HARVARD LAW SCHOOL

CAMBRIDGE · MASSACHUSETTS · 02138

ROBERT H. SITKOFF
Austin Wakeman Scott Professor of Law
John L. Gray Professor of Law

phone: (617) 384-8386
fax: (617) 812-6195
rsitkoff@law.harvard.edu

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

Re: RIN 1210-AC03 – Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights

Dear Sir or Madam:

We are writing in response to the above referenced proposed rulemaking by the Department of Labor (the "**Department**") on prudence and loyalty in selecting plan investments and exercising shareholder rights (the "**Proposal**").

This response is based on our expertise in environmental, social, and governance ("**ESG**") investing, especially ESG investing by trustees and other fiduciaries. We have undertaken several years of scholarly study of ESG investing by fiduciaries. Our article, "Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee," 72 *Stanford Law Review* 381 (2020) ("**ESG Investing by a Trustee**"), is the leading scholarly study on the topic. We enclose copy of *ESG Investing by a Trustee* as **Exhibit A**. In a consulting capacity for Federated Hermes, Inc., we have prepared several white papers and videos and conducted training sessions on ESG investing for trustees and other fiduciary investors. We have also lectured widely in scholarly and industry venues on ESG investing by trustees and other fiduciaries.

We previously commented on the Department's 2020 rulemaking on financial factors in selecting plan investments (the "**2020 Rule**").[1] Our comments were critical of the position taken in the preamble and some substantive aspects of the regulatory text that implied that ESG investing was inherently suspect. We note that the final rule was substantially altered in multiple respects responsive to our criticisms.

Introduction

In general, we are supportive of the Proposal's main purpose of clarifying that ESG investing is not inherently suspect. In our previous comment letter and in our academic writings, we have consistently argued that, in accordance with law and sound public policy, ESG investing is subject to the same fiduciary principles of loyalty and prudence that are applicable to any type or kind of investment strategy. Moreover, we agree that a well-reasoned ESG investing strategy designed to improve risk-adjusted return can be consistent with fiduciary duties under ERISA and the background common law of trusts.

We understand the Department's concern that the process underlying the 2020 rule, and in particular the original proposal for 2020 Rule, created the impression that ESG investing is inherently suspect and subject to more intensive fiduciary scrutiny than other forms of active investing. For the reasons elaborated in *ESG Investing by a Trustee* and our prior comment letter, to the extent the Proposal clarifies that ESG investing can be consistent with fiduciary principles, the Proposal is consistent with ERISA, the case law interpreting ERISA, and the background common law of trusts.[2] In addition, the revised tie-breaker provision improves on the 2020 Rule by more clearly tying the analysis to a portfolio-as-a-whole standard.

We do, however, have two criticisms of the Proposal. Our aim is to offer these criticisms constructively to assist the Department in revising the Proposal toward a final rule. These criticisms, which we elaborate below, may be summarized as follows:

- *First*, the Proposal at times suggests that ESG factors "should" be considered, which is contrary to the long-established neutrality principle in the law of fiduciary investment. The law neither favors nor disfavors ESG investing. The use of the term "often" in the regulatory text is particularly troubling.

- *Second*, the revised tie-breaker rule strikes the enhanced record-keeping obligations of the 2020 Rule, and the preamble suggests that this documentation provision has been a deterrent to ESG investing outside of the tie-breaker context. On the contrary, enhanced scrutiny for conflicted actions, and the attendant

[1] *See* Max M. Schanzenbach & Robert H. Sitkoff, Comment Letter on the Department of Labor's Proposed Rulemaking on Financial Factors in Selecting Plan Investments (July 30, 2020), available at https://ssrn.com/abstract=3667080.

[2] *ESG Investing by a Trustee* provides extensive supportive citation to relevant literature and authority.

> record keeping responsibilities that comes with it, is consistent with long-standing trust law and was not an innovation of the 2020 Rule. Thus, we are concerned that the Proposal may create a trap for the unwary by implying that the normal trust law principles of enhanced scrutiny for a conflict-of-interest situation will not pertain to a collateral benefits ESG tie-breaker.

