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Office of Regulations and Interpretations
Employee Benefits Security Administration
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U.S. Department of Labor
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Washington, DC 20210
www.regulations.gov

RE: *Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights* (RIN 1210-AC03)

Submitted by: James R. Copland*

Dear Acting Assistant Secretary Khawar,

I respectfully submit this letter regarding the Department's proposed rule, Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights ("the Proposed Rule"), 86 Fed. Reg. 57272 (Oct 14, 2021).

Background

A plan manager governed by the Employee Retirement Income Security Act ("ERISA") has a strict fiduciary duty to manage the plan "*solely* in the interest of the participants and beneficiaries."[1] ERISA plans must be managed "for the *exclusive* purpose of providing [financial][2] benefits to participants and their beneficiaries," balancing those benefits *only* against cost constraints.[3] Implicitly and clearly, other interests beyond maximizing financial benefits and minimizing costs—including ESG goals collateral to actual risk-and return analysis—may not be considered by ERISA plan fiduciaries.[4]

Although the statutory language has remained unchanged, the Department has repeatedly vacillated about the meaning of this ERISA fiduciary duty over the last 30 years; a series of interpretive guidance

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[1] Employee Retirement Income Security Act of 1974 § 404(a)(1) (emphasis added), *codified at* 29 U.S.C. § 1104(a)(1).

[2] Fifth Third Bancorp v. Dudenhoeffer, 573 U.S. 409, 420-21 (2014).

[3] ERISA, *supra* note 1, at 1104(a)(1)(A) (emphasis added).

[4] For a description of "collateral benefits ESG" versus "risk-return ESG" investing, see Max M. Schanzenbach & Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*, 72 STAN. L. REV. 381, 382 (2020). For a discussion about how this dichotomy should be applied in terms of ERISA fiduciary duties, see Bernard S. Sharfman, *ESG Investing Under ERISA*, 38 YALE J. REG. BULL. 112, 117–19 (2020), https://digitalcommons.law.yale.edu/jregonline/6.

documents, and later rulemakings, have been promulgated by each successive new administration beginning with the Clinton administration in 1994.[5]

Just last year, the Department engaged in rulemaking that largely comported with the language of ERISA and the governing judicial opinions. The Department's rule specified, appropriately:

- "ERISA requires plan fiduciaries to select investments and investment courses of action based solely on financial considerations relevant to the risk-adjusted economic value of a particular investment or investment course of action";[6]
- "[P]lan assets may not be enlisted in pursuit of other social or environmental objectives";[7] and
- "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 purpose of non-pecuniary objectives."[8]

While the 2020 rule substantially clarified ERISA duties for plan managers, it was still imperfect. Mr. Sharfman argued, for instance, that the rule's discussion of "risk-adjusted economic value" would be better specified as "financial value" so as to avoid ambiguity permitting plan managers to sneak in non-pecuniary concerns;[9] and that the Department should dispense with its "tie breaker" or "all things being equal" standard, which similarly can allow plan managers principally motivated by collateral concerns to sneak in financially imprudent investment decisions under the guise of apparent but nonexistent equipoise.[10]

Whatever those imperfections, the new proposed rule essentially undoes the clarifying language in the 2020 rule and indeed goes significantly further than its predecessors in countenancing—perhaps even encouraging—pension investments oriented toward ESG concerns that go beyond the exclusive purpose permitted in the ERISA statutory mandate. The Department should go back to the drawing board.

Analysis

There is significant tension between Congress's clear statutory mandate that ERISA fiduciaries manage plans "for the exclusive purpose" of providing financial benefits to plan beneficiaries at the lowest possible cost and the Department's decision to backtrack on its 2020 rulemaking and effectively sanction, if not encourage, broad use of ESG investing and ESG-influenced corporate engagement by ERISA fiduciaries. With limited exceptions—which do not constitute the strategies employed in the

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[5] *See, e.g.*, 59 Fed. Reg. 32606 (June 23, 1994); 73 Fed. Reg. 61731 (Oct. 17, 2008); 80 Fed. Reg. 65135 (Oct. 26, 2015); 81 Fed. Reg. 95879 (Dec. 29, 2016); 85 Fed. Reg. 39113 (June 30, 2020); 85 Fed. Reg. 55219 (Sept. 4, 2020); 85 Fed. Reg. 72846 (Nov. 13, 2020); 85 Fed. Reg. 81658 (Dec. 16, 2020); 86 Fed. Reg. 57272 (Oct. 14, 2021).

[6] U.S. Dep't of Labor, Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 39,113 (June 30, 2020), https://www.govinfo.gov/content/pkg/FR-2020-06-30/pdf/2020-13705.pdf.

[7] *Id.* at 116.

[8] *Id.*

[9] *See* Sharfman, *supra* note 4, at 113 & n.8.

