

December 13, 2021

Submitted via: <http://www.regulations.gov/>

Ali Khawar, Acting Assistant Secretary  
Office of Regulations and Interpretations  
Employee Benefits Security Administration  
Room N-5655  
200 Constitution Avenue NW  
Washington, DC 20210

Re: Proposed Rule on Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights (RIN 1210-AC03)

Dear Acting Assistant Secretary Khawar:

This letter is submitted on behalf of the [Fiduciary Duty and Policy Working Group](#) and [Sustainable Retirements Initiative](#) of the [Intentional Endowments Network](#) (“IEN”) in support of the Department of Labor’s proposed rule on “Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights” (RIN 1210-AC03) (the “Proposal”).

While IEN strongly supports the Proposal, we also recommend that the final rule be modified to:

- Explicitly incorporate principles from the fiduciary duty of impartiality, which has been applied to ERISA by the US Supreme Court;
- Establish a presumption that ERISA fund investment analyses nearly always require inclusion of a long-term investment horizon in order to reflect fund obligations;
- Contain additional Preamble background commentary on the principle that prudent fiduciary investment practices have evolved in the past, and are expected to evolve in the future, in response to changes in knowledge and factual circumstances; and
- Provide guidance for ERISA fiduciaries when considering commingled funds that offer investors a new option to exercise pass-through proxy voting rights for fund holdings.

The IEN is a non-profit, peer-learning network of more than 185 higher education financial institutions, investment managers and related advisors. IEN’s primary goal is to support higher education investment fiduciaries, which collectively manage about \$650 billion in endowment assets and \$900 billion of retirement funds, as they seek to understand and apply evolving sustainable investment practices. Our work with higher education institutions has made IEN keenly aware of the inter-generational, long-term aspects of fiduciary responsibility and the ongoing impact that advances in knowledge can have on understanding of the financial implications of the natural, social, and economic environments in which we live and invest.

### **The Proposal will Improve Management of Worker Pension Savings**

We see the Proposal as essential to both the protection and prudent investment of American workers’ life savings. For example, it will:

- Restore the ability of investment professionals to make prudent forward-looking decisions<sup>1</sup> based on application of accepted investment practices to 21<sup>st</sup> century realities, without being forced to use outdated factual assumptions and regulatory standards;
- Resolve confusion in current Department of Labor (“DOL”) regulations about whether environmental, social and governance (“ESG”) factors can be determined to have material risk and return implications, regardless of whether they might be the subject of divergent political party views;
- Recognize that investment industry practices have evolved over the past decade, as illustrated by the overwhelming mainstream industry opposition in comment letters submitted during 2020 to the DOL on enactment of the regulations which this Proposal would repeal and replace;<sup>2</sup> and
- Prevent ERISA fund participants from being forced to continue holding investment risks that result from unsustainable 20<sup>th</sup> century business models that ultimately fail in the face of changing 21<sup>st</sup> century realities.

While we support the Proposal, we also believe that it falls short by failing to apply a full understanding of all the aspects of ERISA fiduciary duties to consideration of material ESG factors. Consequently, we recommend that the following fundamental fiduciary principles be explicitly addressed in the final DOL rule.

### **Fiduciary Duty of Impartiality**

The United States Supreme Court has recognized that ERISA fiduciary duties include a duty of impartiality. When interpreting §§404 and 409 of ERISA, the Supreme Court cited the following common law principle as part of the foundation for its holding. “The common law of trusts recognizes the need to preserve assets to satisfy future, as well as present, claims and requires a trustee to take impartial account of the interests of all beneficiaries. See Restatement (Second) of Trusts § 183 (discussing duty of impartiality); *id.*, § 232 (same).” *Varity v. Howe*, 516 U.S. 489, at 514 (1996).

This common law of trusts principle referenced by the Supreme Court is now set forth in the Restatement of Trusts, Third:

“The ‘Duty of Impartiality’ requires that fiduciaries identify and impartially balance conflicting interests of different trust fund groups, including current and future beneficiaries.” *Restatement of Trusts, Third* §79.<sup>3</sup>

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<sup>1</sup> The word “prudent” implies a forward looking orientation and originates from the Latin word meaning to act with or show care and thought for the future. See Prudent, OXFORD ENGLISH DICTIONARY (3d ed. 2007).

<sup>2</sup> An [analysis](#) of more than 8,700 comments submitted in response to the 2020 rule proposal found that 95% of commenters opposed the proposal and 94% of comments from investment professionals opposed it.

