



December 13, 2021

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Mr. Ali Khawar  
Acting Assistant Secretary  
Employee Benefits Security Administration  
U.S. Department of Labor  
200 Constitution Ave., N.W., Room N-5655  
Washington, D.C. 20210

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

Dear Acting Assistant Secretary Khawar:

Institutional Shareholder Services Inc. (ISS) is pleased to submit these comments regarding the above-referenced proposal to amend the Investment Duties regulation under Title I of the Employee Retirement Income Security Act of 1974 (ERISA) [29 CFR §2550.404a-1].<sup>1</sup> The proposed amendments are designed to clarify and confirm long-standing principles regarding the application of the fiduciary duties of prudence and loyalty to the selection of investments and investment courses of action and to the exercise of shareholder rights, including proxy voting. The proposal also seeks to eliminate confusion that has arisen from two ill-conceived amendments to the Investment Duties regulation that were hastily adopted at the end of 2020 (the 2020 Rules). The first of these (the Financial Factors Rule) effectively discourages ERISA fiduciaries from integrating environmental, social or corporate governance (ESG) factors into their investment strategies for ERISA plans and from selecting economically targeted investments in part, for benefits other than their investment return.<sup>2</sup> The second (the Proxy Rule) effectively discourages fiduciaries from exercising proxy voting and other shareholder rights on behalf of plan participants and beneficiaries.<sup>3</sup>

ISS appreciates the Department's willingness to address the negative ramifications of the 2020 Rules. We generally support the proposed amendments and offer a few suggestions as to how these revisions to the Investment Duties regulation might be improved.

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<sup>1</sup> Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, 29 CFR Part 2550 RIN 1210-AC03 (Oct. 7, 2021), 86 Fed. Reg. 57272 (Oct. 14, 2021) (Proposing Release).

<sup>2</sup> Financial Factors in Selecting Plan Investments, 29 CFR Parts 2509 and 2550, RIN 1210-AB95 (Oct. 30, 2020), 85 Fed. Reg. 72846 (Nov. 13, 2020) (2020 Financial Factors Release).

<sup>3</sup> Fiduciary Duties Regarding Proxy Voting and Shareholder Rights, 29 CFR Part 2550, RIN 1210-AB91 (Dec. 11, 2020), 85 Fed. Reg. 81658 (Dec. 16, 2020) (2020 Proxy Rule Release).

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ISS is a federally registered investment adviser with more than 35 years of experience helping institutional investors meet their fiduciary responsibilities to clients. Through its governance research and proxy voting recommendations, ISS today helps more than 1,600 clients—including employee benefit plans, investment managers and mutual funds—make and execute informed proxy voting decisions for approximately 44,000 shareholder meetings a year in over 110 developed and emerging markets worldwide. In doing so, ISS implements more than 400 custom voting policies adopted by its clients, and also provides vote recommendations and research based on ISS' own benchmark or thematic policies. The former are focused on promoting long-term shareholder value creation, good governance and risk mitigation at public companies, while the latter evaluate governance and voting issues from the perspectives of sustainability, climate and public funds, among others. In addition, ISS provides an electronic platform that automates the operational aspects of proxy voting, thereby allowing institutional investors to focus their resources on the fiduciary task of making voting decisions.

ISS offers other value-enhancing services to institutional investors as well. For example, ISS ESG, the company's responsible investment arm, facilitates investors' integration of ESG factors into their investment decision-making processes. In this regard, ISS ESG provides a comprehensive suite of climate solutions to provide investors with a better understanding of their portfolios' exposure to climate-related risks. ISS ESG's Screening & Controversies solutions identify corporate involvement in a range of controversial products, business practices and high-risk sectors, allowing clients to screen, monitor and analyze responsible investment performance. And ISS ESG Ratings & Rankings solutions provide investors with the insight to incorporate sustainability into their investment processes however they see fit.