Additionally, in the same constructive spirit we offer some suggestions about how to account for the meaning of "portfolio" in the context of constructing a menu of designated investment alternatives for an individual account plan.

Neutrality Among Types or Kinds of Investments

The law neither favors nor disfavors ESG investing. Any investment decision by an ERISA trustee or other fiduciary—whether in the context of a direct investment, shareholder engagement (including proxy voting), or menu construction, and whether reliant on ESG factors or otherwise—is subject to the same fiduciary principles embodied in the duties of loyalty and prudence.

As interpreted by the Supreme Court, the ERISA fiduciary duty of loyalty requires a trustee or other fiduciary to be motivated solely by providing financial benefits to the plan participants.[3] The ERISA fiduciary duty of prudence as applied to investment matters is elaborated by the prudent investor rule, which as interpreted by the Supreme Court aligns with ordinary trust law.[4] The prudent investor rule prescribes neutral principles that require portfolio-level attention to risk and return objectives reasonably suited to the purpose of the account, diversification, cost-sensitivity, documentation, and ongoing monitoring.[5] Crucially, a central contribution of the prudent investor rule—both under ERISA and ordinary trust law—is to eschew favoring or disfavoring any type or kind of investment or investment strategy.[6]

We agree that the process underlying the 2020 Rule led some industry and market participants to conclude that ESG investing is inherently suspect and would be subject to more intensive fiduciary scrutiny in derogation of the foregoing neutrality principle. However, the Proposal overcorrects for this problem by stating that trustees "should" use ESG factors, and that such factors are "often" material risk-and-return considerations. Such language, which appears variously in the preamble and the regulatory text, could be

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[3] *See* Fifth Third Bancorp v. Dudenhoeffer, 134 S. Ct. 2459, 2468 (2014).

[4] *See* Tibble v. Edison Int'l, 135 S. Ct. 1823, 1828 (2015).

[5] We canvass the relevant principles in *ESG Investing by a Trustee* at pp. 426-30.

[6] *See* Unif. Prudent Inv'r Act § 2(e) & cmt. (Unif. Law Comm'n 1994) ("no particular kind of property or type of investment is inherently imprudent"); Restatement (Third) of Trusts § 90 cmt. f (Am. Law Inst. 2007) ("Specific investments or techniques are not per se prudent or imprudent."); *see also* Max M. Schanzenbach & Robert H. Sitkoff, The Prudent Investor Rule and Market Risk: An Empirical Analysis, 14 J. Emp. Leg. Stud. 129 (2017).

read as the Department's expressing a preference for ESG investing relative to other types or kinds of investment strategies. Such a reading would be contrary to both the statute as interpreted by the Supreme Court and the sound public policy underpinning the prudent investor rule's rejection of favoring or disfavoring any type or kind of investment strategy.

In a related vein, the regulatory text includes examples of ESG factors but no other types or kinds of investment factors, and in each such example the factor is presented as a material risk-and-return consideration. The combination of there being no other examples, and that each exemplary ESG factor is presented as a material risk-and-return consideration, could be read to imply that ESG factors are always financially material risk-and-return considerations.

Use of ESG factors, like all forms of active investing, may entail transaction and diversification costs that must be outweighed by reasonably expected return benefits. Thus, a prudent and loyal fiduciary could reasonably conclude that a passive strategy that did not include any factor analysis, whether ESG or otherwise, would be most apt. As recognized by the Supreme Court, in other words, an ERISA trustee could opt for a passive rather than an active investment strategy.[7]

Moreover, given the inherent subjectivity to active investing, whether based on ESG factors or otherwise, there can be reasonable disagreement among prudent and loyal fiduciaries about whether the same ESG factor is a material risk-and-return consideration (or even if it is material), the direction in which it points, and how much weight to give it. As we describe in *ESG Investing by a Fiduciary*, Tesla is a telling case study, as ESG analysts disagree about whether to give Tesla a high or low ESG rating.[8] Such analyses can also change over time. A good ESG bet today could be a bad ESG bet tomorrow if those ESG factors become overvalued. For example, the Proposal highlights climate change as a material ESG risk factor, and firms are widely believed today to be underweighting the risk of climate change. But even if this is true for many firms today, a risk-and-return ESG analysis for a particular firm, whether now or in the future, could conclude that the market has overpriced the value of that firm's climate change response.

