



July 30, 2020

VIA ELECTRONIC SUBMISSION

To: Employee Benefits Security Administration, Department of Labor
Re: Financial Factors in Selecting Plan Investments under the Employee Retirement Income Security Act of 1974 (RIN 1210-AB95)

The Institute for Policy Integrity (“Policy Integrity”) at New York University School of Law¹ and Environmental Defense Fund (“EDF”) respectfully submit the following comments to the Department of Labor (“Department”) regarding a proposed rule that would impose limitations on investors’ ability to choose investments in Environmental Social and Governance (“ESG”) strategies (“Proposed Rule”).² Policy Integrity is a non-partisan think tank dedicated to improving the quality of government decisionmaking through advocacy and scholarship in the fields of administrative law, economics, and public policy. EDF is a non-partisan, non-governmental environmental organization representing over two million members and supporters nationwide. Since 1967, EDF has linked law, policy, science, and economics to create innovative, and cost-effective solutions to today’s most pressing environmental problems. Our comments are focused on how the Department’s Proposed Rule would limit choices available to investors, including by eliminating opportunities to invest their savings in strategies that reflect legitimate perspectives on markets.

The Department’s Proposed Rule suffers from numerous flaws and deficiencies that would render it arbitrary and capricious. Specifically, the Department:

- Provides insufficient factual evidence for the Proposed Rule;
- Does not provide a reasonable basis for changing its existing policy;
- Fails to consider the large and growing body of evidence that ESG investing is a legitimate value-seeking strategy, and in fact, often outperforms its traditional peers;
- Fails to recognize that lack of clarity in the Proposed Rule will have a chilling effect on ESG development and investment;
- Understates the costs of the Proposed Rule; and
- Deprives plan beneficiaries of a broad range of investment alternatives.

¹ This document does not purport to present New York University School of Law’s views, if any.

² Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 39,113 (proposed Jun. 30, 2020) [hereinafter “Proposed Rule”], <https://www.govinfo.gov/content/pkg/FR-2020-06-30/pdf/2020-13705.pdf>.

For the reasons explained further below, the Proposed Rule is arbitrary and capricious.

I. The Department Provides Insufficient Factual Evidence for the Proposed Rule.

The Administrative Procedure Act (“APA”) requires agencies to “examine the relevant data and articulate a satisfactory explanation for their actions, including a rational connection between the facts found and the choice made.”³ Agencies must also “supply a reasoned analysis” for repeals or changes to existing rules⁴ and “show that there are good reasons for the new policy.”⁵

In this Proposed Rule, the Department fails to provide enough factual evidence to support the new rule, and moreover, provides no reasonable basis for changing its prior position on ESG investing strategies, rendering the proposal arbitrary and capricious. Further, as Part III shows, the evidence on ESG investing repeatedly demonstrates that, contrary to the Department’s conclusory statements, ESG investing is a legitimate, value-seeking strategy that has demonstrated superior relative risk-return.

First, the Proposed Rule fails to provide any factual evidence showing that the contemplated changes to the agency’s existing regulations are necessary or rational. The Proposed Rule claims that ESG investing raises “heightened ERISA concerns.”⁶ But in fact, the Department provides no concrete examples of ESG funds raising such concerns. Rather, the agency’s concerns appear to be mere conjecture. For instance, the Proposed Rule notes that fiduciaries must maintain an “‘eye single’ to maximizing the funds available to pay retirement benefits.”⁷ But it does not explain why investing in ESG funds would be incompatible with that requirement. Instead, it simply states, “The Department is concerned, however, that the growing emphasis on ESG investing *may be prompting* ERISA plan fiduciaries to make investment decisions for purposes distinct from providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan.”⁸ But merely speculating as to whether plan fiduciaries are, in fact, making investment decisions for purposes distinct from providing benefits to participants and beneficiaries is not sufficient for the purposes of notice-and-comment rulemaking under the Administrative Procedure Act.⁹ While there might be different reasons that plan fiduciaries include ESG funds in their investment strategy, there is no evidence in the record to suggest that such funds do not seek to maximize funds and provide pecuniary benefits to plan participants and beneficiaries. In fact, there is growing evidence that ESG

³ *Motor Vehicle Mfrs. Ass’n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983) (internal quotation marks omitted); *Citizens’ Comm. to Save Our Canyons v. U.S. Forest Serv.*, 297 F.3d 1012, 1035 (10th Cir. 2002) (agency must examine “the relevant data” and articulate “a satisfactory explanation for its action including a rational connection between the facts found and the choice made.”).

⁴ *State Farm*, 463 U.S. at 42.

⁵ *FCC v. Fox TV Stations, Inc.*, 556 U.S. 502, 515 (2009).

⁶ Proposed Rule, 85 Fed. Reg. at 39,115.

⁷ *Id.*

⁸ *Id.* at 39,116 (emphasis added).

⁹ *State Farm*, 463 U.S. at 52 (“the agency must explain the evidence which is available, and must offer a ‘rational connection between the facts found and the choice made’”) (internal citations omitted).

funds outperform their non-ESG counterparts, contrary to the Department’s conclusions.¹⁰ Failure to acknowledge this evidence is arbitrary and capricious.