### **The Financial Factors Rule**

The Financial Factors Rule amended the Investment Duties regulation in three main respects. First it generally required plan fiduciaries to base their selection of investments and investment courses of action solely on “pecuniary factors.”<sup>4</sup> Second, it permitted the consideration of non-pecuniary factors only when a fiduciary is choosing between or among investment alternatives that the fiduciary cannot distinguish on the basis of pecuniary factors alone, and then only with an extraordinary level of documentation.<sup>5</sup> And third, it prohibited the addition or retention of any investment fund, product or model portfolio as a qualified default investment alternative (QDIA)<sup>6</sup> if the investment objectives or principal investment strategies of that fund, product or model portfolio “include, consider, or indicate the use of one or more non-pecuniary factors.”<sup>7</sup>

In response to public comment, when it finalized the Financial Factors Rule, the Department removed all ESG verbiage that was included in the proposed regulatory text. Nevertheless, the final rule's focus on “pecuniary” factors and statements in the rule's preamble that ESG investing raises “heightened concerns” under ERISA<sup>8</sup> create the perception that fiduciaries who consider climate change and other ESG factors in the financial evaluation of plan investments do so at their peril. Even as modified from proposed to final stage, the Financial Factors Rule can be

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<sup>4</sup> Rule 404a-1(c)(1).

<sup>5</sup> Rule 404a-1(c)(2).

<sup>6</sup> 29 CFR § 2550.404c-5.

<sup>7</sup> Rule 404a-1(d)(2)(ii).

<sup>8</sup> 2020 Financial Factors Release, 85 Fed. Reg. at 72848.

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expected to have, and is already having, a chilling effect on the appropriate integration of these critically important factors in investment decisions for employee benefit plans.

As ISS explained in its comments on this rule last year,<sup>9</sup> ESG investing is no longer a peripheral, or solely values-driven practice. Where ESG investments present material economic considerations under generally accepted investment theories, they should be treated *pari passu* with other types of investments for purposes of the ERISA duty of prudence. We believe that the proposed modifications to the Investment Duties regulation, on the whole, are reasonably designed to achieve this result.

In particular, we are pleased that the Department proposes to eliminate the “pecuniary factors” test from 404a-1(c)(i) and the cautionary language in the preamble about “heightened concerns” around ESG investing. We are also pleased that the Department proposes to dispel the lingering skepticism about the legitimacy of ESG investing by employee benefit plans and expressly acknowledge that consideration of physical and transitional climate-change risks and other ESG factors may enhance investment value and performance and improve an investment portfolio’s resilience over time.<sup>10</sup>

The Department proposes to do this, first, by amending 404a-1(b)(2)(ii)(C) to state that in evaluating an investment or investment course of action, a fiduciary’s consideration of a portfolio’s projected return relative to the plan’s funding objectives “may often require an evaluation of the economic effects of climate change and other [ESG] factors on the particular investment or investment course of action.” In explaining this provision, the Department states that in many cases, a prudent fiduciary is not just *permitted* to consider climate and other ESG factors but is *required* to do so.<sup>11</sup>

While ISS appreciates the Department’s intent to counteract the negative effects of the 2020 Rules, we fear this provision may go too far. It is ultimately the fiduciary’s responsibility to prudently assess facts and circumstances, determine which factors are relevant, and appropriately consider those factors in evaluating a plan investment or investment course of action. We respectfully ask that the proposed language be tempered, as suggested by another commenter, by replacing the words “often require” with “involve.”<sup>12</sup>

Alternatively, the proposed amendment to 404a-1(b)(2)(ii)(C) could be eliminated altogether, since the relevance of climate and other ESG factors to a portfolio’s investment return is already addressed by the proposed addition of a new paragraph (b)(4) to the Investment Duties regulation. This provision affirms that a prudent fiduciary may consider *any* factor the fiduciary deems material to a risk-return analysis of an investment or investment course of action,

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<sup>9</sup> See letter from Gary Retelny (Jul. 22, 2020), available at: <https://beta.regulations.gov/comment/EBSA-2020-0004-0157>.

<sup>10</sup> Proposing Release, 86 Fed. Reg. at 57276.

<sup>11</sup> *Id.*

<sup>12</sup> Letter from Jeffrey P. Mahoney, General Counsel, Council of Institutional Investors (Dec. 2, 2021) available at: [https://www.cii.org/files/issues\\_and\\_advocacy/correspondence/2021/December%2020201%20DOL%20letter%20\(final\).pdf](https://www.cii.org/files/issues_and_advocacy/correspondence/2021/December%2020201%20DOL%20letter%20(final).pdf). As so restated, (b)(2)(ii)(C) would say: “The projected return of the portfolio relative to the funding objectives of the plan, which may involve an evaluation of the economic effects of climate change and other environmental, social, or governance factors on the particular investment or investment course of action.”

