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SUBMITTED ELECTRONICALLY

December 10, 2021

Office of Regulations and Interpretations,
Employee Benefit Security Administration,
Room N-5655,
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

Thank you for the opportunity to comment on the above proposed rule, which would clarify the application of ERISA's fiduciary duties of prudence and loyalty to selecting investments and investment courses of action.

I welcome the Department's recognition of the importance of this subject. Specifically, I welcome the decision to revisit the 2020 rule "Financial Factors in Selecting Plan Investments," which was adopted despite the great majority of public comment having been opposed to it[1].

In the comments below, I:

- highlight the importance of externalities (i.e. the impacts on third parties of investment actions) and the associated potential for market failure, and
- argue that policymakers and regulators have a responsibility to consider externalities in their rule-making, taking steps to align incentives appropriately and to ensure that the necessary conditions exist for markets to succeed by encouraging a long-term and responsible mindset throughout the investment community.

The actions included in the proposed rule are largely to do with removing restraints (the "thumb on the scale") that had been put on the consideration of ESG factors by the 2020 rule and by the subsequent rule "Fiduciary Duties Regarding Proxy Voting and Shareholder Rights". Those are necessary steps, but, given the rapid change in the ESG investing environment, it is unlikely to be the end of the story. To be effective in its role, the Department will need to apply an understanding not only of how individual actions might enhance or detract from benefit security, but also of how the dynamics of the system as a whole – dynamics that are heavily shaped by the regulatory context – can do so. It is this system-wide view, and specifically the part played by externalities, on which the following comments focus.

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[1] See, for example, Gorte et al (2020) *Public Comments Overwhelmingly Oppose Proposed Rule Limiting the Use of ESG in ERISA Retirement Plans.* US SIF. https://www.ussif.org/Files/Public_Policy/DOL_Comments_Reporting_FINAL.pdf

ESG considerations have both a financial impact and a broader societal impact

Many of the comments made in connection with the 2020 rule will apply also to this proposed rule. In my own comments[2], I concentrated on three main points:

1. That the 2020 rule in practice provides little or no additional protection to participants, and causes harm by hindering appropriate activity.
2. That giving consideration to non-pecuniary objectives does not automatically result in the compromising of financial objectives.
3. That the global regulatory trend is supportive of ESG considerations and the Department could play a similarly constructive role in exploring ways that ESG objectives can appropriately be pursued without compromising participants' financial interests.

Because the Department appears currently to be more sympathetic than previously to the third of these points, I would like to take this opportunity to expand on it.

A major reason that ESG considerations are increasingly being integrated into investment processes is that such considerations are financially impactful. Today's prudent investor does not include any investment in their portfolio without having assessed the environmental and social angle. Depending on the type of investment, this might mean an analysis of the risks and the return implications of the investment's impact on climate or biodiversity or health and safety or customer privacy or human rights or any number of other considerations.

This is not, however, the only reason. As noted in my previous response:

"There is a growing awareness, both among regulators and among investors, of the central role played by the investment industry in the economy and in wider society. That role brings responsibilities. The investment process does not take place in a vacuum; investment decisions have impacts. There is a long list of actions that can be taken – whether by individual citizens, by corporations or by investors – that benefit them while imposing costs on others. These externalities are why we have laws and social norms against government officials accepting bribes, against companies polluting public lands, against investors laundering illegal drug money. These – and many other behaviors – are in one person's best interest (in the short term at least) but detrimental to the overall good.

"One of the most important things that regulators do is to minimize any misalignment between individual incentives and the wider good. For that reason,

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[2] https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AB95/00231.pdf

most regulators globally are welcoming and encouraging of a long-term responsible mindset among investors...

"Given the growing importance of this topic, the Department could play a valuable role in exploring ways that ESG objectives can appropriately be pursued within the context of fiduciary duty, just as other regulators around the world are doing."

Policymakers and regulators need to recognize the importance of externalities

Externalities are a huge and unavoidable part of how the economy operates. Indeed, the investment firm Schroders has estimated that the externalities generated by listed companies worldwide are equivalent to more than half of their profits, and that one third of companies would be loss-making if their negative social and environmental impacts were to be taken into account[3]. In today's highly-connected world, very little economic activity is externality-free, neither touched by nor touching the rest of society.

Greenhouse gas (GHG) emissions are a particularly significant example of an externality. The short version of the economics here is that if a ton of carbon (technically: CO2e) emissions creates a cost for society in general of (say) $80, then the emitter should be required to pay that amount. Until that is done, then the entire fossil fuel industry – and all of their customers (i.e. everyone) – has a misdirected financial incentive, and markets don't do their job of correctly allocating resources. In that situation, if I can generate $20 of economic benefit by burning a ton of carbon, it's in my financial interest to do so – even though that leaves everyone else worse off to the tune of $80.

