

July 30, 2020

Via Electronic Filing

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

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

Ladies and Gentlemen:

The Investment Adviser Association (**IAA**)¹ appreciates the opportunity to comment on the Department’s proposed amendments to the “Investment duties” regulation under Title I of the Employee Retirement Income Security Act of 1974, as amended (**ERISA**).² The Proposed Amendments address the consideration of environmental, social, and corporate governance (**ESG**) factors in the investment process. The Proposed Amendments also include provisions that would apply to a fiduciary’s consideration of *all* plan investments, whether or not the result of ESG considerations.

We strongly urge the Department to withdraw this far-reaching rulemaking. We appreciate and share the Department’s interest in ensuring that ERISA investors receive the best possible advice to enable optimal investment performance. We are concerned, however, that the preamble to the Proposed Amendments (**Preamble**) reflects a fundamental misunderstanding about how investment advisers and other investment professionals consider ESG factors as part of the investment process, and how ESG investments are used for the benefit of plan participants and other investors. Moreover, the selection of investment strategy and individual investments should be left to the judgment of investment advisers that serve as fiduciaries, making decisions in the best interest of their clients. Their decisions must be based on all relevant criteria and

¹ The IAA is the largest organization dedicated to advancing the interests of investment advisers registered with the Securities and Exchange Commission (**SEC**). For more than 80 years, the IAA has been advocating for advisers before Congress and U.S. and global regulators, promoting best practices and providing education and resources to empower advisers to effectively serve their clients, the capital markets, and the U.S. economy. The IAA’s member firms manage more than \$25 trillion in assets for a wide variety of individual and institutional clients, including pension plans, trusts, mutual funds, private funds, endowments, foundations, and corporations. For more information, please visit www.investmentadviser.org.

² *Financial Factors in Selecting Plan Investments*, 85 FR 39113 (June 30, 2020), available at <https://www.govinfo.gov/content/pkg/FR-2020-06-30/pdf/2020-13705.pdf> (**Proposed Amendments**).

circumstances related to both the investor and the potential investments. We also disagree with the Department's position that the Proposed Amendments would not increase burdens on fiduciaries of considering ESG factors.³ The Proposed Amendments would impose increased costs and burdens on fiduciaries for all types of investments, and would unnecessarily limit investment choice for plan participants and beneficiaries, without the Department having demonstrated the need for these amendments or having conducted an adequate analysis of their likely costs. Before the Department moves forward, it should, at a minimum, solicit information about ESG investing through a request for information or a roundtable with ERISA plan fiduciaries and investment professionals. The IAA would be pleased to participate in any such effort.

Several significant concerns with the Proposed Amendments compel us to urge its withdrawal, including the following:

- Consideration of ESG factors as part of the investment process is a pecuniary consideration and is consistent with a fiduciary's duty of prudence.
- The proposed additional requirements in connection with ESG investments are unnecessary, unclear, and would have negative impacts on investors.
- The proposed comparability provision is both unattainable and unnecessary, and would increase costs and risks for fiduciaries.
- The Department should not explicitly or implicitly favor one type of investment over another or improperly limit investor choice.

Our strong belief is that the Department should not proceed with this rulemaking. However, if it does, it should at the very least hold a public hearing to ensure appropriate consideration of the concerns of the investor community, address the issues discussed in this letter, grandfather all current investments in ERISA plans, and allow for an adequate period of time for implementation.

I. Background Regarding the Consideration of ESG Factors by Investment Advisers

An increasing number of investment advisers take into consideration ESG factors as part of their investment process. For example, 42 percent of institutional investors incorporated sustainability into their investment decision making in 2019, compared to 22 percent in 2013.⁴ In

³ 85 FR at 39121.

⁴ *Sustainable Investing is an Active Process*, Investment Adviser Association Active Managers Council, *citing* Callan Institute, 2019 ESG Survey. The Active Managers Council's report is attached as an appendix to this letter.

a 2017 survey by the CFA Institute, 73 percent of respondents said that they take ESG issues into account in their investment analysis and decisions, with governance being the most common.⁵ Firms take these factors into account because they find it beneficial for investment performance, particularly over the long term, and crucial for prudent risk management. As one report stated, “For investment professionals, a key idea in the discussion of ESG issues is that systematically considering ESG issues will likely lead to more complete analyses and better-informed investment decisions.”⁶ In its report regarding the consideration of ESG factors in retirement investing, the Government Accountability Office (GAO) found that:

Investors are reported to increasingly use [ESG] factors to assess a wider range of risks and opportunities that may otherwise not be taken into account in financial analysis (footnote omitted)... For example, some investors believe that companies with good corporate governance practices—like well-designed incentives in how executives are compensated—are better managed and will perform better financially over time and thereby deliver better long-term value to shareholders.⁷

The Department’s presumption that consideration of ESG factors is likely to result in underperformance is not supported by the data. Research suggests that ESG portfolios earn returns comparable to the market return, while reducing risk and providing diversification benefits.⁸ The GAO Report notes that “[a]cademic research on the performance of investments incorporating ESG factors suggests that such factors can be a valid financial consideration, both in the aggregate and as individual factors.”⁹ In fact, the GAO’s review of the research found “a

⁵ *Environmental, Social and Governance (ESG) Survey*, CFA Institute (2017), available at <https://www.cfainstitute.org/en/research/survey-reports/esg-survey-2017>.

⁶ *Environmental, Social, and Governance Issues in Investing, A Guide for Investment Professionals*, CFA Institute (Oct. 2015), available at <https://www.cfainstitute.org/-/media/documents/article/position-paper/esg-issues-in-investing-a-guide-for-investment-professionals.ashx>.

⁷ *Retirement Plan Investing: Clearer Information on Consideration of Environmental, Social, and Governance Factors Would be Helpful*, Government Accountability Office (May 2018), available at <https://www.gao.gov/assets/700/691930.pdf> (GAO Report) at 4.

⁸ See Gunnar Friede, Timo Busch, and Alexander Bassen, *ESG and Financial Performance: Aggregated Evidence from More than 2000 Empirical Studies*, *Journal of Sustainable Finance & Investment* (2015), available at <https://www.tandfonline.com/doi/full/10.1080/20430795.2015.1118917>; *Sustainable Reality, Analyzing Risk and Returns of Sustainable Funds*, Morgan Stanley Institute for Sustainable Investing (Aug. 2019), available at https://www.morganstanley.com/content/dam/msdotcom/ideas/sustainable-investing-offers-financial-performance-lowered-risk/Sustainable_Reality_Analyzing_Risk_and_Returns_of_Sustainable_Funds.pdf; *Majority of ESG Funds Outperform Wider Market Over 10 Years*, *Financial Times* (June 13, 2020); and John Hale, *U.S. ESG Funds Outperformed Conventional Funds in 2019* (Apr. 16, 2020), available at <https://www.morningstar.com/articles/973590/us-esg-funds-outperformed-conventional-funds-in-2019>.