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depending on facts or circumstances and identifies a range of climate-related, governance and workforce factors as examples.

Although ISS is generally agnostic about the benefits of including specific references to climate change and other ESG factors in the text of the rule, we ask the Department to consider the possible unintended consequences of doing so. Singling out climate risk and ESG as the only specific examples of factors to be considered in a prudent fiduciary's risk-return evaluation of plan investment options may unwittingly convey the impression that these factors must *always* be considered or that other material factors are of lesser importance. If this were to occur, a fiduciary may feel obligated to document its justification for *not* considering ESG elements or climate risks in a particular case. We do not believe this is the intent of the proposed rule, nor should it be.

Furthermore, specifically identifying ESG factors in 404a-1(b)(4) may invite the addition of other factors in the years to come. If that happens, there is a risk that subsection (b) might cease to serve as a flexible, principles-based safe harbor and instead become a prescriptive inventory of investment considerations whose actual relevance may wax or wane over time. To avoid such an outcome, the Department might consider limiting (b)(4) to a statement of general principle and relocating the specific climate, governance and workforce examples to the preamble.<sup>13</sup>

In addition to confirming the relevance of climate-related and other ESG factors to the prudent management of employee benefit plan assets, the Department also proposes to rectify other problems with the Financial Factors Rule by confirming longstanding non-regulatory guidance in the context of ERISA's fiduciary duty of loyalty. Here, the Department proposes to abandon the unworkable requirement in the current rule that a fiduciary may select plan investments based on collateral benefits other than investment returns only if the fiduciary is unable to distinguish between or among investment options on the basis of pecuniary factors alone. Instead, the proposed "tie-breaker" standard reverts to a more familiar equivalence test under which collateral benefits can be considered if competing investments or investment courses of action "equally serve the financial interests of the plan over the appropriate time horizon."<sup>14</sup> In no event, however, can a fiduciary accept expected lower returns or greater risks to secure collateral benefits.

ISS strongly supports this part of the proposal. As we noted in last year's comments, requiring a plan fiduciary to demonstrate why "a distinguishing factor could not be found" between an ESG investment and another available alternative negates the whole purpose of integrating environmental, social and corporate governance factors into prudent portfolio management. A skilled fiduciary finds prudent ways to leverage the distinctions between ESG and other investments and does so for the financial benefit of the plan's participants and beneficiaries. ISS also expressed concern that the "indistinguishable" standard is unachievable, as evidenced by the Department's repeated warnings that indistinguishable investment alternatives rarely, if ever, exist.<sup>15</sup> Establishing an unattainable standard in this fashion neither clarified nor codified the Department's prior non-regulatory guidance. All it did was set a tripwire for fiduciaries.

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<sup>13</sup> As so revised, (b)(4) would read as follows: "A prudent fiduciary may consider any factor in the evaluation of an investment or investment course of action that, depending on the facts and circumstances, is material to the risk-return analysis."

<sup>14</sup> Proposed Rule 404a-1(c)(3).

<sup>15</sup> Financial Factors in Selecting Plan Investments, 29 CFR Parts 2509 and 2550, RIN 1210-AB95 (Jun. 22, 2020), 85 Fed. Reg. 39113, 39117, 39122, 39123, 39125 (Jun. 30, 2020). The Department also characterized a hypothetical pair of truly identical investments as a "unicorn." *Id.* at 39117 n.22, 39122 n.45.

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ISS also supports the proposal to eliminate the burdensome documentation requirement attendant to the selection of investment options based on collateral benefits. As the Department acknowledges, this requirement has a chilling effect on the legitimate consideration of investment alternatives and is seen as yet another inappropriate suggestion that ESG investing entails extraordinary risks. We further agree that the special documentation requirement is unnecessary, because fiduciaries already have effective recordkeeping requirements as part of their fiduciary duty of prudence.

Finally, ISS supports the proposal to eliminate the current prohibition against using certain investment alternatives as QDIAs. ISS believes that plan participants should not lose access to economically prudent funds simply because those funds have investment objectives, goals, or principal investment strategies that include, consider or indicate the use of non-pecuniary factors. Limiting participants' investment options in this way serves no legitimate purpose and may harm the very parties ERISA is designed to protect.