[10] *See id.* at 130–31.

overwhelming majority of current ESG investing—such strategies will lead to reduced returns, either through a lack of diversification or increased costs.[11]

Such concerns are not merely theoretical. In 2008, the California State Teachers' Retirement System (CalSTRS) estimated that the fund had lost $1 billion in potential gains after State Treasurer Phil Angelides pressured California's pension funds to divest from tobacco companies—just as their share prices had begun to rebound.[12] In 2015, the chief investment officer of CalSTRS told his board: "I've been involved in five divestments for our fund. All five of them we've lost money, and all five of them have not brought about social change."[13]

To be clear: factors that are commonly characterized as ESG may be material for active investors to consider when valuing securities. E.g., unless one believes in the strongest form of the efficient market hypothesis,[14] there are situations in which the market may misprice a company's risk premium associated with global warming (including particularly regulatory risks) or the effectiveness of a company's board composition or governance structures. And an investor with a strong view of market mispricing may even choose to place bets on such factors—effectively doing in-depth company-by-company analyses and taking long or short positions on a security, much like a merger-arbitrage fund places bets on the risk profile of an announced merger actually taking place.[15]

In a 2020 law review article in the *Stanford Law Review* considering ESG investing and fiduciary duties, law professors Max Schanzenbach and Robert H. Sitkoff characterize this form of ESG investing as "risk-return" ESG investing.[16] In contrast, Schanzenbach and Sitkoff characterize investment strategies that sublimate financial return to nonpecuniary objectives—in purpose or effect—"collateral benefits" ESG investing.[17] The latter form of investing violates fiduciary duties of *prudence* and *loyalty*, duties which can only be satisfied if "(1) the trustee reasonably concludes that the ESG investment program will benefit the beneficiary directly by improving risk-adjusted return; and (2) the trustee's exclusive motive for adopting the ESG investment program is to obtain this direct benefit."[18]

The actual strategies employed by most ESG-focused funds trading in public securities fail to meet these criteria. As Schanzenbach and Sitkoff explain, there are two broad categories of strategies for trading in securities by using ESG factors on public exchanges: *screens* and *stock picking*. Screening strategies employ simple, consistent criteria to eliminate "bad" companies or select "good" companies from the market universe—e.g., a *market index* limited by some social criteria, such as the MSCI KLD 400 Social Index.[19] However, "empirical studies find that, on a risk-adjusted basis, employing ESG screens leads to performance about the same as or worse than their benchmark indices."[20] Similarly,

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[11] *See* Bradford Cornell & Aswath Damodaran, *Valuing ESG: Doing Good or Sounding Good?* (Mar. 20, 2020) (unpublished manuscript), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3557432 (citing TIAA-CREF Annual Report, 2017, p. 34) (observing that "a constrained optimum can, at best, match an unconstrained one, and most of the time, the constraint will create a cost").

[12] Pat Geyer, "Report on CalSTRS Meeting," September 4–5, 2008, 5, http://www.calrta.org/dbfiles/nn69mgxs9.pdf

[13] Chriss W. Sweet, *CalSTRS Risks Losing Money if It Divests from Fossil Fuels*, Breitbart, April 7, 2015, http://www.breitbart.com/california/2015/04/07/calstrs-risks-losing-money-if-it-divests-from-fossil-fuels.

[14] *Cf.* Basic v. Levinson, 485 U.S. 224, 247 & n.24 (1988) (discussing efficient-market hypothesis).

[15] *See* Schanzenbach & Sitkoff, *supra* note 4, at 437–39.

[16] *Id.* at 397.

[17] *Id.*

[18] *Id.* at 386.

[19] *See* Sharfman, *supra* note 4, at 120–21.

[20] Schanzenbach & Sitkoff, *supra* note 4, at 440 (citing Benjamin R. Auer & Frank Schuhmacher, *Do Socially (Ir)responsible Investments Pay? New Evidence from International ESG Data*, 59 Q. REV. ECON. & FIN. 51, 57-

there is a well-developed economic literature showing how active stock picking—adjusting for risk and transaction costs—tends to underperform passive stock indexing (the very reason for the broad emergence of stock-index funds in the first place[21]).[22]

The aforementioned difficulties aside, there is substantial empirical evidence that certain activist hedge funds have, over the long run, been significantly wealth-enhancing for investors.[23] Successful activist hedge funds accumulate sizable concentrated holdings in idiosyncratic companies based on "a determination by the hedge fund that the target company is currently not maximizing returns, but that if management would implement the hedge fund's recommended changes, company performance would improve, the stock would increase in value, and the hedge fund would reap excess returns."[24]

ESG plan managers can claim that their engagement strategies with companies—consisting of, e.g., introducing and voting on shareholder proposals or discussing ESG concerns with corporate leadership—are themselves a form of risk-return investing akin to activist hedge fund engagements. But the two strategies could not be more different. Large institutional investor fund families have relatively small corporate-governance and shareholder-engagement operations, only loosely linked to asset managers selecting securities, through which they engage in ESG activism with a host of companies held in heavily diversified portfolios. Each portfolio company bears only an attenuated relationship to overall fund performance. To wit: "As of October 2016, Vanguard's governance team employed 15 people to cover some 13,000 companies; BlackRock employed about 20 for its 14,000 companies; and State Street employed fewer than 10 for about 9,000 companies."[25]

It strains credulity to believe that these thinly staffed corporate-governance offices will be able to improve firm performance through blunderbuss ESG engagement comparable to the targeted investment strategies of activist investors taking concentrated market positions. There is some evidence that such ESG-engagement efforts impair investment performance. In 2015, the Manhattan Institute commissioned an econometric study of shareholder activism and firm value.[26] Tracie Woidtke, a professor at the Haslam College of Business at the University of Tennessee, examined the valuation effects associated with public pension fund influence, measured through ownership, on Fortune 250 companies. Woidtke found that "public pension funds' ownership is associated with lower firm value" and, more particularly, that "social-issue shareholder-proposal activism appears to be negatively related

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60 (2016) (finding little difference between returns for high and low ESG funds in the U.S., though high ESG European funds tend to underperform)).