<sup>3</sup> The Restatement also emphasizes that fiduciaries cannot “ignore the interests of some beneficiaries merely as a result of oversight or neglect.” *Restatement of Trusts, Third* §79, *Comment (b)*.

This duty of impartiality is of particular importance for pension plans, where funds are managed for multiple generations. Since different generations of participants will become entitled to distributions at different times, they are likely to have different risk tolerance levels and time horizons. Inter-generational obligations also raise the potential for uncompensated transfer of risks and returns across fund participant generations. The duty of impartiality mandates careful consideration and good faith efforts to reasonably balance these conflicts.

In addition, systematic risks, costs and opportunities are often invisible to fiduciaries that focus exclusively on generation of short-term returns or are evaluated against only a market-relative performance benchmark. Nevertheless, systematic risks and costs can spread across portfolio companies and compound over time, increasing risk exposures and degrading future returns to fund participants. For a diversified investor, systematic risks drive most of returns.<sup>4</sup>

Climate change presents perhaps the most obvious set of both company specific and systematic risks that raise inter-generational investment risk and return conflicts of interest and implicate the duty of impartiality. For example, failure to address climate risks and opportunities over the near term is likely to generate increased future economic costs and risks that will be primarily borne by today's younger fund participants.

However, climate change is not the only systematic financial cost or risk with duty of impartiality implications. For instance, other financially material ESG factors with varying inter-generational or other beneficiary group impacts can include things like water and air pollution; growing microbial antibiotic resistance in the food chain; shareholder pressure on companies to generate short-term earnings at the risk of undermining future growth; inadequate attention to product safety and health; ecosystem limits on future economic activity; effects of growing income inequality on consumer demand; and political instability fostered by social media business models based on distribution of misinformation.

The duty of impartiality is a fundamental aspect of fiduciary law that governs ERISA funds, as well as other institutional investor trustees.<sup>5</sup> We believe that a major flaw in the Proposal is its failure to explicitly recognize and apply this principle of fiduciary duty. We also see the duty of impartiality as driving a need to address time horizon issues in the Proposal.

### **The Tragedy of the Horizons Requires a Long-Term Investment Horizon Presumption**

The Proposal states that investment analyses should apply the appropriate time horizon. However, given the overwhelming long-term duration of pension fund liabilities and the current

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<sup>4</sup>Some ESG risks, like climate change exposure, have become a systematic component of beta (market) exposure. Returns on beta constitute 75 percent or more of investment performance for broadly diversified pension investors. As passive investment options and active stewardship strategies which effectively address beta risk exposures become more widely available, the fiduciary duties of prudence and impartiality increasingly support consideration of those approaches by ERISA fiduciaries. See Hawley and Lukomnik, [Moving Beyond Modern Portfolio Theory: Investing that Matters](#) (Routledge, 2021) and a related [CFA Institute blog article](#) (May 2021).

<sup>5</sup> For example, §6 of the [Uniform Prudent Investor Act](#) and §7 of the [Uniform Management of Public Employee Retirement Systems Act](#) also contain an explicit duty to exercise fiduciary duties impartially, taking into account any differing interests between categories of participants and beneficiaries.

influence of irrational short-termism in the markets (discussed below), we believe the final rule should explicitly recognize a presumption that a long-term investment horizon will nearly always be an appropriate primary time horizon (although perhaps not the exclusive time horizon) for an ERISA fiduciary's strategic investment decision processes.

From a duty of impartiality perspective, it seems implausible that an investment strategy developed without attention to long-term risks, costs and inter-generational wealth transfers could meet standards referenced by the Supreme Court in *Varity v. Howe*. The duty of prudence obligation to investigate material facts also poses increasing questions about the influence of irrational short-termism on investment decisions.<sup>6</sup>

Nicholas Stern, Nicholas Stern, Professor of Economics and Government and Chair of the [Grantham Research Institute on Climate Change and the Environment](#) at the [London School of Economics](#), highlighted the perverse impact of irrational short-termism in a recent speech:

*“The economics profession has also misunderstood the basics of discounting, in relation to, particularly, its dependence on future living standards. It means economists have grossly undervalued the lives of young people and future generations who are most at threat from the devastating impacts of climate change. . . . Discounting has been applied in such a way that it is effectively discrimination by date of birth.”*<sup>7</sup>

The Bank of England has expressed similar concerns:

*“In the UK and US, cash-flows 5 years ahead are discounted at rates more appropriate 8 or more years hence; 10 year ahead cash-flows are valued as if 16 or more years ahead; and cash-flows more than 30 years ahead are scarcely valued at all. The long is short.”*<sup>8</sup>

The CFA Institute undertook a study in 2020 to examine the costs of this short-termism to investors.

