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Mackinac Center for Public Policy comment in support:

Financial Factors in Selecting Plan Investments

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# ERISA Fiduciaries Must Invest Money they Control Only for Pecuniary Benefits of Plan Participants and Beneficiaries

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Mackinac writes in support of the Department of Labor's proposed rule, "Financial Factors in Selecting Plan Investments," issued on June 30, 2020.

Founded in 1987, the Mackinac Center for Public Policy is a 501(c)(3) public policy research organization with a well-established history of advocating changes to state and federal labor and pension policies that promote freedom in the workplace and mutually beneficial interactions between workers and job creators.

The Department of Labor is correct in seeking to protect the retirement security of millions of Americans. The proposed rule will help ensure that the $10.7 trillion invested in private pensions are not used for politics.[1] For years, some pension plans have been using the money they control (but do not own) to further the political, social, or environmental views of their administrators.[2]

## Introduction

Recently, funds focusing on environmental, social factors and corporate governance issues (ESG) rather than just financial factors have grown exponentially.

According to Morningstar, the number of funds that said they are now considering ESGs has increased from 81 in 2018 to 564 in 2019.[3]

[1] https://www.wsj.com/articles/retirees-security-trumps-other-social-goals-11592953329?mod=searchresults&page=1&pos=1
[2] https://cei.org/studies-point/your-retirement-or-our-political-agenda
[3] https://www.morningstar.com/articles/972860/the-esg-fund-universe-is-rapidly-expanding

A 2019 study by the Pacific Research Institute, a California-based, free-market think tank, showed that ESG funds "have historically underperformed funds investing in the broader market over the long-term."[4]

The proposed rule would ensure that the $10.7 trillion invested in retirement and benefit plans governed by Employee Retirement Security Act (ERISA), are protected from the political leanings of those that are entrusted to protect the retirement of plan participants and beneficiaries. ERISA is administered by the Department of Labor's Employee Benefits Security Administration.

The rule could immediately safeguard 6.6 million people and $610 billion in defined benefit plan assets that are being used for ESGs instead of maximizing returns and minimizing risk. These numbers, which come from DOL calculations,[5] do not include defined contribution plans, which would likely increase the amount and number of people considerably. The rule would also protect the overall $10 trillion-plus assets in ERISA plans which could be used for ESGs if the rule were not promulgated.

Those entrusted with protecting benefits in ERISA plans have a strict fiduciary duty and must only use the money they control, but do not own, for the pecuniary benefit of plan participants and beneficiaries.

Other factors in making investments, such as ESGs, should only be considered as financial impacts, similar to any other factor affecting risk, return, or diversification. ERISA plans that invest for nonpecuniary interests come in several forms, including economically targeted investments (ETIs), which might be more accurately called PTIs, or politically targeted investments. All of these plans, which have exploded in number and assets in recent years, could violate the fiduciary duty prescribed by section 404 of ERISA.

The language of the proposed rule is correct in prescribing that ERISA fiduciaries should only consider pecuniary benefits of maximizing return, minimizing risk, and diversification of investments.

While the proposed rule improves on the current standard, it should go further in reversing the "all things being equal" test, also known as the "tie-breaker" standard. As the Department notes, this test could invite fiduciaries to choose investments without first making a proper analysis. While it is good to require increased documentation and analysis to determine if two similar investment are truly equal, the test could still allow fiduciaries to put a thumb on the scale to pick a winner based on whether it is or pursues an ESG, ETI, or PTI. It will also increase the cost of investment research.

If two investment are truly equal in terms of risk, return, and diversification, the selection should be made "caput et navia."[6] Other allowances — to take into account personal political or social views of the fiduciary — too easily invite bias.

**History**

[4] https://www.pacificresearch.org/new-study-finds-esg-funds-underperform-broader-investment-funds-over-long-term/

[5] https://www.federalregister.gov/documents/2020/06/30/2020-13705/financial-factors-in-selecting-plan-investments#citation-39-p39121 see FN. 39

[6] Essentially by flipping a coin. Romain coins had a head, sometimes of the god Janus, on one side and a ship on the other hence "caput et navia." https://www.britannica.com/topic/Janus-Roman-god

ERISA governs most private sector retirement and other benefit plans, such as health plans.[7] Section 404[8] of the Act specifies the fiduciary duty of plan administrators and their obligation to the participants and beneficiaries who benefits they safeguard. Courts have consistently held that ERISA requires these fiduciaries act with "complete and undivided loyalty to the beneficiaries"[9], and their actions must "be made with an eye single to the interests of the participants and beneficiaries."[10] The Supreme Court in 2014 unanimously held these benefits are financial. These benefits, it said, do not include "nonpecuniary benefits," and ERISA plan managers have a fiduciary duty to only minimize risk and maximize return with the money they control but do not own.[11]

**Fiduciary duty**

The U.S. Department of Labor has constantly held that the core fiduciary standard owed to plan participants and beneficiaries is financial. The Department under President Obama issued an interpretive bulletin,[12] which again affirmed the fiduciary duty of minimizing risk and maximizing return.

