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Ceres comments on forthcoming U.S. Department of Labor rule proposal "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights"

August 27, 2021

Recent DOL rulemaking has had a chilling effect on consideration of ESG factors by ERISA plan fiduciaries, even where such factors are clearly financially material. That was clearly the intent behind the prior Administration's proposed "Financial Factors" rule, and while the final rule dropped its express reference to ESG in the regulatory text, the more than 300 references to ESG factors in the Preamble delivered the message that the intent of the final rule remained the same. Despite an abbreviated comment period of just 30 days, DOL received nearly 9,000 comment letters, with over 95% opposing the rule.

Our discussions with a wide range of plan sponsors have confirmed these fears remain; many have expressed concern that they will be targeted by the DOL if they adopt ESG funds in their plan, while others are reluctant to discuss the issue at all. There is good reason for this fear - DOL did, in fact, conduct investigations during the past two years of plans that invested in certain sustainable funds, and many of those investigations remain open and unresolved.

It is therefore incumbent on the current DOL leadership to undo the damage, and while we appreciate the Department's efforts thus far, such as suspending enforcement of the Financial Factors rule, the most important work is yet to come. A strong proposed regulation that clearly encourages ERISA fiduciaries to take into account the financial risks posed by climate change and other ESG issues, and that clearly encourages ERISA fiduciaries to be engaged shareholders, is essential to achieving better retirement outcomes for American workers and their families.

1. **Climate change poses material financial risks.** Ceres recommends that DOL recognize and credit the rapidly mounting body of evidence in the preamble to its revised regulations. The proposal and the discussion in the preamble should forcefully signal to ERISA plan fiduciaries that they and their investment advisors and managers should factor climate risk into their investment decisions, and that doing so is fully consistent with their statutory responsibilities. Please see the Ceres DOL 2020 comments, the 2020 Ceres report Addressing Climate Risk as a Systemic Risk, and the 2021 report Turning up the Heat. The GAO report Federal Workers' Portfolios Should Be Evaluated For Possible Financial Risks Related to Climate Change also highlights the need to consider climate related risks and market opportunities in retirement savings plans.

Many prudent investors do look at climate risk, and climate and greenhouse gas factors are likely to become an increasingly significant driver of portfolio losses. Fiduciaries who incorporate analysis about climate and its implications across our economy also may provide beneficiaries exposure to significant upside. The new proposal's preamble should comprehensively refute statements in the preambles to prior Administration Rules suggesting that climate risk (among other ESG factors) is generally or normally a non-financial consideration, demonstrating instead that climate risk is a core financial consideration. Summarizing the body of evidence and expert opinion on the financial risks of climate change in the preamble will serve to show that prudent ERISA fiduciaries regularly do and indeed often must consider climate risk.

2. **The "pecuniary" framework of the prior Administration's Financial Factors and Proxy Rules must be rejected.** Since 1978, ERISA regulations have required fiduciaries to consider all relevant, financially material factors when choosing among available investment options. The introduction in 2020 of the new terms "pecuniary" and "non-pecuniary" has resulted in confusion because the new terminology suggests there is a new test that must differ from the prior standard. However, it is not at all clear what the difference is, or how to incorporate the new test into a prudent fiduciary process. Many relevant, financially material factors (that presumably are therefore "pecuniary") also have other "non-pecuniary" aspects, leading to confusion amongst fiduciaries in how to evaluate and utilize these factors. For example, climate risk affects the bottom line of many investments, but also has a moral component that could be viewed as "non-pecuniary." Further, given the negative tone of the prior Administration's rules, many plan fiduciaries and investment managers interpret these rules to impose a new legal regime disfavoring consideration of ESG factors even where they clearly have material financial impact. It is vital that DOL level the playing field by rejecting any presumption that those factors are collateral or that their consideration is imprudent. The DOL should clarify that whatever changes it ultimately makes to the regulatory text are meant to restore the traditional all-relevant-factors test, against the backdrop of fact finding in the preamble that climate risk (among other ESG factors) has material financial effects.