*“CFA Institute partnered with the firm Fund Governance Analytics to take a more academic approach to the issue of short-termism. We took a quantitative look at the data concerning the issue of short-termism between 1996 and 2018 to see whether any short-term behaviors were evident that investors and issuers should better understand.*

*We found that companies that failed to invest in research and development (R&D); selling, general, and administrative (SG&A) expenses; and capital expenditure (CapEx) tended to underperform in the midterm (three to five years). . . .*

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<sup>6</sup> 29 U.S.C. 1104 and [29 C.F.R. § 2550.404a-1\(b\)](#) impose a duty under ERISA to investigate relevant facts and circumstances in evaluating investments.

<sup>7</sup> Professor Stern, speaking at the London School of Economics on [The Economics of Climate Change: The Stern Review](#) prior to the COP26 climate change summit in Glasgow

<sup>8</sup> From [The Short Long](#), a speech by Andrew Haldane, Executive Director, Bank for England, May 2011.

*The study summarized in this report estimated the agency costs (foregone earnings) of short-termism at \$1.7 trillion over the 22-year period covered by our analysis, or about \$79.1 billion annually.”<sup>9</sup>*

We recommend that the final rule affirm presumptive application of a long-term investment horizon by ERISA fiduciaries. This could be linked with both the duty of impartiality, the duty of prudence and the reference in the Preamble to evolution of investment fiduciary practices over time.<sup>10</sup>

### **Implementation of Fiduciary Duties Evolves over Time**

We believe that the final rule should emphasize how application of fiduciary principles is a dynamic process that evolves in response to changes in knowledge and circumstances. ESG-related developments and advances in knowledge since the turn of the twenty-first century present a challenge for ERISA fiduciaries.<sup>11</sup> However, change is a natural constant, and fiduciaries should be prepared to identify, evaluate and respond to it.

This is not a new concept.<sup>12</sup> The last major transition in implementation of fiduciary duties took place in the last half of the 20<sup>th</sup> century. It involved movement from legal lists of allowable investments and the prudent person standard of care to application of Modern Portfolio Theory and adoption of the prudent expert standard. That shift in practices took several decades, leaving fiduciaries caught between two seemingly inconsistent investment approaches. One 1988 commentator described the tension during that transition between adopting modern investment practices and being held back by outdated rules:

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<sup>9</sup> [Short-termism Revisited](#), CFA Institute Position Paper (September 2020). A similar [study](#) published in the Harvard Business Review by [McKinsey Global Institute](#) in cooperation with [FCLT Global](#), found that, between 2001 and 2015, companies that operate with a true long-term mindset consistently outperformed their industry peers across almost every financial measure that matters. They calculated that US GDP over the prior decade might well have grown by an additional \$1 trillion if the whole economy had performed at the level that long-term companies delivered — and could have generated more than five million additional jobs.

<sup>10</sup> An explicit reference to a long-term horizon presumption would also be consistent with corporate law. For example, the Delaware courts have held that (outside of sale of the company) corporate directors must have a similar long-term focus: “the fiduciary relationship requires that the directors act prudently, loyally, and in good faith to maximize the value of the corporation over the long-term... The fact that some holders of shares might be market participants who are eager to sell and would prefer a higher near-term market price likewise does not alter the presumptively long-term fiduciary focus.” *Frederick Hsu Living Tr. v. ODN Holding Corp.*, No. CV 12108-VCL, 2017 WL 1437308, at 18 (Del. Ch. Apr. 14, 2017), as corrected (Apr. 24, 2017).

<sup>11</sup> For example, major 21st century economic shocks that seriously damaged the financial position of pension fund participants include the 2001 dot.com bust ([\\$5 trillion in losses](#)), 2007-2009 Great Recession ([\\$19 trillion in losses](#)) and 2020 pandemic crisis ([8.5 million jobs lost in US](#)). In regard to climate change, [Swiss Re reports](#) that if insufficient mitigating action is taken, global temperatures could rise by more than 3°C and world GDP could shrink by 18% in the next 30 years. These events and changes in circumstances all involve investor ESG-related causes.

