



July 29, 2020

*Submitted electronically*

Office of Regulations and Interpretations  
Employee Benefits Security Administration  
Attention: Financial Factors in Selecting Plan Investments Proposed Regulation  
Room N-5655  
U.S. Department of Labor  
200 Constitution Avenue NW  
Washington, DC 20210

Re: RIN 1210-AB95, Financial Factors in Plan Investments Proposed Regulation

Dear Sir or Madam:

After more than three decades working to build America's workplace savings system, I welcome this opportunity to share Putnam Investments' comments and concerns about the recent rule proposal (85 CFR Part 39113, the "Proposal") from the Employee Benefits Security Administration of the Department of Labor (the "Department") on financial factors in the selection of investments for plans subject to the Employee Retirement Income Security Act of 1974 ("ERISA").

Founded in 1937, Putnam Investments is a leading global money management firm with approximately \$169 billion in assets under management as of June 30, 2020. Putnam provides investment management both to individual investors - primarily through their financial advisors - as well as to institutional investors worldwide. Putnam manages over 100 mutual funds and 60 institutional strategies across a range of asset classes and investment styles. We offer active management across a variety of strategies in equity, fixed-income, asset allocation, and alternative investments, including several strategies that have a central focus on environmental, social and governance ("ESG") considerations, as well as many others that do not.

As an initial matter, we fully endorse the Proposal's focus on investment merits. Plan fiduciaries should make their choices carefully and with an "eye single" to the economic interests of their plans and participants. We fully agree that any investment option - be it an ESG fund, an energy

sector fund, a traditional bond fund, a passive index fund, or any other option – must be evaluated through the lens of expected investment risk and net-of-fee investment performance. It would be inappropriate for a plan sponsor to pursue non-financial outcomes – whether through use of “impact first” investments aimed at bringing about changes in society, overly concentrated investment in industry sectors favored by plan management, or any other criteria – through poor investment choices that risk participant savings. The ERISA plan menu is not the place for pursuit of even the most admirable of non-financial goals, if that pursuit comes through knowing sacrifice of expected returns.

In our view, these principles have long been clear, both through the development of ERISA case law and through the Department’s guidance, and they are uncontroversial to the overall investment community and in the minds of the vast majority of plan sponsors. Indeed, as the Proposal notes, the requirement to focus on financial rather than non-pecuniary factors was recently confirmed by the Supreme Court in *Fifth Third Bancorp. v. Dudenhoeffer*, leaving little doubt as to the rules of the road. For their part, plans and their advisors have generally treaded cautiously in their adoption or recommendation of ESG strategies or approaches, with adoption only beginning to increase recently, as the investment case continues to grow in strength.

Against this background, it is unclear why the Department has chosen to propose additional action in the well-settled area of fiduciaries’ selection of investments – and why it has chosen to focus with such a broad scope on ESG options, in particular. We are not aware of any systemic shortcomings in plans’ selection of investments, either in the ESG arena or more broadly. As detailed below, we are concerned that the Proposal, as drafted, fails in the end to support the best interests of plans and their participants and beneficiaries, and we believe the Department should withdraw it for further review and development. Below are our comments and suggestions, which are organized around policy goals and themes that we believe the Department shares.

### **Investment Merits Must Guide Us**

The Department states that “*ESG investing raises heightened concerns under ERISA*,” yet, in its brief discussion, the Proposal does not develop substantial or credible evidence of either poor performance or any fiduciary abuse or harm among retirement plans using ESG options or strategies, and omits the growing body of evidence that ESG strategies, when used in a judicious and context-aware way, can contribute to strong performance and reduction of risk.<sup>1</sup> Indeed, the