The Department also states that it is “concerned that some investment products may be marketed to ERISA fiduciaries on the basis of purported benefits and goals unrelated to financial performance.”¹¹ But again, this is mere speculation about marketing, as well as speculation about the effect that such marketing may have on what plan fiduciaries actually do. Certainly, plan fiduciaries do not fall prey to every marketing campaign that comes their way. Finally, the Department states that “ESG funds often come with higher fees, because additional investigation and monitoring are necessary.”¹² However, this concern ignores the fiduciary duty of loyalty. Able fiduciaries will assess the expected return from given investments and strategies compared to the fees and make a decision based on the expected return net of fees. Thus, the Department errs by basing its decision on higher fees associated with some ESG funds, when those funds may produce returns that are significantly higher than their non-ESG counterparts.¹³

The scant factual evidence that the Department does cite in the Proposed Rule—primarily, two newspaper articles—does not actually support its conclusions. The first article discusses reasons to participate in ESG investing, the first two of which are to “make money” and “reduce risk.”¹⁴ The second article that the Department cites discusses the rapid growth of ESG as stemming from fact that markets now “have the expertise to understand that these new business models have the potential to be climate solutions and to grow the economy at the same time.”¹⁵ If the rapid growth of a new strategy is heralded for its superior returns and risk-reduction qualities, singling-out such a strategy and preventing American investors from using it, with no factual evidence to support such a position, is arbitrary and capricious. The Department fails to provide any “good reasons” to disregard evidence to the contrary that has informed its prior guidance.¹⁶ Instead, ESG strategies could reap the very benefits to participants and beneficiaries that the Department is attempting to secure.

¹⁰ See Emily Steinbarth & Scott Bennett, *Materiality Matters: Targeting the ESG Issues that Impact Performance*, HARV. CORP. GOV. FORUM (May 10, 2018), <https://corpgov.law.harvard.edu/2018/05/10/materiality-matters-targeting-the-esg-issues-that-impact-performance/>; Siobhan Riding, *Majority of ESG Funds Outperform Wider Market Over 10 Years*, FIN. TIMES, (Jun. 14, 2020), <https://www.ft.com/content/733ee6ff-446e-4f8b-86b2-19ef42da3824>; Audrey Cher, *Sustainable Funds Are Outperforming Their Peers During the Pandemic, BNP Paribas Says*, CNBC (Jun. 2, 2020), <https://www.cnbc.com/2020/06/02/esg-funds-outperforming-peers-during-coronavirus-pandemic-bnp-paribas.html>.

¹¹ Proposed Rule, 85 Fed. Reg. at 39,116.

¹² *Id.*

¹³ See *supra* note 10.

¹⁴ James MacKintosh, *A User's Guide to the ESG Confusion*, WALL ST. J., (Nov. 12, 2019), www.wsj.com/articles/a-users-guide-to-the-esg-confusion-11573563604.

¹⁵ Mark Miller, *Bit by Bit, Socially Conscious Investors are Influencing 401(k)'s*, N.Y. TIMES (Sept. 27, 2019), www.nytimes.com/2019/09/27/business/esg-401k-investing-retirement.html.

¹⁶ *Fox*, 556 U.S. at 516.

Finally, the Department admits in two instances that it does not have sufficient data to reach a reasoned conclusion. First, the Department states that it does not have sufficient data to determine the frequency of investments that are “economically indistinguishable,” yet believes that this scenario is “very rare.”¹⁷ Second, the Department admits that it does not have sufficient data to determine how many plans are “heavily invested in underperforming ESG funds” in order to determine costs of the rule change, yet prematurely “concludes that [the] documentation requirement would impose little, if any, additional cost.”¹⁸ As these examples show, the Department appears intent on reaching conclusions, yet lacks any factual evidence to support the rationality of those conclusions. This is textbook arbitrary and capricious decisionmaking.¹⁹ The public does not know whether the Proposed Rule “rests on factual findings that contradict the agency’s previous record,” and has no way to meaningfully comment on the proposal.²⁰ It appears that the Department may have been better served by an information request, rather than a rulemaking.

As the Department has not provided sufficient factual evidence to support the new proposal, there is no reasonable basis for the Department’s conclusory assertions and the public has no avenue to meaningfully comment on this proposal, in violation of the Administrative Procedure Act.²¹

II. The Department Does Not Provide a Reasonable Basis for Changing Its Existing Policy.

Pursuant to the APA, an agency must “supply a reasoned analysis” for repeals or changes to existing rules²² and “show that there are good reasons for the new policy.”²³ An agency must also “display awareness that it *is* changing position.”²⁴ Here, the Department attempts

¹⁷ *Id.* at 39,124.

¹⁸ *Id.*

¹⁹ *State Farm*, 463 U.S. at 43 (“[A]n agency must ‘examine the relevant data and articulate a satisfactory explanation for its action including a rational connection between the facts found and the choice made’”) (internal quotation marks omitted); *McDonnell Douglas Corp. v. United States Dep’t of the Air Force*, 375 F.3d 1182, 1186-87 (D.C. Cir. 2004) (stating that the Court “will not defer to the agency’s conclusory or unsupported suppositions”); *Cal. Wilderness Coal. v. United States DOE*, 631 F.3d 1072, 1105 (9th Cir. 2011) (finding that “a record that supports the reasonableness of the agency’s decision” is a “critical factual element” without which, the agency’s conclusion is unsupported).

²⁰ *See Fox*, 556 U.S. at 516.

²¹ *Haralson v. Fed. Home Loan Bank Bd.*, 655 F. Supp. 1561, 1566 (D.D.C. 1987) (“Interested parties cannot meaningfully comment upon the agency’s proposal if they do not have an accurate picture of the reasoning that led the agency to the proposed rule.”) (citing *Connecticut Light & Power Co. v. NRC*, 673 F.2d 525, 533 (D.C. Cir. 1982) (cert. denied)); *Alfa Int’l Seafood v. Ross*, 264 F. Supp. 3d 23, 55 (D.D.C. 2017) (“A series of cases from the D.C. Circuit makes clear that when an agency relies on data that is critical to its decision-making process, that data must be disclosed in order to provide the public an opportunity to meaningfully comment on the agency’s rulemaking rationale.”); *Am. Forest & Paper Ass’n v. United States EPA*, 1996 U.S. Dist. LEXIS 13230, *34, 1996 WL 509601 (holding that the EPA’s failure to explain the basis for a change deprived Plaintiff of its right to meaningfully comment on the rulemaking).

