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Modernizing the Social Contract With Investment Fiduciaries

By Tyler Gellasch and Alexandra Thornton November 2020

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Introduction and summary

This report contains a correction.

Over the past several decades, the wages of working-class families have stagnated while corporate buybacks, executive compensation, and mergers and acquisitions have boomed.[1] For many Black working families in particular, who have never been permitted to participate fully in economic opportunities,[2] racial income and wealth gaps have only grown.

Indeed, the voices of working families and other long-term investors often take a back seat to those of corporate executives and short-term oriented market actors. As people across the country continue to face the challenges of the COVID-19 pandemic, deep and persistent racism, climate change, and the collapse of middle-class economic security, a growing chorus of thought leaders are asserting that the country needs a new vision of corporate governance.[3]

Now more than ever, the United States must build a new social contract among companies, investors, working families, and the public. Doing so will not be easy, given that the country will need to implement a wide range of policy changes to align corporate practices with the interests of all stakeholders.[4] Some of the most important but underappreciated actors in this process are the firms that advise and direct the deployment of investor assets. Known loosely as investment fiduciaries, these firms manage the retirement savings, college funds, and assets of millions of American families and businesses. Depending on their choices, they can either facilitate or undermine alignment between corporations and stakeholders.[5] Whether fiduciaries are the investment advisers to mutual funds or private equity funds or the trustees to pension funds, these stewards make critical decisions about how and where to allocate capital, engage with company management, and vote on everything from boards of directors to major corporate strategies and actions.

Put simply, investment fiduciaries are essential market participants that have significant and wide-ranging influence over corporate America. Their influence is not absolute by any means, but it is more significant than that of almost any other set of actors, short of the government.[6] If they were empowered by regulators to prioritize responsible investment strategies, fiduciaries would be well-positioned to help build a new social contract while respecting—and indeed embracing—their core fiduciary duties to investors and beneficiaries.

Fortunately, even without regulatory intervention, many investment fiduciaries have led the demand for better corporate alignment around environment, social, and governance (ESG) factors.[7] In fact, many already consider climate change,[8] worker treatment, corporate political spending, international tax avoidance, human rights abuses and other risks in supply chains, and more when making their investment decisions.[9] Regulators need to help standardize and improve these processes, but those in the United States have instead been moving in the opposite direction.

The Trump administration's efforts to prohibit incorporation have been met with significant resistance in the investment world.[10] Investment fiduciaries know that considering ESG factors is a critical component of their responsibilities to their customers and beneficiaries. Yet not all investment fiduciaries are equally forward-leaning, and the scope and reliability of ESG incorporation and ESG alignment vary widely across firms. As investment fiduciaries increasingly market themselves and their products as "sustainable" or offer ESG funds, the lack of accountability around these claims undermines the financial professionals who are truly aligned with ESG goals and leaves investors vulnerable to abuse.

The current U.S. federal laws governing investment fiduciaries—including investment advisers or those managing Employee Retirement Income Security Act (ERISA) plans—generally do not explicitly require integration of ESG factors into fiduciaries' analysis and advice or provide requirements for transparency regarding how ESG issues are incorporated. In order to better support the needs of today's investors, working families, and the broader economy and to reorient corporate governance toward long-term policy alignment with all stakeholders, investment fiduciaries should be required to adopt and publicly disclose policies for how they identify and assess ESG-related risks and opportunities, including how they integrate these considerations into their investment decisions, engagement, and voting.

Companies must also do far more to internalize ESG factors into their own governance as well as provide needed disclosures to facilitate market efficiency and accountability. To that end, the U.S. Securities and Exchange Commission (SEC) should require standardized, reliable, and comparable disclosures for public companies and close the loopholes that permit an ever-increasing amount of capital to be raised outside of regulated, transparent public markets. However, regulators need not wait until company disclosures are in place; they can simultaneously move forward by requiring investment fiduciaries to consider ESG factors as well. In the face of a worsening global climate crisis, America and the world cannot afford to wait.

There is growing consensus that investment fiduciaries must incorporate ESG factors

Many fiduciaries have taken broad steps to integrate ESG considerations into their overall investment processes. In fact, over the past several years, ESG integration has become increasingly common around the world. Spurred by rising global temperatures, economic inequality, and racial tensions, and accelerated by European regulatory reforms,[11] investment firms of all sizes have implemented ESG integration.

