

Office of Regulations and Interpretations, Employee Benefits Security
Administration, Room N-5655, U.S. Department of Labor, 200 Constitution Avenue
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Financial Factors in Selecting Plan Investments

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To whom it may concern:

Summary: The proposed rule is unnecessary and represents a confused understanding of ESG and its role in mainstream investment analysis. The rule overlooks and fails to address the volume of institutional investors (across segments and strategies) that are incorporating analysis of ESG issues into mainstream investment analysis, including buy, sell and hold decisions, upgrade and downgrade recommendations, and portfolio construction. The rule does not address the imperative of long-term value creation and the key insights ESG provides for assessing long-term corporate resilience.

The proposed rule demonstrates little awareness of the scale and seriousness of corporate America's response to the long-term, ESG imperative, both at the issuer and industry-association level. Leading CEOs of corporate America want the capital markets to understand a corporation's financial prospects and operational performance and acknowledge that this cannot happen without a meaningful understanding of an issuer's financially material ESG issues and how those relate to and interact with long-term business strategy.

The proposed rule will impose direct costs on American retirees. The suggested "benefits" identified in the rule are unsubstantiated in the text of the rule and seem to rest on assertion only. At the same time, the rule seems likely to impose huge indirect costs on our capital markets by undermining innovation, discouraging the development of market-based solutions and the informed use of fiduciary discretion.

"Disproportionately weighted" toward the short-term: ESG information can provide significant insight into the long-term financial prospects and operational performance of portfolio companies¹. The proposed rule, by imposing special rules for considering ESG issues in investment analysis (accompanied by a tone of clear

¹ 5 Ways ESG Creates Value (McKinsey, 2020): https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/five-ways-that-esg-creates-value?cid=socweb&fbclid=IwAR3onKpp8NgbyctliHjvZHNs7HcqFUhaKamqMamTYZYE8eE4aC10BbRgm_U

discouragement) seems intended to reduce the ability of ERISA fiduciaries to be able to consider ESG issues in investment analysis.

In the proposed rule, the Department expressed concern about an investment analysis that is “disproportionately weighted” towards ESG. Is the Department equivalently concerned about a “disproportionately weighted” approach to other pecuniary factors, such as short-term financial metrics (such as Earnings Per Share)? By reducing the ability of ERISA fiduciaries to consider ESG factors in investment analysis, has the Department considered whether this may cause undue focus on short-term metrics – to the detriment of both management decision-making and investor understanding? In the words of the National Investor Relations Institute: “ESG disclosures may provide an opening for Investor Relations professionals and corporate executives to shift the focus away from quarterly earnings toward more thoughtful discussions about long-term strategy.”²

An over-weighted focus on short-term financial metrics is a source of concern for many practitioners and regulators. The Securities and Exchange Commission’s Roundtable on Short-term and Long-term markets (at which we gave evidence) highlighted the breadth of concern from both CEOs and institutional investors about the causes and effects of market short-termism³. Significant evidence suggests that issuing short-term financial guidance can distort management decision-making undermining the long-term performance of a company and the wider economy. Issuing short-term financial guidance is associated with value destructive management decision-making, such as cutting R&D in order to hit a short-term earnings target⁴. Over the long-term such behavior is associated with lower investment returns⁵.

By contrast, firms that are managed for the long-term display robust performance, across both short and long-term time-horizons⁶. Those that perform best on material ESG issues tend to outperform peer-firms⁷; an outcome enabled by having

² NIRI Policy Statement: ESG Disclosure:

<https://www.niri.org/NIRI/media/NIRI/Advocacy/ESG-Policy-Statement-final.pdf>

³ What happened at the CorpFin roundtable on short-termism:

<https://corpgov.law.harvard.edu/2019/07/24/what-happened-at-the-corp-fin-roundtable-on-short-termism/>

⁴ Graham, John Robert and Harvey, Campbell R. and Rajgopal, Shivaram: Economic Implications of Corporate Financial Reporting (01/11/05):

