Dear Sir or Madam:

This letter is submitted on behalf of the Fiduciary Duty and Policy Working Group and Sustainable Retirements Initiative of the Intentional Endowments Network (“IEN”). The IEN is a non-profit, peer-learning network of more than 200 investment fiduciaries from higher education and other nonprofit institutions. 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 investment practices related to sustainability. Our work with higher education investment institutions has made IEN keenly aware of the climate-related financial risks and opportunities they face. We have seen this become a central concern of our members, which calls for greater attention from DOL and other regulators.

Summary

We recognize that fiduciary duty principles underlie all management activities of pension funds. Governance practices, including attention to climate-related risks, must be aligned with fiduciary responsibilities. Accordingly, IEN believes that the EBSA should explicitly address several established, but often ignored, fiduciary duty principles in addressing climate-related risks, as well as in all of its other regulatory activities:

- The duty of impartiality, especially regarding efforts to balance inter-generational differences in risk tolerance and investment time horizons, as well as transfers of costs, evolving risks, and value creation between fund participant generations.
- Dynamic nature of the prudent standard of care which causes it to evolve in response to changes in circumstances, knowledge, and investment industry practices.
- Recognition that growth in size and economic influence of investor fiduciaries has positioned them to collectively influence creation and management of systematic risks, like climate change, with effects across companies, industries and markets which are responsible for 75 percent or more of portfolio returns and cannot be avoided through mere diversification.
In addition, IEN recommends that EBSA incorporate ‘soft law’ approaches into its regulatory agenda. By recognizing that behavioral biases often create roadblocks to adoption of improved investment practices and rational decision making, EBSA could supplement its rules and regulations with “nudge” incentives that encourage fiduciaries to apply best practices rather than focus on compliance approaches that are aimed at liability avoidance. We suggest that EBSA consider establishment of an inter-disciplinary advisory council with a mandate to explore cross-agency and public/private collaboration on research, education, and creation of incentives for pension fiduciaries to develop a culture of constant improvement. The advisory council’s mandate should include, but not be limited to, climate-related risks.

IEN’s comments primarily address RFI questions 5 and 6 (collection and reporting of information); question 7 (impact of market changes on fiduciary duty); question 19 (impediments to addressing climate change financial risks); and questions 20 and 21 (EBSA roles in improving research, investment analysis, and participant education).

Duty of Impartiality

The United States Supreme Court has recognized that fiduciary duties under the Employees Retirement Income Security Act (ERISA) include the 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 §79.¹

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, given the overwhelming long-term duration of pension fund liabilities and the current influence of irrational short-termism in the markets (discussed below), we believe that EBSA regulations should include 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

¹ 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).
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*.

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 on climate change:

> "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."  

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."

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). . . .

> 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."

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2 Professor Stern, speaking at the London School of Economics on *The Economics of Climate Change: The Stern Review* prior to the COP 26 climate change summit in Glasgow.


4 *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.
IEN recommends that EBSA review its regulations for provisions which implicate the duty of impartiality. Climate-related risks are perhaps the most obvious example. Impartiality is a fundamental aspect of ERISA fiduciary law that also applies to other institutional investor fiduciaries.\(^5\) We believe that the duty of impartiality and use of a presumptive long-term investment horizon should be incorporated throughout the ERISA regulatory framework.

**Prudent Standard of Care is Dynamic and Evolves over Time**

The standard of care, which is part of the duty of prudence, is often mistaken as a rigid concept that is impervious to change. Perhaps this belief is the result of the relative stability of investment theory for the past generation. However, prudence is a forward-looking concept,\(^6\) and the standard of care is expected to evolve in response to changes in knowledge and circumstances.

This is not a new construct.\(^7\) The most recent major transition in the standard of care took place in the last half of the 20\(^{th}\) century. It involved movement from using 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 practice took several decades, leaving fiduciaries caught between two seemingly inconsistent investment approaches. One 1988 commentator described the tension during that transition between adoption of modern investment practices and being held back by outdated rules:

"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.\(^8\)

In response to this late 20\(^{th}\) 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:

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\(^5\) 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.

\(^6\) 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 (3rd Edition, 2007).

\(^7\) For a recent 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).

\(^8\) *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.
"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. ESG-related developments and advances in knowledge since the turn of the twenty-first century parallel the transition in the standard of care that took place during the previous century. Better understanding (and experience) of the systematic effects of climate change is just one of these changes. We believe that emphasizing this historical context for the current changes that are occurring in understanding and application of fiduciary duty principles by investor fiduciaries and regulators would help to put the flip-flop of regulatory standards over the past two decades into perspective.

Nevertheless, the direction of 21st century investment industry change is now clear and is largely being driven by mainstream global investors and by regulators in other countries.9 We believe that the EBSA should use the 20th century transition from the prudent person standard to Modern Portfolio Theory to frame a regulatory context which helps us move forward now by demonstrating that evolution of investment industry theory and practice is to be expected when knowledge and circumstances change.

