UNITED BROTHERHOOD OF CARPENTERS AND JOINERS OF AMERICA

Douglas J. McCarron
General President

July 29, 2020

Jeffrey J. Turner
Deputy Director, Office of Regulations and Interpretations
EBSA/DOL
200 Constitution Avenue NW
FP Building, Room N-5655
Washington, DC 20210
Attn: Financial Factors in Selecting Plan Investments Proposed Regulation

Re: Request for Comments, RIN1210-AB95

Dear Mr. Turner:

I am writing on behalf of the United Brotherhood of Carpenters and Joiners of America ("UBC") in response to the proposal to amend certain provisions of the "Investment duties" regulation at 29 CFR § 2550.404a-1.

The DOL has stated that "the proposed rule elaborates upon the core principles provided in the 'investment duties' regulation by making clear that fiduciaries may never subordinate the interests of plan participants and beneficiaries in their retirement income to non-pecuniary goals." 85 FR 39117. The UBC writes this letter because it believes certain portions of the proposed regulation do more than elaborate on the existing rule or the duty of loyalty and the "prudent man" standards set forth in Sections 404(a)(1)(A) and 404(a)(1)(B) of the Employee Retirement Income Security Act ("ERISA"), 29 USC §§ 1104(a)(1)(A) and (B). Specifically, the UBC believes the requirement to compare a contemplated investment to alternatives imposes an undue burden; the proposed amendment may imply that fiduciaries must act with the goal of short-term pecuniary gains rather than long-term ones; the proposed rule is restrictive of when environmental, social, and corporate governance ("ESG") factors may be taken into account as pecuniary factors; and the "tie-breaker" test should not be changed into an "economically indistinguishable" test.

Although the proposed rule is phrased in terms of indicating which steps, if satisfied, will mean that the fiduciary has satisfied the duty of loyalty and the "prudent man" standard, the UBC is concerned that the implication of the proposed regulation is that if certain steps are *not* taken, then the duties are *not* satisfied.

101 Constitution Avenue, N.W. Washington, D.C. 20001 Phone: (202) 546-6206 Fax: (202) 543-5724

The UBC will show, by way of an example of an actual investment that was investigated by the DOL, the undue burden that the proposed amendment will impose on plan fiduciaries.

The proposed amendment imposes an undue burden on the plan fiduciaries

The UBC will describe an investment made by a pension fund sponsored by an affiliated labor organization, the Southwest Regional Council of Carpenters, to demonstrate the undue burden that the proposed amendment would place on plan fiduciaries.

In 1998, the Southwest Carpenters Pension Trust ("Southwest Carpenters") invested $15 million in First Lien Bonds of Playa Pacific Partners, LLC ("Issuer" or "Playa Pacific Partners"). The Issuer issued a total of $40 million to three different pension plans, including the Southwest Carpenters. Playa Pacific Partners also issued $25 million Second Lien Bonds to another pension fund affiliated with a different labor organization. The Series B Bonds were subordinate in priority and payment to the Series A Bonds, but provided for the payment of higher interest rates.

The investment was in a project to develop a planned community with residential, commercial and retail components in Playa Vista, on the Westside of Los Angeles County, California. The residential portion of the project consisted of both units for sale and for rent. Construction on the project began in 2001 on a site that was essentially wetlands, although it had also been the headquarters of Hughes Aircraft Company from 1941 to 1985.

The investment proved to be a very profitable one for the Southwest Carpenters. However, it may have initially looked to a third party to have been a bad investment decision. For instance, there was a danger of potential default on the first cash interest payment due in April 2001, and in October 2002 the Issuer did in fact default on the payment of interest due to both Series of Bondholders, resulting in a dispute between them.

The DOL conducted a vigorous and lengthy investigation of the Southwest Carpenters with respect to the Playa Vista investment. The length of the investigation is in part explained by the fact that there was a tolling agreement. The investigation ended with no complaint being issued. Had it not been for the fact that the Southwest Carpenters received a significant return on the investment, despite the initial obstacles with the project, the Southwest Carpenters believe the DOL may very well have filed a lawsuit.

Among the issues during the DOL investigation was the fact that the only investment professional the Southwest Carpenters Trustees relied on in conducting due diligence on the investment in Playa Pacific Partners was Duff & Phelps, LLC, a company with expertise in debt instruments and in rating bonds. The DOL questioned why the Trustees did not also employ a real estate firm to conduct due diligence, as this was a real estate deal.

Although the investigation revealed that the Trustees made the decision to invest in the Playa Pacific Partners based solely on pecuniary factors, there were facts in connection with the project that to a third person may have raised suspicion that the Trustees also considered non-pecuniary factors in making the investment decision. For instance, there was a Project Labor Agreement pursuant to which workers would be hired through the Southwest Carpenters hiring hall. However, the Trustees and Duff & Phelps did not consider possible job creation when reviewing the investment. Additionally, the project had an environmentally conscious design, with bikeways, open spaces, and high walkability. Although the Trustees did not consider this environmental factor in making the investment decision, this was among the features of the project that to a third party may have made it appear that ESG considerations were taken into account in making the investment decision.