<https://ssrn.com/abstract=491627>

⁵ The Macro Impacts of Short-Termism by Stephen Terry (2017):

<http://economics.mit.edu/files/10386>

⁶ Winning Strategies for the Long-Term (KPMG, 2019):

<https://home.kpmg/xx/en/home/insights/2019/04/winning-strategies-for-the-long-term.html>

⁷ Khan, Mozaffar and Serafeim, George and Yoon, Aaron, Corporate Sustainability: First Evidence on Materiality (November 9, 2016). The Accounting Review, Vol. 91, No. 6, pp. 1697-1724., Available at SSRN: <https://ssrn.com/abstract=2575912>

built operational processes around ESG into the core business⁸. Long-term focused, ESG-enabled firms are also associated with more resilient earnings and higher rates of job creation⁹.

Given the time horizon over which ERISA fiduciaries are seeking to provide benefits, the financial quarter may not be the most appropriate unit of analysis for understanding the prospects and performance of portfolio companies. The Department's intent to discourage or severely limit the use of ESG analysis in investment decision-making seems likely to disproportionately weight analysis toward the short-term and cause the capital markets to over-look key insights into the sources of resilience and shareholder returns.

ESG: a precursor of financial performance: Financial outcomes are primary for ERISA fiduciaries – a position which ERISA fiduciaries, their counsel and advisers, well understand. However, the proposed rule does not engage with the determinants of financial returns and the wide discretion sophisticated institutional investors have to interpret those aspects of corporate practice that influence the risk and return profile of portfolio companies within the scope of their fiduciary duties.

Investors interrogate ESG issues for their impact on financial returns, the likely stability of those returns, and the prospects of scandal or corporate crisis, which can result in permanent value destruction. For example, an investor may focus on a corporation's human capital management practices, particularly in sectors where employees are the key "asset", because these practices provide durable insights into management quality, workforce stability, employee-engagement, and operational efficiency. These are all prudent considerations for an investment fiduciary focused on delivering long-term financial returns as they provide the investor with insight into the quality, stability and resilience of the business.

The Department acknowledges that "improper disposal of hazardous waste" and "dysfunctional corporate governance" would be treated as material economic considerations by qualified investment professionals under generally accepted investment theories. However, these are merely two narrow examples of ESG issues that can be financially material and that consequently would be imprudent for an ERISA fiduciary to fail to consider.

In the recent GAO Report entitled "Public Companies: Disclosure of Environmental, Social and Governance Factors and Options to Enhance Them", the GAO summarized

⁸ Eccles, Robert G. and Ioannou, Ioannis and Serafeim, George, The Impact of Corporate Sustainability on Organizational Processes and Performance (December 23, 2014). *Management Science*, Volume 60, Issue 11, pp. 2835-2857, February 2014, Available at SSRN: <https://ssrn.com/abstract=1964011> or <http://dx.doi.org/10.2139/ssrn.1964011>

⁹ Finally, proof that managing for the long-term pays off (Harvard Business Review, 2017): <https://hbr.org/2017/02/finally-proof-that-managing-for-the-long-term-pays-off>

its survey of institutional investors as including: “Institutional investors with whom we spoke generally agreed that ESG issues can have a substantial effect on a company’s long-term financial performance. All seven private asset managers and representatives at five of seven public pension funds said they seek ESG information to enhance their understanding of risks that could affect companies’ value over time.”¹⁰ This is just one among countless data points that indicate that investors engage with ESG information as a key element of their fiduciary analysis.

Long-term capital markets: To address concerns about market short-termism, we have convened CEO Investor Forums to enable leading CEOs to deliver a long-term strategic plan to an audience of long-term institutional investors, in a Regulation FD setting. In delivering a long-term plan, CEOs seek to address a longer-term time horizon and a broader set of issues than they often address in other disclosure settings¹¹. We do this at a time when the Securities and Exchange Commission is giving significant encouragement to issuers to increase the volume of forward-looking information disclosed to the capital markets¹².