⁹ GAO Report at 7.

neutral or positive relationship between the use of ESG information in investment management and financial returns in comparison to otherwise similar investments.”¹⁰

Retirement investors are typically investing for the long term, and investment advisers often consider ESG factors because of the long-term impact of these factors on investment returns. The GAO Report recognizes this, stating that “[c]limate change may be a particularly important ESG factor for long-term investors in the United States, such as retirement plans.”¹¹ The report notes that retirement plans may be vulnerable to climate risks “given their direct and indirect investments across economic sectors as well as their longer investment time horizons.”¹²

Investors are also increasingly interested in ESG investing, and this is particularly true for those aged 18-37. According to a 2019 report, 85 percent of individual U.S. investors and 95 percent of those aged 18-37 expressed an interest in sustainable investing, and 52 percent of individual U.S. investors and 67 percent of those aged 18-37 take part in at least one sustainable investing activity.¹³

ESG investing is likely to take on increased prominence due to the COVID-19 pandemic. As one report stated, “[o]ver the long run, COVID-19 could prove to be a major turning point for ESG investing, or strategies that consider a company’s environmental, social and governance performance alongside traditional financial metrics.”¹⁴ The Department’s skeptical view of ESG is, thus, we believe, short-sighted.

II. Consideration of ESG Factors as Part of the Investment Process is a Pecuniary Consideration and is Consistent with a Fiduciary’s Duty of Prudence

The Department states in the Preamble that the Proposed Amendments are designed to make clear that “ERISA plan fiduciaries may not invest in ESG vehicles when they understand an underlying investment strategy of the vehicle is to subordinate return or increase risk for the

¹⁰ GAO Report at 7-8.

¹¹ GAO Report at 6.

¹² GAO Report at 7.

¹³ *Sustainable Signals: Individual Investor Interest Driven by Impact, Conviction and Choice*, Morgan Stanley Institute for Sustainable Finance (Sep. 2019), available at https://www.morganstanley.com/pub/content/dam/msdotcom/infographics/sustainable-investing/Sustainable_Signals_Individual_Investor_White_Paper_Final.pdf.

¹⁴ *Why COVID-19 Could Prove to Be a Major Turning Point for ESG Investing*, J.P. Morgan, quoting Jean-Xavier Hecker and Hugo Dubourg, Co-Heads of ESG and Sustainability at J.P. Morgan EMEA Equity Research (July 1, 2020), available at <https://www.jpmorgan.com/global/research/covid-19-esg-investing>.

purpose of non-pecuniary objectives.”¹⁵ The Department should not assume that plan fiduciaries, including investment advisers, intend to subordinate return or increase risk when they make a decision to invest in ESG vehicles or to consider ESG factors as part of their prudent investment process. The objective of investment advisers that engage in these strategies on behalf of their ERISA clients is to seek a competitive return on their clients’ investments and manage risks, with the goal of “[p]roviding a secure retirement for American workers.”¹⁶ Investment advisers must consider a number of criteria about their clients and any potential investment recommendations, including client objectives, portfolio holdings, strategy, and risk-adjusted performance. Consideration of ESG factors is consistent with well-established ERISA fiduciary principles. The Proposed Amendments are not necessary because ERISA fiduciaries understand their obligations in Section 404 of ERISA to act with prudence and solely in the best interest of participants and beneficiaries.

Moreover, the Department – for good reason – has not historically dictated what is a prudent investment process or a generally accepted investment theory and it should not do so now. Limiting or favoring one type of an investment or investment process over another limits the ability of qualified investment professionals to fulfill their fiduciary duties. It is both inappropriate and inconsistent with any fiduciary standard that applies to investment advisers, including ERISA’s standards of care and loyalty, for the Department essentially to prescribe what investments those fiduciaries may or may not recommend to their clients.¹⁷ Consideration of ESG factors is today a component of generally accepted investment theory,¹⁸ and the Department should not be in the business of picking winners and losers from among generally accepted investment theories.

The Department expresses concern, without evidence, “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.”¹⁹ On the contrary, prudent plan fiduciaries that consider ESG factors believe that such consideration will financially benefit plan participants

¹⁵ 85 FR at 39116.

¹⁶ 85 FR at 39115.

¹⁷ See Letter from Kathy D. Ireland, Associate General Counsel, IAA, regarding Definition of the Term “Fiduciary” (RIN 1210-AB32) (July 21, 2015), available at <https://higherlogicdownload.s3.amazonaws.com/INVESTMENTADVISER/aa03843e-7981-46b2-aa49-c572f2ddb7e8/UploadedImages/publications/150721cmnt.pdf> (**IAA 2015 Letter**).

¹⁸ “Among the new normals that may come starkly into view when the all-clear sounds is that ESG integration is likely to be considered foundational to assessing a company’s ability to weather major disruption.” *Why ESG Matters in a Crisis*, Institutional Investor (June 9, 2020) [sponsored by AEGON], available at <https://www.institutionalinvestor.com/article/b1ly879667bxnt/why-esg-matters-in-a-crisis>.

¹⁹ 85 FR at 39116.

and beneficiaries and will facilitate effective risk management. The Department's premise that consideration of ESG factors will virtually never be pecuniary is inaccurate and would hinder the ability of qualified investment professionals to fulfill their duties and would limit participants' investment choices.

The proposed amendments to the "Investment duties" regulation, Rule 404a-1, discuss the consideration of pecuniary and non-pecuniary factors. The proposed definition of a "pecuniary factor" is "a factor that has a material effect on the risk and/or return of an investment based on appropriate investment horizons consistent with the plan's investment objectives and the funding policies established pursuant to section 402(a)(1) of ERISA."²⁰ Under proposed Rule 404a-1(c)(1), ESG "or other similarly oriented considerations are pecuniary factors only if they present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories." The Department appears to recognize in the Regulatory Impact Analysis that consideration of ESG factors may be pecuniary when it states that "[s]ome DB [defined benefit] plans that consider ESG factors would not be affected by the proposed rule because they focus only on the financial aspects of ESG factors, rather than on non-pecuniary objectives."²¹ However, elsewhere in the Preamble the Department takes a very narrow view of situations in which a qualified investment professional may appropriately treat ESG factors as "material economic considerations under generally accepted investment theories."²² The examples of permissible ESG factors for consideration provided by the Department are a company's improper disposal of hazardous waste and dysfunctional corporate governance.²³ In our view, it would likely be inappropriate and inconsistent with an adviser's fiduciary duty for an adviser *not* to consider these egregious examples in any investment decision.

Today, investment advisers consider ESG factors as economic drivers and risk mitigants, similar to other risk-return factors. The Department, however, does not appear to contemplate that ESG factors may be material in circumstances that do not involve extreme risk or mismanagement, nor does it appear to contemplate that the integration of ESG factors into the investment process is pecuniary. We believe this is a mistake. The Department portrays the consideration of ESG factors as outside the investment process, but this is inaccurate. Prudent investment considerations should include those things that are appropriate and relevant under

²⁰ Proposed Rule 404a-1(f)(3). We note that proposed Rule 404a-1(b)(1)(ii) would require fiduciaries to evaluate all investments and investment courses of action "based solely on pecuniary factors that have a material effect on the risk and return of an investment...." The proposed definition of "pecuniary factor" already includes "material effect on the risk and/or return of an investment" and it is not clear why the Department repeated the language in Proposed Rule 404a-1(b)(1)(ii).

²¹ 85 FR at 39121.

²² Proposed Rule 404a-1(c)(1).

²³ 85 FR at 39116.

Section 404 of ERISA, and for the Department to propose a regulation that divides economic considerations from ESG considerations is to misunderstand the investment process. The consideration of ESG factors on behalf of ERISA clients as part of the investment process is a pecuniary process that is consistent with a fiduciary's duty of prudence.