### **The Proxy Rule**

The second of the 2020 Rules added a new component to the Investment Duties regulation aimed specifically at proxy voting. Although the Department's non-regulatory guidance had long established that the fiduciary act of managing plan assets includes the management of voting and other shareholder rights appurtenant to shares of stock and that the management of those rights is subject to the fiduciary duties of prudence and loyalty, the 2020 rulemaking seemed to be driven by the notion that proxy voting is not a worthwhile endeavor.

In response to public comment, some of the most draconian aspects of the proposal—including a requirement that a fiduciary undertake a vote-by-vote cost-benefit analysis and refrain from voting unless doing so is determined to have an economic impact on the plan's investment—were not included in the final rule. Nevertheless, the Proxy Rule as adopted, along with statements in the preamble, still give the impression that even ordinary exercises of shareholder rights require special justification. This perception may cause fiduciaries to act in ways that do not serve the best interests of plan participants and beneficiaries.

The Department proposes to correct this misperception and confirm the application of fundamental fiduciary principles to proxy voting and other exercises of shareholder rights by making four major changes to the Proxy Rule. ISS supports each of these changes.

First, the Department proposes to eliminate the statement in paragraph (e)(2)(ii) of the current rule that the "fiduciary duty to manage shareholder rights appurtenant to shares of stock does not require the voting of every proxy or the exercise of every shareholder right." This provision was ostensibly designed to correct a "persistent misunderstanding"<sup>16</sup> among fiduciaries to the contrary, although evidence of such a misunderstanding was never proffered. While confirming that fiduciaries need not seize every opportunity to cast a proxy vote or engage in shareholder activism, the Department is nonetheless concerned that (e)(2)(ii) might encourage plan fiduciaries to be indifferent to the exercise of shareholder rights.<sup>17</sup> ISS agrees with this concern and with the Department's observation that abstaining from a vote is not a neutral act. We thus agree that (e)(2)(ii) should be revised as proposed and suggest that the preamble of the final rule confirm that proxies should be voted unless the fiduciary reasonably determines that doing so is not in

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<sup>16</sup> Fiduciary Duties Regarding Proxy Voting and Shareholder Rights, 29 CFR Part 2550, RIN 1210-AB91 (August 31, 2020), 85 Fed. Reg. 55219, 55220 (Sep. 4, 2020) (2020 Proxy Rule Proposal).

<sup>17</sup> Proposing Release, 86 Fed. Reg. at 57282.

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the plan's best interest.

Second, the Department proposes to eliminate the requirement found in (e)(2)(iii) of the current rule that a responsible plan fiduciary monitor the proxy voting activities of any investment manager to whom the authority to vote proxies or exercise shareholder rights has been delegated and any proxy advisory firm that provides advisory services relating to a plan's proxy votes. ISS agrees that this duty largely duplicates the general obligation reflected in (e)(2)(ii)(F) [to be slightly modified and redesignated as (d)(2)(ii)(E)] that a plan fiduciary exercise prudence and diligence in the selection and monitoring of persons engaged to advise or otherwise assist with exercises of shareholder rights. The same can be said for proposed paragraph (d)(2)(iii),<sup>18</sup> which ISS believes is also superfluous and should be stricken. Redundancy serves no purpose other than to suggest that monitoring those who provide proxy-related services demands more rigor than that required to monitor other types of service providers. Streamlining the rule will confirm that the statutory obligations of prudence and loyalty do not discriminate in this fashion.

The Department proposes a related change to eliminate the special recordkeeping requirement found in (e)(2)(ii)(E). Since the duty of prudence naturally encompasses a recordkeeping obligation, ISS agrees that expressly articulating this obligation in the context of proxy voting and other exercises of shareholder rights gives the impression that fiduciaries have heightened burdens in this area. We further agree that this misperception might cause fiduciaries either to shy away from exercising shareholder rights or incur unnecessary compliance expenses when doing so. Accordingly, we support the elimination of this requirement in (e)(2)(ii)(E).

Finally, the Department proposes to amend the current rule's provision relating to the maintenance of proxy voting policies by eliminating the two "safe harbors" provided therein. The first, found in paragraph (e)(3)(i)(A), states that a fiduciary can generally satisfy its duties of prudence and loyalty by adopting a policy that limits voting to only those ballot proposals it determines are substantially related to the issuer's business activities or are expected to have a material effect on the value of the plan's investment. In proposing this safe harbor, the Department estimated that adopting a practice of this nature might reduce a plan's voting by more than 94 percent.<sup>19</sup> The second safe harbor, found in (e)(3)(i)(B), covers a fiduciary who adopts a policy to refrain from voting whenever the plan's holdings in a particular company relative to the plan's total investment assets is below a quantitative threshold that is deemed low enough that the matter being voted on is not expected to materially affect the performance of the plan's portfolio.