To deliver a coherent long-term plan, CEOs address themes across the ESG issue spectrum. These include: human capital management, sector-specific ESG risks and opportunities, corporate governance topics such as board strategy engagement and board composition and refreshment, and mega-trends. These themes are set out in our Long-Term Plan Framework¹³ which over 30 issuers (representing over \$2tn in market cap) have engaged with in delivering a long-term plan¹⁴.

The ESG themes addressed in these disclosures give institutional investors an opportunity to understand the systemic risks that portfolio companies are exposed to. For example, issuers have provided disclosures on how they are seeking to address mega-trends such as: the transition to the low carbon economy and the extent to which their business is exposed to climate-related financial risks. Issuers have described how they are seeking to respond to trends of rising healthcare costs,

¹⁰ Public Companies: Disclosure of Environmental, Social and Governance Factors and Options to Enhance Them (Government Accountability Office, 2020): <https://www.gao.gov/assets/710/707949.pdf>

¹¹ Tomlinson, Brian, Emerging Practice in Long-Term Plans: How CEOs Talk About the Long Term (October 2018). CECP: Strategic Investor Initiative White Paper Series 2, Available at SSRN: <https://ssrn.com/abstract=3350117>

¹² The Importance of Disclosure – for investors, markets, and our fight against Covid-19: <https://www.sec.gov/news/public-statement/statement-clayton-hinman>

¹³ The Long-Term Imperative: How companies can respond by Brian Tomlinson, Julia Sahin, and Lauren Scott (CECP / Edelman, 2020): <https://www.edelman.com/insights/the-long-term-imperative-how-companies-can-respond>

¹⁴ The Economic Significance of long-term plans (KKS Advisors and CEO Investor Forum, 2018): <https://cecp.co/wp-content/uploads/2018/11/Economic-Significance-Final-Report.pdf>

deforestation, automation, and ageing societies where these are relevant to the execution of their long-term strategy to deliver shareholder value. As a result, ESG disclosures, accompanied by management commentary, help provide insights for investors into the resilience and durability of the issuers that the savings of American retirees are being invested in. They are themes that leading American CEOs want to address to convey a complete picture of how their firms create value.

By discouraging the use of ESG information and approaches in investment analysis, the Department will undermine ERISA fiduciaries' ability to assess the full risk and return profile of portfolio companies. Accompanied by an undue short-term focus, this approach is likely to result in misallocation of capital and missing key issues that will significantly determine investment returns over the long term.

Corporate engagement with ESG: significant and rapidly increasing: The proposed rule fails to address the extent of ESG-related activity by corporations and industry associations to enable financially material and decision-relevant disclosure on the ESG issues underlying business performance.

The National Investor Relations Institute has recently issued an ESG Policy Statement. Investor Relations professionals, who hold the capital markets relationship within public companies, are encouraged in the policy statement to "become more knowledgeable about the information and data" that investors are seeking on ESG. The statement further goes on to say that: "IR professionals should recognize the growing importance of ESG considerations in company communications regarding long-term strategy. For many investors, ESG factors are becoming a crucial component when they assess whether a company has a well-thought-out plan for long-term shareholder value".

Building on this example, the Edison Electric Institute (EEI) has developed an ESG Reporting Framework for use by its members, to enable disclosure on material ESG themes on a comparable basis¹⁵. Through a robust and collaborative development process, EEI convened the eco-system of preparers and consumers of disclosure, including representatives of different investor segments (both buy-side and sell-side), and reporting frameworks such as the Sustainability Accounting Standards Board (SASB). This framework recognizes that ESG is key to communicating a company's forward-story. It also demonstrates that issuers and investors are collaborating to enable structured discussion of financially material ESG issues.