In late 2019, the U.N. Principles for Responsible Investment (PRI)—which counts many of the world's largest investors and asset managers as signatories—published an important report clarifying the duties of fiduciaries with regard to integration of ESG issues in investment practice and decision-making:[12]

- Incorporate ESG issues into investment analysis and decision-making processes, consistent with their investment time horizons.
- Encourage high standards of ESG performance in the companies or other entities in which they invest.
- Understand and incorporate beneficiaries' and savers' sustainability-related preferences, regardless of whether these preferences are financially material.
- Support the stability and resilience of the financial system.
- Report on how they have implemented these commitments.

A follow-up U.N. PRI analysis showed that asset owners are increasingly considering ESG factors in selecting managers of their assets.[13]

In the United States, many large investment advisory firms have sought to integrate ESG considerations into their investment processes—including asset identification, valuation, and engagement—recognizing that doing so helps them identify companies that are well-managed and more forward-thinking.[14] For example, the CEO of one leading investment advisory firm recently said, "Integrating ESG considerations into our fundamental research has helped the firm identify well-managed companies that are leaders in their industries, more forward-thinking, better at anticipating and mitigating risk, and focused on the long term."[15]

A 2020 U.S. Sustainable Investment Forum Foundation report estimated that about $17 trillion in professionally managed assets incorporated ESG factors, comprising about one-third of all such assets in the United States. It further found that this type of sustainable investing had grown by 42 percent from 2018 to 2020.*[16] The COVID-19 pandemic has only reinforced the urgency of adopting ESG considerations.[17] As the pandemic unfolded, firms that did not have robust relationships with employees or solid supply chains suddenly found themselves facing significantly greater financial risks. Similarly, employees in many companies suddenly found themselves experiencing unemployment, loss of pay, and in some cases, more dangerous working conditions.[18]

U.S. investment fiduciaries' rapid uptake of ESG integration into their investment processes also reflects the fact that ESG factors—including climate-related risks, worker pay and policies, political spending, and tax practices—can have significant effects on investment performance over time.[19] For example, the New York City Employees' Retirement System adopted a responsible contractor policy after an analysis showed that such policies were profitable.[20] And outside of the United States, an analysis of European-domiciled sustainable funds found that most outperformed their average traditional peers over the course of 10 years.[21]

The movement toward ESG is not just about investment performance but also about financial stability and retirement security. The fewer fiduciaries that accurately and consistently integrate ESG considerations related to climate change, the more vulnerable Americans' savings will be to systemic climate risks that could leave investors exposed to losses from fossil fuel-related investments.[22] Unfortunately, U.S. regulators are not acting in accordance with this reality.

U.S. regulations for investment fiduciaries are outdated and lag behind those in the rest of the world

Investment fiduciaries in the United States are generally subject to the federal securities laws, ERISA, and/or state securities and retirement fund laws. The U.S. Department of Labor administers ERISA, which sets minimum standards for the management of retirement and health plans established voluntarily by private employers, including information about conduct of plan managers and other fiduciaries. The Investment Advisers Act of 1940 defines the responsibilities of people and firms that provide investment advice for a fee and requires investment advisers to register with the SEC and conform to regulations designed to protect investors.[23]

In recent years, some states have adopted laws that require their pension plans to consider ESG factors.[24] However, while all investment fiduciaries in the United States are generally required to adhere to duties of loyalty, care, honesty, and prudent investment,[25] at the federal level, neither federal securities laws nor ERISA impose any requirements on investment fiduciaries to specifically identify, assess, and address ESG-related risks. As discussed later in this report, this is in contrast to the practices of many countries outside of the United States.

In the absence of U.S.-based regulatory requirements, investment fiduciaries in the United States that have begun integrating ESG considerations have typically developed customized, ad hoc processes to identify, assess, and address the risks and opportunities posed by issues such as climate change, international tax avoidance, or worker treatment. Some investment fiduciaries voluntarily provide their policies, procedures, and practices to customers, beneficiaries, or the public, while others do not. Some have no such policies, while others integrate risk assessment practices across the firm's investments, irrespective of whether the investments themselves are ESG-focused.

In short, the lack of regulatory obligations has led to inconsistent practices, which in turn makes it challenging for asset owners, retirement plan beneficiaries, regulators, and the public to compare different external managers, much less assess whether fiduciaries are doing what they claim.

