July 30, 2020

Via Electronic Submission:

Office of Regulations and Interpretations
Employee Benefits Security Administration, Room N-5655
U.S. Department of Labor
200 Constitution Avenue NW
Washington DC, 20210

Re: Financial Factors in Selecting Plan Investments Proposed Regulation; RIN 1210–AB95

Dear Sir or Madam:

The Managed Funds Association ("MFA") and the Alternative Investment Management Association ("AIMA") (the "Associations") appreciate the opportunity to provide comments to the Department of Labor ("DOL") in response to the proposed rule (the "Proposed Rule") regarding the requirements for fiduciaries to consider financial factors in selecting plan investments under the Employee Retirement Income Security Act of 1974, as amended ("ERISA").[1] We support the DOL's efforts to codify principles of fiduciary standards for selecting and monitoring investments to assist ERISA fiduciaries in how they can incorporate material factors relating to environmental, social and corporate governance ("ESG") as part of their investment process. We agree that it is important for the DOL to be clear that ERISA requires fiduciaries to select investments based solely on financial considerations, and that ERISA fiduciaries may not subordinate investment returns or increase risk for the purpose of furthering nonpecuniary objectives.

Consistent with this standard, the Associations believe that the Release should provide more clarity on how an ERISA fiduciary may consider pecuniary factors that may also be considered "ESG" factors as part of an assessment of investment return and risk. Indeed, as discussed further below, our members routinely integrate pecuniary considerations that also could be characterized as ESG factors as part of a holistic, comprehensive approach in their investment analyses consistent with generally accepted investment theories, similar to how they integrate other factors that impact investment risk and returns as part of their investment process. We believe it is important for the DOL to better distinguish between the consideration of ESG factors as simply part of the normal investment process from situations where non-pecuniary ESG considerations are beyond the assessment of investment return and risk.

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[1] Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 126 (proposed June 30, 2020) (to be codified at 29 C.F.R. 2550.404a-1) (the "Release").

We are concerned that the Proposed Rule, if adopted as proposed (including with the commentary set forth in the Release), would in practice have a significant chilling effect on the selection by ERISA fiduciaries of the many investment strategies and products that incorporate ESG considerations into their investment analyses and not in an effort to subordinate returns or increase risk due to other, non-pecuniary goals. As discussed in more detail below, we believe that some of the language in the Release is likely to create a misperception that investment strategies that incorporate ESG factors are inconsistent with ERISA's fiduciary requirements, rather than providing the intended clarity to ERISA fiduciaries on how they can incorporate ESG factors as part of an investment return and risk assessment.

The Release contains clear guidance to ERISA fiduciaries with respect to those investments which the DOL has appropriately targeted, those that sacrifice returns or increase risk for the purpose of furthering ESG considerations. In addressing those concerns, however, we are concerned that the Release does not provide adequate guidance to ERISA fiduciaries with respect to investments that appropriately consider ESG factors because they are material to the investment return and risk, as is often the case.

As a result, even where a fiduciary believes that a particular investment that integrates ESG considerations has the potential to provide enhanced risk-adjusted returns over a comparable investment that does not integrate ESG factors, ERISA fiduciaries may forgo these investment opportunities out of concern that the investment performance will be judged in hindsight. We believe that this outcome is contrary to the purposes of ERISA and the DOL's stated goal in issuing the Proposed Rule of safeguarding the interests of plan participants and beneficiaries by ensuring that the paramount focus of plan fiduciaries is the plan's financial returns and risk to participants and beneficiaries.

While we support the goal of the Proposed Rule to emphasize that ERISA fiduciaries must select investments based solely on financial considerations, we are concerned that the highly skeptical view articulated in the Release of a fiduciary's selection of investments that integrate ESG considerations could, over time, deprive plan participants and beneficiaries of prudent investment opportunities that offer the potential for increased risk-adjusted returns. Given the determination by many investment managers that considering ESG factors is a material part of a prudent investment return and risk assessment consistent with generally accepted investment theories, we are concerned that the Proposed Rule could unduly limit ERISA plan access to valuable investment opportunities. Accordingly, we urge the DOL to provide additional clarity or guidelines regarding how ERISA fiduciaries can satisfy their duties when selecting investments that integrate ESG considerations, in light of the potential adverse consequences for plan participants and beneficiaries of a rule that would bluntly discourage the selection of any investment that considers ESG factors.