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<sup>1</sup> See, for example, The CFA Institute, “*Positions on Environmental, Social and Governance Factors*,” 2019 position paper, accessed at <https://www.cfainstitute.org/-/media/documents/article/position-paper/cfa-institute-position-statement-esg.ashx>. CFA Institute Standards of Professional Conduct require CFA® charterholders to conduct appropriate research and investigation of all material information relevant to their investment analyses and portfolio management decisions, recommendations, or actions. In this paper, the CFA Institute states its belief that this requirement includes the consideration of material ESG information/considerations (ESG factoring) as an important component of a complete and thorough financial analysis for any actively managed fundamental investment portfolio. More broadly, CFA Institute encourages all investment professionals to consider ESG factors, where relevant, as an important part of the analytical and investment decision-making process, regardless of investment style, asset class, or investment approach.

Proposal correctly cites the relatively low rates of adoption of ESG options among plans, and frames its concerns in terms of *possible future* misuse or misunderstanding of such options by fiduciaries, without citing any concrete instances of issues actually arising.<sup>2</sup>

We acknowledge that the range of products available under the broad categorization of “ESG” has increased meaningfully in recent years, and that the variety of approaches represent different levels of investment merit. In this regard, it is helpful to distinguish between products that incorporate consideration of material ESG issues in pursuit of financial returns, which are typically called “integrated approaches” or “inclusionary approaches,” and products that primarily seek social or environmental outcomes in a way that supersedes financial returns, which are typically called “impact-first” approaches. We agree that “impact-first” products should be closely examined for suitability in retirement plans, since there could be situations where these approaches are not aligned with fiduciary obligations.<sup>3</sup>

We believe, however, that the Proposal overestimates, based on limited evidence, both the potential for these harms to arise and the number of options available in the marketplace that may not comply with the core ERISA principles stated above. Fundamentally, we believe the Department has cast its net too wide, effectively treating all ESG approaches as if they involve the intentional sacrifice of returns.

At Putnam, we focus on integration of financially material environmental, social, and governance issues, with the goal of enhancing financial returns. In some contexts and some respects, this type of integration has become a standard practice that is as common as analysis of valuation metrics, credit assessment, or free cash flow analysis. We believe that the evidence that thoughtful integration of relevant ESG considerations may in fact improve returns and reduce risk is compelling.<sup>4</sup> While short-term results should not guide our views, the strong performance of many

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<sup>2</sup> The Department notes in clarity in labelling in the ESG field – a fact that reflects its continuing, rapid development – and also seeks to infer that ESG funds are being inaccurately marketed because, for example, some funds disclose that they “may perform differently or forego certain opportunities, or accept different investment risks, in order to pursue ESG objectives.” We would note that similar disclosures can be found in the documents for almost any type of investment option. Growth funds may underperform value funds, sector funds may entail additional risks, bond funds may not keep pace with inflation, etc. – all investing involves choices, and choices involve opportunity costs and risks, because to pick one investment or investment style means that the fund manager must forego another. Robust investor disclosure inherently entails stating the risk that a particular approach may fail, or may not do as well as another approach – and strong risk disclosure is a participant-friendly, positive practice that the Department should embrace, not a factual admission that a fund is inherently “giving up” returns through its investment strategy.

<sup>3</sup> We believe that the limited subset of investment options that represent “impact first” products that primarily seek non-pecuniary goals, and any plans that make use of these options without proper analysis and documentation, can be addressed through the Department’s enforcement program, which is armed with clear case law precedent on the primacy of pecuniary factors.

<sup>4</sup> See, for example, Mozaffar Khan, George Serafeim and Aarn Yoon, *Corporate Sustainability: First Evidence on Materiality* (Harvard Business School, March 9, 2015). The authors mapped SASB’s Materiality Map general issue categories to MSCI KLD data for 2,307 unique firms over 13,397 unique firm-years across six SICs® sectors. Using

options that utilize ESG integration during the current pandemic has provided additional evidence that ESG considerations should not be ignored in traditional investment practice. Indeed, the CFA Institute, widely regarded as a neutral, objective baseline for solid investment practice, incorporates ESG considerations in its core curriculum.<sup>5</sup>