Under the Trump administration, U.S. fiduciary regulations are moving in the wrong direction

As the popularity of ESG investing has increased, questions have arisen about how investment fiduciaries can best integrate ESG considerations into their investment decisions.[26] Rather than acknowledge the clear benefits of ESG-conscious investing to investors and other stakeholders and improve on investment fiduciaries' efforts to achieve better ESG integration, the Trump administration has moved to quash ESG integration, effectively pressuring fiduciaries to focus only on short-term financial returns—a strategy that benefits fossil fuel firms and their wealthy investors. For example, in June 2020, the U.S. Department of Labor proposed severely limiting the ability of ERISA plan fiduciaries to consider ESG factors in their investment processes.[27] Two months later, the agency reportedly sent enforcement letters to investment fiduciaries seeking extensive information regarding their consideration of ESG factors—enforcement that, along with the earlier proposed rule, could have a chilling effect on fiduciaries' consideration of ESG factors.[28] While the final rule that was adopted in October 2020 is less troubling in some ways than the proposal, it still is likely to have a severely chilling effect on ESG integration and ESG investing.[29] In fact, the new rule effectively prohibits fiduciaries from using funds that consider ESG factors as Qualified Default Investment Alternatives. This change, which is scheduled to come into effect in mid-January, could result in significantly less ESG investing.

Meanwhile, at the SEC, years of pleas by investors for more and better ESG-related disclosures have been roundly ignored. Instead of making it easier for investors to identify, assess, and address ESG factors, the agency has focused on enforcement of claims. For example, in 2019, the agency reportedly investigated certain investment advisers to determine the extent to which firms were adhering to their disclosed ESG-related practices or the principles they purportedly had adopted as signatories to the U.N. PRI.[30]

In some cases, fiduciaries may be misleading their investors and the public, in the same way that companies or funds market themselves as green, sustainable, or ESG-conscious even if their practices do not align with those claims. This practice is sometimes called "greenwashing" and is incentivized by the fact that investors are increasingly flocking to ESG products, for which investment fiduciaries can often charge premiums.[31]

Clearly, investment fiduciaries' claims deserve scrutiny from regulators and private plaintiffs.[32] Yet rather than focusing solely on perceived greenwashing concerns[33] and reducing the ability of ERISA plan fiduciaries to consider ESG factors or vote on them in proxies,[34] U.S. regulators should be promoting improved ESG integration and transparency to ensure that fiduciaries responsibly report their ESG policies and procedures. In fact, by promoting standardized practices and public disclosures, the risks of greenwashing should diminish significantly.

Interestingly, the hostility toward ESG integration in the United States seems to be found largely at the federal level. Some state pension plans have long adhered to sustainability policies and practices, and state government action to encourage consideration of sustainable investing has taken off in recent years. Most notably, Illinois passed its Sustainable Investing Act in 2019.[35] While this act solely mandates that entities managing public funds should integrate "material, relevant, and decision-useful sustainability factors" into their policies, process, and decision-making, it also lays the groundwork for what mandating sustainability considerations for investors more broadly might look like at the federal level.[36] In this case, the sustainability criteria defined in the law regulate the process through which investment advisers can integrate sustainability factors into their decision-making, but they do not prescribe a specific desired outcome.

While U.S. federal regulators are marching in the wrong direction under the Trump administration's policies, advisory committees for those regulators, which are comprised of a wide range of market participants, have sounded the alarm and made significant recommendations for reform:

- In May 2020, the SEC's Investor Advisory Committee made a number of ESG-related recommendations to the agency.[37] In calling for the SEC to require companies to make ESG disclosures, the committee noted that asset owners and managers are "required to comply with ESG reporting obligations, integrate related policies and procedures, and take ESG factors into account as part of their compliance with statutorily imposed fiduciary duties outside of the US and client-driven mandates within (and outside) the US."[38]
- Similarly, a September 2020 report of a subcommittee of the Commodity Futures Trading Commission concluded that climate change poses a systemic risk to U.S. financial markets[39] and, among other findings and recommendations, appeared to recommend a reversal of the U.S. Department of Labor's June 2020 proposed rule that severely limited ERISA fiduciaries' consideration of ESG factors.[40]

