July 14, 2020

VIA Email

Megan Sweeney
Employee Benefits Security Administration
United States Department of Labor
200 Constitution Avenue NW
Washington, DC 20210

Re: Release No. 20-997-NAT; 29 CFR Part 2550; RIN 1210-AB95; Financial Factors in Selecting Plan Investments

Dear Ms. Sweeney:

I appreciate the opportunity to submit comments in response to the above-referenced Release regarding Financial Factors in Selecting Plan Investments.

I presently serve as an Associate Professor of Law with tenure at the George Mason University Antonin Scalia Law School. I am also a certified public accountant in the state of Virginia. I also serve on the Investor Advisory Committee of the Securities and Exchange Commission where I and the other members advise the Commission on matters pertinent to investor protection. I am writing in my individual capacity, and my views are my own.

My views are however informed by my work as a professor of Securities Law. My views are also informed by my recent experience as Senior Counsel and Chief Economist to the House Committee on Financial Services, where I took academic leave from my teaching position to serve from May 2013 until April 2015 as an advisor to former Chairman Hensarling on a variety of financial regulatory issues.

The Rise in ESG Investing Raises Unique Challenges for ERISA fiduciaries

The proposed rule text points to data from Morningstar showing that the amount of assets in ESG related funds was four times larger in 2019 than it was in 2018. From my work on the SEC's Investor Advisory Committee discussing ESG issues and related compliance and disclosure problems among ESG providers, I know that there is nowhere near a universal definition of ESG or sustainable impact investing. This begs the question of whether investors are aware of the potential tradeoffs in placing retirement investments into a fund that prioritizes ESG goals, particularly when those goals may be so nebulous as to limit oversight by both the plan beneficiary and the plan fiduciary or provider.

Beneficiaries of retirement funds may lack the expertise to review the performance of the fiduciaries who management their retirement investments. They may further suffer from a collective action problem, in that the marginal benefits of monitoring the fiduciary managing their money may not make it worthwhile for any one beneficiary to invest sufficient resources in overseeing their plan fiduciary.

Their employer may further limit the range of options they have to invest in. If a beneficiary were obligated to only select from a menu of options that all included an option for ESG it may force upon them investment products that are incongruent with their investment goals.

The vague and non-uniform nature of ESG means that providers of ESG focused funds are not readily comparable. Beneficiaries of ERISA funds may be told that their fund is pursuing ESG objectives that are in line with value maximization, when in fact that is not the case. The lack of a uniform definition for ESG investing is what makes it possible for this failure of disclosure to occur.

ESG funds come with higher fees, which may be the reason why some many providers are adding an ESG element to their services. If investors are not made aware of the relative tradeoffs involved, they may be misled into selecting those fund providers when alternative, passive investing strategies may provide them with a better return.

Some supporters of ESG investing have argued that ESG investing tends to result in outsized returns for investors. To the extent that is true, then an ESG fund that can demonstrate this empirically will be able to operate pursuant to rules contained in this proposal.

This will not be true for all ESG focused funds, simply because ESG metrics are often very different from provider to provider. Further, the empirical evidence on superior returns to ESG investments is at best mixed. Halbritter and Dorfleitner find in a Review of Financial Economics piece surveying the literature on the relationship between superior returns and ESG ratings find that "ESG portfolios do not state a significant return difference between companies with high and low ESG ratings" and that "the magnitude and direction are substantially dependent on the rating provider, the company sample and the particular subperiod" and ultimately that "investors should no longer expect abnormal returns by trading a difference portfolio of high and low rated firms with regard to ESG aspects."[1]

<u>Spectrem Survey Data Regarding investor and ERISA Fund beneficiary preference for wealth maximization</u>

Regardless of what investors say they want in their investing goals, the statutory language in ERISA is clear: the fiduciary obligation of a plan sponsor is the objective and relatively high standard of a "prudent person." This carries regulatory obligations to maintain the financial health of the investment through diversification and rigorous investment analysis. This regulatory construction nevertheless continues to serve the needs of retirees well and continues to reflect their stated retirement goals.

I worked with Spectrem Group to design and conduct a survey of 5,000 retail investors to determine their preferences with respect to socially responsible or ESG investing.[2] That survey is attached as an appendix to this comment letter. 67% of the respondents in the survey were defined contribution plan

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[1] *See* Gerhard Halbritter and Gregor Dorfleitner, The Wages of social responsibility—where are they? A critical review of ESG investing, Review of Financial Economics, Volume 26, September 2015, pages 25-35, available at https://www.sciencedirect.com/science/article/abs/pii/S1058330015000233

[2] Spectrem Study is available at https://corpgov.law.harvard.edu/wp-content/uploads/2019/04/Exile-of-Main-Street-A-Spectrem-Group-Whitepaper-Providing-a-Voice-to-Retail-Investors-on-the-Proxy-Advisory-Industry.pdf

investors. This survey demonstrates that the singular focus of retirement investors that motived ERISA's adoption in 1974 is just as relevant today as it was when ERISA was adopted.

When asked about the possibility of instances where shareholder wealth maximization and social responsibility goals are in conflict, the retail investor community strongly supports wealth maximization. 91% of the over 5,000 investors surveyed indicated a preference for wealth maximization over political or social objectives. In fact, 17% of the sample fully aligned with return maximization, whereas only 0.2% fully aligned with political/social objectives. Retail investors' average value in weighing these two factors on a scale of 1-100, 1 being fully aligned toward social investing and 100 being return maximization, was a score of 76%, indicating a more than 3-1 preference for shareholder wealth maximization over political and social objectives.

