

O'Melveny & Myers LLP
Times Square Tower
7 Times Square
New York, NY 10036-6537

T: +1 212 326 2000
F: +1 212 326 2061
omm.com

July 30, 2020

Alicja I. Biskupska-Haas
D: +1 212 728 5829
abiskupska-haas@omm.com

Via Federal eRulemaking Portal

Office of Regulations and Interpretations
Employee Benefits Security Administration
U.S. Department of Labor
100 Constitution Ave., N.W.
Washington, D.C. 20210

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

Ladies and Gentlemen:

This letter provides comments of O'Melveny & Myers LLP in response to the request for comments by the Employee Benefits Security Administration ("**EBSA**") in Release No. RIN 1210-AB95, entitled "Financial Factors in Selecting Plan Investments," published at 85 Fed. Reg. 39113-02 (June 30, 2020) (the "**Proposed Rule**"). The Proposed Rule proposes to place restrictions on the use of environmental, social, and governance ("**ESG**") factors in pursuing investment opportunities and to make changes to the Department of Labor's (the "**Department**") 1979 regulation with respect to fiduciary obligations under ERISA section 404(a)(1)(B) regarding an investment or an investment course of action. We appreciate the opportunity to provide comments in connection with the Proposed Rule.

The purpose of this comment letter is to address the unintended consequences of the Proposed Rule should it be adopted as currently written. Many ERISA fiduciaries (including investment advisors) use ESG factors as part of their risk assessment for any given investment. The Proposed Rule would require ERISA fiduciaries that use ESG factors in evaluating any investment to perform additional analysis of ESG factors in order to confirm that such investment is "economically indistinguishable" from an alternative investment where ESG risks were not considered.

With respect to the Proposed Rule, we believe that: (1) it may harm ERISA beneficiaries by (x) increasing the cost of investments (to compensate fiduciaries for additional due diligence), (y) limiting the universe of available investments to those investments that do not implicate ESG considerations, and (z) interfering with the ability of ERISA beneficiaries to select fiduciaries that align with their investment goals, (2) it will discourage asset managers from considering ESG factors in the risk assessment in the first place and restrict managers' ability to provide investment advice that complies with their clients' investment mandates, (3) EBSA has not properly considered the benefits of ESG investing and did not present any evidence that ESG investing is being misused by asset managers, and (4) current law is adequate in this regard and the proposed

changes, especially with respect to ERISA section 404(a)(1)(B), are too broad and unnecessary. As a result of the forgoing, we believe that the Proposed Rule as it is currently structured should be reconsidered or abandoned entirely.¹

I. THE PROPOSED RULE WILL HARM ERISA BENEFICIARIES

The heightened scrutiny of investment opportunities that are attractive from an ESG perspective that the Proposed Rule would require will distort efficient market responses. The Proposed Rule will increase the management costs of investment opportunities with ESG components. For example, ERISA fiduciaries may charge higher fees to compensate themselves for conducting the additional due diligence that would be required to determine whether each ESG-themed investment will be appropriate under the heightened standard. Further, the Proposed Rule may limit the universe of available investments to those investments that do not implicate ESG considerations. This is because plan fiduciaries will be (1) reluctant to participate in more time- and labor-intensive ESG investments, and (2) fearful of exposing themselves to potential liability for failure to properly consider and quantify each ESG factor. Fewer investment opportunities may lower the overall returns of each plan's portfolio. Indeed, investments with ESG components may produce better returns for ERISA beneficiaries than investments that do not include those components.

Moreover, investment managers that would otherwise involve ERISA fiduciaries in co-investment opportunities will seek other co-investors that do not have similar limitations on their investment discretion. Many asset managers believe that ESG considerations are part of prudent risk management and have increased their focus on ESG-themed investments as a result. Those asset managers will try to avoid the heightened ESG analysis and thus may avoid partnering with ERISA fiduciaries for attractive investment opportunities that involve an ESG component. By contrast, we note that utilizing ESG analysis in the decision-making process is not only encouraged, but often mandated, by European regulators.² Therefore, the Proposed Rule could limit investment opportunities available to ERISA fiduciaries and negatively affect the investment returns of ERISA beneficiaries.

The Proposed Rule would also interfere with the ability of ERISA beneficiaries to select fiduciaries that align with their investment goals. In recent years, a number of large, publicly traded companies across the globe adopted ESG criteria in their investment analysis. Given the global economic climate and its focus on ESG factors, many expect an acceleration in ESG investments.³

¹ We also echo the sentiment of many others that the 30-day comment period is unusually short and should be extended. *See* Bernice Napach, *DOL Plan to Limit ESG in 401(k)s Draws Growing Opposition*, ThinkAdvisor (July 27, 2020) (avail. at <https://www.thinkadvisor.com/2020/07/27/dol-plan-to-limit-esg-in-401ks-draws-growing-opposition/>).