Meanwhile, international regulators are forging ahead

In much of the rest of the world, regulators have adopted a significantly more favorable approach to ESG integration in recent years. For example, in 2019, the International Organization of Securities Commissions (IOSCO)—whose members regulate more than 95 percent of the world's securities markets in more than 115 jurisdictions[41]—recommended that institutional investors, asset managers, and asset owners, consistent with their fiduciary duties, "incorporate ESG-specific issues into their investment analysis, strategies and overall governance, and take into account material ESG disclosures of the entities in which they invest."[42] In addition, the European Securities and Markets Authority issued technical advice to the European Commission calling for asset managers to establish decision-making procedures that take sustainability risks into account and to disclose these policies, including their underlying methodologies.[43] In early 2020, the United Kingdom proposed requiring pension funds to disclose how they integrate climate change concerns across their governance, strategies, and risk management.[44] And in August 2020, the United Kingdom went so far as to propose requiring defined benefit and defined contribution schemes to have detailed, public policies for identifying, assessing, and addressing ESG issues.[45]

These international efforts have already had significant effects on the practices of investors around the world. In 2019, the U.N. Environment Programme and U.N. PRI released a report finding that global markets have made significant progress incorporating ESG issues into investment fiduciaries' duties, including in Canada, China, the European Union, and the United Kingdom. The same was not found true of U.S. markets.[46] As the SEC's Investor Advisory Committee alluded to in its May 2020 recommendations, requiring all U.S. investment fiduciaries to successfully incorporate ESG issues into their processes would harmonize standards in a positive way for investors and companies in the United States and throughout the world.

Requiring ESG-conscious investing would yield many benefits

As mentioned above, the fact that investment fiduciary firms in other countries already have to incorporate ESG issues suggests that a similar requirement for all fiduciaries in the United States would provide consistency for these firms and their clients. ESG-conscious investing by fiduciaries could push companies to more quickly identify and disclose the ESG risks they face. In addition, by explicitly requiring ESG integration and establishing clear rules for disclosure, greenwashing and other misleading practices can be held to a minimum.

Critics of ESG-conscious investing sometimes argue that investing should only focus on financial returns, which are often interpreted on a fairly short-term horizon. However, this view glosses over risk and overlooks that the primary interest for most investors is risk-adjusted returns.

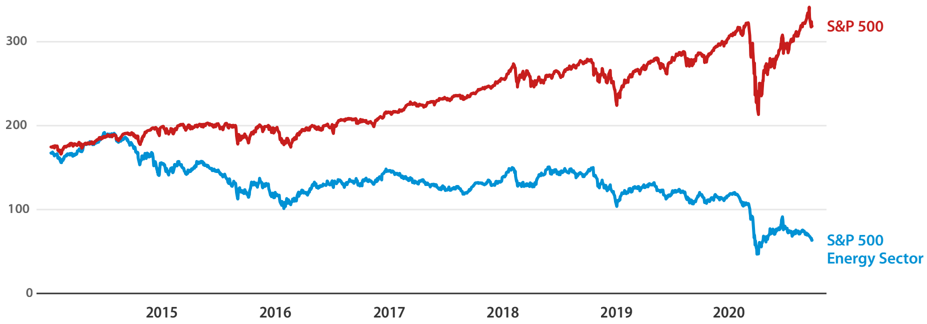
A significant and growing amount of research suggests that ESG-conscious investing performs at least as well as, if not better than, investment approaches that do not factor in these issues.[47]

This is in part due to the fact that ESG-conscious investment can help firms spot risk signals earlier than if they are singularly focused on short-term financial returns. ESG analysis tends to highlight developing risks that are not yet affecting—or being measured in a way that affects—short-term returns. As a basic example, the energy sector of the S&P 500 has been in trouble for a decade and underperformed the rest of the index since 2014.[48] Therefore, an ESG-minded investor who decided 10 years ago to invest in the S&P 500 but exclude the energy components—which are almost exclusively oil and gas firms—would have significantly outperformed the overall market. That is not an accident. Investors are increasingly aware of the risks posed by fossil fuel investments and have voted with their dollars. The entire U.S. coal industry's market capitalization, for instance, has dropped precipitously over the past decade.[49]

FIGURE 1

The S&P 500 Energy Sector has persistently underperformed the S&P 500 index from 2014 onwards

Performance of the S&P 500 Energy Sector compared with that of the S&P 500 index, January 2014–September 2020



Source: S&P Dow Jones Indices, "S&P 500 Energy," available at https://www.spglobal.com/spdji/en/indices/equity/sp-500-energy-sector/#overview (last accessed October 2020).

