

To:  
Office of Regulations and Interpretations  
Employee Benefits Security Administration  
Room N-5655 U.S Department of Labor  
200 Constitution Avenue NW  
Washington, DC 20210

From:  
Steve Loren, CFA, FRM, MBA

Re; Proposed rule on Financial Factors in Selecting Plan Investments  
Proposed Regulation (RIN 1210-AB95)

Dear Director Canary:

I write to provide comments in response to the Department of Labor's proposed rule, "Financial Factors in Selecting Plan Investments" (RIN 1210-AB95) (the "Proposal").

I am a former Chair of the Sustainable Investing Committee of the New York Society of Security Analysts, now known as CFANY. CFANY is largest chapter of the CFA institute worldwide and is widely respected and recognized as a global thought leader in capital markets. In my tenure at CFANY I had the opportunity to interact with a number of leading practitioners and academicians who have been shaping the contours of what is now known as ESG investing. I have considerable knowledge of the field.

I write this letter with the weight of my experience. I will outline my letter as follows:

- 1) The behavioral finance roots of the automatic "opt out" retirement plan enrollment and the 'qualified default investment alternative' (QDIA) safe harbor.
- 2) ESG investing is an accepted investment process and not a product. ESG investing is not to be confused with economically targeted investing.
- 3) The proposed rule appears to have some significant internal inconsistencies

**Behavioral Finance and the institutionalization of automatic retirement plan enrollment and qualified default investment alternatives (QDIA):**

There is a small irony in the history that has led up to this proposed rule. Advancements in behavioral finance theory ultimately became the justification for the establishment of default investment options in defined contribution retirement plans on the theory that institutionalizing 'opting out' instead of 'opting in' to employer provided retirement savings plans would lead to higher retirement savings for Americans and consequently greater retirement security. Behavioral finance, as a relatively young sub-field in finance, informed retirement benefits policy and was institutionalized in the pension protection act of 2006.<sup>1</sup> Yet the current proposed rule seems to contradict the views of some of the most respected proponents of behavioral finance and finance proper with respect to ESG investing.

In 2011, I hosted noted economics Nobel Laureate and behavioral finance pioneer Robert Shiller at the New York Society of Security Analysts (NYSSA) to speak about his book ‘Finance and the Good Society’. In his presentation at NYSSA Professor Shiller remarked about how novel financial innovations, which include institutional innovations that make use of behavioral finance such as automatic retirement plan enrollment, as well as investment process innovations such as ESG investing, can lead to superior financial market outcomes and more resilient financial institutions.

Since that prophetic presentation, much academic and practitioner evidence continues to accumulate that substantiates Professor Shiller’s claims. Defined contribution retirement savings rates have been significantly bolstered by institutionalizing automatic employer provided retirement plan enrollment.<sup>2</sup> Likewise, the portfolio risk and return benefits of ESG investing approaches has become widely accepted by practitioners and investors world-wide, supported by rigorous evidence from academicians.

Indeed, the innovation of the defined contribution default enrollment option became widely adopted through the passage of the pension protection act of 2006 which created a safe harbor for employers through the mechanism of the ‘qualified default investment alternative’(QDIA). The irony is that the proposed rule under discussion here intends to exclude investment options that use an ESG investing process from the QDIA safe harbor under the *mistaken premise* that ESG investment options are not “based solely on financial considerations relevant to the risk adjusted economic value of a particular investment or investment course of action”. As Professor Shiller suggested in 2011 and as subsequent evidence has rigorously confirmed, ESG investment methodologies can and do lead to superior risk adjusted financial returns.

