefits" in the provision just quoted must be understood to refer to the sort of *financial* benefits (such as retirement income) that trustees who manage investments typically seek to secure for the trust's beneficiaries.[60]

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[55] BlackRock's iShares MSCI KLD 400 Social ETF, Fact Sheet (03.31.20) (identifying an expense ratio of 0.25%), https://www.ishares.com/us/literature/fact-sheet/dsi-ishares-msci-kld-400-social-etf-fund-fact-sheet-en-us.pdf.
[56] Vanguard Total Stock Market ETF (identifying an expense ratio of 0.03%), https://investor.vanguard.com/etf/profile/fees/vti.
[57] Fidelity's ZERO℠ Total Market Index Fund, Fact Sheet (07.03.20) (identifying an expense ratio of 0.00%), https://fundresearch.fidelity.com/mutual-funds/fundfactsheet/31635T708.
[58] Michal Barzuza, Quinn Curtis, and David Webber, *Shareholder Value(s): Index Fund Activism and the New Millennial Corporate Governance* (forthcoming, 93 SO. CAL. L. REV.), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3439516.
[59] *Id.*
[60] Fifth Third Bancorp v. Dudenhoeffer, 573 U.S. 409, 420-21 (2014).

Moreover, "[t]he term does not cover nonpecuniary benefits."[61] Therefore, ERISA's fiduciary duties incorporate a mandatory *common investor purpose*,[62] the pursuit of *financial* benefits for the plan beneficiaries, that does not allow for the pursuit of nonfinancial or nonmonetary benefits even if participants and beneficiaries approve.

C. Duty of Loyalty (Summary)

Two important implications can be drawn from an ERISA plan manager's fiduciary duty of loyalty. First, the common investor purpose completes the range of collateral benefits ESG that a plan manager must not participate in to include all possible non-wealth-maximizing objectives, including moral or ethical investing. In sum, *collateral benefits ESG, in whatever form, is not compatible with ERISA*. This means that even if the ERISA plan documents stated that other objectives could or must be pursued, such as cleaning up the environment, raising labor wages, excluding investments that involve alcohol, guns, or tobacco, etc., making the workplace safer, providing better medical benefits for employees, or solving the numerous political problems that exist around the world, no matter how worthy, this would conflict with ERISA's fiduciary duties and would be void as a matter of public policy.[63]

Second, the combination of the *sole purpose rule* and the *common investor purpose* puts significant limits on how a plan manager can operate under ERISA. The only alternative for a plan manager that wants to be in compliance with its fiduciary duties is to have the sole focus of pursuing *the highest risk-adjusted return possible* for its participants and beneficiaries. If the pursuit of this maximization does not occur, the plan manager must be in breach of its fiduciary duties—for example, if the plan manager uses portfolio screening.

IV. The Proposed "Tie-breaker" Standard or "All Things Being Equal" Test

The DOL has stated its intention of continuing with its "all things being equal" test or "tie-breaker" standard. That is, the DOL expects to keep in place its historical guidance of allowing a non-pecuniary objective to be used as a tiebreaker when comparing two investment funds that have "the same target risk return profile or benchmark, the same fee structure, the same performance history, same investment strategy, but a different underlying asset composition;"[64] this means more than two investments simply having identical risk-adjusted returns. As the proposed rule goes on to say, "Even then, moreover, those two alternatives would remain two different investments that may function differently in the overall context of the fund portfolio, and which going forward may perform differently based on external economic trends and developments."[65] Such expectations of identical investment parameters, cash flows, and financial interaction with a plan portfolio is the reason that the DOL believes that true ties will rarely occur.[66] However, because it does not have sufficient evidence to say that such ties will never occur, it believes that it must continue with this guidance.[67]

A. Do Not Allow the Guidance to Continue

This guidance, which essentially creates a safe harbor for collateral benefits ESG to enter the investment portfolio of an ERISA plan, should not be allowed to continue. Even if it were to occur only on rare occasions, the tiebreaker is a violation of ERISA because it brings into a plan manager's

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[61] *Id.* at 421.
[62] This term is used in Sean J. Griffith's new article, *Opt-In Stewardship: Toward an Optimal Delegation of Mutual Fund Voting Authority*, 98 TEX. L. REV. 983 (2020).
[63] *See* Fifth Third Bancorp, 573 U.S. at 421 ("With irrelevant exceptions, 'any provision in an agreement or instrument which purports to relieve a fiduciary from responsibility . . . for any . . . duty under this part shall be void as against public policy' " (citing 29 U.S.C. § 1110(a)).
[64] 85 Fed. Reg. 39113, 39117.
[65] *Id.*
[66] *Id.*
[67] *Id.*

investment decision-making process the use of a non-pecuniary objective. As already discussed, it should be clear that the combination of the *sole purpose rule* and the *common investor purpose* does not allow for non-pecuniary objectives to be considered in a plan manager's investment decision, even in a tiebreaker situation.