²² *State Farm*, 463 U.S. at 42.

²³ *Fox*, 556 U.S. at 515.

²⁴ *Id.* (emphasis in original).

to craft its proposal as simple codification of existing guidance instead of acknowledging significant changes from its prior guidance, which is codified in the Code of Federal Regulations,²⁵ and provides no reasonable basis for making such changes.

In its 2018 guidance, the Department stated that fiduciaries merely “must not too readily treat ESG factors as economically relevant to the particular investment choices at issue when making a decision,” whereas the Proposed Rule strictly prohibits such discretion by fiduciaries except in the “rare event of [investment] alternatives being indistinguishable.”²⁶

In the case of “economically indistinguishable” investments, the Proposed Rule also requires documentation of a fiduciary’s “basis for concluding that a distinguishing factor could not be found and why the selected investment was chosen based on the purposes of the plan, diversification of investments, and the financial interests of plan participants and beneficiaries in receiving benefits from the plan.”²⁷ The Department provides no basis for this new and additional documentation requirement. Although one may be led to presume that such documentation is for the benefit of investors, the documentation is in addition to, rather than instead of, requirements in previous guidance that already require fiduciaries to “appropriately document their investment activities.”²⁸ Given the preexisting documentation requirements and this additional requirement for documentation that is aimed at investments that are already “indistinguishable,” it appears that the Department’s intention behind this requirement is to discourage plan managers from choosing ESG investments, perhaps in the absence of any reasonable basis to simply ban ESG investments outright. Once again, the lack of a reasonable basis—or any basis at all—on which to evaluate this documentation requirement leaves the public with no way to meaningfully comment on the Proposed Rule.

Further, the Proposed Rule claims that material factors include only generally accepted investment theories, and gives some counterexamples of corporate behavior that are so dysfunctional, and borderline criminal, that it provides no helpful elucidation of the Department’s position on materiality. This provides no helpful elucidation on ESG factors, which though not traditionally “generally accepted investment theories,” have grown tremendously in recent years²⁹ and have shown conclusive ability to outperform “generally

²⁵ As noted in the Proposed Rule, prior guidance includes Interpretive Bulletin 94-1 (59 FR 32606 (June 23, 1994)), Interpretive Bulletin 2008-01 (73 FR 61734 (Oct. 17, 2008)), Interpretive Bulletin 2015-01 (80 FR 65135 (Oct. 26, 2015)), and Field Assistance Bulletin No. 2018-01 (“FAB 2018-01”) (Apr. 23, 2018). This guidance has, over time, clarified the Department’s changing interpretations of the ERISA requirements as they relate to ESG investing. These Interpretive Bulletins are codified in the Code of Federal Regulations. *See* 29 C.F.R. §§ 2509.2015-01; 2550.404a-1.

²⁶ Proposed Rule, 85 Fed. Reg. at 39,115, 39,124.

²⁷ *Id.* at 39,124.

²⁸ *Id.* (stating, “[i]n prior guidance, the Department has encouraged plan fiduciaries to appropriately document their investment activities”).

²⁹ Sean Collins & Kristen Sullivan, *Advancing Environmental, Social, and Governance Investing*, DELOITTE (Feb. 20, 2020) (“Evidence suggests a similar growth in a desire for [ESG] investments. Globally, the Percentage of both retail and institutional investors that apply [ESG] principles to at least a quarter of their portfolios jumped from 48 percent in 2017 to 75 percent in 2019.”) (citation omitted), <https://www2.deloitte.com/us/en/insights/industry/financial-services/esg-investing-performance.html>.

accepted investment theories” to which the Department intends to tie American investors.³⁰ American investors deserve the full menu of options for value-seeking investments, and the Department’s failure to adequately recognize and analyze the propensity of ESG investing to outperform the agency’s narrowly tailored conception of “generally accepted investment theories” is arbitrary and capricious.

In sum, the Department has failed to “supply a reasoned analysis”³¹ for changing its existing rules and guidance, and has not shown that “there are good reasons for the new policy.”³²

III. The Department Fails to Consider the Large and Growing Body of Evidence that ESG Investing Is a Legitimate Value-Seeking Strategy, and In Fact, Often Outperforms Its Traditional Peers.

In the Proposed Rule, the Department fails to consider the large and growing body of evidence that ESG investments are both a legitimate, value-seeking investment strategy, and also a strategy that in many cases outperforms its traditional peers. Consideration of this analysis should lead to the conclusion that rather than restricting access to ESG funds, the Department should be encouraging greater consideration of ESG factors. But at bare minimum, this evidence suggests that the Department’s Proposed Rule rests on flawed and irrational assumptions and conclusions. Failure to acknowledge or consider this information renders the Proposed Rule arbitrary and capricious.

ESG investing has grown and matured significantly in recent years. In fact, there is now solid evidence that many ESG factors are wealth maximizing.³³ Another way of viewing ESG investing is that, for large institutional investors, diversification has strongly reduced exposure to idiosyncratic risk, and through ESG factors, investors are attempting to reduce vulnerability to systemic risk. ESG factors account for those systemic risks: for example, increasingly frequent severe weather events directly affect wide swaths of the economy, and climate change risks affect nearly every company by posing physical risks, transition risks, or both. The global systemic risk that climate change presents cannot be reduced through diversification, alone; thus judicious investors rely on ESG factors to secure their portfolios.³⁴

In this light, the Department’s concern over ESG products is misguided, as it ignores and attempts to curtail an important and legitimate value-seeking investment strategy.