ESG fund performance is likely not equal to the broader market over time. Wayne Winegarden, Ph.D., a Pacific Research Institute Senior Fellow in Business and Economics analyzed 18 ESG funds. He concluded that "a $10,000 ESG portfolio (equally divided across the funds including the impact from management fees) would be 43.9 percent smaller after 10-years compared to a $10,000 investment into an S&P 500 index fund."[13] Similarly, Winegarden found that ESGs have higher costs, 0.69% in expenses as opposed to 0.09% for S&P 500 index funds. Finally, these funds carried more risks because they were less diversified, as PRI notes in its introduction to the study : "37 percent of funds are allocated to the top 10 holdings on average in ESG funds Winegarden studied, compared to 21 percent in a broader S&P 500 index fund."[14]

Fiduciaries that want to invest for ESG, ETI, or PTI causes could put their thumb on the scales and risk the retirement security of participants by making riskier investments or ones with less potential for return. Fiduciaries could also invest with future plans of shareholder activism, with a goal of advancing causes that may then harm the investments and the plan's bottom line.

**All things being equal test**

Unfortunately, the Obama bulletin instituted the "things are equal" test that allowed fiduciaries to take other considerations into account when investing.

The proposed rule notes that ties among possible investments are rare. But it also points to the fourfold explosion of ESG investing in 2019, showing the exponential growth since the Obama bulletin. In light of

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7 https://www.dol.gov/general/topic/retirement/erisa#:~:text=The%20Employee%20Retirement%20Income%20Security,for%20individuals%20in%20these%20plans.

8 https://www.law.cornell.edu/uscode/text/29/1104

9 https://law.justia.com/cases/federal/district-courts/FSupp/609/1221/1886536/

10 https://law.justia.com/cases/federal/district-courts/FSupp/538/463/2296992/

11 https://www.supremecourt.gov/opinions/13pdf/12-751_d18e.pdf

12 https://www.law.cornell.edu/cfr/text/29/2509.2015-01

13 https://www.pacificresearch.org/new-study-finds-esg-funds-underperform-broader-investment-funds-over-long-term/

14 Ibid.

the significant increase in ESG investing, the tendency of some pension funds to engage in PTIs and shareholder activism is growing. [15]

The current proposed rule does place safeguards on the “all things being equal” test. But as is noted in the proposal, the rule still “could invite fiduciaries to find ties without a proper analysis, in order to justify the use of non-pecuniary factors in making an investment decision.”

The safeguards envisioned by the proposal are better than the current allowance, which was created by the Obama administration, but they could also come with increased cost to the plan, diminishing their utility. An even better standard would be to invest “caput et navia” and not allow ESG factors to influence a decision other than the considerations of potential risk or return for an investment.

Absent repealing the “all things being equal” test, the rule correctly reiterates the fiduciary duty of loyalty and helps eliminate some bias by increasing analysis and documentation. Doing so will ensure ESG investments are given the same treatment as other investments, and plan managers are not giving them extra weight. The result will be to improve the retirement security of plan participants and beneficiaries. While the proposal is not as beneficial as one that would require a true neutral decision (it still leaves the opportunity for bias and the increased cost of extra analysis), it is a step in the right direction.

## Conclusion

Investors should be able to invest in ESGs with their own money. But ERISA fiduciaries that are controlling money for others should only invest for the benefit of plan participants and beneficiaries.

The proposed rule would protect the retirement security of millions of Americans and safeguard $10.7 trillion in assets invested in ERISA plans. ERISA fiduciaries should not be able to use the money they control but do not own to invest ESGs, ETI, or PTIs. The duty of loyalty owed by ERISA fiduciaries to plan participants and beneficiaries must be complete and undivided, and they should invest with only an eye to pecuniary benefits.

[15] https://pdfs.semanticscholar.org/fe20/cc4b210a1fdb1cae03e719d91907fb90db46.pdf