**ESG investing is an accepted investment process and not a product. ESG investing is not to be confused with economically targeted investing.**

The QDIA safe harbor recognizes three main categories of investments: lifecycle funds, balanced funds and managed accounts. Each of these three categories of investments can utilize an ESG lens to *enhance* portfolio risk and return profiles. This is because ESG investing is *not a separate investment niche category* such as statistical arbitrage or momentum investing, nor is it properly understood as an investment theme or vehicle that seeks to achieve certain non-pecuniary goals. Instead, *ESG investing is a broad investment approach that is more akin to the traditional ‘value investing’* of the kind practiced by the founders of the investment profession such as Benjamin Graham and his progenitors. In fact, this position on ESG as an investment process akin to fundamental analysis is held by the prestigious CFA institute. Quoting from the CFA Institute website:

*“We believe more thorough consideration of ESG factors by financial professionals can improve the fundamental analysis they undertake and ultimately the investment choices they make. CFA Institute is specifically focused on the quality and comparability of the ESG information provided by corporate issuers and how to integrate various ESG factors into the investment selection process.”<sup>3</sup>*

While it is possible to construct funds that can be managed to various ESG related ‘themes’ such as carbon neutrality or gender diversity, ESG investing as an investment process is itself not a theme and is not reducible to a specific theme. Neither should the ESG investment process be confused with what it is most definitely is not: economically targeted investment. As the CFA

institute statement above clearly articulates, *ESG investing is in fact an investment process just as value investing is an investment process*. While both value and ESG investing can be packaged, marketed and labeled as specific investment ‘products’ this does not change the essential character of what Value and ESG investing are: *investment processes* that aim to improve the analysis of the risk and return profiles of a portfolio of securities in line with *accepted investment theories*.

### **There is an apparent lack of internal consistency of the proposed rule:**

The language of the proposed rule appears to accept that ESG investing can be used in a manner that does not entail consideration of non-pecuniary objectives. From page 9 of the proposed rule the language states:

“Some DB plans that consider ESG factors would not be affected by the proposed rule because they focus only on the financial aspects of ESG factors, rather than on non-pecuniary objectives.”

Yet, the language that justifies the exclusion of investment products informed by ESG investing practices from QDIA investment options is based on the presumption that ESG investment products by definition have impermissible non-pecuniary objectives. From page 7 of the proposed rule:

“The Department does not believe that investment funds whose objectives include non-pecuniary goals—even if selected by fiduciaries only on the basis of objective risk-return criteria consistent with paragraph (c)(3)— should be the default investment option in an ERISA plan...it is inappropriate for participants to be defaulted into a retirement savings fund with other objectives absent their affirmative decision.”

Why do the drafters of this rule believe that it is possible and acceptable for DB plans to use ESG criteria and not be affected by the proposed rule“ because they focus only on the financial aspects of ESG factors, rather than on non-pecuniary objectives” while DC plans that choose ESG informed investment products “ selected by fiduciaries only on the basis of objective risk-return criteria consistent with paragraph (c)(3)”— should nonetheless have such investment options excluded as a qualified default investment alternative?

If the proposed rule claims that non-pecuniary objectives are part of the defining character of an ESG informed investment, what is the harm that a DC beneficiary suffers that an identical DB plan beneficiary does not suffer by virtue of benefiting from an ESG informed fund that is selected solely on the basis of its pecuniary factors ( i.e. the financial aspects of ESG factors) ? Alternatively, if it is ceded that it is possible that ESG informed investments can be selected by fiduciaries *only on the basis of the financial aspects of these ESG factors*, then what is it about DC plans that prohibit that possibility? Why propose a rule that will exclude investment options

from QDIA that may in fact offer superior risk and return profiles if the ‘cost’ of potential outperformance is the mere exposure to extra ‘non-pecuniary’ benefits?

Regardless of the answers to this apparent inconsistency, the crux of the matter rests on the misapprehension of ESG as something other than an accepted investment process and I trust any revised rulemaking will take this fact into consideration. Sincerely,

Steve Loren, CFA, FRM., MBA

<sup>1</sup><https://www.marketwatch.com/story/nobel-prize-winner-richard-thaler-may-have-added-296-billion-to-retirement-accounts-2017-10-09>

<sup>2</sup><https://www.project-syndicate.org/commentary/richard-thaler-nobel-behavioral-economics-by-robert-j--shiller-2017-10?barrier=accesspaylog>

<sup>3</sup><https://www.cfainstitute.org/en/research/esg-investing>