² For example, effective March 10, 2021, European regulators have imposed rules that require financial market participants and financial advisers to incorporate into the investment process ESG risks that might have a material negative impact on the financial return of an investment or advice. *See* Regulation (EU) 2019/2088 of the European Parliament and the Council of 27 November 2019 on Sustainability-Related Disclosures in the Financial Services Sector (avail. at <https://eur-lex.europa.eu/eli/reg/2019/2088/oj>).

³ *See* Pippa Stevens, *Sustainable Investing Is Set To Surge in Wake of the Coronavirus Pandemic*, CNBC.com (June 7, 2020) (avail. at <https://www.cnbc.com/2020/06/07/sustainable-investing-is-set-to-surge-in-the-wake-of-the-coronavirus-pandemic.html>).

In addition, fund managers are also using ESG screens to identify investments on a more regular basis. By way of example, in 2017, 75% of the largest 100 companies across 49 countries were employing ESG business models or incorporating aspects of sustainability approaches.⁴ By comparison, that percentage was only 12% in 1993.⁵ We do not believe this trend is necessarily based on the corporate entities or asset managers trying to further their political or social agenda. Rather, it is in large part a direct response to clients' demand that such criteria be considered. Similarly, ERISA plans, on behalf of their beneficiaries, increasingly seek and select managers that align with their investment strategy, including ESG-conscious investing.

II. THE PROPOSED RULE WILL RESTRICT ERISA FIDUCIARIES ABILITY TO PROVIDE INVESTMENT ADVICE THAT COMPLIES BOTH WITH THEIR INVESTMENT MANDATES AND THEIR FIDUCIARY DUTIES

In making investment decisions, an ERISA fiduciary should be able to exercise its discretion in a manner that comports with both its fiduciary duties and its investment mandate. However, the Proposed Rule may prevent an ERISA fiduciary from acting in the best interests of plan beneficiaries. This is because the Proposed Rule appears to treat ESG investments as a separate asset class. The Department's attempt to regulate this purported asset class is misguided. The Proposed Rule would force ERISA fiduciaries to quantify the importance of ESG risk factors in making each investment decision in order to compare it to alternatives. In practice, such quantification is extremely difficult, if not impossible, to accomplish. However, considering ESG factors in the risk management of investment opportunities is a normal part of prudent asset management. For example, a fiduciary's consideration of ESG factors in potential investments may expand the investor base by attracting investors that are seeking ESG-conscious fiduciaries. The wider investor base may in turn be critical to the long-term success of the investment. However, under the Proposed Rule, ERISA fiduciaries would be required to distinguish between pecuniary and non-pecuniary ESG factors at the outset of each investment and to quantify those factors. We believe that it is extremely difficult, if not impossible, to make such a distinction and to quantify each factor in a manner that would allow a fiduciary to compare an ESG-sensitive investment to one that is not. Most if not all risk factors are not quantifiable, and the assessment of risk generally is often subjective. By oversimplifying and restricting the investment decision-making process of ERISA fiduciaries, the Proposed Rule interferes with their ability to comply with investment mandates.

III. EBSA HAS NOT FULLY CONSIDERED THE DATA ON THE BENEFITS OF ESG INVESTING AND DID NOT PRESENT ANY EVIDENCE THAT ESG INVESTING IS BEING MISUSED BY ASSET MANAGERS

The Proposed Rule is seeking to cure alleged improprieties in the investment decisions of fiduciaries by placing a heightened standard on those fiduciaries that propose investment

⁴ See The KPMG Survey of Corporate Responsibility Reporting 2017, *The Road Ahead*, at 9 (avail. at <https://integratedreporting.org/wp-content/uploads/2017/10/kpmg-survey-of-corporate-responsibility-reporting-2017.pdf>).

⁵ See Sunny Oh, *Here's What You Need To Know About the \$12 Trillion ESG Investment World*, MarketWatch.com (Dec. 18, 2019) (avail. at <https://www.marketwatch.com/story/heres-what-you-need-to-know-about-the-12-trillion-dollar-esg-investment-world-2019-12-18>).

opportunities containing an ESG component. This heightened standard as well as the due diligence requirement contained in 29 C.F.R. § 2550(A) (specifically, reviewing the level of diversification, degree of liquidity, and potential risk of a given ESG investment in comparison to other available alternative investments) would only be appropriate if fiduciaries were not already analyzing ESG factors in their analysis of risk, return, and other fiduciary considerations. EBSA has provided no concrete evidence or data to support the assumption that investment managers are not appropriately evaluating such factors.