Departure from neutral application of fiduciary principles also requires drawing distinctions between ESG investing and other types of investing, a definitional morass that would create uncertainty and invite litigation. If the Department takes the position that ESG investing is "often" required, then ESG factors must be defined to provide regulatory certainty. But as we discuss in *ESG Investing by a Trustee*, the practice of ESG investing is widely agreed to resist such precise definitions.[9]

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[7] Fifth Third Bancorp v. Dudenhoeffer, 134 S. Ct. 2459, 2471 (2014).

[8] *See ESG Investing by a Trustee* at pp. 432-33.

[9] *See* id. at pp. 430-33.

We strongly suggest, therefore, that language such as "should" and "often" be excised from the preamble and regulatory text and be replaced with terms such as "may" and "could." Thus, for example, we would revise subsection (b)(2)(ii)(C), which references "may often," to read more like subsection (4), which speaks of "might include" and "depending on the facts and circumstances." We likewise suggest that the ESG examples be relocated to the preamble and reworked to include one in which the ESG factor is not material or be contextualized with other potentially material factors.[10] In other words, we suggest reframing so that a reader cannot help but to conclude that ESG investing is permissible depending on the circumstances, and that because circumstances change over time, a permissible ESG investing strategy today may be impermissible tomorrow. Most importantly, we strongly urge the Department to communicate that, other than in application to a particular investment context, the law takes no position on ESG's (or any other investment factor's) materiality or usefulness in general.

Finally, anticipating that some commentators may urge the Department to mandate ESG investing, we draw the Department's attention to the more extensive analysis of that issue in *ESG Investing by a Trustee*, in which we conclude that such a mandate would be contrary to law and sound policy.[11]

The Tie-Breaker

For the reasons given in *ESG Investing by a Trustee*, we believe that the statute does not allow for fiduciary reliance on a non-financial factor even in the case of two investments that "equally serve the financial interests of the plan."[12]

Setting this disagreement to the side, we believe subsection (c)(3) is a clarifying step forward because relying on "the financial interests of the plan" forces the tie-breaker analysis into a comparison of each alternative in relation to the portfolio as a whole. In other words, we understand the reference to "the financial interests of the plan" to require that the two competing investment alternatives have the same economic effect on the plan's overall risk-and-return profile.

We hasten to add, however, that such equivalence is all but impossible in liquid financial markets. The risk-and-return attributes of any two assets, even if identical on some metric, will nonetheless not be perfectly correlated and so will almost certainly have different effects at the portfolio level. Under the portfolio-as-a-whole standard, therefore, the "equally serve" condition for the tie-breaker will be all but impossible to satisfy in liquid financial markets.

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[10] We note, for example, that Unif. Prudent Inv'r Act § 2(c) (Unif. Law Comm'n 1994) provides a nonexhaustive list of factors that may be relevant depending on the circumstances.

[11] *See ESG Investing by a Trustee* at pp. 448-53.

[12] *See* id. at pp. 408-11.

Outside of liquid financial markets, satisfying the "equally serve" condition for the tie-breaker will turn on a liquidity or transaction cost explanation. If there is no liquidity constraint and trading costs are low, textbook financial economics teaches that in the event of two "equally serve" options so defined, an investor should invest in both to achieve improved diversification. A tie-breaker can only exist, therefore, if there is some reason why the fiduciary cannot make both investments and thereby achieve improved diversification to create a tie-breaker condition.

Finally, although we support the more explicit embrace of a portfolio-as-a-whole standard for application of the tie-breaker, we are troubled by the removal of the enhanced documentation requirement prescribed by the 2020 Rule. We do not find compelling the suggestion that ordinary risk-return ESG investing will be chilled by an enhanced documentation requirement applicable to the highly unlikely event of a collateral benefits ESG tie-breaker.