Leading companies are increasingly reporting using the framework developed by the Sustainability Accounting Standards Board¹⁶. This framework enables issuers to report on the ESG issues that are financially material for their business model and sector. In addition, in our work with companies, we are seeing leading executives

¹⁵ Edison Electric Institute, ESG/Sustainability:
<https://www.eei.org/issuesandpolicy/Pages/FinanceAndTax-ESG.aspx>

¹⁶ <https://www.sasb.org/>

building out operational processes to account for the impact ESG issues have on business performance and enabling those to be communicated to the capital markets.¹⁷

Corporations have also begun to feature ESG-related disclosures into the content of quarterly earnings calls¹⁸. Corporations are doing this to convey to the capital markets the key themes underlying their financial performance and prospects; a key part of which is performance on financially material ESG factors. Sell-side analysts are beginning to build ESG content into their buy/sell/hold and upgrade and downgrade decisions¹⁹. In addition, through issuing ESG-related corporate debt, corporations are directly linking their cost of capital and access to capital to their performance on key ESG issues²⁰.

Corporate boards are building ESG performance into the structure of CEO compensation packages²¹. This clearly indicates that ESG performance, and its link to financial performance, are key elements for a CEO's focus in leading a corporation and delivering shareholder value.

In addition the Business Roundtable Statement on the Purpose of a Corporation²² signed by over 180 CEOs provides that a key focus for America's largest companies is: "Generating long-term value for shareholders, who provide the capital that allows companies to invest, grow and innovate. We are committed to transparency and effective engagement with shareholders." The proposed rule would undermine ability of CEOs to implement this stated purpose, by limiting the ability of institutional investors to engage with companies on key issues related to long-term value.

Given the scale and seriousness of the corporate America's engagement with ESG in management decision-making, board oversight, capital markets disclosure and debt

¹⁷ Tomlinson, Brian and Krzus, Michael P., Method of Production of Long-Term Plans (January 25, 2019). CECP: Strategic Investor Initiative White Paper No. 3, Available at SSRN: <https://ssrn.com/abstract=3332342> or <http://dx.doi.org/10.2139/ssrn.3332342>

¹⁸ Eckerle, Kevin and Tomlinson, Brian and Whelan, Tensie, ESG and the Earnings Call: Communicating Sustainable Value Creation Quarter by Quarter (May 27, 2020). NYU Stern Center for Sustainable Business; and CEO Investor Forum at CECP, 2020, Available at SSRN: <https://ssrn.com/abstract=3607921>

¹⁹ ESG in the Mainstream (Wachtell Lipton Rosen and Katz, 2020): <https://corpgov.law.harvard.edu/2020/05/29/esg-in-the-mainstream-sell-side-analysts-addressing-esg-concerns/>

²⁰ Several issuers have closed sustainability-linked loans over the past year. For example: <https://www.ft.com/content/789a54b8-5599-11ea-a528-dd0f971febbc>

²¹ New research finds progress on the use of ESG incentive metrics (Willis Towers Watson, 2020): <https://www.willistowerswatson.com/en-US/Insights/2020/03/New-research-finds-progress-on-the-use-of-ESG-incentive-metrics>

²² Statement on the Purpose of a Corporation (Business Roundtable, 2019): <https://opportunity.businessroundtable.org/ourcommitment/>

issuance, it seems a laggard step for the Department to seek to discourage and limit the ability of ERISA fiduciaries to integrate ESG into their investment analysis of those same portfolio companies.

ESG: part of a prudent investment decision: In its prior guidance, issued in Interpretive Bulletin 2015-1 and repeated in 2018's Field Assistance Bulletin, the Department indicated that ESG issues were an appropriate component of a fiduciaries' investment analysis provided they were financially material²³. The Department has not set out any clear evidence or rationale in the Proposed Rule for why that carefully constructed and repeated guidance is no longer sufficient.