Contrary to the Department’s suggestion, ESG integration is not premised on sacrificing financial returns for social or environmental outcomes. Rather, it is grounded in the belief that, by tending to those social, environmental, and/or governance matters that are financially material to their specific setting, companies often can strengthen their businesses and their long-term fundamental prospects. For example, manufacturing companies that are more efficient in environmental practices like energy or materials use might have lower cost structures than competitors; retail companies that are more attentive to social issues like worker safety and supply chain management might have fewer business disruptions; and technology companies with strong governance processes might make better capital allocation decisions.

Funds that focus on ESG integration can thereby pursue strong returns by identifying companies that are managing material ESG issues in a proactive and value-enhancing way, mitigating related risks, creating new business opportunities, and improving long-term fundamental prospects. Of course, context matters, and materiality is key. The ESG considerations that investors may bring to bear vary by, among other things, sector, issuer, and point in the market cycle. Fundamentally, integrated ESG analysis is another tool in the modern investment toolkit, and is best used in combination with other essential tools like traditional fundamental analysis, valuation assessment, or quantitative analysis.

This form of ESG integration is a way of seeking to be smarter about investing— and, while context specific and different from fund to fund and investment provider to investment provider, its use is widespread and appropriate. Indeed, ESG integration of this type is so prevalent that, literally applied, the first part of the Department’s definition of ESG options — [options that] “include one or more environmental, social, corporate governance, or similarly oriented assessments or judgements in their investment mandates”— would capture, in our estimation, a wide swath of “traditional” U.S. equity funds. For example, governance factors have been important in fundamental investing for decades, and relevant environmental and social factors are often part of the overall mosaic of information considered by informed investors who are guided by generally

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both calendar-time portfolio stock return regressions and firm-level panel regressions, they found that firms with good ratings on SASB’s material sustainability issues significantly outperformed firms with poor ratings on these issues. In contrast, firms with good ratings on immaterial sustainability issues (ESG issues not identified by SASB for a given industry) did not significantly outperform firms with poor ratings on the same issues. Lastly, they found that, all else equal, firms scoring in the top quintile on the material issues have higher future return-on-sales growth.

<sup>5</sup> See, for example, documentation of the CFA Institute’s research and educational focus on ESG: <https://www.cfainstitute.org/en/research/esg-investing>. In response to the question, “Why is the CFA Institute Focused on ESG?” the Institute notes, “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.”

accepted investment theories. However, the Department’s rule seems to suggest that such considerations are misaligned with the search for superior returns.

This does not mean that every ESG analysis is successful, that all practices and products branded as ESG have investment merit, or that practices will not continue to evolve. Yet the Department’s Proposal is unique in its apparent effort to penalize this one approach among all the many diverse, variegated approaches offered in retirement plans. If ESG considerations are, for most funds, additional tools in the investing toolkit, and if funds that focus on ESG integration strategies offer another path to pursuit of strong returns, the Proposal, by over-solving for the potential harm posed by the small cohort of ESG options that may raise heightened fiduciary concerns, risks stunting the continuing development of mainline investment practice and preventing fiduciaries from making appropriate decisions based on analytically important considerations.

### **A Level Playing Field Matters**

Viewed from another angle, ESG investing is an investment lens or strategy – like growth or value approaches, quantitative or fundamental analysis, credit investing or sovereign or securitized debt investing, passive or active approaches, or sector or region-based investing. Yet under the proposal, only ESG investing would be subject to additional review by plan sponsors and required to meet standards that no other plan option, regardless of its risk, novelty, or complexity, must meet.

The Proposal suggests that it merely restates existing principles. In practical terms, however, by judging ESG options under a different standard than other options, the Proposal would likely chill their use, regardless of the ultimate validity of plan sponsors’ motivations and analysis.<sup>6</sup> There is a very real risk that plan fiduciaries have incentives to pick only the easy options, and not the best ones, when the specter of costly litigation looms and caution seems more critical than care. Particularly in light of the Department’s clear skepticism for ESG strategies, many plan sponsors may simply decline to consider them.