The Proposed Rule is predicated on the fact that an ERISA plan fiduciary may, as a result of pursuing ESG goals, make an investment decision that does not benefit participants and beneficiaries of the retirement plans with respect to which it acts as a fiduciary. The Proposed Rule references the potential abuse of fiduciary responsibilities with respect to ESG investment opportunities. Specifically, the Proposed Rule states that (a) the term ESG is being used more frequently by institutional asset managers, (b) more ESG ratings services exist, and (c) more ESG funds are being offered.⁶ However, we disagree with the Proposed Rule’s assertion that these factors are signs of potential misuse of ESG factors by ERISA fiduciaries. First, one would expect ESG terminology to be used more frequently by institutional asset managers, especially given the guidance from the U.S. Securities and Exchange Commission.⁷ Second, it is not clear how an increase in ESG rating services is relevant to the determination of whether an institutional asset manager is abusing its fiduciary responsibilities, especially as those services provide information that aids the fiduciary in the performance of its due diligence obligation. Third, the fact that more ESG-focused funds exist does not demonstrate that any institutional asset manager has acted inappropriately, but rather that there is an increased demand among investors for ESG-focused funds. Indeed, it is appropriate for fiduciaries to take into account the preferences and attributes of the plan population and offer ESG-themed investments if there is demand from plan participants.

Importantly, there is no data to support the assumption that institutional asset managers are abusing their fiduciary obligations by investing in ESG opportunities. In fact, we believe the contrary to be true. A study published in the *Sustainability Accounting, Management and Policy Journal* found that disclosure of environmental performance correlated with better performance at the 78 companies in environmentally sensitive industries that the study examined.⁸ Further, a July 2020 report from the U.S. Government Accountability Office (“GAO”) stated that ESG issues can have a substantial and positive impact on a company’s long-term financial performance.⁹ The GAO report further confirmed that private asset managers of public pension funds seek and analyze

⁶ See 85 Fed. Reg. 39113-02, at 39115 (June 30, 2020).

⁷ In 2010, the SEC provided guidance to public companies regarding the SEC’s existing disclosure requirements as they apply to environmental and climate-related matters. Since then, SEC staff has continued to consider these matters, including as part of regular reviews of annual and periodic reports and other company filings by the Division of Corporation Finance. See SEC, *Commission Guidance Regarding Disclosure Related to Climate Change*, Rel. No. 33-9106, 2010 WL 2199526 (Feb. 2, 2010); Public Statement of SEC Chair Jay Clayton (Jan. 30, 2020) (avail. at <https://www.sec.gov/news/public-statement/clayton-md-a-2020-01-30>).

⁸ See Hani Tadros & Michel Magnan, *How Does Environmental Performance Map Into Environmental Disclosure? A Look at Underlying Economic Incentives and Legitimacy Aims*, *Sustainability Accounting, Mgt. and Policy J.* (Mar. 14, 2019) (avail. at <https://www.emerald.com/insight/content/doi/10.1108/SAMPJ-05-2018-0125/full/html>).

⁹ See U.S. GAO, *Public Companies: Disclosure of Environmental, Social, and Governance Factors and Options To Enhance Them* (July 2020) (avail. at <https://www.gao.gov/assets/710/707949.pdf>).

ESG information to enhance their understanding of risk. We posit that by pursuing ESG investment opportunities, plan fiduciaries are not sacrificing potential returns on investment and are instead potentially receiving better financial outcomes for the plan beneficiaries they advise.

IV. CURRENT LAW IS ADEQUATE AND CHANGES IN THE PROPOSED RULE ARE TOO BROAD AND UNNECESSARY

The Proposed Rule includes the current standard for how EBSA evaluates whether a given retirement plan's investment strategy is in compliance with EBSA standards, stating "that the focus of plan fiduciaries must be on the plan's financial returns and that furthering the interest of plan participants and beneficiaries in financial benefits under the plan must be paramount." The Proposed Rule also cautions that fiduciaries may violate ERISA if they accept expected reduced returns or greater risks to secure social, environmental, or other public policy goals. Further, the Proposed Rule expands the scope of 29 C.F.R. § 2550.404a-1 to cover ERISA's duty of loyalty, and further complicates the duties of loyalty and prudence as described in § 2550.404a-1(b).