³⁰ Jon Hale, *U.S. ESG Funds Outperformed Conventional Funds in 2019*, MORNINGSTAR (Apr. 16, 2020), (“Sustainable funds comfortably outperformed their peers in 2019. The returns of 35% of sustainable funds placed in the top quartile of their respective categories, and nearly two thirds finished in the top two quartiles. By contrast, the returns of only 14% of sustainable funds placed in the bottom quartile, and only about one third placed in the bottom half.”), <https://www.morningstar.com/articles/973590/us-esg-funds-outperformed-conventional-funds-in-2019>.

³¹ *State Farm*, 463 U.S. at 42.

³² *See Fox*, 556 U.S. at 515.

³³ Steinbarth & Bennett, *supra* note 10.

³⁴ Miguel A. Centeno, et al., *The Emergence of Global Systemic Risk*, 41 ANN. REV. SOCIOLOGY 65 (2015), <https://www.annualreviews.org/doi/pdf/10.1146/annurev-soc-073014-112317>.

Moreover, fiduciaries are already obligated to focus on the substance of investments, rather than making judgments based on how products or strategies are marketed. It is the Department's responsibility to ensure that Americans' retirement incomes consider all material risk, including ESG risks, yet this proposal rejects that responsibility. As one investment professional explained, "ESG isn't an asset class, but rather prudent risk management. . . It is the DOL's responsibility to protect savers and the retirement incomes of millions of Americans—which means ensuring our 401(k)s and pensions consider all material risks, including ESG risks."³⁵

ESG factors function as a viewpoint on risk. For example, in the environmental context, this entails using current, rather than backwards-facing, analysis on rapidly developing and ahistorical climate data in order to calculate risk. Typically, risk assessment is backwards-facing: historical data is used to model the likelihood of risk scenarios, which are then priced.³⁶ However, ESG investors' preferences can be understood in terms of an altered risk assessment model. In particular, current risk assessment modeling uses outdated assumptions about the likelihood of certain risk scenarios occurring. Increased frequency of natural disasters that have the potential to, and do, destroy billions of dollars of assets are the downside scenario that risk-aware ESG investors want to avoid.³⁷ Evidence has shown that exposure to climate risks negatively affects creditworthiness,³⁸ and structural incentives and barriers fundamentally prevent markets from accurately pricing climate risks. For example, industries such as fossil fuels could see a significant portion of their assets become stranded in the near future.³⁹ As certain academics have characterized the issue, "one of the main drivers of uncertainty in predicting the economic impacts of climate change is the inability to predict how sufficiently—and how fast—markets and governments will act to limit emissions. But all pathways lead to significant costs, some larger than others."⁴⁰ Other academics go further into the technical details to confirm that "the latest academic work in creating asset pricing models that account for both carbon

³⁵ Fiona Reynolds, Letter to the Editor, *ESG Is Risk Management, Not an Asset Class*, WALL ST. J. (Jun. 29, 2020), <https://www.wsj.com/articles/esg-is-risk-management-not-an-asset-class-11593453762>.

³⁶ See Institute for Policy Integrity at NYU School of Law, *Comments to Vanessa A. Countryman, Secretary, Securities and Exchange Commission, Re: Management's Discussion and Analysis, Selected Financial Data, and Supplementary Financial Information* (Apr. 28, 2020), https://policyintegrity.org/documents/Policy_Integrity_Comments_SEC_Reg_S-K_.pdf.

³⁷ Adam B. Smith, *2010-2019: A Landmark Decade of U.S. Billion-Dollar Weather and Climate Disasters*, NTL OCEANIC & ATMOSPHERIC ADMIN., (Jan. 8, 2020), ("Four of the five most costly U.S. billion-dollar disasters occurred in the 2010s (i.e., Hurricanes Harvey, Irma, Maria, and Sandy). In addition, the two most destructive and costly wildfire seasons in U.S. history have taken place over the last three years, with losses exceeding \$40 billion, with much of this damage in California."), <https://www.climate.gov/news-features/blogs/beyond-data/2010-2019-landmark-decade-us-billion-dollar-weather-and-climate>; Madison Condon, *Market Myopia's Climate Bubble* (Working Paper 2020).

³⁸ Gianfranco Gianfrate, *Climate Change and Credit Risk*, 266 J. CLEANER PROD. 121634 (2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3568711.

³⁹ Drew Riedl, *Why Market Actors Fuel the Carbon Bubble: The Agency, Governance, and Incentive Problems that Distort Corporate Climate Risk Management*, J. SUSTAINABLE FIN. & INV. (Jun. 1, 2020), <https://www.tandfonline.com/doi/full/10.1080/20430795.2020.1769986>.

⁴⁰ Condon, *supra* note 37.

emissions and stochastically varying risk confirm that ‘climate change entails a positive and increasing risk premium.’⁴¹

Financial risk factors for firms relating to climate change come in two forms: physical risks and transition risks. Both forms of risk can negatively affect firms through multiple channels and on multiple timeframes.⁴² Even incomplete estimates show that climate risks are enormous: a survey of voluntary disclosures from 215 of the world’s 500 largest firms showed approximately \$1 trillion in climate-related risks.⁴³ These risks are also occurring over an investor-relevant time frame. For example, climate change-related extreme weather could cost the Gulf Coast states \$18-23 billion annually by 2030.⁴⁴ The failure of the Department to acknowledge or consider the evidence that climate risk negatively affects creditworthiness, returns, volatility, and more is arbitrary and capricious.