Discussion

As noted above, we acknowledge that ERISA requires fiduciaries to select investments based solely on financial considerations, and that ERISA fiduciaries may not invest in ESG-oriented vehicles when they understand an underlying investment strategy of the vehicle is to subordinate return or increase risk for the purpose of nonpecuniary objectives. The Release "reiterates and codifies" DOL's "longstanding position" in this regard, stating:

> [T]he interests of plan participants and beneficiaries in their plan benefits must be paramount. The fundamental principle is that an ERISA fiduciary's evaluation of plan investments must be focused solely on economic considerations that have a material effect on the risk and return of an investment based on appropriate investment horizons, consistent with the plan's funding policy and investment policy objectives. The corollary principle is that ERISA fiduciaries must never sacrifice investment returns, take on additional investment risk, or pay higher fees to promote non-pecuniary benefits or goals.[2]

The Release does recognize, and attempts to differentiate between, investments that consider ESG factors for permissible ERISA purposes and investments that are made for the purpose of achieving non-pecuniary aims, such as advancing social goals unrelated to the risk/return profile of a particular investment. Specifically, the Proposed Rule provides that ESG considerations are pecuniary factors that may be considered by an ERISA fiduciary only if they present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories.[3] The Proposed Rule also provides that ESG considerations should be appropriately weighted to reflect a prudent assessment of their impact on risk and return.

While we appreciate the DOL's efforts to differentiate where consideration of ESG factors may be permissible for an ERISA fiduciary, we are concerned, as discussed further below, that the DOL's discussion in the Release will in practice have a significant chilling effect on the selection by ERISA fiduciaries of any investments that incorporate ESG considerations. We believe that this could ultimately harm plan participants and beneficiaries, because, given the lack of clarity and potential resulting liability, ERISA fiduciaries will be inclined to avoid investments that expressly incorporate ESG considerations, even where the particular investment would offer attractive risk-adjusted returns over other comparable investments.

Further, the stark dichotomy articulated in the Release between ESG investments that further pecuniary goals and those that further non-pecuniary goals does not, in our view, comport with the way our members currently and increasingly incorporate ESG considerations into their investment approaches. Indeed, considering factors that have now become known as "ESG" to identify opportunities and areas of risk is a regular component of our members' long-standing practices of conducting in-depth investment analyses consistent with their fiduciary duties under the Investment Advisers Act of 1940. Our members are increasingly incorporating ESG considerations more formally into their investment approaches as a part of their comprehensive investment process that is designed to increase returns or reduce risk. This common use of ESG analysis is not "to subordinate return or increase risk for the purpose of nonpecuniary objectives" but, instead, is part of a holistic, comprehensive approach to investment analyses designed to generate attractive risk-adjusted returns. For example, our members often-as they have for many years-consider various ESG factors (*e.g.*, practices impacting the environment that may pose regulatory or litigation risks, employee policies affecting a company's human capital, governance structures that entrench management at the expense of shareholders) as data points when conducting standard analyses of potential risks and opportunities of investments for relevant strategies. More recently, some

[2] Release at 39116.

[3] *Id.*

members have begun to draw upon commercially available ESG information as additional data points.

1. The Proposed Rule is Likely to Discourage the Selection of Prudent Investments by ERISA Fiduciaries That Could Benefit Plan Participants and Beneficiaries

On the whole, we are concerned that the Release takes a highly skeptical view of investments that consider ESG factors, expressly stating that "ESG investing raises heightened concerns under ERISA." The Release points to articles and speeches that suggest ESG investing involves higher fees, lacks "precision and rigor," and relies on rating systems that are "often vague and inconsistent, despite featuring prominently in marketing efforts."[4] The Release also points to regulatory interest by the examination staff of the Securities and Exchange Commission as apparent evidence of the heightened concern for ERISA fiduciaries.[5] While we recognize the purpose of these statements in the context of ESG investments that might be made for the purpose of achieving non-pecuniary aims, we are concerned that this language inappropriately creates a heightened burden for ERISA fiduciaries with respect to consideration of ESG factors that are relevant to risk-adjusted returns compared to other factors that fiduciaries consider for the same reason.

In discussing the ability of an ERISA fiduciary to include an ESG-themed investment alternative on a 401(k) plan investment platform, the Release states that in this context fiduciaries "should carefully review the prospectus or other investment disclosures for statements regarding ESG investment policies and investment approaches," noting that "fiduciaries should also be skeptical of "ESG rating systems"-or any other rating system that seeks to measure, in whole or in part, the potential of an investment to achieve nonpecuniary goals."

