

July 30, 2020

Office of Regulations and Interpretations  
Employee Benefits Security Administration,  
U.S. Department of Labor  
200 Constitution Avenue, N.W.  
Washington DC 20210

**RE: RIN 1210-AB95; “Financial Factors in Selecting Plan Investments”**

Ladies and Gentlemen,

I am pleased to submit this comment letter<sup>1</sup> on the proposed rule “Financial Factors in Selecting Plan Investments.”<sup>2</sup> I study the costs and design of menus in 401(k) plans and other participant-directed retirement accounts. The last ten years have seen an industry-wide reduction in the costs of investing in these plans. The proposed regulation creates a substantial risk of undoing that progress. The rule is likely to create significant new costs for employers offering 401(k) plans by increasing liability and documentation requirements.

These costs arise for three reasons. First, the rule is insufficiently sensitive to the fact that it is interpreting a provision enforced through private lawsuits brought by commission-compensated plaintiffs’ attorneys. Second, the rule casts doubt on a broad class of mutual funds that are not marketed as ESG funds, but nevertheless consider ESG factors as part of a strategy aimed at realizing pecuniary goals. Third, the rule puts the onus on plans to defend choices with reference to conventional performance measures of return, volatility, and other metrics when ESG has arisen out of a recognition that these metrics may be insufficient measures of the true risk associated with some investments.

If exclusionary ESG funds in 401(k) plans are a problem, they are a small one. By DOL’s own estimate, only 0.1% of 401(k) assets are in investments marketed as ESG funds<sup>3</sup> and the true number may be lower still.<sup>4</sup> If the DOL proceeds with this rule, it should offer a bright line safe harbor to protect participant-directed retirement plans from unnecessary litigation.

**The Rule is Liability-Creating**

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<sup>1</sup> I thank Shannon Brooks, Robert Gunn, and Philip Iacovou for excellent research assistance in drafting this comment.

<sup>2</sup> 85 Fed. Reg. 39,113 (proposed June 30, 2020).

<sup>3</sup> *Id* at 39,121.

<sup>4</sup> Nevin E. Adams, *Environmental Impasse?*, Nat’l Ass’n of Plan Advisors (Mar. 19, 2019) (citing Plan Sponsor Council of America, 61st Annual Survey of Profit Sharing and 401(k) Plans (2018)), <https://www.napa-net.org/news-info/daily-news/environmental-impasse> (finding that plan participants “only have 0.03% of assets” in sustainable investment offerings).

Sponsors of 401(k) plans are, not infrequently, sued for breach of fiduciary duty under precisely the provisions of ERISA that this rule interprets. Over the last ten years, more than 100 major lawsuits have been brought against retirement plans for fiduciary breaches related to excessive fees, resulting in hundreds of millions of dollars in settlements. The main effect of these lawsuits has been to lower the cost of plan menus across the industry, but this regulation promises additional, and less-meritorious, litigation.

The proposed regulation has the effect of sharpening and heightening sponsor fiduciary duties. No lawsuit against a 401(k) plan to date has alleged that a plan impermissibly considered ESG factors in opting for a particular investment, but this rule affirmatively invites such litigation. As discussed below, the vast majority of mutual funds now consider one or more ESG factors as part of their investment strategy, even when the fund is aimed at the conventional goal of maximizing returns. Such funds are, in principle, permissible under the rule, because their ultimate goal is pecuniary, but the rule requires plan sponsors to consider specific factors and document specific considerations in constructing the menu. By focusing on the process followed by plan sponsors, rather than the objectively observable characteristics of selected funds, the rule increases the likelihood that litigation will turn on factors that require costly discovery to determine. This is a recipe for drawn out, costly litigation with no clear benefit to plan participants.

### **ESG Describes an Array of Loosely Related, Strategies, Many of Which Pursue “Pecuniary” Goals**

“ESG” is an umbrella term for risks beyond the scope of traditional financial metrics. These are long-term risks associated with increased regulation, political uncertainty, reputational harm, and environmental change. While some funds incorporate ESG as part of an explicit commitment to avoid contributing to social harms, the more common approach is to consider ESG factors as part of an investment strategy that aims to achieve an optimal balance of risk and return given the funds’ risk profile and asset mix: the conventional goals of investing.