In the social and governance realms, a growing body of research is documenting the links between prudent management and firm value. To name just a few, employee satisfaction is associated with higher equity prices⁴⁵ and corporate social responsibility reduces firms’ cost of equity.⁴⁶ Perhaps even more importantly, shareholders demonstrate that they care about these initiatives,⁴⁷ and subsequently reward companies which have better stakeholder engagement with enhanced financial value.⁴⁸ ESG investors see these risks as not being adequately priced into markets, and thus investment in funds that monitor to ensure such company characteristics allows for this viewpoint on risk to be incorporated into investors’ portfolios.

⁴¹ See Christos Karydas & Anastasios Xepapadeas, *Pricing Climate Change Risks: CAPM with Rare Disasters and Stochastic Probabilities* (CER-ETH Working Paper Series, Working Paper No. 19/311, 2019), <https://ssrn.com/abstract=3324499>.

⁴² Policy Integrity, *supra* note 36 at 2.

⁴³ *Id.* (citing Brad Plumer, *Companies See Climate Change Hitting Their Bottom Lines in the Next 5 Years*, N.Y. TIMES (June 4, 2019), <https://www.nytimes.com/2019/06/04/climate/companies-climate-change-financial-impact.html> (noting that these disclosures are voluntary and non-exhaustive of all firms, meaning the value of overall climate risk to the economy is likely significantly higher)).

⁴⁴ *Id.* (citing ENTERGY CORP., BUILDING A RESILIENT ENERGY GULF COAST: EXECUTIVE REPORT 6 (2010), https://www.entergy.com/userfiles/content/our_community/environment/GulfCoastAdaptation/Building_a_Resilient_Gulf_Coast.pdf).

⁴⁵ Alex Edmans, *Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices*, 101 J. Fin. Econ. 621 (2011), <http://faculty.london.edu/aedmans/Rowe.pdf>; Alex Edmans, *The Link Between Job Satisfaction and Firm Value, With Implications for Corporate Social Responsibility*, Academy of Management Perspectives (2012), <http://faculty.london.edu/aedmans/RoweAMP.pdf>.

⁴⁶ Sadok El Ghouli, Omrane Guedhami, Chuck C.Y. Kwok, Dev R. Mishra, *Does Corporate Social Responsibility Affect the Cost of Capital?*, 35 J. BANKING & FIN. 2388 (2011), <https://www.sciencedirect.com/science/article/pii/S0378426611000781>.

⁴⁷ Philipp Krueger, *Corporate Goodness and Shareholder Wealth*, 115 J. FIN. ECON. 304 (2015), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2287089; Olga Hawn, Aaron K. Chatterji, and Will Mitchell, *Do Investors Actually Value Sustainability? New Evidence from Investor Reactions to the Dow Jones Sustainability Index*, 39 STRATEGIC MGMT. J. 949, (2017) <https://onlinelibrary.wiley.com/doi/abs/10.1002/smj.2752>.

⁴⁸ Witold J. Henisz, Sinziana Dorobantu, & Lite J. Nartey, *Spinning Gold: The Financial Returns to Stakeholder Engagement*, 35 STRATEGIC MGMT. J. 1727 (2013), <https://onlinelibrary.wiley.com/doi/abs/10.1002/smj.2180>.

Investment by companies to earn higher ESG ratings often means that they have more information about aspects of their company and supply chains relevant to strategic risk, leading to positive effects that make companies stronger and more resilient to shocks such as physical climate change risks or even Covid-19.⁴⁹ One apt example is Walmart, which pledged to cut carbon emissions. Through the increased information about its supply chain that came from this endeavor, Walmart discovered that 90% of its emissions came from its suppliers, and is now working with them to reduce its carbon emissions by one gigaton by 2030. The company says that the project has improved its financial resilience, as well.⁵⁰ A report by State Street and Harvard Business School notes that, “[f]irms that commit to their stakeholder relations provide a signal of resilience to investors, leading to less negative stock returns during the market collapse.”⁵¹ Asset managers understand this change in the markets. One industry leader stated that the Department’s Proposed Rule:

[S]uggests, but without evidence, that the growing emphasis on ESG investing may be prompting plan fiduciaries to make investment decisions for purposes distinct from providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan. However, the DOL proposal is out of step with professional investment managers, who increasingly analyze ESG factors precisely because of risk, return and fiduciary considerations.⁵²

An overwhelming majority of asset managers polled in 2018 described their motivations for incorporating ESG as the desire to improve returns and minimize risk, as well as adhering to their duties as fiduciaries.⁵³

Investors in ESG strategies today are generally highly sophisticated and driven by expected returns. Studies show that “ESG-focused indexes have matched or exceeded returns of their standard counterparts, with comparable volatility.”⁵⁴ Additionally, according to one report, screening for ESG factors would have avoided 90% of S&P 500 bankruptcies from 2005-2015, and “S&P 500 companies in the top 25% by ESG ratings experienced lower future earnings-per-share volatility than those in the bottom 25%.”⁵⁵ ESG funds have similarly

⁴⁹ Gillian Tett, Opinion, *Why ESG Investing Makes Fund Managers More Money*, FIN. TIMES (Jul. 9, 2020), <https://www.ft.com/content/1cfb5e02-7ce1-4020-9c7c-624a3dd6ead9?shareType=nongift>.

⁵⁰ *Id.*

⁵¹ *Id.* (citing Alex Cheema-Fox et al., *Corporate Resilience and Response During COVID-19*, (Harv. Bus. Sch. Working Paper No. 20-108, 2020), https://www.hbs.edu/faculty/Publication%20Files/20-108_150212c6-b496-458a-8584-5f2ae9d5e44a.pdf).

⁵² Press Release, US SIF: The Forum for Sustainable and Responsible Investment, Statement on Department of Labor Rulemaking Related to ERISA and ESG Considerations (Jun. 24, 2020), https://www.ussif.org/blog_home.asp?Display=141.