<sup>12</sup> For a partial history of evolution in the application of fiduciary duties, see Paul G. Haskell, [The Prudent Person Rule for Trustee Investment and Modern Portfolio Theory](#), 69 N.C.L. Rev. 87 (1990)

*"A fiduciary cannot behave as a careful, wise, discreet, judicious and prudent man if he acts within the strictures of a prudent man rule that forces him to behave imprudently in the contemporary economic marketplace."<sup>13</sup>*

In response to this late 20<sup>th</sup> century evolution of the investment industry knowledge base, the following provisions were added to the Restatement of Trusts to incorporate lessons learned from the transition:

*"There are no universally accepted and enduring theories of financial markets or prescriptions for investment that can provide clear and specific guidance to trustees and courts." Restatement of Trusts, Third, §227, Comment (f).*

*"Trust investment law should reflect and accommodate current knowledge and concepts. It should avoid repeating the mistake of freezing its rules against future learning and developments." Restatement of Trusts, Third, §227, Introduction.*

These principles speak to us today as investor fiduciaries face similar industry transition challenges. We believe that including more background in the Preamble on historical context for the current ongoing evolution in understanding and application of fiduciary duty principles would help to put the flip-flop of regulatory standards between administrations into perspective.

However, it should be stressed that the direction of investment industry change is clear and is largely being driven by mainstream global investors and by regulators in other countries.<sup>14</sup> The US has fallen behind other markets in this transition. Comparisons to the 20<sup>th</sup> century transition from the prudent person standard to Modern Portfolio Theory could help the US move forward by demonstrating that evolution of investment industry theory and practices are to be expected when knowledge and circumstances change.

### **Commingled Fund Pass-Through Proxy Voting Rights**

Since the Proposal was issued, BlackRock announced that is offering pass-through proxy voting rights to asset owners in several of its index funds.<sup>15</sup> It seems likely that this will be expanded to other commingled funds and that competitors will develop similar options to match BlackRock.

We applaud the availability of pass-through voting rights, as it could increase the ability of investors to access inexpensive passive funds while ensuring that proxy votes are exercised in conformity with their investment beliefs and portfolio strategies. However, we also believe that

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<sup>13</sup> [Review by Lynn Nichols of 'Modern Investment Management and the Prudent Man Rule'](#), *The Business Lawyer* Vol. 43, No. 2 (February 1988), pp. 779-786

<sup>14</sup> For example, the [UK](#) and [EU](#) are far ahead of the US in a adoption of investor and corporate regulatory mandates for ESG and sustainable practices and reporting. BlackRock, the world's largest investor, [explains its commitment to sustainable investing](#): "Sustainable investing focuses on companies that are managed in a way that is mindful of the long view and thus have the potential to deliver long-term portfolio returns. It combines traditional investment analysis with the additional lens of environmental, social and governance (ESG) insights to provide portfolio managers a more complete view of the long-term risks and opportunities associated with a company." A [Morningstar 2019 study](#) found that 72% of the United States population expressed interest in sustainable investing.

<sup>15</sup> See BlackRock's [announcement](#) about its expansion of proxy voting choice for clients.

pension fund participants should be accorded some level of transparency into when and how such rights are exercised.<sup>16</sup> In addition, it may be helpful to provide ERISA fiduciaries with guidance on the standards that apply to consideration of when to opt for using pass-through proxy voting rights and what guardrails are needed to ensure they are exercised in accordance with fiduciary duties.<sup>17</sup>

We encourage the DOL to work with the Securities Exchange Commission to ensure that transparency on proxy votes is not diminished by this development. In addition, we recommend that the Proposal be modified to provide guidance to ERISA fiduciaries for their development of appropriate fiduciary processes.

We would like to express our appreciation for the work that the DOL is doing on these important issues and hope that our comments will be helpful. Feel free to contact us if you would like additional information.

Respectfully submitted,  
Intentional Endowments Network

Keith Johnson, Working Group Chair  
On behalf of the Fiduciary Duty and Policy Working Group

Chris Walker, IEN Senior Advisor  
On behalf of the Sustainable Retirements Initiative

Georges Dyer, Executive Director  
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<sup>16</sup>See <https://corpgov.law.harvard.edu/2021/11/20/blackrocks-move-to-expand-proxy-voting-choice-creates-unknowns/> for background on potential transparency issues created by BlackRock's announcement.

<sup>17</sup> It seems that fiduciary decisions on use of pass-through voting rights options might include consideration of proxy voting guidelines, oversight of investment manager practices, alignment of votes with fund investment beliefs and strategy, availability of internal and external expert resources, reporting protocols, collaboration opportunities, associated costs, and compliance with the full range of fiduciary duties (including the duty of impartiality, application of appropriate time horizons and duty to the investiga te referenced in footnote 6).