Moreover, many types of investment considerations that today may be considered ESG factors have long been part of a prudent investment process. For example, even before the market coined the term ESG, investment advisers analyzed crop and climate reports in connection with reviews of companies that use agricultural products in their supply chains. A plan fiduciary considering how climate change might affect a company's future business, or doing due diligence on a company's management, is doing so as part of its efforts to increase return and manage risk for plan participants, which is what ERISA requires of plan fiduciaries. The Department uses the term "generally accepted investment principles" in the proposed rule text, but the Department does not appear to recognize that these "principles" are dynamic and change over time. For example, investment advisers analyzing portfolio companies' risk management programs may now be focusing on how those companies are dealing with the COVID-19 pandemic. The consideration of ESG factors is now widely considered to be part of the framework of generally accepted investment principles.

The Department's statement that one of the purposes of the Proposed Amendments is to "separate the legitimate use of risk-return factors from inappropriate investments that sacrifice investment return, increase costs, or assume additional investment risk to promote non-pecuniary benefits or objectives"²⁴ appears to be based on the incorrect assumption that ESG investing reduces returns, increases risks, and subordinates returns to a non-pecuniary objective.²⁵ ERISA plan fiduciaries that consider ESG factors and invest in ESG investment vehicles are not promoting non-pecuniary benefits or objectives, but instead are engaged in a prudent investment process that is designed to benefit plan participants and beneficiaries. ESG considerations, such as those related to climate change, may be particularly significant for investments held by long-term retirement investors.²⁶ We have serious concerns that the combination of the Department's skepticism about ESG investing and the additional proposed requirements that we discuss below may cause plan sponsors and plan fiduciaries to feel it necessary to artificially decouple investment factors into those that are permissible under the regulation and those that are not, which may lead them to avoid taking into account *any* ESG considerations. This would not be a

²⁴ 85 FR at 39116.

²⁵ In its Regulatory Impact Analysis, the Department makes a similar statement that "[t]o the extent that ESG investing sacrifices return to achieve non-pecuniary goals, it reduces participant and beneficiaries' retirement investing returns" without providing any data showing that is the case. 85 FR at 39121.

²⁶ "Climate change has increasingly been recognized as an important long-term investment risk by some retirement plans and other investors because it is expected to have widespread economic impact." Cover Letter to GAO Report.

beneficial result for plan participants and beneficiaries and indeed would affirmatively harm retirement investors.

III. The Proposed Additional Requirements in Connection with ESG Investments are Unnecessary, Unclear, and Would Have Negative Impacts on Investors

The Department should not impose additional requirements on a particular investment process or strategy. All investments have unique characteristics and risks, and investment advisers as fiduciaries understand their obligations under ERISA with respect to plan participants and beneficiaries. We believe that singling out ESG investments, or the analysis of ESG investments, sets a dangerous precedent, and would likely have a chilling effect on future innovations in investing and investment analysis. The current regulatory framework provides significant protections to plan participants and beneficiaries such that additional requirements are unnecessary. The Department states that fiduciaries should be “skeptical of ‘ESG rating systems’—or any other rating system that seeks to measure, in whole or in part, the potential of an investment to achieve non-pecuniary goals—as a tool to select designated investment alternatives, or investments more generally.”²⁷ Investment advisers and other fiduciaries use a variety of inputs to analyze investments, and ESG ratings may be one of those inputs. We are concerned that this type of statement by the Department may limit the development of additional analytical tools in the ESG investment space.

Proposed Rule 404a-1(b)(1)(ii) and Proposed Rule 404a-1(c)(1)

It is not clear how fiduciaries would comply with the proposed analytical and documentation requirements. With regard to the analysis, proposed Rule 404a-1(b)(1)(ii) would require a fiduciary to evaluate all investments and investment courses of action:

based solely on pecuniary factors that have a material effect on the return and risk of an investment based on appropriate investment horizons and the plan’s articulated funding and investment objectives insofar as such objectives are consistent with the provisions of Title I of ERISA.

As discussed above, proposed Rule 404a-1(c)(1) provides that:

Environmental, social, corporate governance, or other similarly oriented considerations are pecuniary factors only if they present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories. The weight given to those factors should appropriately reflect a prudent assessment of their impact on risk and return.

²⁷ 85 FR 39118, n. 24.

It is unclear how an ERISA plan fiduciary would demonstrate compliance with these provisions. For example, if an investment adviser conducts any type of review or analysis across companies, would it be required to demonstrate that each review or analysis had “a material effect on the return and risk” on each investment over all periods? In addition, if an investment adviser’s review of board structure or composition was considered to be a “G” consideration, would the adviser be required to show that each review presented “economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories?” Similarly, how would the adviser show that the weight given to that review “reflected a prudent assessment of [its] impact on risk and return?” There is also no way for an adviser to determine what considerations would be viewed under the regulation as “similarly oriented considerations.” The fact that the Department felt the need to include this type of “catchall” provision indicates that the Department is aware that there is a spectrum of investment considerations, all pecuniary, that are integrated into the investment process. Nevertheless, the proposal would attempt to deter investors from using the full spectrum of considerations.

Investment advisers routinely analyze a wide range of research, reports, and quantitative and qualitative factors as part of a prudent investment process, and the incorporation of ESG factors is one of many components in that process. We believe that it would be extremely burdensome, if not impossible, to show the specific economic value of each component of that review, ESG or otherwise.²⁸ These proposed provisions also put investment advisers at a disadvantage when decisions are reviewed with the benefit of hindsight. The investment process is holistic. Attempting to separate each consideration is not feasible. As long as an investment adviser uses a prudent process for selecting investments, it should not be subject to these additional requirements.

Proposed Rule 404a-1(c)(3) and Investment Platforms for Defined Contribution Individual Account Plans

In the case of investment platforms for defined contribution individual account plans that include one or more ESG or “similarly oriented assessments or judgments in their investment mandates,” or include those parameters in the fund name, proposed Rule 404a-1(c)(3)(i) would require the ERISA plan fiduciary to use:

only objective risk-return criteria, such as benchmarks, expense ratios, fund size, long-term investment returns, volatility measures, investment manager investment philosophy and experience, and mix of asset types...in selecting and monitoring *all* investment alternatives for the plan including any environmental, social, corporate governance, or similarly oriented investment alternatives (emphasis added).

²⁸ We also believe that showing compliance with proposed Rule 404a-1(c)(2), which addresses the “all things being equal” test and would require alternative investments to be “economically indistinguishable” would be extremely challenging, if not unworkable.

Proposed Rule 404a-1(c)(3)(ii) would further require the fiduciary to document its selection and monitoring of the investment in accordance with proposed Rule 404a-1(c)(3)(i).

These proposed requirements raise a number of questions. For example, like our discussion above regarding “similarly oriented considerations,” what does the phrase “similarly oriented assessments or judgments” mean? Would an investment adviser’s review of each portfolio company’s board structure and composition – which is a standard consideration – mean that the investment mandate includes “similarly oriented assessments or judgments” that would subject the fiduciary to the requirements in proposed Rule 404a-1(c)(3)? The Proposed Amendments raise the question of whether a fund that is not branded or marketed as an ESG fund may be offered to ERISA clients where the adviser to the fund incorporates consideration of any ESG factors into the investment process. Neither the Proposed Amendments nor the Preamble adequately addresses this question. Also, why should a fiduciary be required to conduct the review described in proposed Rule 404a-1(c)(3)(i) across “*all* investment alternatives for the plan” just because an investment platform includes an ESG investment? Requiring this review and documentation would significantly increase burdens and costs on fiduciaries.