Economists have been aware of the potential for externalities to cause market failure for at least 100 years[4]. The textbook response is to "internalize" the externality, i.e. to require (in this example) the emitter to pay the $80 that we have estimated as the third-party impact of the emissions. As Milton Friedman put it "there is always a case for the government [acting] to some extent when what two people do affects a third party", going on cite a carbon tax as an example of an appropriate intervention in order to "make it in the self interest of the car manufacturers and the consumers to keep down the amount of pollution"[5]. Even for free market economists such as Friedman, there is an essential role for the

[3] Schroder Investment Management (2019) *SustainEx: Examining the social value of corporate activities* at https://www.schroders.com/en/sysglobalassets/digital/insights/2019/pdfs/sustainability/sustainex/sustainex-short.pdf
[4] Pigou, A.C. (1920) *The Economics of Welfare.* Macmillan.
[5] These quotes are taken from an appearance on *The Phil Donahue Show*, September 1979 accessed at https://www.youtube.com/watch?v=0YGfwSvLkC0

policymaker and the regulator here: not simply to get out of the way, but rather to ensure that the necessary conditions exist for markets to succeed.

Dealing with externalities in the context of a fiduciary relationship

These considerations become especially pertinent in the context of a fiduciary relationship. When a fiduciary is acting on behalf of a third party, their motivation to act in a way which creates negative externalities is no longer merely one of self-interest, but rather may involve a legal obligation. This situation – of being legally bound to pursue gain at the expense of the broader good – has been described by the commentator Duncan Austin as one "which no non-sociopath would ever accept."[6]

This is why the Agency's mission to "ensure the security of the retirement, health, and other workplace-related benefits of America's workers and their families," demands paying attention not only to actions taken at the individual level but also to the dynamics of the system, and taking steps where necessary to minimize structural strains and as far as possible to avoid misalignment between the incentives of individuals (participants, fiduciaries and others) and the best interest of the community as a whole.

To overlook this wider role is, in effect, to devote all of one's attention to insisting on the pursuit of the $20 individual profit gained at the expense of an $80 loss to others, and disregarding the policymaker's role in correcting the misalignment of incentives.

Broader responsibility should also be encouraged

Although internalization is the textbook policy response to the problem of externalities, it is only a partial solution. This is because of the significant practical challenges involved: there are too many different types of externality to address; they can be difficult to put a value on; there's usually no simple way to transfer compensation from the right source to the right recipient; and so on. Corporate lobbying doesn't make it any easier.

Hence, while a policy of internalizing the most significant externalities is appropriate (for example, through implementation of a carbon pricing regime), it is also necessary for regulators to recognize that just about all economic activity – whether by individuals, corporations or investors – has impacts on third parties that may not be fully captured in the financial terms. Society functions better when individuals retain a notion of good citizenship, when corporations accept a degree of

[6] Austin, D. (2021) *Market-led Sustainability is a 'Fix that Fails'* at https://bothbrainsrequired.com/wp-content/uploads/2021/10/2021-10-21-Market-led-Sustainability-is-a-Fix-that-Fails-Final.pdf

corporate social responsibility, and when investors likewise retain a sense of responsibility for the impacts of their decisions.

That is one reason for the poor reception of the 2020 rule, which in effect presupposed that any effort to achieve social or environmental goals was necessarily imprudent and hence discouraged good citizenship.

While the notion of a broader responsibility clearly does not negate the fiduciary's duties of prudence and loyalty, it can sit alongside them. The Department can play a supportive role in offering guidance on how this can be done. As I noted in my previous comments: "A different approach, one that is more consistent with the global context, would take a starting point of 'if it's possible to fully look after investors' interests while also playing a positive role in the broader social good, we're all for it'."

Regulatory action that is supportive of ESG considerations is being implemented elsewhere

There are many examples around the world of regulation that adopts this approach. As of September 2021, the UN Principles for Responsible Investment regulation database[7] covered 750 policy tools and guidance which support, encourage or require investors to consider all long-term value drivers, including environmental, social and governance (ESG) factors.

The EU action plan for financing sustainable growth, for example, is a wide-reaching program of reforms aimed at promoting sustainable investment. The changes implemented to date include the Sustainable Finance Disclosure Regulation (SFDR)[8], a series of disclosure requirements aimed at improving transparency and combating greenwashing. In practice, this is leading investment firms to better define their investment processes. Another change has been the broadening of the suitability assessment that investment firms must carry out when they give advice or make a portfolio management decision to include not only the client's investment objectives, but also their sustainability preferences[9]. As firms learn more about the preferences of their client base, product line-ups will evolve.

In similar vein, the UK recently brought in a requirement[10] for pension plan trustees to implement climate change governance measures and produce a Task Force on Climate-related Financial Disclosures (TCFD) report that includes consideration of

[7] https://www.unpri.org/policy/regulation-database
[8] https://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX:32019R2088
[9] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32021R1253&from=EN
[10] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1006024/statutory-guidance-final-revised.pdf

short-, medium- and long-term risks and opportunities, scenario analysis, emissions and other metrics, and the adoption of targets. This is likely to lead to improvement in the identification, assessment and management of climate risk among those plans.

These examples show how other regulators are approaching their responsibility to ensure an appropriate focus on climate and to protect the best interests of plan participants and savers in general.

Background

The comments above are my personal perspective, based on over thirty years professional experience of working with institutional investors as an actuary and investment consultant, including leading the investment consulting practices of Russell Investments in both the UK and the US, as well as the research team of Willis Towers Watson's Thinking Ahead Institute. Today, I advise investment organizations on best practice in ESG and sustainable investing.

I would of course be happy to expand on any of the above.

Sincerely,

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