

December 13, 2021

VIA ELECTRONIC FILING

Office of Regulations and Interpretations
Employee Benefits Security Administration Room N-5655
U.S. Department of Labor
200 Constitution Avenue, N.W.
Washington, D.C. 20210

RE: *Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights*
Attention: RIN 1210-AC03

Dear Acting Assistant Secretary Khawar,

Impact-Weighted Accounts Initiative at Harvard Business School respectfully submits this letter in support of the Department's proposed rule, *Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights* ("the Proposed Rule"), 86 Fed. Reg. 57272 (Oct 14, 2021).

The mission of the Impact-Weighted Accounts Initiative (IWAI) at Harvard Business School is to drive the creation of financial accounts that reflect a company's financial, social, and environmental performance. Our ambition is to create accounting statements that transparently capture external impacts in a way that drives investor and managerial decision-making. Recent years have offered previews of the increasing challenges resulting from humanity exceeding the planetary boundaries, with stronger and more frequent storms and wildfires, as well as the frustrations of the populace with unfair, discriminatory treatment, as well as increasing intra-economy wealth inequality and the significant risks that these pose to investors.

We applaud the Department for its thorough and carefully considered proposal. We believe the Proposed Rule aligns with longstanding Department guidance and the protective nature of the Employee Retirement Income Security Act of 1974 (ERISA). The Proposed Rule would reverse the troublesome provisions in two rules adopted in late 2020, *Financial Factors in Selecting Plan Investments* and *Fiduciary Duties Regarding Proxy Voting and Shareholder Rights*. Rushed through despite the overwhelming [opposition](#) of stakeholders, these rulemakings ushered in a series of changes that overturned long-established Department policies. The predictable effect of the 2020 rulemakings was the stifling of an ERISA fiduciary's otherwise prudent consideration of environmental, social and governance (ESG) factors in their investment decision-making and proxy voting. These rules caused precisely the investor confusion that the Department sought to eliminate. As a result, American workers and retirees are being denied access to ESG investment opportunities that offer competitive returns and reduce risks to their investments. The Proposed Rule would fix this.

Climate change is a relevant factor that fiduciaries must be free to consider

Fiduciaries must be empowered to evaluate *all* factors that impact risk and return, including climate change, which affects nearly [all sectors](#) of the economy. Climate related disasters are increasingly frequent, with a record 22 events causing over \$1 billion damage each in the US during 2020 alone, for a total cost of [\\$100 billion](#). A 2019 analysis of 215 of the world's [largest companies](#) identified just under \$1 trillion of potential risk to them from climate change – and noted that half of these losses are expected to materialize in the next five years. As an empirical

matter, climate risks are not yet fully reflected in asset prices, which means that prudent fiduciaries are warranted in probing further. Climate-related financial risks are especially relevant to retirement investors, who invest over decades, and are generally universal owners with exposure to many at-risk sectors. As society increasingly recognizes the importance of responding to the climate crisis, new regulation and changes in consumer demand will create significant [market and investment opportunities](#) that fiduciaries may wish to [consider](#).

Sophisticated institutional [investors](#) recognize these risks and opportunities, and are addressing climate risk as a bedrock principle of capital preservation and growth. Individual investors also [want](#) access to ESG funds. Climate concerns and other ESG risks will be a significant driver of investment risk and return for the foreseeable future. As with any factor, performance of ESG funds will vary, but an analysis of 11,000 mutual funds over 14 years showed that [ESG funds had lower downside risk and equivalent returns](#) to the broader market. In spite of this overwhelming evidence, organizations that offer retirement plans, or “plan sponsors,” wary of the Department’s stance, have largely remained on the sidelines, with [fewer than 3%](#) offering ESG funds in their investment menu. The Proposed Rule removes the impediments to ESG considerations, returning to fiduciaries their broad mandate to consider all relevant factors.

The Proposed Rule restores fiduciary authority to consider all relevant factors

Since 1978, Department regulations have required fiduciaries to consider all relevant factors when choosing among available investment options. The *Financial Factors* rule replaced this well-understood legal standard with a new and ill-defined “pecuniary” test, causing considerable confusion. The Proposed Rule appropriately eliminates this new term, restoring the traditional all-relevant-factors test.