For decades, the Department has hewed close to the principle of even-handedness, neither favoring nor disfavoring, as a general matter, any particular style or strategy of investing, so long as plan fiduciaries act with prudence and an eye single to participants’ interests. In our view, for a regulator to determine that a particular investment strategy— particularly one offered in regulated vehicles such as registered mutual funds and bank-maintained collective investment trusts – raises heightened fiduciary concerns and should be subject to additional requirements, demands that a high bar of evidence and certainty be cleared. That bar, in our view, has not been met here. We

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<sup>6</sup> This is particularly true since, under the structure of the Proposal in (3)(i), the use of an ESG option triggers requirements *for all other options in the plan*. While the substance of the considerations in (i) is generally straightforward, plans may rightly hesitate to expose their overall decisions further to potential second-guessing and litigation risk.

believe it is critical that the Department maintain a level playing field among investment options, leaving plan menus to be driven by market forces and the power of informed fiduciaries' choices.

We have faith in the abilities of plan fiduciaries, working with their advisors, to review investment options on behalf of plans and their participants.<sup>7</sup> We note that the Proposal contains little evidence that plan sponsors and their advisors do not understand their duties or have systemically failed to uphold the strict standards that apply to their decisions—either more broadly, or specifically with respect to ESG options.<sup>8</sup>

In addition, it is important to note the fierce competition in the investment product market. All investment options must survive the test of daily competition. The market stands still for no one, and there is no reason to believe that poorly- designed investment options, whether or not they make use of ESG considerations or pursue ESG-focused strategies, will flourish without a foundation in solid investment performance for participants.

It is also important to note that applicable law outside the ERISA arena may help to mitigate the Department's concerns. ESG investment options offered to ERISA plans are almost exclusively managed by registered investment advisers and regulated banks. Taking the core example, SEC-registered investment advisers are subject to a strict fiduciary duty as well as robust requirements around client disclosures. We firmly disagree with the notion that these regulated firms would offer products that seek to subordinate returns to social, environmental, or other non-pecuniary goals without clearly disclosing that fact and considering its potential impact on their legal duties as fiduciaries. If anything, many SEC-registered managers generally have erred toward caution in adopting ESG techniques over time, with many managers moving to embrace these approaches only gradually over time, as they have concluded that the growing evidence on investment merits suggests it.

For all the reasons above, we urge the Department to take a sensible, prudent middle path on ESG matters, neither favoring nor disfavoring them, but emphasizing the primacy of financial performance and permitting plan sponsors and their fiduciary advisers, guided by performance

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<sup>7</sup> To support fiduciaries, the Department has progressively developed ERISA's requirements, improving the rules of the plan market over time by, among other things, requiring more robust disclosure from service providers to plan sponsors and from plan administrators to participants, and, most recently, providing additional guidance and a new prohibited transaction exemption that will impose new requirements on investment advice fiduciaries. Investment advisors that work with plan sponsors or participants must now meet tougher standards under both the SEC's Regulation Best Interest and the Department's own existing and proposed standards.

<sup>8</sup> Indeed, the Department now permits the use of private equity components within plan investment options, including qualified default investment alternatives (QDIAs). This action, which we support, seems to reflect a fundamental belief in plan fiduciaries' ability to assess and understand investments far more complex than ESG options. Based on the Proposal, an illiquid private equity investment strategy may form a component of a QDIA, yet a broad-based, liquid ESG-focused equity fund, competing against traditional investment benchmarks through investment in the stocks of large capitalization U.S. companies, cannot.

results and buoyed by the positive impact of choice and market competition, to guide the development of plan menus.