Critics have also raised significant questions about the reliability of data inputs and analysis around ESG factors. Unquestionably, corporations should be mandated to provide standardized and comparable disclosures using robust methodologies. That the SEC has failed to adequately keep up with the needs of investors and the public should not, however, be an excuse for continued inaction on investment fiduciaries.

A great deal of relevant ESG-related information is available, and many investment fiduciaries in the United States and abroad are already making use of it. Moreover, the approach proposed in this report is flexible. For risks that are longer term or harder to measure, investment fiduciaries could take these considerations into account in different ways. Companies, investors, and regulators around the world are already taking steps to address and combat the effects of climate change, and the United States must do so as well.[50] Systems for change must be set up simultaneously, including systematic integration of ESG factors into investment fiduciaries' analysis.

The most recent report of the Financial Stability Board's Task Force on Climate-Related Financial Disclosures—which analyzes on an annual basis the worldwide take-up of its 2017 recommendations for disclosure of climate-related financial risks—found that asset manager and asset owner reporting is likely insufficient and that more progress is needed to ensure that clients and beneficiaries have the information they need.[51] As the report states, "the appropriate pricing of risks and efficient allocation of capital depends on all parties in the investment chain providing sufficient decision-useful information to one another," and asset owners and managers "may encourage better disclosures across the investment chain," including by underlying companies.[52]

If the SEC continues to drag its feet on mandatory corporate ESG disclosure, it would be even more important to press forward with ESG transparency for investment fiduciaries. Without publicly available investment policies that clearly lay out investment fiduciaries' approaches to ESG-related issues, it will be extremely difficult for beneficiaries, the public, and regulators to hold fiduciaries accountable.

Policy recommendation: Sustainable investment policies

The United States urgently needs to modernize expectations for investment fiduciaries. Investment fiduciaries need to adapt to changing markets and respond to calls from investors to better integrate ESG factors into their investment processes. They must also be held accountable for their sustainability claims. One efficient way to do so would be to require investment fiduciaries to adopt and disclose sustainable investment policies that could be readily understood and compared to one another.[53]

Recently, SEC Commissioner Allison Herren Lee, in a speech to the Practising Law Institute, suggested that the agency consider requiring investment advisers to "maintain and implement policies and procedures governing their approach to ESG investment."[54] She noted that this could include how an adviser handles a client's ESG preferences.[55]

As a starting point, the Center for American Progress recommends that the federal government modernize ERISA, the Investment Advisers Act, and the rules adopted pursuant to them to mandate that each ERISA plan fiduciary and SEC-registered investment adviser prepare and publicly disclose a sustainable investment policy that identifies specific ESG-related factors that the fiduciary considers as part of its investment, voting, and engagement duties and describes how the investment fiduciary handles those factors in the course of the execution of its duties.[56] At a minimum, the factors mandated for consideration should include climate and environmental risks; worker rights, compensation, health and safety, and diversity and inclusion; political spending and lobbying practices; corporate tax risks; competition strategy risks; and supply chain risks, including human rights, among others that are commonly required by national and internationally recognized independent sustainable investing standard-setters.

A sustainable investment policy should describe whether and how these ESG factors are included in investment processes. As the Investment Company Institute explains, inclusion of ESG factors exists along a continuum, from no inclusion at all, to integration of ESG factors into traditional investment processes along with other material factors and analysis, to sustainable investing in which a firm actively uses ESG analysis as a significant part of its investment thesis.[57] In this way, investors could distinguish between a fund that, for example, includes oil and gas investments alongside investments in wind and solar energy production so long as both meet financial return objectives and a fund that also seeks sound financial return objectives but expressly excludes investments in companies that run counter to climate goals.

Thus, a sustainable investment policy should:

- Identify all ESG issues that the fiduciary includes in its analysis.
- Explain how the fiduciary integrates the ESG factors at each stage of the investment life cycle, including engagement and voting activities.[58]
- Explain how its factors address the overall long-term well-being of beneficiaries.
- Commit to using the fiduciary's best efforts to implement the ESG-related preferences of their beneficiaries, including with respect to engagement and voting.[59]

Additionally, a sustainable investment plan should be:

- Publicly filed with the appropriate regulator—for example, the U.S. Department of Labor or the SEC
- Disclosed, perhaps during the account opening process and periodically thereafter
- Subject to basic record-keeping obligations to ensure compliance
- Subject to annual audits by independent auditors, with disclosure thereof
- Subject to examination by the relevant regulators

There is a risk that some investment fiduciaries may make imprecise and unhelpful disclosures. Regulators should demand both precision and auditing of disclosed policies based on available data. Of course, these efforts should proceed in tandem with regulatory and other federal initiatives to expand and improve ESG disclosure by underlying companies and to develop standardized data and methodologies.[60]

Ultimately, a sustainable investment policy mandate should be expanded to cover broker dealers and other investment fiduciaries, regardless of the types of assets in which they invest, including equities, commodities, real estate, and fixed income. This type of approach is important to protect all investors and ensure that full alignment of long-term outcomes is achieved across all types of fiduciaries. It would also help to ensure that the broadest swath of assets under management is covered under a sustainable investment plan.