The example of the investment in the Playa Vista project highlights the undue burden that the proposed amendment to the Regulation at 29 CFR § 2550.404a-1 would present to trustees, as further discussed below.

<u>The requirement to compare the investment to alternatives imposes an undue burden</u>

The proposed amendment provides that the duty of loyalty and the "prudent man" standard are satisfied if certain requirements are met. Among these requirements is the following:

> [The fiduciary] [h]as given appropriate consideration to those facts and circumstances that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved, including the role the investment or investment course of action plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties;

Proposed § 2550.404a-1(b)(i). The proposed amended rule then states that "appropriate consideration" ***shall*** include, but is not necessarily limited to, consideration of the following with respect to the portion of the portfolio: "[h]ow the investment or investment course of action compares to available alternative investments or investment courses of action with regard to the factors listed in paragraphs (b)(2)(ii)(A) through (C) of this section." These factors are diversification; "liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan"; and the "projected return of the portfolio relative to the funding objectives of the plan[.]" "Investment course of action" is also a defined term, and is defined, in relevant part, to mean "any series or program of investments or actions related to a fiduciary's performance of the fiduciary's investment duties, and includes the selection of an investment fund as a plan investment[.]"

It is difficult to determine what available alternative investments or investment courses of action" would be that must be considered to satisfy the "appropriate consideration" prong. Trustees sometimes are apprised of an opportunity for the plan to make a certain investment and the question is whether or not the plan should make the investment, consistent with the trustees' legal obligations, not how the investment compares to other potential investments. In other words, the choice is whether to make investment X, not how investment X compares to investment Y. The UBC does not believe that, in all cases, the lack of such a comparison is an indication that the duty of loyalty or the "prudent man" standard may have been breached, and the regulation should not be phrased in such a way that the implication is that these duties are breached if there is no such comparison.

For instance, the Playa Vista project was a brand new real estate project. In was an attractive investment for a number of reasons, including that the Southwest Carpenters would have collateral in the seven operating companies. To satisfy the "appropriate consideration" prong, what were the "available alternative investments or investment courses of action" to which the trustees of the Southwest Carpenters had to compare this investment? If the Southwest Carpenters had to compare this project to other potential real estate investments, it would have been difficult to determine what the basis for comparison could be because, at the time, it was a unique project in the Los Angeles area both in its scope and concept.

The UBC does not believe that trustees must always compare a potential investment to other potential investments or courses of action to satisfy their fiduciary duties in situations when the question is whether or not to make a certain investment. Creating the duty to compare, or raising the suspicion that the trustees breached their fiduciary duties because they did not make the comparison, may impose the undue burden of finding a basis for comparison and doing due diligence on it, and may result in missing out on a very profitable investment such as the Playa Vista project. Additionally, imposing the duty to compare adds an operating cost that may be unnecessarily in many circumstances.

What is particularly troubling about the requirement to compare is that if the proposed amendment is adopted, the requirement will apply even if the trustees did not consider ESG factors in making the investment decision. That means that even if no ESG factors were considered, and the investment was made based solely on pecuniary factors, plan fiduciaries may be suspected of the breach of fiduciary duty—of subordinating pecuniary interests to other interests—simply because they did not make a documented comparison. Thus, trustees may feel obligated to do a due diligence on "available alternative investments or investment courses of action" with respect to every single investment, which is overly burdensome. The UBC therefore does not believe that the regulation should have language imposing the requirement to compare the investment to other alternatives, or language implying that fiduciary duties may have been breached if such alternatives were not considered.

<u>The proposed rule may imply that fiduciaries must have only short-term pecuniary interests in mind rather than long-term pecuniary interests</u>

While the UBC does not take issue with the reiterated requirement that investments must be made solely on pecuniary factors, it is concerned that the proposed amended rule may imply that trustees are breaching their fiduciary duties if they consider long-term rather than short-term pecuniary interests.

In particular, Subsection (b)(1) of the proposed amended rule provides that the duties of loyalty and the "prudent man" standard are satisfied if, among other things, the fiduciary "[h]as evaluated investments and investment courses of action based solely on pecuniary factors that have a material effect on the return and risk of an investment based on appropriate investment horizons and the plan's articulated funding and investment objectives insofar as such objectives are consistent with the provisions of Title I of ERISA[.]" There is no indication as to what length of time is referred to with respect to "appropriate investment horizons."