⁵³ *Id.*

⁵⁴ Brian Deese, et al. *Sustainability: The Future of Investing*, BLACKROCK INV. INST. (Feb. 2019), <https://www.wlrk.com/docs/bii-sustainability-future-investing-jan-2019.pdf>.

⁵⁵ BANK OF AMERICA MERRILL LYNCH, ESG FROM A TO A: A GLOBAL PRIMER (Nov. 25, 2019), https://www.bofaml.com/content/dam/boamlimages/documents/articles/ID19_12722/ESG_from_A_to_Z.pdf.

outperformed the market during the Covid-19 pandemic⁵⁶ and are still attracting growing inflows while the overall fund universe saw outflows.⁵⁷ As attorney Martin Lipton has noted, such evidence underscores “growing investor recognition of the importance of ESG in risk management and mitigation, as well as the view that addressing ESG issues promotes long-term value creation.”⁵⁸ And with respect to this proposal, he noted that, “[i]t is particularly anomalous, especially in these times, for the DOL to limit or unduly burden the ability of plan fiduciaries to exercise a judgment that items like good corporate governance, effectively navigating energy transitions or operating in a sustainable manner can enhance or protect returns.”⁵⁹

In short, failure to acknowledge the substantial evidence that ESG investing is a legitimate value-seeking strategy, and in fact, often outperforms its traditional peers renders the Proposed Rule arbitrary and capricious.

IV. The Department Fails to Recognize that Lack of Clarity in the Proposed Rule Will Have a Chilling Effect on ESG Development and Investment.

Lack of clarity in the Proposed Rule will likely have a chilling effect on ESG development and investment, which the Department fails to acknowledge or assess as a forgone benefit.

As discussed, many plans use ESG factors as a part of their overall assessment of risk and return. The Proposed Rule purports to allow inclusion of such funds as part of a value-maximizing strategy, yet also suggests that any mention of an ESG oriented inclusion would trigger the rule’s limitations and/or additional paperwork requirement.⁶⁰ In the face of the Proposed Rule, plan administrators will likely interpret this rule conservatively to avoid their decisions running afoul of the Department’s interpretation. The effect of this conservative compliance will be to eliminate even ESG funds that focus only on returns, lest their mere inclusion of ESG factors—even as a tie-breaker between investments—be deemed non-compliant in the future.

Additionally, the Department admits that there is no clear consensus about what constitutes an ESG investment.⁶¹ This creates vagueness that will result in a Rule that is arbitrary and capricious because the Department itself admits that there is no consistent meaning of this term. Such vagueness also makes the Department’s documentation requirement in the context of a “tie-breaker” scenario confusing. For instance, fund

⁵⁶ Madison Darbyshire, *ESG Funds Continue to Outperform Wider Market*, FIN. TIMES (APR. 3, 2020), <https://www.ft.com/content/46bb05a9-23b2-4958-888a-c3e614d75199>.

⁵⁷ MORNINGSTAR, *GLOBAL SUSTAINABLE FUND FLOWS: ESG FUNDS SHOW RESILIENCE DURING COVID-19 SELL-OFF* (May 2020), [https://www.wlrk.com/docs/Global_ESG_Q1_Flow_Report_\(2\).pdf](https://www.wlrk.com/docs/Global_ESG_Q1_Flow_Report_(2).pdf).

⁵⁸ Alicia McCarthy, et al., *DOL Proposes New Rules Regulating ESG Investments*, HARV. CORP. GOV. FORUM (Jul. 7, 2020), <https://corpgov.law.harvard.edu/2020/07/07/dol-proposes-new-rules-regulating-esg-investments/>.

⁵⁹ *Id.*

⁶⁰ *See* Proposed Rule, 85 Fed. Reg. at 39,122.

⁶¹ *Id.* at 39,115.

managers may not know when to consider some funds and factors as “ESG,”⁶² or they might be over-inclusive in considering funds as ESG funds, which would make the documentation requirement onerous and burdensome.

V. The Department Understates the Costs of the Proposed Rule.

The Department understates the costs of the Proposed Rule. When an agency relies on costs and benefits in the analysis supporting a rule, the APA requires the agency to provide a satisfactory explanation of that analysis.⁶³ The Department has failed to do so here.

A. The Department Understates the Costs of the Documentation Requirement, Fails to Consider the Chilling Effects on ESG Investment, and Fails to Assess Numerous Other Costs.

The Department admits that it does not have sufficient data to determine how many plans are “heavily invested in underperforming ESG funds” in order to determine costs of the rule change, yet prematurely “concludes that [the] documentation requirement would impose little, if any, additional cost.”⁶⁴ Such a conclusion is not supported by any evidence. Further, the Department fails to account for the possibility that many funds are heavily invested in *overperforming* ESG funds and will face an onerous and unnecessary documentation requirement for an investing strategy that already follows good fiduciary practice. The Department implies that fund managers with sufficient recordkeeping will not incur any additional costs in order to comply with additional documentation requirements.⁶⁵ However, the Department fails to provide any evidence to support its assertion of “little, if any,” compliance costs.

Ultimately, the special documentation requirements are very likely to impose new compliance costs. Experts warn that the requirements will “increase compliance costs and risks associated with including those products in retirement plans” and “dissuade at least some fiduciaries from engaging in ESG activity at all for fear of being unable to adequately justify their decisionmaking.”⁶⁶ This suggests that that Proposed Rule will impose

⁶² While attempting to clarify what risks constitute pecuniary versus ESG factors, the Department cites a few examples of what might constitute a non-economic consideration. But these examples are instances of failing to comply with existing regulations or potentially criminal actions, and thus a regular business risk, not ESG factors. See Proposed Rule, 85 Fed. Reg. at 39,116.