ISS agrees that a thoughtfully designed proxy voting policy can help a fiduciary satisfy its duties of care and loyalty while reducing costs and compliance burdens.<sup>20</sup> Nevertheless, ISS believes that the current safe harbors may encourage fiduciaries to limit their proxy voting activities in ways that harm plan participants and beneficiaries. As the Department notes, the second safe harbor is also impractical, since a fiduciary cannot calculate the requisite threshold when "total

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<sup>18</sup> This paragraph (currently found in (e)(2)(iv)) forbids a fiduciary to adopt a practice of following the recommendations of a proxy advisory firm or other service provider without determining that such party's proxy voting guidelines are consistent with the fiduciary's prudence and loyalty obligations.

<sup>19</sup> 2020 Proxy Rule Proposal, 85 Fed. Reg. at 55233 and note 127, *citing* data from the Investment Company Institute.

<sup>20</sup> Fiduciaries who are registered under the Investment Advisers Act of 1940 are expressly required to adopt and implement written policies and procedures that are reasonably designed to ensure that they vote client securities in the clients' best interest. Advisers Act Rule 206(4)-6 [17 CFR § 275.206(4)-6].

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investment assets” are spread among a number of separately managed accounts and collective investment vehicles. ISS thus supports the adoption of Rule 404a-1(d)(3)(i) as proposed.

In addition to the foregoing, ISS offers one further suggestion regarding the specific standards a fiduciary must satisfy when deciding whether to exercise shareholder rights and when exercising such rights. Proposed paragraph (d)(2)(ii)(A) obliges a fiduciary to act “solely in accordance with the economic interest of the plan and its participants and beneficiaries, in a manner consistent with paragraph (c)(2) of this section.”<sup>21</sup>

In proposing the Proxy Rule last year, the Department opined that “voting the shares of plan holdings that comprise a small portion of total plan assets rarely advances plans’ economic interests.”<sup>22</sup> As ISS explained in its comments,<sup>23</sup> depending on the size of the plan, even relatively small positions can have a big dollar value. Moreover, narrowly focusing on a proxy vote’s effect on a single portfolio’s holdings ignores the synergistic power of proxy voting.

We respectfully ask the Department to eliminate confusion in this area by confirming prior non-regulatory guidance to the effect that in deciding whether to vote a proxy the fiduciary should determine whether “the plan’s vote, either by itself or together with the votes of other shareholders, is expected to have an effect on the value of the plan’s investment that warrants the additional cost of voting.”<sup>24</sup>

## Conclusion

ISS appreciates the opportunity to provide these comments on the proposed changes to the Investment Duties regulation. For the reasons stated above, we believe the proposal will address the shortcomings in the 2020 Rules and will inure to the benefit of America’s workers and retirees.

We would be happy to supply the Department with additional information regarding any of the matters discussed herein. Please direct any questions about these comments to the undersigned, to our General Counsel, Steven Friedman, who can be reached at 301.556.0420, or to our outside counsel, Mari-Anne Pisarri, who can be reached at 202.223.4418.

Respectfully submitted,



Gary Retelny  
President and CEO

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<sup>21</sup> We understand that the cross-reference to the investment loyalty provision of the regulation is designed to counteract the sentiment expressed in connection with the adoption of the Proxy Rule that environmental and social shareholder proposals are likely to have “little bearing on share value or other relation to plan financial interests.” 2020 Proxy Rule Release, 85 Fed. Reg. at 81681.

<sup>22</sup> 2020 Proxy Rule Proposal, 85 Fed. Reg. at 55234.

<sup>23</sup> See letter from Gary Retelny, President and CEO, ISS (Oct. 5, 2020), available at: <https://www.regulations.gov/comment/EBSA-2020-0008-0221>.

<sup>24</sup> Interpretive Bulletin 2016-01, 29 CFR § 2509.2016-01, 81 Fed. Reg. 95879, 95883 (Dec. 29, 2016).

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Cc: Joe Canary, Office Director, Office of Regulations and Interpretations  
Jeffrey Turner, Deputy Director, Office of Regulations and Interpretations  
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