In the Proposed Rule, the Department, citing confusion, consistently presents a confused analysis of ESG's role in investment analysis. For example, ESG is not an asset class. It is a set of techniques and approaches that enable mainstream investment professionals to form a comprehensive view of a portfolio company's operational performance and financial prospects over multiple time-horizons, including the long-term. ESG information can be integrated into investment analysis across strategies and products.

It is worth noting that the nature of a prudent investment decision also changes over time as market participants develop new concepts and approaches to conducting mainstream investment analysis. This is reflected in the expansion of the continuous disclosure regime for public companies. In recent decades, this has expanded to include reporting on a corporation's liquidity, capital structure, credit risk instruments and off-balance sheet transactions as these have become necessary features of investment analysis²⁴. It should be noted that several Rulemaking Petitions have been submitted to the SEC requesting that ESG be built expressly into the continuous disclosure regime. Many leading public companies are already incorporating ESG disclosures into their filings with the Commission including in 10-K's and proxy statements.

Institutional Investors have built ESG into their mainstream investment analysis as it has become recognized as a key addition to the prudent assessment of risk and return. The integration of ESG into mainstream investment analysis is a market-based solution which enhances the security of American retirees present and future. It is a development that our leading financial regulators ought to welcome. In the words of the Restatement (Third) of Trusts: "Trust investment law should reflect and accommodate current knowledge and concepts. It should also avoid repeating the mistake of freezing its rules against future learning and developments."

²³ DOL/ESG: New Tone, Same Analysis (Brian Tomlinson, 2018):

<https://www.linkedin.com/pulse/doesg-new-tone-same-analysis-brian-tomlinson/>

²⁴ ESG and Fiduciary Duties by Brian Tomlinson (Harvard Law School Corporate Governance Forum, 2016): <https://corpgov.law.harvard.edu/2016/11/01/esg-and-fiduciary-duties-a-roadmap-for-the-us-capital-market/>

Integrate ESG into QDIAs: Given the preceding commentary, the basis for excluding ESG from QDIAs is poorly founded – and out of step with mainstream investment reality. The objective of an ESG integrated fund is financial returns; that is the essence of ESG integration. ESG analysis intends to bring greater and more sophisticated analysis to bear on the financial prospects and operational performance of portfolio companies. Given this, the absence of meaningful ESG analysis in QDIA’s deprives beneficiaries of a key element of analysis into the performance and prospects of their underlying investments. That exclusion imposes significant risks on the security of America’s retirement assets.

Impartiality: Among the duties of prudence and loyalty that fiduciaries owe to their beneficiaries is the duty of impartiality. This provides that fiduciaries treat their beneficiaries, across classes, and consequently time horizons, fairly. Given the preceding analysis around ESG’s role in providing key insights into systemic risks and long-term financial performance, has the Department conducted analysis as to whether its proposed rule is consistent with the duty of impartiality? Short-term metrics, such as earnings per share and dividend yield, may be relevant to the immediate cash needs of a plan. However, such metrics give very little insights into the broad set of factors that impact long-term financial performance. Given that many plans will be managing assets for beneficiaries who won’t retire for upwards of 40 years, how does discouraging integrating ESG issues into investment analysis, square with fairly looking after the financial interests of those long-term future retirees?

Imposes visible (and invisible) costs: The proposed rule assumes, without evidentiary support, that it will result in higher returns and lower fees. The proposed rule implies a reduction in the use of actively managed “ESG funds” and the increased use of “mutual funds with lower fees or passive index funds”; yet the rule fails to mention that many passive index funds already deploy a mix of ESG techniques, at very low expense ratios. Such funds have often outperformed their parent indices. The rule does not seek to quantify the costs to American retirees of reducing the ability of ERISA fiduciaries to consider ESG in investment analysis, which we believe could be substantial.

Given the foregoing analysis, we regard the proposed rule as unnecessary and potentially freighted with negative consequences for American retirees. We request that it is withdrawn.

Yours sincerely,

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