Under proposed Rule 404a-1(c)(3)(iii), an ESG “or similarly oriented investment mandate alternative” may not be added as, or as a component of, a qualified default investment alternative (**QDIA**). Again, it is not clear what would be considered a “similarly oriented investment alternative.” In addition, ESG investments or investment processes that integrate the review of ESG considerations currently may be included as components of target date funds that serve as QDIAs in order to provide additional diversification, which benefits plan participants and beneficiaries.

Plan Fiduciaries Would Incur Significant Costs to Comply with the Proposed Amendments

The Department states in the Regulatory Impact Analysis that “[w]hile fiduciaries may modify the research approach they use to select investments as a consequence of the proposed rule, the Department assumes this modification would not impose significant additional cost.”²⁹ We strongly disagree with this conclusion. Not only is it not clear how an investment adviser would be expected to demonstrate compliance with the proposed analytical requirements, but the Department also has not adequately assessed the associated costs. The proposed requirements would impose significant compliance burdens and costs on ERISA plan fiduciaries, and the Department substantially underestimates these burdens and costs. The lack of clarity around the proposed requirements makes the related proposed documentation requirements similarly unclear. In addition to the significant costs and burdens on ERISA plan fiduciaries, we are very

²⁹ 85 FR at 39121-39122.

concerned that an unintended consequence of this rulemaking would be that plan sponsors would prohibit investment advisers from including in their investment processes consideration of *any* E, S, or G factor, even though including such factors may lead to better returns, particularly over the long term, and better risk management for plan participants and beneficiaries. The combination of these additional and ambiguous provisions, and the Department's skeptical tone in the Preamble, increases the chilling effect on the selection of these investments.

IV. The Proposed Comparability Provision is Both Unattainable and Unnecessary, and Would Increase Costs and Risks for Fiduciaries

Proposed Rule 404a-1(b)(2)(ii)(D) provides that, for purposes of Rule 404a-1(b)(1), appropriate consideration of an investment or investment course of action includes “[h]ow the investment or investment course of action compares to available alternative investments or investment courses of action with regard to the factors listed in paragraphs (b)(2)(ii)(A) through (C) of this section.” Paragraphs (b)(2)(ii)(A) through (C) include the composition of the portfolio with regard to diversification, the liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan, and the projected return of the portfolio relative to the funding objectives of the plan. The Department states in the Preamble that “[c]larifying that an investment or investment course of action must be compared to available alternatives is an important reminder that fiduciaries must not let non-pecuniary considerations draw them away from an alternative option that would provide better financial results.”³⁰

This proposed provision is extremely broad and its application is not clear. For example, an investment adviser managing a fund or separately managed account focused on U.S. fixed income securities would not look at equity securities for potential investments. Plan fiduciaries selecting investment options for their plans understand their duties when considering investments and investment courses of action, including reviewing alternatives where appropriate as part of that process. The Preamble provides no guidance on the reasonable parameters for the proposed comparisons. The proposed approach is also counter to the Department's recently proposed investment advice class exemption, in which the Department recognizes that a fiduciary is not expected to compare a potential investment to every other potential investment to determine which is the best. The Department states in the preamble to that proposal that “[t]he best interest standard in this proposal would not impose an unattainable obligation on Investment Professionals and Financial Institutions to somehow identify the single ‘best’ investment for the Retirement Investor out of all the investments in the national or international marketplace, assuming such advice were even possible at the time of the transaction.”³¹ We question why the Department did not take a similar approach here. This proposed provision sets up an unattainable

³⁰ 85 FR at 39117.

³¹ *Improving Investment Advice for Workers & Retirees*, 85 FR 40834 (July 7, 2020), at 40843.

standard, and is likely to lead to increased costs and risks for fiduciaries without providing commensurate benefits to plan participants or beneficiaries.

In addition, while the proposed provision does not include a specific documentation requirement for every investment selected, we believe that it is an implicit requirement that investment advisers will feel compelled to follow in order to avoid regulatory second-guessing and litigation. This represents a significant burden for every investment decision without a clear benefit to plan participants or beneficiaries.

V. The Department Should Not Explicitly or Implicitly Favor One Type of Investment Over Another or Improperly Limit Investor Choice

The Value of Active Management

In the Regulatory Impact Analysis, the Department states “as plans invest less in actively managed ESG mutual funds, they may instead select mutual funds with lower fees or passive index funds. In this case, the societal resources freed for other uses due to lessened active management (minus potential upfront transaction costs) would represent benefits of the rule.”³² This statement conflates several erroneous points and reflects a fundamental misunderstanding about active management. First, although ESG investing inherently involves active decision-making, there are both active approaches and index-based approaches to ESG investing. Second, both active and passive management involve a range of fees. In other words, there are higher and lower cost active funds, including ESG funds, and higher and lower cost passive funds, including ESG funds. Third, actively managed ESG funds are not necessarily more expensive than actively managed funds that do not incorporate ESG. Fourth, the Department is simply wrong that reducing the use of active funds would benefit investors, re-introducing a longstanding, misguided Department view of active management.³³

Thus, the Department’s framing of this issue entirely misses the mark and perpetuates a false dichotomy pitting active management against passive management. Both active and passive management, and indeed a wide range of investment strategies, have important roles to play in investment management and the markets.³⁴ Active management adds value by helping to meet investors’ individualized and multifaceted risk, return, and other long-term goals. Active

³² 85 FR at 39121.

³³ See *Definition of the Term “Fiduciary”* (RIN 1210-AB32), available at <https://www.govinfo.gov/content/pkg/FR-2015-04-20/pdf/2015-08831.pdf>, and IAA 2015 Letter. In response to our 2015 comments, the Department appropriately did not include its safe harbor for passive funds in its subsequent re-proposal of the fiduciary rule.

³⁴ Members of the IAA’s Active Managers Council met with Department staff last fall regarding the value of active management, urging the Department not to favor passive over active management implicitly or explicitly in its policymaking. Council members presented the research referenced in n. 36 infra and noted the important role that both active and passive management play for investors.

management enables investors to navigate complexity, manage risk, capitalize on specific skills, or profit from market inefficiencies.³⁵ The fundamental research that is the hallmark of many actively managed investment strategies enables a nuanced approach to evaluating ESG factors, enabling more customized portfolios. Active management also contributes to market efficiency and price discovery.³⁶ Passive management can help reduce cost, particularly in more efficient market segments. Indeed, the great majority of investment advisers – 75 percent – believe that active and passive strategies complement each other in constructing an effective portfolio.³⁷ The Department recognizes the value of active management in a recent Information Letter regarding “the use of private equity investments within professionally managed asset allocation funds that are designated investment alternatives for participant-directed individual account plans.”³⁸

Retirement policies should recognize the importance of preserving investor access to a range of investments and investment strategies, and the Department’s commentary should not include language or analysis that favors one type of investment strategy over another. The value of investor choice is not fairly measurable by a single metric of cost. Retirement savers should have access to a sufficient variety of investment products and strategies to meet their goals, and maintaining that access is a benefit, not a cost. As we have previously commented to the Department, active management is unquestionably a generally accepted investment strategy.³⁹

We also strongly disagree with the Department’s statement regarding “societal resources.” The “societal resources” used in active management, including fundamental research and analysis, serve to *benefit* investors, including plan participants and beneficiaries. Indeed, in addition to adding value on a risk-adjusted basis, active management is critically important to

³⁵ See Martijn Cremers, Jon A. Fulkerson, and Timothy B. Riley, *Challenging the Conventional Wisdom on Active Management: A Review of the Past 20 Years of Academic Literature on Actively Managed Mutual Funds*, Financial Analysts Journal, Vol. 75, No. 4 (Fourth Quarter 2019), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3247356; and David F. Lafferty, CFA, Chair, IAA Active Managers Council, *A More Balanced Narrative, Setting the Record Straight on Active Management*, available at <https://www.activemanagers.com/amc/insights/more-balanced-narrative>.