Systematic Risks

For a diversified investor, systematic risks associated with beta (i.e., market) exposure drive most portfolio returns.10 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

9 For example, the UK and EU are far ahead of the US in adoption of investor and corporate regulatory mandates for climate risk reporting. In addition, an analysis of more than 8,700 comments submitted in response to the 2020 Trump Administration proposed rule seeking to discourage consideration of climate risk and other ESG issues found that 95% of commenters opposed the proposal and 94% of comments from investment professionals were in opposition to it. Furthermore, the 2022 update (being released soon) to the 2021 Schroders’ US Retirement Survey cited by DOL in the RFI found that the percentage of 401k plan participants who say they would or might increase their overall contribution rate if offered ESG options in their 401k increased from 69% in 2021 to 74% in 2022. When offered ESG options, 90% of respondents invested in them.

10 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 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) and Forbes article (Eccles, May 18, 2021).
spread across portfolio companies and compound over time, increasing risk exposures and degrading future returns to fund participants.\textsuperscript{11}

Climate change presents perhaps the most evident set of both company-specific and systematic risks that raise inter-generational investment risk and return conflicts of interest and implicate the fiduciary duties of impartiality and prudence. For example, failure to address climate risks and opportunities is likely to result in stranded asset losses with increased future economic costs and risks that will be primarily borne by today’s younger fund participants in the future.

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; inadequate attention to product effects on both worker and public 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 that are based on distribution of misinformation.

The U.S. Department of Defense has even concluded that “climate change is reshaping geostrategic, operational, and tactical environments with significant implications for U.S. national security and defense.” The Secretary of Defense summarized the Department’s conclusion as, “No nation can find lasting security without addressing the climate crisis.”\textsuperscript{12}

Economic effects of the war in Ukraine have certainly brought home the systematic financial risks associated with reliance on fossil fuels when world pricing and supply are subject to manipulation by leaders of unpredictable autocratic nations.

Given the growth of institutional investor assets and economic influence over the past 50 years and the global transition toward integration of ESG factors into investment analysis, there is a developing trend toward investor stewardship initiatives to address systematic risks through “beta activism.” For example, in 2014 the New York City pension funds engaged 75 companies on provision of investor access to include board candidates on the proxy in what was called the Boardroom Accountability Project. At the time there were only six companies that provided proxy access to shareholders. The 75 companies experienced $25 billion in excess return when the initiative was announced. Five years later, there were more than 600 companies with proxy access provisions. Estimates of added global wealth from this and other beta activism initiatives go as high as $2 - $5 billion.\textsuperscript{13}

\textsuperscript{11} While definitions of systematic risk vary, for purposes of this comment letter we use systematic risk to reference risks that cut across a broad swath of companies, securities, industries, and markets and include risks that originate in the economic, environmental, social, and financial systems upon which the capital markets depend.


\textsuperscript{13} See Hawley and Lukomnik, Moving Beyond Modern Portfolio Theory: Investing that Matters (Routledge, 2021) and a related CFA Institute blog article (May 2021) and Forbes article (May 18, 2021).
IEN recommends that the EBSA make systematic risk a future focus. Climate risk should be among the first systematic risks to be addressed. Given the risks and value involved, this is a huge area for protection and growth of ERISA fund assets.

**Behavioral “Soft Law” Regulatory Approaches**

Investment management is fraught with behavioral biases that undermine rationality of financial analyses and investment decision making. The following are just some examples of unconscious and illogical behavioral biases that permeate the investment process.\(^\text{14}\)

- **Anchoring**: Influence exerted by the last piece of information come across prior to considering a decision.
- **Bandwagon Effect**: Believing something is true or correct because many other people do.
- **Clustering Illusion**: The tendency to overestimate the importance of small patterns or clusters found in a large amount of data.
- **Confirmation Bias**: The tendency to search for, interpret, and remember information in a way that confirms existing preconceptions.
- **Conservatism Bias**: When we cling to an initial viewpoint even when there’s new information or evidence that challenges it.
- **Endowment Effect**: When we consider an asset that we already own as more valuable than similar assets that we don’t.
- **Framing Effect**: Drawing different conclusions from the same information, depending on how or by whom that information is presented.
- **Gambler’s Fallacy**: The belief that future probabilities are altered by past events; also called the Hot Hand Fallacy.
- **Short-term Bias**: The tendency to favor immediate or short-term gain over greater gain available in the long-term.
- **Herding Effect**: The tendency to follow the actions of a larger group; seeking safety of group conformity and not standing out as different.
- **IKEA Effect**: Tendency to place a disproportionately high value on objects that a person partially created themself, regardless of the quality or value of the end result.
- **Illusion of Control**: When we tend to overestimate our control over events or outcomes.
- **Loss Aversion**: The tendency for people to prefer avoiding losses than acquiring gains.
- **Optimism Bias**: Propensity to overestimate the probability of positive outcomes but underestimate the potential for negative ones.
- **Outcome Bias**: Tendency to judge quality of a decision by its eventual outcome rather than quality of the decision process.
- **Overconfidence Bias**: When confidence in our own judgements is greater than the objective accuracy of those judgements.
- **Recency Bias**: When people weigh recent events and observations more heavily than those in the past. Or its opposite, viewing the past as an accurate predictor of the future.