By allowing a trustee or other fiduciary to rely on a nonfinancial factor, the rule of subsection (c)(3) involves a conflict of interest. Under traditional trust law, "the trustee has a duty to the beneficiaries not to be influenced by the interest of any third person or by motives other than the accomplishment of the purposes of the trust."[13] Because the tie-breaker carves an exception to this principle, traditional trust law would call for enhanced scrutiny of a tie-breaker decision.[14] Such scrutiny will be difficult for a fiduciary to satisfy without appropriate documentation recording the analysis behind the decision at the time it was made. Contemporaneous documentation also protects plan participants from post-hoc rationalizations, a concern that is acute in a conflict-of-interest situation. In the absence of appropriate documentation to establish the "equally serve" condition for the tie-breaker, under traditional trust law a court would likely "resolve doubts against the trustee."[15]

By way of illustration, suppose in constructing a menu of designated investment alternatives for an individual account plan, a plan fiduciary is choosing between two mutual funds to round out the plan menu. If the plan fiduciary reasonably determines that, on risk-and-return grounds, both funds would "equally serve the financial interests of the plan" (under the portfolio standard suggested below), but one fund uses ESG factors for collateral benefits, then under subsection (c)(3) the fiduciary could break the tie by choosing that fund. However, under traditional trust law the fiduciary would be subject to enhanced scrutiny of that decision. To satisfy such scrutiny, the fiduciary would need appropriate contemporaneous documentation recording its analysis establishing the "equally serve" criteria on risk-and-return grounds, and the fiduciary would also need to

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[13] Restatement (Third) of Trusts § 78 cmt. f (Am. Law Inst. 2007).

[14] *See, e.g.*, id. § 37 cmt. f(1) ("especially careful scrutiny"); *see also* id. § 78 cmt. c.

[15] Id. § 83 cmt. a.

continue documenting its ongoing monitoring of the "equally serve" criteria. Without such documentation, a court would be entitled to draw an adverse inference against the trustee.

Accordingly, by striking the documentation requirements for the tie-breaker prescribed by the 2020 Rule, the Proposal creates a trap for the unwary.

The Meaning of "Portfolio"

The Proposal continues the longstanding practice under the prudent investor rule of "portfolio" level analysis (e.g., the reference in subsection (b)(i) to "the role the investment … plays in … the plan's investment portfolio").

Increasingly, however, the paradigmatic role of an ERISA fiduciary is in constructing a menu of designated investment alternatives for an individual account plan rather than direct investment management. In consequence, we suggest adding a definition of the term "portfolio" to clarify that, in the context of constructing a menu of designated investment alternatives for an individual account plan, the relevant portfolio analysis involves two questions:

- *First*, how does a given fund fit within the menu of funds to enable plan participants to construct an overall portfolio suitable to their circumstances? In other words, how does a given fund make sense in light of the other funds within the same menu?

- *Second*, how does a given fund compare to a reasonable number of alternative funds to fill the given fund's role in the overall menu?

For example, suppose a plan offers an actively managed growth fund that uses ESG factors in assessing investment opportunities. The questions would be, first, does an actively managed growth fund make sense in light of the overall menu of funds? And, second, how does this ESG growth fund compare to a reasonable number of alternative growth funds that the plan could have offered instead?

A clarification of the meaning of "portfolio" along these lines for the menu construction context would assist plan fiduciaries in understanding their duties of loyalty and prudence in general and specifically those duties as applied to the tie-breaker of subsection (c)(3).

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Please do not hesitate to contact us if we may be of further assistance in amplification of the foregoing or otherwise.

Very truly yours,

/s/

Max M. Schanzenbach
Seigle Family Professor of Law
Northwestern Pritzker School of Law
m-schanzenbach@law.northwestern.edu
(312) 503-4425

/s/

Robert H. Sitkoff
Austin Wakeman Scott Professor of Law
John L. Gray Professor of Law
Harvard Law School
rsitkoff@law.harvard.edu
(617) 384-8386