In this regard, a significant benefit of this proposal is that it would cover fiduciaries that provide investment advice related to investments in both public and private companies. While the latter might not be covered by any future SEC regime mandating public company ESG disclosures, investors would still have the benefit of fiduciaries' guidance on ESG factors when investing in private firms. To the extent that investment fiduciaries are taking up opportunities to invest in nonpublic companies, it is ostensibly on the grounds that they are sophisticated institutional investors that are able to secure adequate information from investment targets on their own behalf. To that end, ensuring that sustainable investment policies apply to private market investments is more critical than ever.

Another benefit of this approach is that it would not require changing fiduciaries' duty of care or loyalty under ERISA or the Investment Advisers Act. While changes to duties of care and loyalty may be appropriate for regulators to consider, those are left to other proposals.

The real-world impact of this proposal on investors would be significant. Individual investors tapping investment advisers for advice on how to manage their portfolios would better understand how those advisers consider sustainability factors. A sustainable investment policy mandate on investment fiduciaries should also be complemented by related disclosures by underlying investment vehicles. For example, a mutual fund's required disclosures via prospectus or statement of additional information should reflect the fund's implementation of its advisers' sustainable investment policy.

The resulting transparency would also help external evaluators analyze funds' holdings and strategies to improve investor outcomes. For example, investment research firms currently provide data and analysis of ESG-specific investment funds, but consistent, comparable information about investment fiduciaries is often hard to obtain. If investment fiduciaries were required to adopt sustainable investment policies, research firms could assess those policies and test for fiduciaries' compliance. As mentioned above, due to the significant investor appetite for ESG investment products and investment products that consider ESG factors, this comparability would provide a "carrot-and-stick" mechanism for fiduciaries to better identify, assess, and act on ESG risks, including with respect to engagement and proxy voting.

Sustainable investment policies would assist regulators and financial industry experts in clarifying different types of ESG-related investment strategies. These efforts include the Investment Company Institute's initiative to develop and implement a self-categorizing regime for ESG funds.[61] Many investment fiduciaries—including those that already have robust ESG integration policies—may not be eager to have a legally mandated fiduciary obligation to have a sustainable investment policy. However, these standardized policies, which could be used across different jurisdictions and products, actually could shield fiduciaries against liability to regulators or private plaintiffs for alleged greenwashing.

Conclusion

Building a new social contract among companies, workers, society, and government will require a range of policy tools and aggressive actions, as ESG issues such as climate change have grown increasingly urgent over the past few decades. To that end, financial regulators—given their oversight responsibilities over capital markets and investment fiduciaries—have vital roles to play.

Regulators will need to step in to help develop and standardize data that will enable individual players in the economy to better understand and change their behavior. While this process will take time, there is no excuse for waiting to drive change among investment fiduciaries and companies. Firms and regulators already have significant information about the benefits of ESG-conscious investing that can form the basis for action now and in the future. Finding better ways to integrate ESG factors into the investment process is an essential step for investment fiduciaries to take.

While regulators in the rest of the world have updated their expectations of fiduciaries, U.S. regulators have affirmatively discouraged ESG integration and ESG investing. Policymakers should modernize the obligations of investment fiduciaries under federal laws to require them to adopt and implement sustainable investment policies. With these policies, investors would be compelled to focus on the risks associated with the world's most pressing challenges and act appropriately. That is not just good for investors; it is good for everyone.

***Correction, November 20, 2020:** This report has been updated to reflect the most recent data on the amount of professionally managed assets in the United States that incorporate ESG factors.*

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62 Tyler Gellasch is also the executive director of the Healthy Markets Association, an investor-focused nonprofit coalition educating market participants and promoting data-driven reforms to market structure challenges. His work on this report, however, is strictly in his personal capacity and not as a representative of the coalition.

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