3. **The Financial Factors Rule's "tiebreaker" provision must be overhauled as it is ambiguous and creates unnecessary legal and regulatory risk for plan sponsors.** The reality of making investment decisions is that there is rarely one clear answer—ERISA fiduciaries employing a prudent investment process typically find that several investments meet the plan's criteria, and thus any of those investments is "prudent." When multiple investment options are found to be "prudent," the plan sponsor should be

able to select any of them without further justification or the need to provide special documentation.

The prior Administration's rule created confusion around this concept by (1) incorrectly suggesting that such multiple outcomes are rare, (2) stating that "non-pecuniary" factors can only be used to decide when two investment alternatives are indistinguishable from one another, and (3) requiring that special documentation justifying the final choice is maintained. This inappropriately exposes fiduciaries to significant risk, as it suggests that there must be clear documentation as to why one investment already deemed prudent is "better" than another investment already deemed prudent. The Department must reframe this issue to make it clear that whenever more than one investment option has been selected through the plan's prudent process, all options are equally prudent—the decision as to which of these options to select does not require any additional documentation, or special rules for considering ESG or any other factors. While of course the normal documentation related to a prudent investment selection process should be maintained, Ceres recommends that DOL eliminate the special documentation requirements, as they create additional costs and invite the attention of the plaintiffs' bar. This clarification will reduce cost and legal risk for plan sponsors, preserve the longstanding protections for plans selecting economically targeted investments (ETIs), and give safe harbor to those wishing to include ESG funds in their plans, even as it maintains ERISA's rigorous prudent selection process.

4. **The Financial Factors Rule must be amended to treat Qualified Default Investment Alternatives (QDIAs) the same as other investments on the plan's menu**. Participant-directed ERISA plans give participants choice and control. Participants decide whether to join the plan, how much to contribute, and which investments to select. They can do so affirmatively, or through automatic enrollment. A QDIA is an investment vehicle that is used for participants who are automatically enrolled to provide them with an appropriate investment allocation. Even when participants are automatically enrolled, they still have the freedom to choose—they are informed how much their contribution will be and what the QDIA receiving their contributions will be, and then they have the opportunity to elect not to participate or to give different investment instructions. QDIAs are very important because, in practice, roughly 80% of new participant contributions are allocated to them. Although it allows ESG factors to be present in other plan investments, The Financial Factors Rule does not permit QDIA investments to incorporate ESG factors, even when those factors are financially material, because they may have non-pecuniary implications as well. This effectively bans ESG from the most popular plan investment category. The DOL's rationale for this disparate treatment was that participants did not affirmatively select the QDIA, and therefore the fiduciary should not impose its "values" on participants. Because a QDIA is no less participant-directed than

any other alternative, however, there is no legal basis for this different treatment. Ceres recommends that the new QDIA-specific regulatory text introduced in the prior Administration's rule be eliminated. We further recommend that DOL clarify that the fiduciary's responsibilities of prudence and loyalty are no different for a QDIA than for other plan investments.

5. **DOL should eliminate the provisions of the Proxy Rule requiring cost-benefit analysis as a precursor to exercising shareholder rights.** Just as there should be no presumption that an investment supportive of ESG goals is imprudent, fiduciaries must not be constrained or discouraged from exercising shareholder rights in a manner supportive of ESG goals. Fiduciaries must act "prudently" and "solely in the interest" of the participants "for the exclusive purpose" of providing benefits and defraying reasonable plan expenses. Investment managers regularly exercise shareholder rights as part of their fiduciary responsibilities. Such rights are particularly relevant for pension beneficiaries, given they are generally diversified (Universal Owners) and invest over a long horizon, and are therefore particularly exposed to the financial impacts of governance decisions on specific companies and across their portfolios. Investment managers should not have to provide a cost benefit analysis each time they wish to exercise their shareholder rights as (1) it is broadly accepted that prudent investors do exercise these rights as part of their fiduciary responsibilities, (2) the cost and legal risk of such analysis discourages their engagement, and (3) a prudent investment selection process already considers a potential investment's management fees, which do not vary as a result of a manager's decision to exercise their shareholder rights. Ceres recommends DOL's regulations be amended accordingly.

Thank you for your consideration.

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