It should be noted that the survival of this guidance over the decades is truly surprising. As the DOL stated in a 2008 Interpretive Bulletin, "ERISA's plain text does not permit fiduciaries to make investment decisions on the basis of any factor other than the economic interest of the plan."[68] As stated by Schanzenbach and Sitkoff, "the tiebreaker is irreconcilable with the strict 'sole interest' or 'exclusive benefit' rule."[69] Edward Zelinsky stated that the DOL's position "replaces ERISA's strong statutory standard of loyalty ('solely' and 'exclusive') with a weaker rule of nonsubordination."[70] If this weren't clear enough, Zelinsky states that DOL's position "flouts ERISA's statutory text."[71] Why has the DOL continued to allow ERISA plan managers to go beyond the plain and unambiguous language of the law? In sum, any use of non-pecuniary objectives in the investment decision-making process is beyond the scope of what ERISA provides and is a nonambiguous breach of a plan manager's fiduciary duties.

B. If the "Tie-Breaker" Standard Is Allowed to Continue

Alternatively, if the DOL decides to continue with the tiebreaker standard, it must do more than just acknowledge that the "test could invite fiduciaries to find ties without a proper analysis, in order to justify the use of non-pecuniary factors in making an investment decision."[72] As stated by Zelinsky when critiquing Interpretative Bulletin 2015-01, this type of guidance "implicitly propounds a naive theory of decisionmaking."[73] It assumes that plan managers utilize a two-step process in their investment approach.[74] First, it scours the universe of investment opportunities for those investments that can maximize the plan portfolio's risk-adjusted returns.[75] Then, when it runs across two viable investments with "economically indistinguishable" properties, it will have the option of breaking the tie by evaluating the alternatives based on non-pecuniary factors (objectives).[76]

My recommendation is to start with the assumption that plan managers will try "to find ties without a proper analysis, in order to justify the use of non-pecuniary factors in making an investment decision."[77] This simply reflects the reality that when there is money to be made, opportunistic behavior will follow. As stated by prominent finance professors Bradford Cornell and Aswath Damodaran:

> In many circles ESG is being marketed as not only good for society, but good for companies and for investors. In our view, however, the hype regarding ESG has vastly outrun the reality of both what it is and what it can deliver. The potential to make money on ESG for consultants, bankers and investment managers has made them cheerleaders for the concept, with claims of the payoffs based on research that is ambiguous and inconclusive, if not outright inconsistent with some of the claims.[78]

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[68] Interpretive Bulletin Relating to Investing in Economically Targeted Investments, 73 Fed. Reg. 61,734, 61,735 (Oct. 17, 2008).
[69] Schanzenbach and Sitkoff, *supra* note 11, at 408.
[70] Edward A. Zelinsky, *The Continuing Battle over Economically Targeted Investments: An Analysis of the Department of Labor's Interpretive Bulletin 2015-01*, 2016 CARDOZO L. REV.: DE NOVO 197, 202 (2016).
[71] *Id.*
[72] 85 Fed. Reg. 39113, 39117.
[73] Zelinsky, *supra* note 70, at 203.
[74] *Id.*
[75] *Id.*
[76] *Id.*
[77] 85 Fed. Reg. 39113, 39117.
[78] Cornell and Damodaran, *supra* note 34.

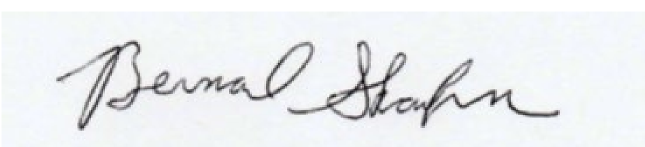
If my recommendation is accepted, the DOL must determine what procedures and documentation are required to minimize the potential for opportunistic behavior. At the very least, plan managers will need to document how they went about implementing the two-step approach as described above. In sum, if the DOL does not take up-front steps to minimize opportunistic behavior, then, in order for plan managers to justify the use of higher profit-margin collateral benefits ESG, it will be faced with having to review a large number of claims that economically indistinguishable investments exist.

On a more technical note, the preceding discussion on portfolio screening should provide value in the context of the "tie-breaker" standard. That is, if an investment manager tries to make the case that a particular ESG fund is economically indistinguishable, it will definitely have to jump the first hurdle of clearly and unambiguously explaining how portfolio screening, if it is being applied, does not financially affect the risk-adjusted return of the ESG fund to the point where it is not inferior to the non-ESG fund. Without such an explanation, the ESG fund should not be considered an economically indistinguishable investment.

Conclusion

Despite ERISA being clear in what it requires of its fiduciaries, many commentators will completely disagree with the analysis provided here and, more importantly, continue to be vigorously opposed to the proposed rule. I view it as a clash between the personal desires of some commentators and what ERISA actually provides. For example, see Martin Lipton's recent commentary on the proposed rule, *DOL Proposes New Rules Regulating ESG Investments*.[79] If these commentators truly want to implement their personal desires, they have but one option: to lobby to change the statutory law. But until then, as with the DOL's proposed rule, they must respect what the current law clearly and unambiguously provides. In sum, I strongly support the DOL's approach in the proposed rule and hope that my observations and recommendations will assist in the process of its finalization.

Very truly yours,



Bernard Sharfman

[79] Martin Lipton, *DOL Proposes New Rules Regulating ESG Investments*, HARV. L. SCHOOL FOR. ON CORP. GOV. (July 7, 2020), https://corpgov.law.harvard.edu/2020/07/07/dol-proposes-new-rules-regulating-esg-investments.