By their very nature, ESG risks resist quantification alongside more traditional measures of financial risk, but that does not mean that asset managers acting in the interest of their investors can disregard them. For example, Papa John’s International suffered a significant decline in its stock price after its founder admitted to using a racial slur on a conference call.<sup>5</sup> A reasonable investor might conclude that the risk of this type of reputational damage would be reduced among companies that made a demonstrated commitment over a period of years to include directors of diverse backgrounds on their boards. An asset manager incorporating this consideration would presumably be invoking the “S” and “G” elements of ESG in pursuit of increased returns. Indeed, all three of the

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<sup>5</sup> Noah Kirsch, *Papa John’s Founder Used N-Word On Conference Call*, Forbes (July 11, 2018), <https://www.forbes.com/sites/noahkirsch/2018/07/11/papa-johns-founder-john-schnatter-allegedly-used-n-word-on-conference-call/#4997b2e84cfc>.

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largest asset managers in the US have noted that they consider board diversity an important factor in well-run companies.<sup>6</sup>

This is not a niche phenomenon. To varying degrees, one or more ESG factors plays a role in every investment decision. Consider the “G” in ESG: governance. The governance rights associated with a share of stock (voting, control, board seats, change in control provisions) are surely implicitly considered by every investor. It would be rank malpractice to buy a share of Snap, Inc., without considering that the shares *cannot vote*.<sup>7</sup> Does every fund that considers an investment in Snap become an ESG fund by virtue of weighing the implications of its governance structures? What about evaluating investments in controlled companies? The intent of considering these types of governance factors is oriented to pecuniary factors, but the risk-return benefits can be hard to demonstrate empirically. After all, no-vote stock is a new phenomenon, and there are few such companies. Would a plan have to point to historical volatility and return data to justify the inclusion of a fund that underweighted no vote stock if it faced a lawsuit for fiduciary breach?

Turning to “E” and “S,” the problem only grows. Most asset managers incorporate ESG principles into broader company practices, including considering ESG factors in otherwise traditional funds. BlackRock, Vanguard, or State Street,<sup>8</sup> have company-wide commitments to principles that fall under the ESG umbrella. More than 3,000 investment groups including many of the largest asset managers in the world have signed the Principles for Responsible Investment, publicly committing to “incorporate ESG issues into investment analysis and decision-making processes.”<sup>9</sup> The COVID-19 pandemic has highlighted the importance of considering long term, unconventional risks and will further accelerate this movement.<sup>10</sup>

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<sup>6</sup> *Governance - Board Diversity at BlackRock*, BlackRock, <https://ir.blackrock.com/governance/board-of-directors/Board-Diversity-at-BlackRock> (last visited July 29, 2020); *Vanguard Investment Stewardship Perspectives - Board Diversity*, Vanguard (2019), [https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/persp\\_board\\_diversity.pdf](https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/persp_board_diversity.pdf); Amy White, *State Street to Turn Up the Heat on All-Male Boards*, Institutional Investor (Sept. 27, 2018), <https://www.institutionalinvestor.com/article/b1b4fh28ys3mr9/State-Street-to-Turn-Up-the-Heat-on-All-Male-Boards>.

<sup>7</sup> Maureen Farrell, *In Snap IPO, New Investors to Get Zero Votes, While Founders Keep Control*, Wall St. J. (Jan. 16, 2017), <https://www.wsj.com/articles/in-snap-ipo-new-investors-to-get-zero-votes-while-founders-keep-control-1484568034>.

<sup>8</sup> See John Hale, *The Number of Funds Considering ESG Explodes in 2019*, Morningstar (Mar. 30, 2020), <https://www.morningstar.com/articles/960790/new-years-resolutions-for-sustainable-investing>; BlackRock, <https://www.blackrock.com/corporate/about-us/investment-stewardship#our-responsibility> (last visited July 29, 2020); Vanguard, <https://about.vanguard.com/investment-stewardship/> (last visited July 29, 2020); Richard O’Hanley, *ESG Investing 2.0: Moving Toward Common Disclosure Standards*, State Street (Nov. 7, 2019), <https://www.statestreet.com/content/dam/statestreet/documents/Articles/1369%20ESG%20Metric%20and%20Reporting%20Standards.pdf>.

<sup>9</sup> *What are the Principles for Responsible Investment?*, Principles for Responsible Investment, <https://www.unpri.org/pri/an-introduction-to-responsible-investment/what-are-the-principles-for-responsible-investment> (last visited July 29, 2020).