We are particularly supportive of paragraph (b)(4) which, as the preamble states, “clarifies and confirms that a fiduciary may consider *any* factor material to the risk-return analysis, including climate change and other ESG factors.” This reaffirms that “under ERISA, if a fiduciary prudently concludes that climate change or another ESG factor is material to an investment or investment course of action under consideration, the fiduciary can and should consider it and act accordingly, as would be the case with respect to any material risk-return factor.” In our view, the Proposed Rule is consistent with, and encapsulates, the spirit and text of ERISA, as stated in the paragraph (c)(1), “A fiduciary may not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to other objectives, and may not sacrifice investment return or take on additional investment risk to promote benefits or goals unrelated to interests of the participants and beneficiaries in their retirement income or financial benefits under the plan.” Fiduciaries require autonomy to set strategy and execute investment decisions in line with that strategy without excessive regulatory scrutiny spurred by hostility to ESG or any other kind of potentially relevant considerations.

An IWAI study¹ documents the dynamic nature of issues considered to be financially material and hypothesizes a pathway by which issues can rise, often extremely quickly, to the level of financial materiality. Critically, the authors discuss how important proper organizational and industry response to the elevated demands of stakeholders is to preserving shareholder value. Proper risk management dictates that corporations should be anticipating and managing material issues to stakeholders; a business cannot operate at odds with stakeholders for long

¹ Freiberg, David, Jean Rogers, and George Serafeim. "How ESG Issues Become Financially Material to Corporations and Their Investors." Harvard Business School Working Paper, No. 20-056, November 2019. (Revised November 2020.)

without these issues impacting the business itself and therefore investors. Our research on product and employment impact suggests significant dispersion between firms operating within the same industries, which has the potential for significant outperformance or underperformance in firm's ability to recruit talent, maintain a legitimacy within communities and jurisdictions, and continue to resonate with consumers.²

Indeed, this is already happening. Our research shows that employment intensity³ is positively associated with firm value in a number of industries including air freight & logistics, building products, chemicals, and health care, and is negatively associated with net turnover in a number of industries including health care, food staples & retail, and air freight & logistics. Similarly, environmental intensity⁴ is correlated with lower equity valuations by certain measurements; specifically greater environmental intensity is negatively correlated with both Tobin's Q⁵ and the price to book value of equity ratios in a number of industries including textiles & luxury goods, construction materials, chemicals, utilities. This is after controlling for other determinants of valuation ratios, such as return on assets, leverage, firm size, capital expenditures, R&D expenditures, and dividends divided by sales. All models include industry, country, and year fixed effects. The estimates suggest that a firm with twice the environmental intensity has 2.4% lower Tobin's Q and 5.2% lower price to book value of equity.

In summary, our findings support the conclusion that ESG factors are a critical point of evaluation in assessing an investment. Fiduciaries who fail to take these into account are harming beneficiaries by failing to consider risks and opportunities that have economic consequences either now or in the future. The nature of dynamic materiality suggests that even factors which are not immediately financially material to firms may quickly become so, i.e. a 'viral' video of worker abuse or breaking investigative reports, and firms or investors that have not properly managed such issues ahead of time find it is often too late to avoid significant losses.

The Proposed Rule clarifies that investment options incorporating relevant climate and other ESG factors are eligible as defaults

We endorse the Department's rescission of the prohibition on certain investment alternatives being used as a default investment: the Qualified Default Investment Alternative (QDIA). A fiduciary's responsibilities of prudence and loyalty are no different for a QDIA than for other plan investments, and if a participant does not wish to invest in the QDIA, they can select another investment vehicle. Any other approach would, as the Department observes in the preamble, "only serve to harm participants by depriving them of otherwise financially prudent options as QDIAs."