⁶³ See, e.g., *Chamber of Commerce v. SEC*, 412 F.3d 133, 144 (D.C. Cir. 2005) (agency was required to consider the “economic consequences of a proposed regulation” in order to comply with the statutory requirement to consider the public interest and the APA’s requirement of a satisfactory explanation); see also *Competitive Enter. Inst. v. NHTSA*, 956 F.2d 321 (D.C. Cir. 1992) (agency was required to explain whether safety concerns outweighed benefits of energy savings in new fuel economy standards); *Ctr. for Biological Diversity v. NHTSA*, 538 F.3d 1172, 1200 (9th Cir. 2008) (“NHTSA’s decision not to monetize the benefit of carbon emissions reduction was arbitrary and capricious”).

⁶⁴ Proposed Rule, 85 Fed. Reg. at 39,125.

⁶⁵ *Id.* at 39,122 (“[T]he rule may impose costs on fiduciaries whose current documentation and recordkeeping are insufficient to meet the new requirement.”).

⁶⁶ Ann Lipton, *Private Equity In, ESG Out*, BUS. L. PROF BLOG (Jun. 27, 2020), https://lawprofessors.typepad.com/business_law/2020/06/private-equity-in-esg-out.html.

documentation costs, costs to constituents of ESG funds, and more. Moreover, the Department fails to acknowledge the overall chilling effect on ESG investment that is likely to result from this rule, as described above in Part IV. Failure to address and analyze these costs is arbitrary and capricious.⁶⁷

The Department also fails to discuss costs to fiduciaries, fund participants, and beneficiaries. The Proposed Rule is likely to pose new costs to fiduciaries (such as lost revenue), fund participants (such as lower levels of investment or stock prices), and beneficiary holders of ESG funds (such as lost long-term revenue and greater risk and volatility), none of which are adequately assessed here.⁶⁸ Pursuant to the APA and legal precedent, the Department cannot merely treat such costs as nonexistent.⁶⁹

Furthermore, because many state pension funds are not covered by ERISA but follow its lead, the Proposed Rule could have costs extending even beyond ERISA-regulated participants. The Department fails to account for all of these foreseeable costs, in violation of the APA.

B. Other Regulators Around the World Require Consideration of ESG Factors, Placing U.S. Investors at a Strategic Disadvantage.

The Department's Proposed Rule moves American markets in the opposite direction of their global counterparts, many of which now consider ESG factors to be the default for prudent asset management.⁷⁰ Even here in the United States, the Department's regulatory counterpart at the Securities and Exchange Commission (SEC) has published recommendations that the SEC "begin in earnest an effort to update the reporting requirements of Issuers to include material, decision-useful, ESG factors" out of concern that failure to do so will allow other jurisdictions to lead markets on ESG.⁷¹ Experts believe

⁶⁷ Executive Order No. 12,866 §(1)(b)(6)), 58 Fed. Reg. 51,735 (Sept. 30, 1993).

⁶⁸ See Proposed Rule, 85 Fed. Reg. at 39,122 (stating, "the Department assumes this modification would not impose significant additional cost.").

⁶⁹ See, e.g., *Chamber of Commerce*, 412 F.3d at 144; *Ctr. for Biological Diversity*, 538 F.3d at 1200; *California v. Bernhardt*, No. 4:18-cv-05712-YGR, 2020 U.S. Dist. Ct. LEXIS 128961, at *36 (N.D. Cal. July 15, 2020) (stating that, "[g]iven the specific findings in the Waste Prevention Rule as to the environmental impacts, BLM was required to address those impacts and quantify the foregone environmental benefits of the Rescission."); *State of California v. United States Bureau of Land Management*, 277 F. Supp. 3d 1106, 1122 (N.D. Cal. 2017) (holding that, "[w]ithout considering both the costs and the benefits of" a deregulatory action, an agency "fail[s] to take [an] 'important aspect' of the problem into account"); see also *id.* at 1123 ("[F]ailure to consider the benefits of compliance with the provisions that were postponed, as evidenced by the face of the Postponement Notice, rendered [the agency] action arbitrary and capricious and in violation of the APA.").

⁷⁰ Press Release, Capital Markets Union: Commission Welcomes Agreement on Sustainable Investment Disclosure Rules, European Commission (Mar. 7, 2019), https://ec.europa.eu/commission/presscorner/detail/en/IP_19_1571.

⁷¹ Recommendation of the Investor-as-Owner Subcommittee of the SEC Investor Advisory Committee Relating to ESG Disclosure, Securities and Exchange Commission (May 14, 2020), <https://www.sec.gov/spotlight/investor-advisory-committee-2012/recommendation-of-the-investor-as-owner-subcommittee-on-esg-disclosure.pdf>.

that the Department’s Proposed Rule “will only accelerate the process of ceding leadership to the European Union.”⁷²

Such lagging leadership from the Department, now manifested through this Proposed Rule, poses real costs to American retirement investors. While other countries reap the benefits of modern risk assessment methodology, the Proposed Rule would force American investors and beneficiaries to forgo such methods—and their superior returns—in order to adhere to the Department’s outdated and unjustified requirements. In issuing regulations, a federal agency must assess the costs of its action; the Department’s failure to do so is arbitrary and capricious.⁷³

VI. The Proposed Rule Deprives Plan Beneficiaries of a Broad Range of Investment Alternatives.

Fund managers have fiduciary duties to their investors under ERISA, as well as the Investment Company Act. Even if the Department were to follow its own interpretation of that duty as it pertains to ERISA to maximize wealth to investors, the Proposed Rule would then perplexingly deny a tested strategy with rapidly growing investor support to ERISA plan participants. In other words, the Department would be forbidding Americans access to a winning strategy. Such a decision undercuts the very purpose of ERISA and conflicts with the legal requirement to provide plan participants a broad range of investment alternatives.⁷⁴