However, we believe that (1) EBSA has shown no evidence that the existing fiduciary standard is not being met or that it is in any way inadequate for covering all current fiduciaries and investment options, (2) the Proposed Rule fails to recognize the breadth of financial factors, and the complexity of evaluating them, and (3) the proposed change in the law, especially with respect to ERISA section 404(a)(1)(B), is vague, creates unnecessary confusion and is not based on any documented evidence that a problem exists that needs to be addressed.

First, current law already imposes an obligation on plan fiduciaries to act in accordance with ERISA's prudence and loyalty responsibilities, including the "exclusive purpose" rule in ERISA section 404(a)(1)(A), when making investment decisions.¹⁰ The existing regulations have always required a fiduciary to engage in a prudent and documented process, carefully evaluating all risks and gains associated with a given investment. The Proposed Rule, however, singles out ESG considerations by imposing heightened due diligence requirements for evaluating ESG factors. This specific requirement concerning ESG in the Proposed Rule seems to rely on the assumption that investment managers are not appropriately evaluating ESG factors; however, this assumption is not supported by any data.

Second, the Proposed Rule provides that the duty of loyalty contained within ERISA section 404(a)(1)(A) would prohibit plan fiduciaries from investing in opportunities that do not prioritize pecuniary factors. The Proposed Rule states that ESG factors *could* only be considered pecuniary (and thus in compliance with the fiduciary's duty of loyalty) if they "present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories."¹¹ If a pecuniary factor is one that "present[s] economic risks or opportunities that qualified investment professionals would treat as material economic considerations" when considering an investment, we believe that almost all

¹⁰ See 29 U.S.C § 1104.

¹¹ See U.S. Department of Labor, *Notice of Proposed Rulemaking on Financial Factors in Selecting Plan Investments Amending "Investment Duties" Regulation at 29 CFR 2550.404a-1*, at 3 (avail. at <https://www.dol.gov/sites/dolgov/files/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/financial-factors-in-selecting-plan-investments.pdf>).

ESG factors would qualify as pecuniary.¹² Since an ESG assessment will often lead to better financial outcomes for plan beneficiaries, ESG factors are always ultimately pecuniary in nature.

Third, the Proposed Rule would amend the 1979 regulation so that it covers not just the prudence requirement of ERISA section 404(a)(1)(A) but also the exclusive purpose requirement of ERISA section 404(a)(1)(B)¹³. The Proposed Rule purports to interpret loyalty and prudence as requiring identical steps contrary to existing practice and court interpretations. These changes represent dramatic changes in the law that are not necessary and rest upon an unsupported new theory of loyalty. These two duties have never been construed by courts to require the same actions by fiduciaries.¹⁴ Yet, in failing to acknowledge the distinction between loyalty and prudence and to carefully articulate loyalty principles as supported by existing practice, the Proposed Rule creates unnecessary confusion. Such a change should not be undertaken without a demonstration of the harm that the change is designed to address.

We believe that the Proposed Rule may undermine the ability of ERISA fiduciaries to act in the best interests of plan beneficiaries. Asset managers adopting ESG investment policies are doing so not only in response to client demands and the current social and economic climate, but also because such policies have been shown to be prudent investment strategies that lead to better financial outcomes for plan beneficiaries. Therefore, imposing unnecessary burdens on ERISA fiduciaries with respect to their investment decisions relating to ESG investments will only harm plan participants. Further, given the broad-ranging and often inconsistent definitions of ESG, a sensible approach is to require ERISA fiduciaries to comport with all their investment mandates, including ESG ones. Accordingly, we believe that the Proposed Rule is ill-advised and respectfully ask that it be withdrawn from consideration.

Sincerely,

/s/ Alicja I. Biskupska-Haas

By: Alicja I. Biskupska-Haas
Title: Partner, O'Melveny & Myers LLP

¹² The Department also holds the view that certain ESG factors are pecuniary factors that should be considered by plan fiduciaries as part of such fiduciary's broader review of whether an investment decision is prudent. *See* 85 Fed. Reg. 39113-02, at 39115 (June 30, 2020).

¹³ The section requires a fiduciary to discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and — (A) for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan; (B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. *See* 29 U.S.C. § 1104(a)(1).

¹⁴ *See, e.g., Wildman v. American Century Services, LLC*, 362 F. Supp. 3d 685, 700–01 (W.D. Mo. 2019); *Brotherston v. Putnam*, 907 F.3d 17, 25, 30 (1st Cir. 2018).