The Proposed Rule clarifies that ERISA plans may continue to make prudent investments that provide collateral benefits for workers, communities, and the environment

² Serafeim, George, and Katie Trinh. ["Impact Accounting for Product Use: A Framework and Industry-specific Models."](#) Harvard Business School Working Paper, No. 21-141, June 2021., Fadhel, Adel, Katie Panella, Ethan Rouen, and George Serafeim. "Accounting for Employment Impact at Scale." (pdf) Harvard Business School Working Paper, No. 22-018, December 2021

³ Employment intensity is calculated as total employment impact divided by the number of employees

⁴ Environmental Intensity is calculated as total environmental impact divided by revenues

⁵ Tobin's Q is a measure of the market value over the replacement value of assets.

The *Financial Factors* rule provided that non-financial factors that offer collateral benefits to beneficiaries could be used to decide between funds only where the funds are economically “indistinguishable” (a provision known as the “tie-breaker rule.”) This untenable standard effectively prohibited the use of collateral benefits altogether, a stark departure from longstanding Department guidance. While the Proposed Rule’s “equally serve the financial interests of the plan” language is an improvement on the term “indistinguishable,” we suggest that the language is still too narrow. The issue is not how closely two or more investments resemble one another, but whether they are each the product of a prudent selection process. Fiduciaries should receive equal deference if their investment choice is the product of such a process. We believe it is more appropriate for the collateral benefit provision in the final rule to focus on whether investments are equally prudent (i.e., the output of a prudent fiduciary process,) rather than on an analysis of the equivalence of their financial characteristics.

In the case of evaluating such situations where investments are equally prudent, impact monetization, the process of estimating the relative value that an organisation creates, preserves or erodes for its stakeholders, expressed as a common monetary unit, can be an important way of helping fiduciaries to evaluate the comparative magnitude/importance of different ESG factors and to incorporate these into their traditional financial analysis tools.

ESG aligned investing will reduce unpriced risk, create jobs, and generate wealth

The physical risks of climate change and other ESG issues present a minefield that fiduciaries must attempt to navigate. The transition to a net-zero economy will require nearly every industry to be redesigned and rebuilt, resulting in many stranded assets. But this transition also presents generational wealth and job creation opportunities. The Proposed Rule clears the way for fiduciaries to offer retirement investors access to these investment opportunities, that other institutional investors are now pursuing and to which retirement savers say they want access.

The Proposed Rule restores fiduciary authority to make prudent decisions in proxy voting

We also support the ability of ERISA plan fiduciaries to exercise their judgment to vote proxies in the best interest of participants and beneficiaries. ERISA’s fiduciary duties include active ownership, including informed proxy voting on shareholder proposals affecting companies owned by the plan. Fiduciaries must be given discretion to vote on these proposals, exercising critical oversight that has been shown to reduce downside risk. We support the Proposed Rule’s revisions to the current rule, rightfully restoring a fiduciary’s ability to vote on a wide array of important issues, including climate change.

Closing

In sum, the Proposed Rule would amend numerous confusing, contradictory and burdensome provisions of the current rules that display a prejudice against climate-related and other ESG considerations. The clear prejudice against this potentially relevant economic information is outside the investment mainstream⁶ and could force fiduciaries to fail to consider, or act in spite of knowledge of, information potentially providing for lower risk and/or higher returns. The

⁶ <https://www.unpri.org/pri-blog/ceo-quarterly-update-celebrating-4000-signatories-and-supporting-the-evolution-of-ri/8033.article>

Proposed Rule allows fiduciaries to consider all available information in seeking to best serve the interests of the plan's participants and beneficiaries and provides fiduciaries the clarity and autonomy necessary to appropriately utilize information on climate-related and ESG factors to make investment decisions and exercise shareholder rights in line with their fiduciary duties and overarching investment strategy.

Sincerely,

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Impact-Weighted Accounts Project Advisory Councils Chair, Global Steering Group for Impact
Investment (GSG) Co-founder Chair, Apax Partners Worldwide LLP, Bridges Fund
Management, Big Society Capital Co-founder, British and European Venture Capital
Associations, Social Finance

cc: Honorable Marty Walsh, Secretary of Labor