³⁶ See Russ Wermers, *Active Investing and the Efficiency of Security Markets* (Dec. 15, 2019), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3353956; and IAA Active Managers Council, *Active Management and Market Efficiency: A Summary of the Academic Literature*, available at https://higherlogicdownload.s3.amazonaws.com/INVESTMENTADVISER/4d240ae3-bc9b-4155-8bd1-14cbac904146/UploadedImages/amc/docs/WP-AMC-Market-Efficiency_v0719.pdf.

³⁷ See Lee Barney, *Advisers Say Active and Passive Investing Go Hand in Hand*, quoting Brendan Powers, Senior Analyst at Cerulli, planadviser.com (Apr. 10, 2018), available at <https://www.planadviser.com/advisers-say-active-passive-investing-go-hand-hand/>.

³⁸ Information Letter 06-03-2020, available at <https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/information-letters/06-03-2020>.

³⁹ See IAA 2015 letter.

healthy markets, making markets efficient, by keeping price in line with value. Active management also supports capital formation and entrepreneurship, providing a market for IPOs and other forms of capital-raising. Discouraging active management in no way benefits investors and fails to preserve investor choice. The Department should not place its finger on the scale favoring passive funds to the detriment of investors.

The Proposed Amendments Improperly and Needlessly Limit Investor Choice

It is imperative that government policies do not explicitly or implicitly favor one type of investment management over the other. Doing so is not consistent with Section 404 of ERISA that requires fiduciaries to engage in a prudent investment process in the best interest of plan participants and beneficiaries. We believe that it is beneficial for retirement savers to have a wide variety of available investment options because of the differences in their needs, goals, and preferences. Government policies also should not limit choice or create disincentives for investors to save for retirement. We believe that the Proposed Amendments would improperly and needlessly limit investor choice, with the likely result that many investors may limit their participation in ERISA retirement plans. As discussed above, many investors want an ESG investment as part of a diversified long-term retirement portfolio.⁴⁰ Plan participants, particularly younger plan participants, may be more likely to participate, or may increase their participation, in retirement plans that provide ESG investment options. Conversely, prohibiting plan fiduciaries from considering ESG factors for plan investments may cause younger plan participants not to participate in, or to contribute less to, retirement plans.

VI. If the Department Proceeds, it Should Grandfather Investments in ERISA Plans and Provide for an Adequate Implementation Period

We have very serious concerns about this rulemaking and do not believe that the Department should proceed with it. If the Department goes forward with this rulemaking, however, it should grandfather all existing investments in ERISA plans. Participants should not be forced to exit investments, which could be detrimental to them in terms of increased costs and decreased returns. Firms also should not be required to change the composition of existing QDIAs, including target date funds. Fiduciaries should not retroactively be subject to the documentation and other requirements of the Proposed Amendments for current investments.

As proposed, the amendments would be effective 60 days after the date of publication of the final rule in the *Federal Register*. If the Department does not grandfather these investments, it should provide at least 18 months for implementation. And, even if the Department grandfathers these investments, it needs to provide a sufficient period of time of at least 12 months for fiduciaries to implement any new requirements.

⁴⁰ See Section I.

* * *

We strongly believe that, rather than proceed with this rulemaking, the Department should further study current data and practices in ESG investing and the consideration of ESG factors in the investment process. We are very concerned that the Proposed Amendments will bring with them a number of unintended consequences, including pecuniary harm for investors and significant burdens and costs for plan fiduciaries, and will unnecessarily limit investment choice for plan participants and beneficiaries. We appreciate the Department's consideration of our comments and would be happy to provide any additional information that may be helpful. Please contact Sarah Buescher, IAA Associate General Counsel, or the undersigned at (202) 293-4222 if we can be of further assistance.

Respectfully Submitted,

/s/ Gail C. Bernstein

Gail C. Bernstein
General Counsel

Appendix: *Sustainable Investing is an Active Process*, Investment Adviser Association Active Managers Council

Sustainable Investing is an Active Process

Sustainable investing and index-based investing: they're clearly the two most important trends in investing today. With investor interest in both strategies increasing rapidly, it's not surprising that there's been a movement to combine the two approaches.

This paper compares traditional actively-managed sustainable investing with the newer index-based methodologies. Our central insight is that sustainable investing inherently involves active decision-making. Active and index-based managers alike assess both the importance of sustainability issues and how firms are managing the risk posed by these issues. As we discuss below, however, active and index-based managers have very different approaches to making those assessments.

The active approach to sustainable investing focuses on:

- A tailored assessment of individual investments.
- A future-focused evaluation of an investment's long-term risk and opportunity.
- A holistic approach to assessing portfolio risk management.
- A long-term commitment to stewardship.
- Integration with investor goals.

In sum, the traditional fully active approach allows for a more nuanced consideration of a wider range of quantitative and qualitative factors, which helps investors tailor their portfolios to their sustainability goals.

SUSTAINABLE GROWTH

Sustainable investing is experiencing strong growth, both in assets under management and in investor acceptance:

- Total U.S.-domiciled assets under management using sustainable investing strategies rose from \$8.7 trillion at the start of 2016 to \$12.0 trillion at the start of 2018, a 38% increase. Source: US SIF, *2018 Report on US Sustainable, Responsible and Impact Investing Trends*
- 42% of institutional investors incorporated sustainability into their investment decision making in 2019, compared to 22% in 2013. Source: Callan Institute, *2019 ESG Survey*

Divergent Paths

The active and index-based approaches share a similar origin story. Both sustainable investing funds and index funds were developed in the 1970s as responses to modern portfolio theory, the efficient market hypothesis, and other models of the financial markets that were gaining currency during the decade.

But their paths immediately diverged.

Index-based investing wholeheartedly embraced the new theories. Proponents argued that if investors couldn't beat the market – because the market was highly efficient – then investors were better off joining the market by investing in an index fund. They'd save time, money and aggravation as a result.

By contrast, sustainable investing rejected what had become the conventional wisdom; its core premise was that markets weren't efficient because they didn't reflect the long-term impact of social criteria. One of the early advocates of sustainable investing, Milton Moskowitz, put it this way in 1973: "I do harbor the suspicion that a socially insensitive management will eventually make enough mistakes to play havoc with the bottom line."¹ In other words, investors who considered their values when making financial decisions weren't just doing the right thing ethically – they were doing the right thing financially.

Skepticism about Moskowitz's argument, combined with the limited investor interest in both sustainable and index investing, meant that there was a significant chasm between the two approaches for the next four decades. Sustainable investing remained largely in the realm of active managers, while index funds generally focused solely on replicating the market at low cost without consideration of risk or sustainability issues.

In recent years, increasing acceptance of the financial impact of social and environmental considerations, which has led to strong growth in the sustainable investing category, together with the growing interest in index investing, has changed the landscape considerably. In this environment, some advisers have sought to bridge the gap between index funds and sustainable investing by offering funds that combine elements of both.²

However, this hybrid approach remains significantly different from the traditional actively-managed sustainable investing approach.

A WORD ABOUT TERMINOLOGY

We use *sustainable investing* as an umbrella term to refer to investment approaches that consider values in investment decision-making, either because adherence to those values has a long-term financial benefit or as a way to advance those values. ESG (environmental, social, governance), impact, responsible, and purpose-driven investing would all be included under the term "sustainable investing," together with sustainable sector funds.