With some investments, such as the case with the Playa Vista investment, the trustees may understand that it may not be profitable in the initial years, but they may have reasonable expectations that it will become very profitable later, which proved to be the case in that particular example. If "appropriate investment horizons" is interpreted to mean short-term gains, the trustees risk being found to be in breach of their duties even though they considered only pecuniary factors in making the investment decision.

Subsection (b)(1) of the proposed amended rule places an emphasis on investment return and risk analysis in relation to "appropriate investment horizons," which casts doubt as to whether trustees can consider other pecuniary factors such as supporting the contribution base. When evaluating investments such as the Playa Vista investment, trustees could very reasonably consider the investment's role in supporting the contribution base via hourly contributions to the plan on the project. This is particularly true of defined benefit pension plans currently, a significant percentage of which receive supplemental contributions of often several dollars per hour on a nonaccrual basis to secure plan funding. Under the Pension Protection Act of 2006, many funding improvement plans and rehabilitation plans require such supplemental contributions years into the future. Additional contributions to the plan could very well yield a significant pecuniary benefit to the plan beyond investment return. By placing an emphasis on short term or undefined investment horizons, the proposed rule fails to account for the long-term nature of plan investments and the significant pecuniary value of supporting the contribution base.

The UBC is concerned that the fact there is at most a six-year statute of limitations for bringing a lawsuit against the fiduciaries under 29 USC § 1113 will prompt investigations regarding investments that have not yet proven to be profitable, even if no ESG factors were considered in making the decision to invest. Therefore, the UBC believes that if an amendment to the regulation is made, it should be clarified that a fiduciary does not breach his or her duty simply because they consider long-term pecuniary factors with the understanding that there may not be a short-term gain.

<u>The proposed rule is restrictive in when ESG factors may be taken into account as pecuniary factors</u>

The UBC believes that the proposed regulation is overly restrictive in when ESG factors may be considered pecuniary factors.

Proposed § 2550.404a-1(c)(1) provides, in relevant part, that "[e]nvironmental, social, corporate governance, or other similarly oriented considerations are pecuniary factors only if they present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories." There are two issues with this restriction. First, it is debatable what is meant by "generally accepted investment theories," and this uncertainty may deter the consideration of ESG factors even though they were treated as pecuniary factors by the qualified investment professional on whose advice the investment was made. Second, the UBC believes the restriction is reflective of a narrow interpretation of what pecuniary factors are.

With respect to the first point, there is a growing—but not a universal—recognition that ESG factors may be integral to pecuniary interests. For instance, BlackRock, Inc. ("BlackRock"), the world's largest asset manager, in July 2020 issued an Executive Summary, titled "Our approach to sustainability," where it stated that "climate risk is investment risk and that sustainability-integrated portfolios, and climate-integrated portfolios in particular, can produce better long-term, risk-adjusted returns."[1] The report indicates that in 2020, BlackRock took voting action against a number of companies that made insufficient progress in integrating climate risk into their business models or disclosures, and placed an even greater number of companies on a "watch list" out of recognition that "[t]hese companies face material financial risks in the transition to a low-carbon economy[.]" Under the proposed regulation, it is uncertain whether the environmental sustainability risks BlackRock refers to are pecuniary factors, as it is unclear whether these factors are pecuniary ones under "generally accepted investment theories."

Additionally, ESG factors are not stagnant—they are ever-evolving. For example, the same BlackRock report indicates that "[i]n the second half of 2020, as [it] assess[es] the impact of companies' response to COVID-19 and associated issues of racial inequality, [it] will be refreshing [its] expectations for human capital management and how companies pursue sustainable business practices that support their license to operate more broadly." While many qualified investment professionals so far may not have considered factors such as racial inequality or health safety precautions in the workplace, more and more of them are likely to deem these factors to be among the ESG factors they monitor. Simply because certain considerations are not currently treated as pecuniary ESG factors under generally accepted investment theories does not render them non-pecuniary. Fiduciaries should not be penalized in having foresight: in being early in identifying social trends that are likely to impact the value of a company, and in making investment decisions based in part on those new trends.

The second point may be illustrated by an example. For instance, as the recent years have demonstrated, reputable companies with well-performing stocks may have had their

---

[1] The report may be found on this link: https://www.blackrock.com/corporate/literature/publication/our-commitment-to-sustainability-exec-summary-en.pdf.

reputations damaged by negative media coverage about revelations of an emission cover-up by an automaker or data-sharing by a social media site that many of its users found surprising or offensive. Such one-time scandals may perhaps cause the value of the stock to decrease over a short period of time, and the value may rebound quickly. In other instances, however, particularly when there had been prior scandals involving the same company, such conduct by companies may affect not only their reputation but their long-term value, as more individuals may choose not to use the services or purchase products from a company that they find socially irresponsible. Such events affecting a company's reputation may not necessarily be treated by qualified investment professionals as "material economic considerations under generally accepted investment theories," but they are ESG considerations that are also pecuniary ones.