\(^{14}\) Essentia Investments, *How Behavioral Bias Impacts Investments*, <last visited 5-12-2022>
- **Status Quo Bias:** Discomfort with change, preference for things to stay the same or tendency to stick with previous decisions; intellectual inertia.
- **Sunk Cost Effect:** Tendency to throw good money after bad; continuing to invest in something based on earlier decisions, rather than on current objective merits.

The effects of unconscious bias can have a subtle, but dramatic effect on the ability of investment fiduciaries to make logical decisions. The implications for compliance with fiduciary duties are significant.

Regulatory “hard law” standards alone are unlikely to effectively protect beneficiaries from the unconscious biases of well-meaning fiduciary agents who control the management of plan participants’ life savings. Personal biases are difficult to control simply because people are usually not aware of them. Behavioral biases can, however, often be countered through careful structuring of the decision-making process and the use of incentives or behavioral nudges that encourage rational, prudent, and loyal fiduciary behavior. Design of regulatory approaches that incorporate behavioral science principles could greatly improve the quality of fiduciary decision making and produce better results for plan participants and beneficiaries.

ERISA was enacted to protect the interests of plan participants and their beneficiaries and to establish standards of conduct, responsibility, and obligation for plan fiduciaries. Advances in behavioral science and related fields now offer EBSA the opportunity to better implement ERISA’s intent. While hard law standards set minimum conduct expectations, soft law behavioral incentives could supplement those standards and encourage adoption of best practices that promote implementation of fiduciary duty principles within a governance culture of continuous improvement. Use of behavioral incentives, rather than relying only on hard law standards, would also be consistent with the focus of ERISA on the integrity of the processes used by fiduciaries.

Although EBSA may not have the behavioral science expertise needed to explore the potential benefits of incorporating soft law regulatory approaches into its regulatory scheme, that expertise is readily available to EBSA. IEN recommends that EBSA create an inter-disciplinary advisory council tasked with assisting the agency in examination of potential regulatory approaches that apply behavioral science principles to counteract biases and improve the integrity of fiduciary decision making. To more effectively identify options that would align behavioral incentives throughout the environment in which pension plan fiduciaries function, the advisory council could be structured as a public/private collaboration with behavioral sciences experts, key pension plan service providers, regulators, policymakers, insurers and other industry infrastructure representatives as members.

For example, areas where use of incentives might be considered could include topics like education/training approaches (and content), adviser/manager compensation design, use of supplemental performance benchmarks, reporting metrics for short- and long-term time horizons, participant surveys, development of investment beliefs, adviser expertise verification, preferred

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board governance practices, multi-generational board membership, board member expertise development, systematic risk (including climate risk) exposure metrics, fiduciary insurance underwriting standards, etc.

Consideration might be given to soft law incentives or behavioral nudges that use things like insurance premium discounts, tax benefits tied to best practices, enforcement safe harbors/penalty adjustments, stricter scrutiny investigations when processes are misaligned, compensation incentives, injunction (rather than financial penalty) remedies, etc. In addition, the council might advise EBSA about funding of research on related issues.

Advisory council membership should supplement existing EBSA staff areas of expertise. For instance, to ensure that appropriate inter-disciplinary expertise and public/private sector viewpoints are present, consideration might be given to including members who are representatives/experts from behavioral science, neuro-psychology, climate change, adult education, investment management, tax policy, insurance regulation, risk management, investment advisory services, organizational design, pension oversight policy, finance/securities industry regulation, accounting/audit services, futurist/strategic planning, etc.

IEN offers this recommendation from the perspective of an organization that works with academic, investment and nonprofit institutions. We see collaboration between the public and private sectors, with a focus on application of advances in knowledge from multiple disciplines, as the most effective way to improve the ability of EBSA to implement policy goals of ERISA. Reducing the impact of behavioral biases and conflicts of interest in the governance and management of pension funds would remove some of the biggest roadblocks to implementation of fiduciary best practices in addressing climate change and other 21st century challenges faced by pension plans. We hope you will seriously consider including this recommendation in EBSA’s strategic planning.

Conclusion

IEN appreciates the opportunity to provide input on protection of life savings and pensions from threats of climate-related financial risks. Our comments focus on anchoring EBSA regulatory actions in a comprehensive understanding of fiduciary duties. That includes recognition of often overlooked fiduciary principles: the duty of impartiality, the dynamically evolving nature of the prudent standard of care and appreciation that systematic risks (like climate change) are the “elephant in the room” that drive 75 percent or more of pension asset returns over the long term.

IEN also views use of behavioral science insights in design of soft law regulatory incentives as one of the most promising opportunities for EBSA to improve its effectiveness in addressing climate-related risks and delivering on the goals set by ERISA.

Please feel free to contact us if we can be of assistance.

Respectfully submitted,
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