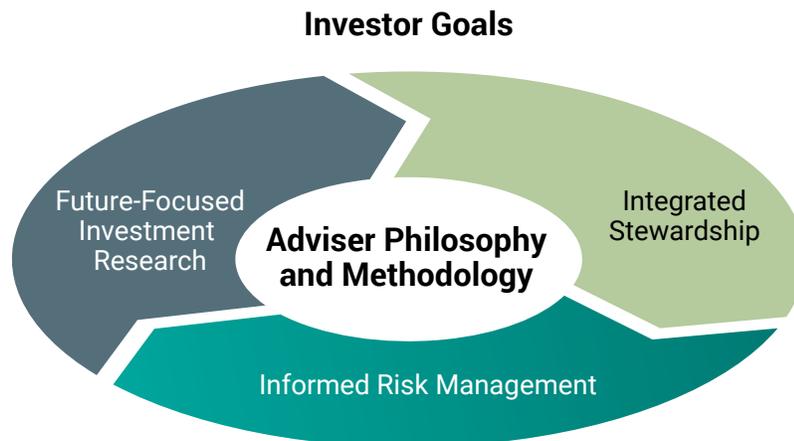
¹ Milton Moskowitz, "Why 'Good Guy' Funds have Flopped," New York Times, February 11, 1973, p. 179.

² For an overview of the historical background, see Blaine Townsend, "From SRI to ESG: The Origins of Socially Responsible and Sustainable Investing," Baillard Thought Series (June 2017).

The Active Approach to Sustainable Investing

To set the stage for our analysis of active and index-based approaches to sustainable investing, we begin with a deep dive into traditional actively-managed sustainable investing. The core components of the approach – which have evolved over 50 years of experience – define the essential elements of a sustainable investing program.

AN INTEGRATED APPROACH TO SUSTAINABLE INVESTING



Adviser Philosophy and Methodology

The active approach to sustainable investing begins by defining the adviser’s overall philosophy – how the adviser views the intersection of values and investing. This philosophy is tailored to each firm.

In addition to the general philosophy, the adviser defines its specific methodology for incorporating sustainability into investment selection. For example, sustainability can factor into the beginning of the selection process (initial screening), the middle (ESG integration in analysis) or the end (ESG overlay on portfolio construction) – or can be an element in all three stages of the process. Establishing a governance structure to monitor sustainability efforts is also critical.

APPROACHES TO SUSTAINABLE INVESTING

Broad categories include:

- ESG integration. Considering environmental, social, and governance factors as part of the security selection process. This category focuses on the financial impact of these factors.
- Impact investing. Seeking to have a positive environmental and social impact, in addition to a financial return.
- Sustainable sectors. Focusing on a particular industry or sector, such as renewable energy, that advances specific environmental or social goals.
- Values-system based. Selecting investments that are consistent with the precepts of a particular values system, such as the values of a particular religion.
- Exclusionary. Avoiding investments in companies that engage in activities that are inconsistent with specific values.

Future-Focused Investment Research

It's only after this foundation is established that the investment work can begin.

Active managers do in-depth research on potential investments, evaluating not just their past performance but, even more importantly, their future potential. They delve into a company's financial reports, interview its management, study its businesses, and assess its competitive strengths to develop a forecast of its financial prospects.

An essential part of this research process is examining the environmental, social and governance factors that could affect a company's performance. Analysts can draw from a variety of sources for making this assessment, including a company's disclosures, third-party ESG ratings, site visits, discussions with management, and monitoring of the trade press.

An assessment of the materiality of the environmental, social and governance factors is what converts a traditional investment process into a sustainable approach. This assessment involves:

- Identification of factors that are currently having a material impact on a company's business.
- Tracking of emerging issues that could have a significant impact in the future.
- An assessment of the short- and long-term impacts of these factors.

This materiality assessment can be both top-down and bottom-up. For example, a big-picture analysis might identify water usage and quality as an important issue, but in-depth research on specific companies and industries might identify this as a particularly important issue for breweries in emerging markets.

The goal of the research process is to identify investments with superior prospects for financial returns that also align with investors' goals and are consistent with the adviser's philosophy and process.

“The active approach to sustainable investing begins by defining the adviser's overall philosophy – how the adviser views the intersection of values and investing.”

Informed Risk Management

Risk management is the next step – evaluating how the individual investments that have been identified through the research process will interact when combined in a portfolio.

Quantitative tools are the starting point for this assessment. Advisers routinely assess portfolio weightings relative to the index, monitor overall volatility, measure a portfolio's correlation with the market, and estimate potential tracking error versus index returns. From a sustainability perspective, the quantitative assessment might also consider average third-party ratings compared to the index and trends in those ratings.

But active managers will also take a step back and consider risks that might not be considered in the quantitative evaluation. That's especially important for emerging issues that might not yet have impacted the historical data.

This informed approach to risk management enables active managers to incorporate long-term thinking into the portfolio.

Integrated Stewardship

But the effort to advance sustainability goals doesn't end with portfolio construction. Asset owners play a critical role in corporate governance through their proxy voting and their engagement with management on strategic issues.

Active managers can integrate this stewardship effort with the investment selection process. For each investment, they can:

- Identify the sustainability issues that are most material to the company's future.
- Tailor an approach to proxy voting that can encourage management to address critical issues.
- Engage in conversations with management about the opportunities and challenges of sustainable practice.

The cumulative effect of these practices, compounded over the length of the holding period, can add considerable value to a portfolio. Importantly, however, if the probability of positive outcome to a stewardship approach begins to shrink, the adviser has the option of selling the security.

Critically, active managers can focus on the issues that are most consequential for a particular company. By encouraging managements to address these key issues, active managers help companies improve performance which, in turn, boosts investor returns.

Passive managers also seek to advance sustainability through proxy voting and engagement. Because of their broad holdings they can be particularly effective in helping to change standards, especially in the area of governance.

Connecting with Investor Goals

Connecting with the investor's goals – and assessing their fit with the adviser's philosophy – is an equally important foundational step in the active approach to sustainable investing.

Advisers engage with the investor to determine:

- The investor's values with regard to environmental, social and governance issues.
- How the investor would like to advance those values through their portfolio.
- How they view the relative importance of advancing those values and of earning the highest financial returns, if those objectives might be in conflict.

In addition, the adviser must assess:

- Whether the investor's values and goals are compatible with the adviser's philosophy and process.
- Whether customization may be needed to better align the approach with the investor's values and goals, and whether that customization makes sense within the context of the adviser's philosophy.

Throughout this phase of the process, communication with the investor is critical. This communication can take many forms – directly with the investor, through disclosure documents, or by communicating with investment advisers, brokers, or financial planners working with the investor.

However the communication occurs, the purpose is to determine if the investor's philosophy on sustainability aligns with the adviser's process and methodology.

Importantly, active managers work with investors to update their goals over time. Perhaps the investor's sustainability goals have evolved, or research has provided further insights on how best to achieve those goals. Sustainable investing isn't "set it and forget it." Active managers help investors to understand changes in the sustainability landscape and its implications for their portfolio.

The Index-Based Approach to Sustainable Investing

By contrast, the index-based approach to investing emphasizes quantitative screening of large numbers of securities using standardized measures.