We believe that the DOL should modify statements in the Release such as those identified above to present a more balanced and accurate view of investments that consider ESG factors and better reflect the way that many investment managers incorporate ESG considerations into their investment approaches for the purpose of generating attractive risk-adjusted returns. While we appreciate the DOL's efforts to accommodate consideration by ERISA fiduciaries of ESG factors when the conditions of the Proposed Rule are met, the skeptical view articulated in the Release - without more clear guidance to ERISA fiduciaries on how to select investments that incorporate ESG factors consistent with the rule - will likely lead ERISA fiduciaries to avoid investments that consider ESG factors altogether, and particularly in cases where there is any question whatsoever regarding the purpose of the ESG consideration. Indeed, we believe that the Release could be interpreted as suggesting a higher standard that an ERISA fiduciary must meet to consider an investment that incorporates ESG factors. We fear that regardless of whether ESG issues are appropriately considered, ERISA fiduciaries will simply avoid investments that are designed to provide strong, risk-adjusted returns because those investments could be said in hindsight to further non-pecuniary goals, particularly in light of the DOL's overly skeptical view of ESG-oriented investments. The result is that plan participants and beneficiaries may not have the opportunity to participate in investments that may in fact provide better risk-adjusted returns. Accordingly, we urge

[4] Release at 39115.

[5] *Id.*

the DOL to provide more clarity to ERISA fiduciaries in how to comply with the Proposed Rule for appropriate investments in order to avoid this potential harm to plan participants and beneficiaries.

In the Release, the DOL also notes its concern that "fund managers are representing that the fund is appropriate for ERISA plan investment platforms, while acknowledging in disclosure materials that the fund may perform differently or forgo certain opportunities, or accept different investment risks, in order to pursue the ESG objectives." We note that the legal disclosure required to be provided by fund managers often serves various purposes, including to provide full and fair disclosure to investors, and to highlight material risk factors, especially in light of the forward-looking nature of the disclosure, which helps to protect fund managers from having their investment performance being inappropriately judged in hindsight. We agree that a fund that discloses that it will restrict particular types of investments otherwise within the fund's investment mandate for the purpose of achieving a nonpecuniary goal without regard to the economic consequences of that restriction would generally not be an appropriate investment under ERISA. However, many funds that would be appropriate investments under ERISA may disclose that the fund may perform differently or forgo certain opportunities, or accept different investment risks, as a result of integrating ESG factors into their investment analyses, similar to disclosures about how a fund may perform as a result of integrating other factors into their investment process. These disclosures should not be interpreted as statements that a fund subordinates return or increases risk for the purpose of nonpecuniary objectives.

2. <u>The DOL's Proposed Standard of Economically Indistinguishable Alternative Investments Will Result in Plan Fiduciaries Avoiding Comparable Investments That Incorporate ESG Considerations</u>

Under the DOL's current guidance, as proposed to be codified in the Proposed Rule, an ERISA fiduciary's consideration of ESG factors must be focused on their potential pecuniary elements, and a fiduciary may not "sacrifice investment return or take on additional investment risk as a means of using plan investments to promote collateral social policy goals."[6] We are concerned, however, that the "economically indistinguishable" standard set out in the Proposed Rule is less likely to clarify that an ERISA fiduciary must focus on an investment's pecuniary benefits and instead will create a new standard that will be difficult, if not, impossible for fiduciaries to meet. As a result, we believe the Proposed Rule effectively will preclude an ERISA fiduciary from choosing an investment that is appropriate based on an assessment of pecuniary factors if the fiduciary also considers non-pecuniary factors (*i.e.*, "break the tie").[7]

In considering the future investment returns and risks of different investment options, we believe it is unlikely that an ERISA fiduciary will be able to adequately document that those investment opportunities are economically indistinguishable. In considering investment options, ERISA fiduciaries will seldom consider two investment funds and find the "same target risk-return profile or benchmark, the same fee structure, the same performance history, the same investment strategy, but a different underlying asset composition."[8] Indeed, the DOL acknowledges this likely outcome, stating such a standard will almost never be met under this framing of the criteria. As

[6] Field Assistance Bulletin No. 2018-01 (April 23, 2018).

[7] Release at 39117.

[8] *Id.*

such, we do not believe the "economically indistinguishable" standard clarifies ERISA fiduciaries' well-accepted obligations, but instead creates a new standard. Importantly, this new standard could harm plan participants and beneficiaries as ERISA fiduciaries may forgo beneficial investment opportunities that incorporate ESG factors because of concern they cannot adequately document compliance with the new, heightened standard.