### **Fees are not the only Factor**

We also note that, in some parts of the Proposal, the Department seems to suggest that ESG options are potentially inappropriate simply because some are actively managed, and thus carry management fees concomitant with the use of active strategies, rather than passive approaches, which often bear lower fees (Proposal at 39115).<sup>9</sup> Indeed, the Proposal goes so far as to suggest that a possible reduction in active management through the enforcement of stricter rules on ESG funds (based on the Proposal's unsupported assertion that the proposed rule would lead to higher returns as putatively lower-returning ESG options are eliminated from plans) would be a societal good (Proposal at 39121).

We disagree, and, more fundamentally, believe that such assertions are wholly inconsistent with the Department's historical approach and its guidance in other contexts. The choice between active and passive strategies should not be the subject of a regulatory imprimatur, and fees are not the sole compass for prudent investing. Indeed, as recently as this month, in its proposed new exemption for investment advice fiduciaries, the Department itself acknowledged that cost is not the only consideration in investing, stating that "recommendation by a fiduciary adviser of the "lowest cost" security or investment strategy, without consideration of other factors, could in fact violate the exemption." (Improving Investment Advice for Workers & Retirees, 85 FR 40834, at 40843)

### **Regulatory Comity**

In its recent proposed actions on investment advice fiduciaries, the Department showed appropriate deference to the SEC as primary securities regulator in matters involving the investment markets. We would urge the Department not to redirect or stall the continuing development of ESG practice with a regulatory fiat, particularly where the SEC continues to monitor and evaluate ESG developments, with a clear focus on disclosure and accuracy.

### **Retirement Savings Matters**

Finally, we believe in savings, and in the project of the American retirement system. Supporting secure retirement for American savers has been a personal crusade of mine for three decades. There is growing evidence that ESG options may offer younger savers a point of new engagement with and interest in their plans.<sup>10</sup> When workers want to save, the country benefits, and we urge the

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<sup>9</sup> The Department has not presented substantive evidence to establish, for example, that actively managed ESG-focused funds are more expensive than other comparable actively-managed strategies.

<sup>10</sup> See, for example, Morgan Stanley Institute for Sustainable Investing, *Sustainable Signals: Individual Investor Interest Driven by Impact, Conviction and Choice* (White Paper, 2019). This study finds that 95% of millennials and 85% of

Department to reconsider before effectively shutting down a possible path to greater engagement and improved retirement outcomes for a meaningful cohort of retirement savers, particularly in the years to come.

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We reiterate that we strongly support the Department's policy goal: ensuring that investment fiduciaries consider only appropriate, investment-based considerations when selecting investments for ERISA plans. Yet we question whether there is truly any doubt on this point that calls for pre-emptive, competition-reducing action of the type proposed by the Department.

Were ESG funds or approaches inherently or structurally deficient on investment merits, as the Department appears to have concluded through its initial review, we would fully support restrictions on their use. But the Department has not mustered evidence to this effect, and the realities of the marketplace, our own research, and a growing consensus among traditional, prudent investors, in Putnam's view, belie such a conclusion.

Like the fiduciaries it oversees, the Department should continue to reference ERISA's single lodestar, the best interests of retirement savers, to guide its actions. Measured by this standard, we are concerned that the Proposal, as it stands today, misses the mark. We believe the Department, after further consideration, will conclude that its proposed rule is not only unnecessary, but risks harm to the very plans and retirement savers that it seeks to protect. Given our shared belief in a safe, robust U.S. retirement system, we stand ready to assist with any information that the Department may find useful in re-evaluating this important topic.

Sincerely,

A handwritten signature in black ink, reading "Robert L. Reynolds". The signature is fluid and cursive, with a long, sweeping underline that extends to the right.

Robert L. Reynolds  
President and Chief Executive Officer, Putnam Investments

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all investors are interested in sustainable investing, and that 88% of all surveyed investors are interested in pursuing sustainable investing in 401k plans, but only 42% have known options to do so.