Screening of Company Ratings

The core component of the index-based approach is the use of a ratings system that assigns scores to companies as a measure of their sustainability risk. While each ratings system has its own methodology, the common elements are:

- Enumeration of material issues. The ratings providers must determine which environmental, social and governance issues are material to financial performance. While the providers do not provide transparency into how these issues are selected, their process appears to be top-down and focus on consensus opinion.
- Develop weighting scheme. To arrive at an overall assessment for a company, the ratings system must have a way to aggregate performance on individual issues. Generally, this is done through the use of a weighted average.
- Identification of data sources. The system must identify data that can be used to assess a company's exposure to and performance on the material issues. Ratings systems draw much of their analysis from corporate disclosures, though other sources such as government data and media reports may be incorporated.

To be useful for ratings, the data must be both consistent and available for a large number of companies. The most useful data also provides a direct measurement of performance related to a particular issue; however, ratings providers may rely on proxies to arrive at an estimate.

- Calibrate scores. The data for a particular company needs to be turned into a score. This calibration may be done using an absolute scale, or a score may be determined by ranking within a specific subset or against the universe as a whole.

These ratings are applied to large numbers of companies to create a database of rankings.

Quantitative Portfolio Construction

Index managers use quantitative tools to assemble portfolios and manage risk. A typical approach to portfolio construction might begin by screening a broad market index, possibly excluding ratings below a specified level or including only those stocks in an industry with the highest ratings. The screen would identify the securities to be held in the portfolio.

Then, the adviser would use quantitative optimization techniques to determine the weightings of the securities within the portfolio. These techniques generally create a portfolio with an overall risk profile that is similar to the broad market index that was the starting point of the process, with the goal of minimizing tracking error versus the index. The end result is that portfolio performance should be similar to that of the index, even as the portfolio emphasizes companies with sustainable practices.

Investor Decision Making

In a separate process, investors determine how best to advance both their financial and their sustainability goals. They must first select the broad market index that is most appropriate for their risk profile. They then identify a ratings system that best reflects their sustainability priorities (if there is enough information available for them to make that assessment).

Institutional clients may be able to customize some aspects of the portfolio construction, but not the basic components of the ratings system.

If their goals – or the sustainability landscape – changes, investors will need to repeat this process to update their portfolio.

“By encouraging managements to address these key issues, active managers help companies improve performance which, in turn, boosts investor returns.”

Key Takeaways from a Comparison of the Approaches

The deep dives into the two approaches provide insights into both the nature of sustainable investing and the differences between the active and the index-based methodology.

Sustainable Investing is Inherently Active

Sustainable investing inherently involves active decision-making that begins with an assessment of the materiality of sustainability issues. Both active and index-based managers must determine how these issues apply to individual companies and evaluate how companies are managing the related risks.

Perhaps the most compelling evidence for the subjective nature of the process is the dispersion of the sustainability ratings used in the index-based approach. If the ratings process was 100% objective, all of the ratings systems should generate similar scores for the same companies. However, those scores can differ significantly.

The ratings on automaker General Motors are a case in point. In May 2020, ratings provider JUST Capital ranked GM as #1 in the “automobile and parts” industry and within the top 2% of all 922 companies that it rates. By contrast, according to ratings provider MSCI, GM is a “laggard” in its industry, earning the lowest grade of CCC.

Academic studies have found that these kinds of divergences are common. An early study in this vein examined six ratings systems and found “little overlap in their assessments of CSR [corporate social responsibility].”³ A recent study in the ECGI Working Paper Series in Finance found that the average correlations between ratings from six different providers was just 0.46.⁴ One of the better-known studies analyzed the sources of the discrepancies among five different ratings providers and determined that 44% was due to differences in the attributes being measured and 53% was due to differences in how those attributes were measured; just 3% was due to differences in the weighting of those attributes.⁵

³ Aaron K. Chatterji, David I. Levine, and Michael W. Toffel, “How Well Do Social Ratings Actually Measure Corporate Social Responsibility?”, *Journal of Economics and Management Strategy* 18, no. 1 (2009): 125–69. <https://doi.org/10.1111/j.1530-9134.2009.00210.x>.

⁴ Rajna Gibson, et al., “ESG Rating Disagreement and Stock Returns,” Social Science Research Network (2019). <https://doi.org/10.2139/ssrn.3433728>.

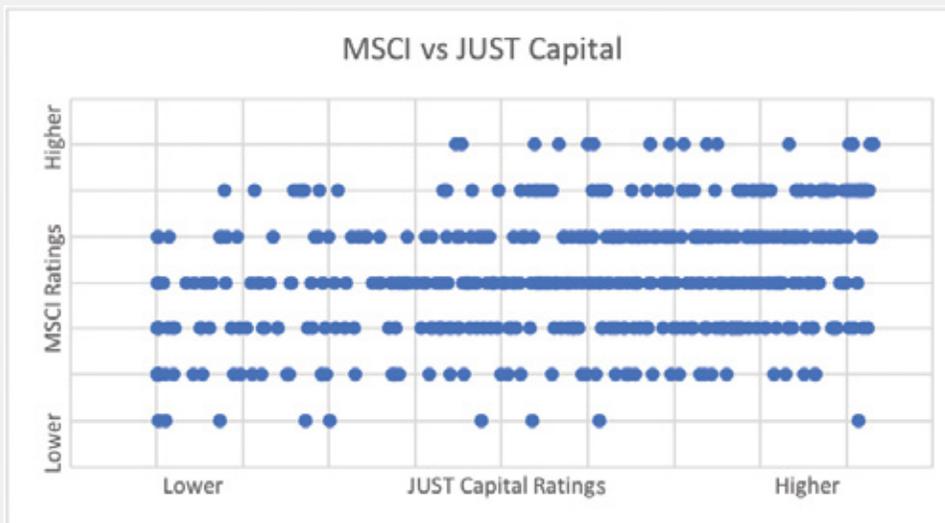
⁵ Florian Berg, Julian F. Kölbl, and Roberto Rigobon, “Aggregate Confusion: The Divergence of ESG Ratings,” MIT Sloan School Working Paper 5822-19 (2019). https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3438533.

Professor Ingo Walter summed up the situation this way:

Accessing and filtering hundreds of quantitative and qualitative information points across thousands of companies by armies of assessors of unknown capability boggles the mind. So does the meaningfulness of the calibration and factor-weighting process. And when it is all cooked-down to an alphanumeric score or other display, what does it really mean in benchmarking against ESG targets that may themselves be controversial?⁶

A SNAPSHOT OF SUSTAINABILITY RATINGS DIVERGENCE

Sustainability ratings from different providers can seem to have little connection with each other, as this scatter diagram illustrates. It plots the MSCI ESG ratings of 518 companies against ratings for the same companies from JUST Capital.



Data: MSCI and JUST Capital ratings available online on May 28-29, 2020.

Sustainability Ratings are Data-Dependent

A major concern with sustainability ratings is their overall accuracy and their usefulness as a predictor of future performance.

Some of the issues raised with the ratings methodology are:

- Reliance on narrative disclosure. The ratings systems rely heavily on narrative disclosures of companies' sustainability efforts. Corporations are increasingly providing this type of information in response to investor requests.

However, relying on corporate disclosure may be skewing scores, because this disclosure is more readily produced by larger firms with more resources. In fact, studies have documented that ratings systems tend to favor larger firms and suggest that the higher ratings are the result of the greater volume of disclosure.⁷

⁶Ingo Walter, "Sense and Nonsense in ESG Scoring," Social Science Research Network (2019). <https://doi.org/10.2139/ssrn.3480878>.

