Mr. Jason A. DeWitt
Office of Regulations and Interpretations
Employee Benefits Security Administration
Room N-5655
U.S. Department of Labor
200 Constitution Ave., N.W.
Washington, DC 20210

Rule Number: RIN 1210-AB95

Dear Mr. DeWitt:

I am writing today to thank you for proposing a new Department of Labor (DOL) rule on June 23, 2020 that outlines clear guidelines for fiduciaries tasked with overseeing the $10.7 trillion invested in private pension plans that are regulated by the Employee Retirement Income Security Act (ERISA). Issuing this new guidance will reaffirm the fact that it is unlawful for ERISA fiduciaries to sacrifice returns, or accept additional risk, through environmental, social and governance (ESG) investments that are intended to promote a social or political end.

ESG investing has been adopted by over 2,300 participating financial institutions around the world with over $80 trillion in assets under management. All of these organizations have signed onto the United Nations Principles for Responsible Investment, which includes six principles for incorporating ESG issues into investment practice. Most of these types of investments are used to further an environmental or social justice cause and often have little to do with sound money management. Rather they are a feel-good approach to investing by those who believe in advancing public policy and political change over maximizing returns.

The proposed DOL provides concrete guidance and reinforces the need of fiduciaries to only consider pecuniary factors when picking investments. The only goal of the ERISA is to maximize returns for private pension funds around the country and to ensure the retirement security for American workers, not to advance social or environmental causes. Given the international and societal pressures many fiduciaries are facing to take part in social causes that could potentially jeopardize the retirements of millions of hard-working Americans with risky so-called politically correct ESG investments, this proposed rule is not only prudent but necessary.

If personal and retail investors would like to include ESG investments in their portfolios to engage in "stakeholder capitalism" – defined by corporate shareholders sacrificing returns for social and environmental obligations and constituencies – that is their prerogative. However, under ERISA the fiduciary's duty is to the retiree alone and to maximizing returns for the American worker's retirement.

Historically, ESG investments have been attractive for the investment firms that offer them, as they maintain a higher expense ratio than traditional investment instruments or standard index funds. According to Wayne Winegarden of the Pacific Research Institute these fees are on average almost 7.7 times higher than broad based index funds. This is great for the fund managers, who receive larger payouts in the form of higher administrative fees, but it comes at the detriment of retirees.

Research has also shown that ESG funds underperform standard index funds which combined with the higher fee structure significantly eat into returns. In fact, an analysis in Bloomberg found that “one of the oldest and largest ESG ETFs on the market…has trailed the S&P 500 Index by 37 percentage points during the past 10 years.” Private pension funds already suffer from unfunded liabilities and further undermining that by investing in funds with substandard returns could deprive future beneficiaries of seeing their contractual retirement as promised.

It is worth nothing though, that the proposed rule does acknowledge that ESG factors can be pecuniary factors, but only under specific circumstances and generally accepted investment theories. The proposal adds new regulatory disclosure analysis and documentation requirements in the rare circumstance when an ESG fund is truly economically ‘indistinguishable’ from other investments, and only then can non-pecuniary factors can be considered.

Another issue related to ESG investing is the proxy voting and shareholder activism. While it has often been abused by activists who do not bear a fiduciary responsibility and often have undisclosed conflicts of interest, it is a tactic that has become increasingly popular with ERISA fiduciaries as well. This is wholly inappropriate.

Historical data shows that waging ESG proxy battles does not enhance shareholder value, thus making it contrary to good stewardship of an ERISA fund. The Department of Labor has acknowledged this fact and in 2018 issued a field bulletin instructing fiduciaries not to incur expenses to actively sponsor such shareholder activism. Unfortunately, the proposed rule as it currently stands does not include language on this matter. Given the temptation for fiduciaries to join a hostile political movement that demands change, regardless of consequences to the economic wellbeing of the nation’s retirement pensions, the rule should be emended to discourage this kind of activity.

One other critique pertaining to the proposed rule would be to strengthen the enforcement mechanisms in place for fiduciaries that may willingly choose to disregard this guidance. The fact that the DOL’s approach is “enforcement by education,” implies that there are expectations of fiduciaries to comply with their legal mandates with no penalties if they put their fund at risk for social or political reasons. This lack of enforcement may need to be revisited.

As a former Arizona State Senator, I helped oversee the Arizona State Retirement System (ASRS) when I sat on the Finance committee. For over 50-years the ASRS has provided retirement security to Arizona’s public employees – including teachers, municipal workers and other government employees – and serves more than half a million members, including more than 100,000 retired members. Ensuring that we could fulfill the promises we made to these civil servants and being held responsible for their financial future has underscored to me the importance of getting pension investing right.

We have seen in the states what can happen if pension funds are close to bankruptcy or are underfunded due to political expediency. In the case of New Jersey, for example, prior Administrations stole billions of dollars from the Public Employees Retirement System with impunity. While some funds have recently been paid back under new leadership the state does not have nearly enough money to cover the shortfall, cheating a generation of public servants of their promised benefits. While the proposed DOL rule will only apply to private pensions, this cautionary tale shows why we cannot allow similar kinds of wounds to be self-inflicted on private pensions through substandard returns.

It is worth restating that this ruling only pertains to private pensions governed by ERISA. 401(k) retirement accounts and other retail investors have every right to choose ESG funds, even if they offer below-market rates of return in exchange for promoting environmental and social justice goals. That type of trade-off may appeal to some investors, but it is not appropriate for an ERISA fiduciary managing other people's retirement funds.

This DOL proposed rule is a great first step to codifying investment decisions pertaining to ERISA governed private pensions and it should be passed and adopted with minor changes. Politics should never play into the field of investments or the contractual duties of fiduciaries who are obligated to maximize returns in their investors' retirement pension funds.

Sincerely,

Lori Klein
Arizona State Senator, District 6 (2011-2013)
Former Member, Appropriations Committee, Subcommittee on Health and Welfare and Finance Committee