<u>This Proposal Is Consistent with the legislative purpose of ERISA and subsequent legislation</u>

The ERISA regulatory design was informed by concerns about impediments to collective action. Indeed, the most recent major change to ERISA law contained in the Pension Protection Act of 2006 was motivated by the notion that automatic enrollment would significantly increase beneficiary participation in ERISA funds because beneficiaries pay insufficient attention to retirement savings particularly early in their careers when saving is most important.[3]

That act included a provision that made monumental changes to defined contribution plans, including a provision for automatic enrollment in savings plans unless a beneficiary specifically opts out. These new automatic enrollment plans were encouraged by exemptive relief from certain regular examination obligations otherwise applicable to ERISA covered plans.

The Pension Protection Act also included a provision defining a Qualified Default Investment Alternative, or QDIA, defined as a well-diversified portfolio of investments in a combination of equity investments and fixed income investments like bonds. Use of the QDIA design was encouraged because plans utilizing QDIA accounts were granted the same protection from liability that beneficiary directed investments enjoyed.

Empirical studies of employee participation rates and retirement savings behavior show that employees do not tend to change their contribution rate or the mix of investments in their ERISA accounts after their initial onboarding.[4]

These changes to the landscape for defined contribution plans were premised in part on a lack of financial literacy among plan beneficiaries. A survey of plan beneficiaries issued prior to the adoption of automatic enrollment plans indicates that 38% of plan beneficiaries indicated they had little to no

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[3] *See* John Beshears, James Choi, David Laibson, Brigitte Madrian and Brian Weller, Public Policy and Saving for Retirement: The "Autosave" Features of the Pension Protection Act of 2006, American Economics Association, available at https://www.researchgate.net/profile/Brigitte_Madrian/publication/237286274_Public_Policy_and_Saving_for_Retirement_The_Autosave_Features_of_the_Pension_Protection_Act_of_2006/links/53f4a6d20cf2fceacc6e9592/Public-Policy-and-Saving-for-Retirement-The-Autosave-Features-of-the-Pension-Protection-Act-of-2006.pdf

[4] *See* Beshears at 6.

investing knowledge.[5] Thus even those investors who could overcome the collective action constraints that made it inefficient for them to monitor custodianship of their retirement funds may lack the financial expertise to do so. This is a recipe for trouble that may allow conflicts of interest on the part of plan sponsors and administrators to use ESG goals to divert resources away from retirement security and instead use them to subsidize political objectives of the plan sponsor or administrator.

Thus the logic behind the design of ERISA generally, and of the recent change to facilitate automatic enrollment, is the same logic behind this new rule. To the extent that plan beneficiaries do not want ESG priorities to conflict with their primary goal of investment returns, or to the extent they lack the financial expertise to understand the difference, this new rule codifying existing guidance on non-financial priorities protects the interest of plan beneficiaries.

Evidence suggests this isn't merely a hypothetical concern. The attached survey of retail investors and pension beneficiaries demonstrates that when asked to choose between conflicting goals of investment returns and social governance goals, they overwhelmingly select investment returns as their preferred focus.

Thus, not only is this proposal in line with the statutory requirements of the ERISA Act, it also reflects the policy goals embodied in the statutory amendments and regulation design that are meant to solve the collective action problems and financial literacy constraints that limit beneficiary oversight of plan management.

The lack of active participation by retail beneficiaries presents a very real threat that the beneficiaries focus on maximizing returns, reflected in the ERISA statute and confirmed by this recent survey, will be subsumed into other ESG factors. That distraction of attention from shareholder returns could come about because the ERISA fiduciary simply wants to support a political cause important to them. It may also be the result of plan managers seeking to generate an excuse for added fees despite ESG investments not generating superior returns such that increased fees are justified.

This proposed rule will help to operationalize a focus on shareholder returns by requiring plan administrators to select a fund with ESG components only for those funds that are not QDIAs. One author finds that ESG focused companies do not provide superior returns on their fixed income debt, which has unique implications for the fixed income portion of QDIAs.[6] The level of liability protection afforded QDIAs, combined with the prospect of a clear conflict of interest with ESG investing via QDIAs, demonstrates that ESG focused funds are entirely inappropriate for QDIA investments.

This new rule will further operationalize a focus on shareholder returns by requiring the selection of funds using ESG factors only take place insofar as administrators are able to demonstrate that the ESG factor represents an independent and material economic investment consideration under generally

[5] *See* Beshears at 4.

[6] *See* Bruno Gerard, ESG and Socially Responsible Investment: A Critical Review, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3309650&download=yes

accepted investment theories. This can be accomplished by comparing the investment on the basis of pecuniary factors diversification, returns, or liquidity.

This rule will help to fulfill the original intent behind the ERISA law, which is in part to impose stringent fiduciary duties on plan sponsors to ensure they remain focused on the safety of the retirement savings they are charged with preserving. This rule will also meet the retirement goals of ERISA beneficiaries as they have expressed them in the rigorous Spectrem Group Survey provided as an attachment to this comment letter. I hope this survey is useful in your design of the final rule on this matter

I thank you for considering this comment letter.

Sincerely,

J.W. Verret, JD, CPA

Associate Professor of Law

George Mason University Antonin Scalia Law School