Already, academic commentators have foreseen this problem. Professor Ann Lipton summarizes the problematic issues in the Proposed Rule as follows:

[A]ttempts to discourage the inclusion of ESG funds in ERISA plans ...[is] a peculiar elevation of legally constructed investor preferences over the ...actual preferences of investors – what Daniel Greenwood dubbed “fictional shareholders.” It’s all well and good to require that ERISA fiduciaries act solely in the economic interests of beneficiaries, on the assumption that this is what beneficiaries would likely want, and on the assumption that wealth maximization functions as “least common denominator” for beneficiaries’ otherwise conflicting interests.⁷⁵

But limiting beneficiaries’ choices, as this Proposed Rule would do, is not the best way to capture investors’ actual preferences. This is particularly true when beneficiaries are capable of making informed decisions for themselves, as those choices need not affect the choices available to other beneficiaries with different preferences. In fact, ERISA savings

⁷² Lipton, *supra* note 66.

⁷³ Executive Order No. 12,866 §(1)(b)(6), *supra* note 67 (instructing agencies to consider the costs of a rule in order to make “a reasoned determination that the benefits of the intended regulation justify its costs”); *see also Chamber of Commerce*, 412 F.3d at 144.

⁷⁴ *See* 29 C.F.R. § 2550.404c-1(b)(3).

⁷⁵ Ann Lipton, *ESG and ERISA*, BUS. L. PROF BLOG (Jun. 2, 2018), https://lawprofessors.typepad.com/business_law/2018/06/esg-and-erisa.html.

plans are required to offer a “broad range of investment alternatives” that are “diversified” and have “materially different risk and return characteristics.”⁷⁶ While offering plan participants a broad array of investment options may bring more complexity to the exercise of choosing appropriate investments, “courts have bristled at ‘paternalistic’ theories that suggest ERISA ‘forbids plan sponsors to allow participants to make their own choices.’”⁷⁷ Limiting fund options could have particularly negative pecuniary effects for younger plan participants, for instance, who might prefer ESG funds that reduce systemic climate change risk.

In addition, a “safe harbor” provision in ERISA is designed to allow certain plan participants to exercise control over their investment choices, placing it at odds with the Proposed Rule. Generally, ERISA imposes liability for resulting losses on fiduciaries who commit breaches of their duties.⁷⁸ However, Section 404(c) of ERISA provides that a plan fiduciary is not liable if (1) the plan is an “individual account plan,” (2) the plan participants can exercise control over the assets allocated to their accounts, and (3) the plan participants actually do exercise control over their accounts in a manner proscribed under the regulations.⁷⁹ Under Section 404(c), plan participants that exercise such control over their accounts will not be treated as fiduciaries, and neither the plan participants nor the other plan fiduciaries will be liable for any loss or breach that results from the plan participants’ exercise of control over the plan administration.⁸⁰ This “safe harbor” provision in ERISA is designed to encourage plan sponsors to allow more investment choices to participants in defined-contribution plans.⁸¹

Regulators should at least give plan participants the option to align their investments with their own ideas about how to best maximize value in their portfolio. ERISA requires such broad investment choices, yet the Proposed Rule would pose roadblocks to legitimate investor preferences.

⁷⁶ 29 C.F.R. § 2550.404c-1(b)(3).

⁷⁷ *Jacobs v. Verizon Commc’ns, Inc.*, No. 16 CIV. 1082 (PGG), 2017 U.S. Dist. LEXIS 162703, at *19-20 (S.D.N.Y. Sept 28, 2017) (order partially granting motion to dismiss) (citing *Sacerdote v. New York Univ.*, No. 16 Civ. 6284 (KBF), 2017 U.S. Dist. LEXIS 137115, 2017 WL 3701482, at *11 (S.D.N.Y. Aug. 25, 2017)); see also *Loomis v. Exelon Corp.*, 658 F.3d 667, 673 (7th Cir. 2011) (stating, “all that matters is the absence from ERISA of any rule that forbids plan sponsors to allow participants to make their own choices. Far from reflecting a paternalistic approach, the safe harbor in §1104(c) encourages sponsors to allow more choice to participants in defined-contribution plans”).

⁷⁸ 29 U.S.C. § 1109(a) (“Any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this subchapter shall be personally liable to make good to such plan any losses to the plan resulting from each such breach. . .”).

⁷⁹ 29 U.S.C. § 1104(c).

⁸⁰ See *id.*; *Tittle v. Enron Corp. (In re Enron Corp. Sec. Derivative & ERISA Litig.)*, 284 F. Supp. 2d 511, 574-75 (S.D. Tex. 2003); *In re Unisys Sav. Plan Litig.*, 74 F.3d 420, 443-46 (3d Cir. 1996), *cert. denied sub nom. Unisys Corp. v. Meinhardt*, 519 U.S. 810 (1996).

⁸¹ *Loomis*, 658 F.3d at 673.

Conclusion

In sum, the Department has failed to provide a factual basis for the Proposed Rule and does not provide a reasonable basis for changing its position. Contrary to the Department's conclusory assertions, fiduciaries with an "eye singular" towards the best financial performance of their beneficiaries should consider including ESG factors in their investing strategy, given the ample evidence showing ESG funds' strong returns and risk reduction benefits. The Department also understates the costs of the Proposed Rule and deprives plan beneficiaries and shareholders of their legitimate preferences. For all of the forgoing reasons, the Proposed Rule should not be finalized and should be deemed arbitrary and capricious if finalized in its current form.

Respectfully submitted,

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