[21] *See* Jeff Cox, *Passive Investing Automatically Tracking Indexes Now Controls Nearly Half the US Stock Market*, CNBC.COM, Mar. 19, 2019, https://www.cnbc.com/2019/03/19/passive-investing-now-controls-nearly-half-the-us-stock-market.html.

[22] Kenneth R. French, *Presidential Address, The Cost of Active Investing*, 63 J. Fin. 1537, 1561 (2008) (concluding that a passive investor from 1980 to 2006 would have beaten an active investor by sixty-seven basis points per year).

[23] *See, e.g.*, Lucian A. Bebchuk, Alon Brav & Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085, 1085 (2015); Robin M. Greenwood & Michael Schor, *Investor Activism and Takeovers*, 92 J. FIN. ECON. 362, 374 (2009); April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J. FINANCE 187, 213, 217–18 (2009); Alon Brav, Wei Jang, Frank Partnoy & Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FINANCE 1729, 1732 (2008); Christopher P. Clifford, *Value Creation or Destruction? Hedge Funds as Shareholder Activists*, 14 J. CORP. FIN. 323, 324 (2008).

[24] Paul Rose & Bernard S. Sharfman, *Shareholder Activism as a Corrective Mechanism in Corporate Governance*, 2014 BYU L. REV. 1015, 1034 (2014).

[25] M. Todd Henderson & Dorothy Shapiro Lund, *Index Funds Are Great for Investors, Risky for Corporate Governance*, WALL ST. J., June 22, 2017.

[26] *See* Tracie Woidtke, *Public Pension Fund Activism and Firm Value* (Manhattan Institute 2015), *available at* https://www.manhattan-institute.org/html/public-pension-fund-activism-and-firm-value-7871.html.

to firm value."[27] As such, public employee pension funds' use of the shareholder-proposal process in an effort to affect corporate behavior in pursuit of social or policy goals seemed to be harming the financial interests of plan beneficiaries.

In addition to these *prudential* concerns, it is important to recognize that large fund families' ESG engagement is typically rife with conflicts of interest that implicate ERISA plans' *duty of loyalty* as well. As Mr. Sharfman writes in his recent paper analyzing BlackRock's shareholder engagement, fund activism is probably best explained—apart from agency costs allowing managers to leverage passive index fund holdings for idiosyncratic personal social goals—as being related to strategic decisions to attract and retain fund capital by *marketing* to millennial and left-leaning investor preferences and by *appeasing* social investors, including public pension funds responsive to political interests and public employee labor unions.[28]

Some fund managers may also prefer to attract new ESG dollars, relative to lower-cost index-fund vehicles, precisely because such funds can maintain a higher overall fee structure for the organization. Low-fee index funds now approach half of all dollars invested through stock mutual funds in U.S. equity markets,[29] and although ESG-focused funds remain a minority of stock funds in the market, they have been increasing in share of new investment dollars: in 2020, ESG-related investment funds constituted close to one-fourth of new U.S. mutual dollar inflows—double the level in 2019 and up from just 1% in 2014.[30]

Put simply: the economic and other interests of fund managers and executives tend to be well-aligned with ESG engagement strategies—but not the interests of the underlying investors owed a fiduciary duty. These potential duty of loyalty concerns are essentially unexplored in the Department's rulemaking.

In sum, this latest switch in the Department's continuing revision of an unchanged statute strays from the statute's clear command that ERISA fiduciaries manage funds *solely* for the *exclusive purpose* of maximizing plan beneficiaries' financial returns at the lowest cost. There is substantial reason to believe that the proposed rule compromises ERISA plans' duties of prudence and loyalty and runs afoul of Congress's legislative directive.

Very truly yours,

James R. Copland

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[27] *Id.* at 16.

[28] *See* Bernard S. Sharfman, *The Conflict Between BlackRock's Shareholder Activism and ERISA's Fiduciary Duties*, 73 CASE W. RES. U. REV. 1240, 1243–44 (2021), https://scholarlycommons.law.case.edu/caselrev/vol71/iss4/10/.

[29] *See* Cox, *supra* note 21.

[30] *See* Greg Iacurci, *Money Invested In ESG Funds More Than Doubles In a Year*, CNBC.COM, Feb. 11.2021, https://www.cnbc.com/2021/02/11/sustainable-investment-funds-more-than-doubled-in-2020-.html.