<sup>10</sup> Corinne Bendersky et al., *The ESG Lens on COVID-19, Part I*, S&P Global Ratings (Apr. 20, 2020), <https://www.spglobal.com/ratings/en/research/articles/200420-the-esg-lens-on-covid-19-part-1-11444298>.

### **The Rule Provides Insufficient Protection to Plans in Constructing Menus**

The clear intent of the rule as applied to 401(k) plans is to require sponsors to focus exclusively on pecuniary goals in constructing menus. Most funds that weigh ESG factors do so for pecuniary reasons, but the rule repeatedly casts doubt on ESG factors as a legitimate investment strategy. Rather than cleanly resolve this tension, the rule puts the onus on individual plans to defend ESG considerations using conventional investment metrics. This is ironic, since the purpose of ESG investment strategies is to supplement conventional notions of investment risk with factors that are often overlooked by traditional metrics.

Consider the example above of a fund that publicly commits to consider board diversity as a means of reducing the fund's exposure to reputational risk as a pecuniary matter. By virtue of this commitment, the fund is weighing an ESG factor in its investment decision. Under the rule the plan sponsor must appeal to conventional financial metrics to justify the choice, potentially in a lawsuit alleging a fiduciary breach.

This could prove quite challenging. The risk of a Papa John's like scandal is doubtlessly real, but it's not clear that these types of new, fast-evolving risks are going to be evident in conventional risk-return metrics, which rely on long periods of data to calculate (to say nothing of the challenge of measuring diversity). Indeed, addressing such shortcomings is the point of ESG. At best, a plan opting to include such a fund is inviting a significant paperwork burden. At worst, it is inviting a lawsuit for fiduciary breach.

All of the major (and lowest-cost) asset managers for 401(k) plans have signed the PRI and committed to consider ESG factors. Funds from these asset managers are in fact the QDIAs in thousands of plans. Would this be permissible under the rule? Could sponsors face litigation for including these ordinary funds? What will happen when, inevitably, a fund from a PRI signatory lags the market? While it is true that most funds of PRI signatories don't mention ESG factors in the name or in the investment mandate (and therefore aren't clearly within the scope of (c)(3)), this is purely a matter of marketing, and sponsors would still need to demonstrate, possibly at trial or after extensive discovery, that their selection process comported with sections (b)(1) and (b)(2) of the rule. These issues will be hard to resolve on the pleadings.

### **A Solution**

While there are thousands of funds, managing trillions of dollars, that consider ESG factors as part of a returns-maximizing strategy, regulating these funds is presumably not the intention of the rule. So long as ESG factors are considered for pecuniary reasons, including those funds should not be a fiduciary breach, even under the rule. But, given the scope and frequency of private lawsuits, sponsors need certainty, not just a good chance in litigation.

The solution is to give plans a bright line safe harbor in section (c)(3). The safe harbor should operationalize the following principles:

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- Funds that consider only governance factors should be clearly permissible. Governance is a conventional part of investing and a legitimate concern of any shareholder. The DOL should not create any heightened requirements related to funds that weigh shareholder rights.
- Funds that consider ESG factors as part of a value maximizing strategy should be clearly permissible. These funds are mainstream at this point.
- Funds that screen entire asset classes for environmental or social reasons raise more concerns about diversification and returns, and should be the focus of the rule.

The DOL should revise (c)(3) to *explicitly* state that a plan sponsor does not breach a fiduciary duty by including an otherwise prudent fund that considers ESG factors so long as the fund does not mention environmental or social factors (governance should be allowed) in its name or investment mandate and that such funds may be QDIAs. This would provide a bright line safe harbor for funds that merely consider ESG, but are not core ESG funds. For funds that explicitly address social or environmental issues in their name or investment mandate, the list of factors in (c)(i) should be extended to include “other pecuniary considerations” so that plans are free to defend the inclusion of explicit ESG funds as a value-maximizing play without being constrained to a DOL-prescribed list of factors.

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The DOL should not jeopardize a decade’s worth of progress on plan costs to fend off the specter of perceived fiduciary problems related to ESG. If the DOL presses forward with this rule, a more capacious safe harbor is a necessity to mitigate risk to plan sponsors.

Regards,