In general, the UBC believes that pecuniary factors are not always reflected on quarterly balance sheets or earning statements. In the case of something novel, e.g., new technology or a new development project such as the Playa Vista one, there may not be a past record of performance that the fiduciaries may rely on in making an investment decision. On the flip side, there may be a past record of good performance that is not indicative of future performance in the case of, for instance, a scandal involving an established and previously reputable company, or in the case of something that is likely to be obsolete. For instance, news of the nation's largest pension fund divesting from private prisons is certainly relevant to fiduciaries' decision as to whether to keep similar stock, since such a major divestment may only be the beginning of the end of such companies, even though such news may not yet be reflected in the financial documents the fiduciary has reviewed. This principle is reflected in SEC 156, which requires mutual funds to tell investors not to base their expectations of future investment results on past performance. 17 CFR § 230.156(b)(2)(ii).

A fiduciary, in summary, does not necessarily breach their duties by considering ESG factors that do not necessarily "present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories." Any amendment to the rule should therefore not have this restriction.

<u>The "tie breaker" test should not be changed into an "economically indistinguishable" test</u>

The DOL has expressly invited comment on the "tie-breaker test," "including whether true ties exist and how fiduciaries may appropriately break ties." 85 FR 39117. It has expressed skepticism about the test, stating 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." *Id.* The "tie-breaker" test has been described as follows: "when competing investments serve the plan's economic interests equally well, plan fiduciaries can use such collateral considerations as tie-breakers for an investment choice." Field Assistance Bulletin ("FAB") No. 2018-01. The UBC believes the "tie-breaker" test should remain the standard for when ESG factors are non-pecuniary.

The UBC is concerned that the proposed "economically indistinguishable test" is more restrictive than the current "tie-breaker" standard. Specifically, assuming the ESG factors are non-pecuniary, the proposed regulation allows fiduciaries to select an ESG investment over a non-ESG one only if the two are "economically indistinguishable." It is not clear in the proposed regulation whether the "economically indistinguishable" test is more stringent than the current "tie-breaker" test, but it appears that it is. The DOL has stated that "[s]eldom . . . will an ERISA fiduciary consider two investment funds, looking only at objective measures, and find 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." 85 FR 39117. This comment implies that two investments are "economically indistinguishable" only when they are the same on *every* criterion, e.g., performance history, not when, overall, they "serve the plan's economic interests equally well." FAB No. 2018-01. If this is the correct interpretation of the intended meaning of "economically indistinguishable," the UBC believes that the test is too restrictive and will never be met.

Regarding the DOL's concern that fiduciaries will "find ties without a proper analysis" in order to justify making an ESG investment, the UBC believes this concern does not justify changing the standard since fiduciaries already keep records to show they have given "appropriate consideration" to the factors required under the current section 2550.404a-1, including the "risk of loss and the opportunity for gain" associated with the investment. 29 CFR § 2550.404a-1(b)(2)(i). Whether or not a tie was fabricated may be determined from reviewing the records justifying the decision to make the investment, and an adverse inference may perhaps be made from sparse documentation about the decision. Detailed record-keeping, rather than a more stringent test, is the more reliable method by which to screen for fabricated ties.

Lastly, the UBC would like to address the comment made by the DOL, in a footnote, that "fiduciaries should . . . be skeptical of 'ESG rating systems.'" 85 FR 39118. The UBC does not believe that ESG rating systems or disclosures that tie ESG factors to pecuniary goals are any more likely to be deceptive than the other financial information fiduciaries normally review. Fiduciaries must comply with their fiduciary obligations regardless of which rating systems they review. While there certainly is potential to exploit fiduciaries' and the public's growing concern in ESG considerations, there are existing tools available to deter misrepresentations about ESG factors. For instance, the SEC has recently filed a complaint against a company that issued a misleading press release claiming to offer a product to combat the virus that causes COVID-19. The complaint was filed pursuant to 15 USC § 78j(b) and SEC Rule 10b-5, i.e., 17 CFR § 240.10b-5 ("Employment of manipulative and deceptive devices"). These same existing tools may be used to deter misleading ESG rating systems and disclosures. Fiduciaries should not be burdened with a duty to be more skeptical of ESG information than the other financial information they review.

In summary, the current "tie-breaker" test should be preserved. If the regulation is amended, the current "tie-breaker" test, which has never been codified, should explicitly be made a part of the regulation to make it clear that the new regulation is not imposing a more stringent standard.

The UBC appreciates the opportunity to comment on this proposed amendment and respectfully requests that its comments be taken into consideration as the Department of Labor further reviews this matter.

Sincerely,

Douglas J. McCarron

Douglas J. McCarron
General President