⁷Michael J. LaBella, et al., "The Devil is in the Details," Legg Mason (2019). <https://www.leggmason.com/content/dam/legg-mason/documents/en/insights-and-education/whitepaper/lm-qs-the-devil-is-in-the-details-0919.pdf>; Timothy M. Doyle, "Ratings That Don't Rate: The Subjective World of ESG Ratings Agencies," American Council for Capital Formation (2018). https://accfcorgov.org/wp-content/uploads/2018/07/ACCF_RatingsESGReport.pdf.

“The in-depth nature of the active research process makes it possible for advisers to assess not just short-term risks . . . but, even more importantly, the direction of long-term trends.”

Paradoxically, other researchers have demonstrated that increased disclosure leads to greater disagreement in sustainability, suggesting that disclosure is not a reliable basis for ratings.⁸

- **Reliance on proxy statistics.** Another concern raised with the ratings systems is that they can't measure sustainability activity directly, so they rely on proxy statistics to estimate the level of that activity. For example, corporate disclosure about sustainability is a proxy for direct observation of the company's efforts. Similarly, monitoring media reports will generally not provide a complete picture of a company's activities. As a result, use of proxy statistics like these increases the likelihood that ratings will be less helpful.
- **Overly mechanical.** In order to evaluate thousands of companies, ratings systems must rely heavily on rules that can be applied mechanically – by computers or by large teams of raters – as much as possible. These rules-based approaches are useful for estimating overall trends but can have a high error rate when used to evaluate individual companies, where there are likely to be exceptions and nuances.
- **Backward-looking approach.** In general, the ratings systems tend to be more focused on measuring the past rather than predicting the future. The use of reported financial information rather than forecasts is a significant source of this bias. In addition, the emphasis on broadly-recognized sustainability concerns suggests that the systems will be slow to address emerging issues or recognize innovative responses.

These limitations have led researchers to question the value of the ratings systems, particularly as a tool for making securities selection. In a 2018 study, Bennani et al. note that the lack of long-term data makes it difficult to draw conclusions. Based on the limited data available, the researchers find that “the impact of ESG screening on return, volatility and drawdown is highly dependent on the time period,⁹ the investment universe or the strategy.”⁹

On the other hand, sustainability ratings can provide insights and, as a result, can serve as a useful starting point for a securities selection process. In fact, active managers often use these ratings to narrow down the candidates for future research or help identify industries or companies that present higher risk. However, active managers perform in-depth research to validate the insights provided by the ratings before making security selection decisions.

COMBINING DATA SCIENCES AND INSIGHTS

Active managers are using data science to assess sustainability – by tapping into new data sources and analytical methods to confirm insights gathered from sector, industry, and company research. For example, an active manager might identify employee sentiment as a material factor driving long-term sustainability for service companies, because better employee morale leads to greater customer satisfaction. By using technology to monitor data on LinkedIn, an analyst could receive early warning of a change in trend, signaled by an increase or decrease in staff turnover.

⁸ Gibson et al. 2020; Dane Christensen, George Serafeim, and Anywhere Sikochi, “Why is Corporate Virtue in The Eye of the Beholder? The Case of ESG Ratings,” (November 2019). http://www.israeli-corporate-governance.org/files/content/banner/Sikochi_ESGRatings.pdf.

⁹ Leila Bennani et al., “How ESG Investing Has Impacted the Asset Pricing in the Equity Market,” Social Science Research Network (November 2018). <https://doi.org/10.2139/ssrn.3316862>.

Active Approaches Take the Long View

The in-depth nature of the active research process makes it possible for advisers to assess not just short-term risks that are visible in the current data but, even more importantly, the direction of long-term trends and how they will affect companies.

The active approach:

- Takes a dynamic approach to the assessment of the materiality of sustainability issues. Advisers consider both today's issues and issues that are likely to have a significant impact in the future.
- Thinks broadly about how those factors affect specific companies. An individual company may have operations that are impacted by sustainability issues that don't generally apply to companies in that industry.
- Engages with corporate managements around their efforts to address sustainability risks. By integrating stewardship with research, the active approach helps companies prepare for the future.

In sum, active approaches to sustainability investing are forward-looking.

Traditional Active Approaches Help Investors Align with Their Goals

As one of the foundational steps, active managers assess investor goals and how those goals connect with the adviser's philosophy and process. The active approach is adaptive – able to react to innovation and changes in the environment and to quickly evaluate how they impact the achievement of investor goals.

By contrast, the investor bears the responsibility for research in the index-based approach. The investor defines both their investment goals and their sustainability targets. The burden is on the investor to determine if the particular ratings system and portfolio construction approach are a good fit for those goals. (That is, if they can get the relevant information about the ratings system.) And, if there are changes in the ratings or portfolio construction methodology, the investor will need to repeat the process.

In sum, the active approach helps investors to align their portfolios with their sustainability goals.

“The active approach is adaptive – able to react to innovation and changes in the environment and to quickly evaluate how they impact the achievement of investor goals.”

THE BLACK BOXES OF SUSTAINABILITY RATINGS

One of the challenges with the sustainability ratings is that detailed information isn't generally available. The major producers of these ratings publish a general description of their approach on their websites. However, more detailed information is normally available only to subscribers, if at all.

As a result, investors may have difficulty determining whether a ratings system aligns with their sustainability priorities. That is particularly true for retail investors who participate in a mutual fund that uses the ratings as a core component of its investment approach.

For example, an investor who is especially interested in supporting renewable energy could have difficulty determining how a sustainable index advances that interest.

Takeaways

The active approach to sustainable investing begins by defining the adviser's overall philosophy. Active managers perform in-depth research on potential investments; an essential part of this research process is examining the environmental, social and governance factors that could affect a company's performance. Risk management is the next step – evaluating how the individual investments that have been identified through the research process will interact when combined in a portfolio. Active managers integrate stewardship with the investment selection process, through proxy voting and engagement. At the same time, connecting with the investor's goals – and assessing their fit with the adviser's philosophy – is an equally important foundational step in the active approach.

By contrast, the index-based approach emphasizes quantitative screening of large numbers of securities using standardized measures. The core component of the index-based approach is the use of a ratings system that assigns scores to companies as a measure of their sustainability risk. Index managers then use quantitative tools to assemble portfolios and manage risk. In a separate process, investors determine how best to advance both their financial and their sustainability goals.

The examination of both approaches highlights the active aspects of the index-based approach, as evidenced by the dispersion in sustainability ratings. In addition, researchers have raised concerns about the overall accuracy of these ratings and their usefulness as a predictor of future performance.

The traditional actively-managed sustainable investing takes a dynamic approach to the assessment of the materiality, thinks broadly about how those factors affect specific companies, and engages with corporate managements around their efforts to address sustainability risks. Active managers also consider how changes in the sustainability landscape intersect with investor goals.

The long-term focus of the traditional actively-managed approach helps investors to align their portfolios with their sustainability goals.

About the Active Managers Council

The Investment Adviser Association formed the Active Managers Council in 2017 to support education and research on the value of active management for investors and the capital markets and to engage on relevant public policy issues. For more information, visit www.activemanagers.com or follow us on [Twitter](#), [LinkedIn](#) and [YouTube](#).

About the Investment Adviser Association

The Investment Adviser Association (IAA) is the leading trade association representing the interests of SEC-registered investment advisers. The IAA's member firms collectively manage assets in excess of \$25 trillion for a wide variety of institutional and individual investors. For more information, visit www.investmentadviser.org or follow us on [Twitter](#), [LinkedIn](#) and [YouTube](#).