In addition to the concerns that the proposed "economically indistinguishable" language creates a new standard that ERISA fiduciaries likely will not be able to meet, we are concerned that the Proposed Rule suggests an artificial distinction in how investment managers incorporate ESG factors into their decision making. As discussed above, integrating ESG factors is rarely a binary choice between furthering pecuniary goals and sacrificing returns or increasing risk to achieve non-pecuniary goals. As a result, we believe the standard in the Proposed Rule on economically indistinguishable alternative investments, together with guidance in the Release, will result in ERISA fiduciaries shunning investments that include consideration of ESG factors in most, if not all cases, because of concerns about potential liability under the DOL's Proposed Rule. Even where a fiduciary believes that a particular investment that includes ESG factors has the potential to provide enhanced risk-adjusted returns over a comparable investment that does not include ESG factors, ERISA fiduciaries will fear that the investment performance will be judged in hindsight.

The Associations respectfully suggest that the DOL consider alternative language in addressing this important issue, for example, requiring an ERISA fiduciary to document that, based on consideration of pecuniary factors (which may include ESG factors that meet the standards of the Proposed Rule), a fiduciary has concluded that the investment is prudent and that the fiduciary has concluded that its consideration of any non-pecuniary factors is not sacrificing investment returns or accepting increased risk. We believe that this approach is more consistent with clarifying how an ERISA fiduciary can meet its obligations and creates less risk of being interpreted as creating a new, higher standard. We further encourage the DOL to clarify in its discussion of "economically indistinguishable alternatives" that ESG factors may be appropriately considered and weighted as pecuniary factors in analyzing available alternative investments.

3. The Prohibition on ESG-Oriented Investment Funds as Qualified Default Investment Alternatives Underscores the DOL's Overly Skeptical View and Will Discourage ERISA Fiduciaries from Considering ESG Investments More Broadly

Although it is not a primary focus of our members to develop investment funds to be designated as Qualified Default Investment Alternatives ("QDIAs"), the DOL's approach in the Proposed Rule to prohibit as QDIAs investments that have ESG-oriented assessments or judgments in their investment mandates, or include ESG parameters in the fund's names, underscores the concerns raised above. The DOL's approach with regard to QDIAs presupposes that all ESG-oriented investment funds, including those that use ESG-oriented assessments or judgments in their investment mandates, involve non-pecuniary aims and, in effect, must sacrifice returns or increase risk for these aims.[9]

[9] Specifically, the Release states that the DOL "does not believe that investment funds whose objectives include non-pecuniary goals—even if selected by fiduciaries only on the basis of objective risk-return criteria consistent with paragraph (c)(3)— should be the default investment option in an ERISA plan. . . . Thus, this requirement in the proposal is intended to help ensure that the financial interests of plan participants and beneficiaries in retirement benefits remain paramount

We do not agree with this premise. As discussed above, we do not believe consideration of ESG factors is a binary choice between furthering risk-adjusted returns and furthering non-pecuniary goals. As discussed throughout this letter, many of our members routinely incorporate ESG considerations into their investment analyses in order to provide enhanced risk-adjusted returns.

Thus, we believe that the provisions addressing QDIAs, and particularly the statements in the Release justifying the prohibition of ESG-oriented investment vehicles as QDIAs, will also significantly discourage plan fiduciaries from selecting investments that integrate ESG considerations more broadly, both as plan investments and as designated investment alternatives for individual account plans. We believe that tipping the scale so strongly against these investments will ultimately harm plan participants and beneficiaries.

MFA[10] and AIMA[11] appreciate the opportunity to contribute to the DOL's efforts to set forth a regulatory structure to assist ERISA fiduciaries in navigating ESG investment trends. If you have any questions about these comments, please do not hesitate to contact the undersigned at (ballensworth@managedfunds.org) or (ajacobs-dean@aima.org).

Respectfully submitted,

/s/ Benjamin Allensworth
Benjamin Allensworth
Managing Director & Counsel,
Tax and Finance
Managed Funds Association

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Adam Jacobs-Dean
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by removing ESG considerations in cases in which participant's retirement savings in individual accounts designed for participant direction are being automatically invested by a plan fiduciary.

[10] The Managed Funds Association (MFA) represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, North and South America, and many other regions where MFA members are market participants.

[11] The Alternative Investment Management Association is the global representative of the alternative investment industry, with around 2,000 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than $2 trillion in hedge fund and private credit assets. AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programs and sound practice guides. AIMA works to raise media and public awareness of the value of the industry. AIMA set up the Alternative Credit Council ("ACC") to help firms focused in the private credit and direct lending space. The ACC currently represents over 170 members that manage $400 billion of private credit assets globally. AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation ("CAIA"), the first and only specialized educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors).