Statement

of

The Honorable Preston Rutledge

to the

United States House Ways and Means Committee

Hearing on

Ensuring that “Woke” Doesn’t Leave Americans Broke: Protecting Seniors and Savers from ESG Activism

November 7, 2023

I am pleased to provide comments to the House Ways and Means Committee on the history and evolution of the Department of Labor ("DOL") guidance on ESG investing by ERISA governed retirement plans.

I am Preston Rutledge, the Founder and Principal of the Rutledge Policy Group. I am the former Assistant Secretary of Labor, and, in that capacity, I led the Employee Benefits Security Administration which has oversight and regulatory responsibility for ERISA employee benefit plans. Prior to assuming the position of Assistant Secretary, I served eight years as the Senior Tax and Benefits Counsel for the Senate Finance Committee, Republican staff. I also served in senior capacities at the Internal Revenue Service and the Office of Chief Counsel, and for many years in private ERISA practice.

DOL History on ESG Investing

The Employee Retirement Income Security Act ("ERISA") was enacted in 1974. The statute includes a prudence standard that requires fiduciaries to discharge their duties with respect to a plan solely in the interest of the participants and beneficiaries and for the exclusive purpose of providing benefits to the participants and their beneficiaries.[1] The solely in the interest standard and exclusive purpose standard are bedrock principles of ERISA and are reflected in the Department's guidance.

The Department has a long history of addressing the use of retirement assets for collateral purposes, that is, for purposes other than or in addition to the provision of retirement benefits to plan participants and beneficiaries. For almost 50 years following the enactment of the historic retirement protection legislation the Department has opined in various forms on the appropriateness of the use and investment of employee retirement funds. I will provide the Committee with a brief history of the evolution of guidance in this area.

The DOL has addressed collateral investment practices in a number of forms, including Interpretive Bulletins ("I.B.s"), Field Assistance Bulletins ("FABs"), and Advisory Opinions (a "DOL Adv. Op." or "AO"). Interpretive Bulletins provide guidance of general applicability to plan sponsors and plan fiduciaries to help them understand their responsibilities under ERISA. Field Assistance Bulletins provide DOL investigators and enforcement staff with clarifications and policy changes. I.B.s and FABs are developed and issued under the Department's general authority to administer the laws and regulations under its jurisdiction. They may reflect changes or clarifications based on court decisions, legislative changes, or interpretations of the Department.

[1] ERISA Section 404(a)(1)

Individuals and organizations may also request specific guidance from the Department. Requests related to ERISA employee benefit plans are handled by the EBSA Office of Regulations and Interpretations under provisions established by ERSIA Procedure 76-1. EBSA responds to inquiries in the form of AOs or Information Letters. AOs apply the law to a specific set of facts submitted by the requestor. Information Letters are used to call attention to established principles or interpretations.

The Department also addresses issues though rulemaking subject to the Administrative Procedures Act, which includes notice-and-comment rulemaking. Issues related to investment practices, the duties of fiduciaries and collateral benefits have been addressed in a variety of these forms throughout the years. I will highlight significant ESG guidance and rulings that the Department has issued throughout the years.

Early Guidance

Advisory Opinions and Information Letters

Soon after the enactment of ERISA the Department was asked to opine on investment practices and collateral benefits. In the first two decades after the enactment of ERISA, the guidance was in the form of Advisory Opinions and Information Letters. A small sample of such guidance is summarized below, which generally reiterated the Department's position that plans could not subordinate a participant's interest in retirement benefits to the pursuit of collateral benefits.

DOL Adv. Op. 85-36A (October 23, 1985)

The DOL addressed the question whether the trustees of a pension plan could make an investment which was part of an overall agreement obligating an insurance company to invest a specified amount of insurance company assets in construction mortgages within the geographic jurisdiction of a union whose members were participants in a pension Fund. The agreement would also have required the insurance company to make such investments in construction projects employing only labor represented by a union and subject to a collective bargaining agreement.

The DOL pointed out that because the investment would cause the plan to forego other alternative investment opportunities, the investment would not be prudent if it provided the plan with less return, in comparison to risk, than comparable available investments. Additionally, the Department noted the investment would not be prudent if it involved a greater risk to the security of plan assets than other investments offering a similar return.

The DOL construed the requirement that a fiduciary act solely in the interest of, and for the exclusive purpose of providing benefits to, participants and beneficiaries as prohibiting a fiduciary from subordinating the interests of participants and beneficiaries

in their retirement income to unrelated objectives. The DOL observed that a decision by a fiduciary to make a plan investment may not be influenced by a desire to stimulate the construction industry and generate employment, unless the investment, when judged solely on the basis of its economic value to the plan, would be equal or superior to alternative investments available to the plan.

DOL Adv. Op. 88-16A (December 19, 1988)

In 1988, the DOL was asked to address whether a company and a union may recommend that a plan allocate up to five percent of annual contributions to investments in residential mortgages in communities with substantial numbers of union members, and loans to nonprofit institutions in communities with large concentrations of union members.

The DOL concluded that the investments, with the potential to provide collateral benefits to union members, would be appropriate under ERISA only if the investment manager retained exclusive investment discretion and was required to obtain the maximum attainable total return, consistent with sound pension fund management. Also, the DOL stated that the plan fiduciary could be influenced by facts not related to investment return only if the investment is equal or superior to alternative available investments.

Information Lette to Mr. Kevin E. Davis (July 17, 1991)

In response to an inquiry whether an ERISA fiduciary may consider the fact that a securities firm is minority-controlled when deciding whether to retain the firm for securities execution services, the DOL responded: "[i]n deciding whether and to what extent to engage a service provider, fiduciaries must ordinarily consider only factors relating to the interests of plan participants and beneficiaries in their retirement income. Such decision may not be influenced by non-economic factors unless the services provided, when judged solely on the basis of economic value to the plan, would be equal or superior to services otherwise available to the plan."

A significant theme of these examples of early DOL guidance was that non-economic factors or collateral benefits could not justify higher risk or supplant maximizing financial return to the plan.

Second Generation Guidance

Interpretive Bulletins and Clarifications

By the 1990s, questions arose over the use of economically targeted investments ("ETIs") by retirement plans. ETIs are investments selected for the economic benefits they create, such as jobs, in addition to the investment return to the retirement plan.

Some plan sponsors and fiduciaries were concerned that the early guidance did not fully address whether ETIs were appropriate. DOL was also concerned that its early guidance had created a perception within the investment community that investments in ETIs were not compatible with ERISA's fiduciary standard. The Department decided to issue an Interpretive Bulletin to address the issue.

Interpretive Bulletin 94-1, 59 FR 32606 (June 23, 1994)

I.B. 94-1 was the DOL's first formal broad-based guidance setting forth the DOL's views with respect to a plan fiduciary's decision to invest plan assets in ETIs. The DOL referred to "certain broad principals" established through previous guidance, principally that ERISA's fiduciary duty provisions require the investment manager to retain exclusive investment discretion and obtain the maximum attainable total return, consistent with sound pension fund management.

The I.B. states that the ERISA investment duties regulation requires the fiduciary to give appropriate consideration to the relevant facts and circumstances, and that consideration of the relevant facts and circumstances includes considering available alternative investments, and not choosing an investment (1) with a rate of return lower than available alternative investments with commensurate degrees of risk, or (2) with higher risk than available alternative investments with commensurate rates of return.

The DOL concluded that ETIs are compatible with ERISA's fiduciary duty obligations if the decision to invest follows these principles.

DOL Adv. Op. 98–04A (May 28, 1998)

Following the issuance of I.B. 94-1, the DOL issued an Advisory Opinion expressing the view that ERISA does not preclude consideration of collateral benefits, such as those offered by a ''socially responsible'' mutual fund, in a fiduciary's decision to designate an investment alternative in an ERISA section 404(c) participant-directed individual account plan. In many ERISA plans, the plan trustee or plan fiduciary makes all investment decisions. However, certain defined contribution plans give participants investment options within a suite of available options selected by the plan trustee. These plan accounts are commonly referred to as participant-directed accounts, or self-directed accounts, because they allow the participant to exercise an amount of independent control over the investment of their individual assets. The DOL stated that the question whether a particular fund or investment alternative satisfies the requirements of ERISA, including section 404(c) is an inherently factual question that the appropriate plan fiduciaries must decide based on all the facts and circumstances of the individual situation.

Interpretive Bulletin 2008-1, 73 FR 61734 (October 17, 2008)

In 2008, the DOL modified and superseded I.B. 94-1 relating to ETIs with I.B. 2008-1. The new I.B. addressed the limited circumstances under which fiduciaries may, in connection with investment decisions, take into account factors other than the economic interests of the plan.

I.B. 2008-1 clarified that a fiduciaries consideration of noneconomic factors (1) should be rare, and (2) when considered, should be “documented in a manner that demonstrates compliance with ERISA’s rigorous fiduciary standards.”

Fiduciaries may never subordinate the economic interests of the plan to unrelated objectives and may not select investments on the basis of any factor outside the economic interest of the plan, except in very limited circumstances. The DOL concluded that proper consideration of the relevant facts and circumstances includes giving appropriate consideration to the role that the investment plays in terms of such factors as diversification, liquidity, and risk/return.

Because every investment necessarily causes a plan to forgo other investment opportunities, the DOL concluded an investment would not be prudent if it would be expected to provide a plan with a lower rate of return than available alternative investments with commensurate degrees of risk or is riskier than alternative available investments with commensurate rates of return.

However, the DOL noted that if two or more investment alternatives are of equal economic value to a plan, fiduciaries could choose between the investment alternatives on the basis of a factor other than the economic interest of the plan - the so-called “tiebreaker” rule. This also has been described as the “all things being equal” test.

Interpretive Bulletin 2015-1, 80 FR 65135 (October 26, 2015)

By 2015, the DOL observed that it had been asked periodically over the previous 30 years to consider the application of ERISA’s fiduciary rules to pension plan investments selected because of the collateral economic or social benefits they may further in addition to their investment returns.

The DOL noted that various terms have been used to describe these collateral investment behaviors, such as socially responsible investing, sustainable and responsible investing, environmental, social and governance (ESG) investing, impact investing, and ETIs. Further, the DOL observed that the terms did not have a uniform meaning and the terminology was evolving.

The I.B. again stated the principle that ERISA does not prevent plan fiduciaries from investing plan assets in ETIs if the ETI has an expected rate of return that is

commensurate to rates of return of alternative investments with similar risk characteristics that are available to the plan, and if the ETI is appropriate in terms of diversification and the investment policy of the plan.

The DOL has stated that the focus of plan fiduciaries on the plan's financial returns and risk to beneficiaries must be paramount and, under ERISA, the fiduciary may not use plan assets to promote ESG at the expense of the financial interests of the plan's participants and beneficiaries. Thus, plan fiduciaries may not accept lower expected returns or take on greater risks to secure collateral benefits.

However, the Department believed that I.B. 2008-1 had unduly discouraged fiduciaries from considering ETIs and ESG factors, even where they would be used solely to evaluate the economic benefits of investments and identify economically superior investments. DOL also was concerned that a documentation requirement added by I.B. 2008-1 set a higher, but unclear, standard of compliance for fiduciaries when they were considering ESG factors or ETIs. The new I.B. stated that ESG factors may have a direct relationship to the economic value of the plan's investment, and in these instances such issues are not merely collateral considerations.

I.B. 2015-1 concluded that the fiduciary standards applicable to ETIs, and the selection of a ''socially responsible'' mutual fund or a designated investment alternative by an ERISA section 404(c) participant-directed individual account plan, are no different than the standards applicable to plan investments generally. Therefore, if the prudence and exclusive purpose requirements of ERISA as applied to fiduciary decisions to invest plan assets are met, the selection of an ETI would not violate ERISA.

Field Assistance Bulletin 2018-01 (April 23, 2018)

The DOL issued FAB 2018-1 to clarify I.B. 2015-1 for EBSA employees fielding calls in the National and Regional Offices. The FAB reiterated the DOL's longstanding position that ERISA fiduciaries may not sacrifice investment returns or assume greater investment risks as a means of promoting collateral social policy goals.

The guidance clarified that I.B. 2015-1 merely recognized that there could be instances when otherwise collateral ESG issues present material business risk or opportunities to companies that officers and directors need to manage as part of the company's business plan and that qualified investment professionals would treat as economic considerations under generally accepted investment theories. The DOL stated that, in such situations, these ordinarily collateral issues (1) are themselves appropriate economic considerations; (2) should be considered by a prudent fiduciary along with other relevant economic factors to evaluate the risk and return profiles of alternative investments; and (3) in these instances, the factors are more than mere tiebreakers.

The DOL then warned fiduciaries to “not too readily” treat ESG factors as economically relevant. The guidance cautioned that it does not necessarily follow that an investment which promotes ESG factors, or that arguably promotes positive general market trends or industry growth, is necessarily a prudent choice for retirement investors.

FAB 2018-1 also addressed the question whether the selection of an ESG-themed fund as a designated investment alternative in an ERISA section 404(c) plan or other individual account plan would be appropriate. The DOL concluded that a prudently selected, well managed, and properly diversified ESG-themed investment alternative could be added to the available investment options on a 401(k)-plan platform in response to participant requests for an investment alternative that reflects their personal values. However, it would not be prudent if the fund would provide a lower expected rate of return than available non-ESG alternative target date funds with commensurate degrees of risk, or if the fund would be riskier than non-ESG alternative available target date funds with commensurate rates of return.

FAB 2018-1 then addressed whether it is appropriate for a fiduciary of a 401(k)-type plan that allows participants to choose from a menu of investment funds to select an ESG-themed fund as a Qualified Default Investment Fund (“QDIA”). DOL stated that in the QDIA context, where the participant by definition has not affirmatively made an investment choice, the decision to favor the fiduciary’s own policy preferences in selecting an ESG-themed option as a default investment without regard to possibly different or competing views of plan participants and beneficiaries would raise questions about the fiduciary’s compliance with ERISA’s duty of loyalty.

Regulations

2020 ESG Final Rule, 85 FR 72846 (November 13, 2020)

The 2020 ESG rule was a “notice-and-comment” rulemaking, the first ESG guidance from the DOL to seek formal public comment. The DOL’s proposed rule received 692 individual comments, and six petitions containing a total of 7,617 signatures, which evidenced the widespread interest in the issue and represented significant stakeholder input.

In the preamble to the final rule the DOL noted the upward trend in use of the term ESG among institutional asset managers, an increase in the array of ESG focused investment vehicles, a proliferation of ESG metrics, services, and ratings offered by third-party service providers, and an increase in asset flows into ESG funds. Studies were cited showing that assets invested in sustainable funds were nearly four times larger in 2019 than in 2018.

The DOL concluded that as ESG investing has increased, it has engendered important and substantial questions due to a lack of precision and consistency in the marketplace with respect to defining ESG investments and strategies. Further, the Department expressed concern about shortcomings in the rigor of the prudence and loyalty analysis by some participating in the ESG investment marketplace.

The DOL observed that there was no consensus about what constituted ESG investing, and that rating systems were vague and inconsistent, despite featuring prominently in marketing efforts. The DOL stated that terms such as ESG, impact investing, sustainability, and nonfinancial performance metrics, among others, encompassed a wide variety of considerations without a common nexus or accepted taxonomy, and could take on different meanings to different people.

The DOL also noted that confusion stemmed from the fact that the ESG investing movement has had multiple goals, both pecuniary and non-pecuniary.[2] The DOL did not attempt to define the term ESG in its final rule. Rather, the rule required the fiduciary to evaluate an investment based only on pecuniary factors. "Pecuniary" was defined as a factor that a fiduciary prudently determines is expected to have a material effect on the risk and/or return of an investment based on appropriate investment horizons consistent with the plan's investment objectives and funding policy.

The DOL noted that ESG funds often come with higher fees, because additional investigation and monitoring are necessary to assess an investment from an ESG perspective (i.e., active management). The DOL stated the regulatory project was undertaken in part to make clear that ERISA plan fiduciaries may not subordinate return or increase risks to promote non-pecuniary objectives.

The rule also banned the selection of an ESG-themed fund as a QDIA in a participant-directed plan due, in part, to the heightened protections necessary in the context of QDIA's. A QDIA is a default investment that exists for participants who do not actively direct the investment of their account and would in operation sweep in many participants and beneficiaries with less investment experience and sophistication than more active investors.

The final rule retained the long-standing position of the DOL that when making an investment decision a fiduciary must give appropriate consideration to the risk of loss and the opportunity for gain associated with the investment, compared to the opportunity for gain associated with reasonably available alternatives with similar risks.

[2] The concept of "nonpecuniary" to describe non-financial factors was introduced by the U.S. Supreme Court in *Fifth Third Bancorp v Dudenhoeffer,* 573 U.S. 409 (2014). The Court stated that the exclusive purpose of providing benefits required of fiduciaries by ERISA must be understood to refer to financial benefits, such as retirement income, and does not cover nonpecuniary benefits like those supposed to arise from employee ownership of employer stock.

2022 ESG Final Rule, 87 FR 73822 (December 1, 2022)

The 2022 ESG rule also was a "notice-and-comment" rulemaking. The proposed rule received 895 individual comments, and six petitions containing a total of 21,469 signatures. Again, evidence of the ongoing strong interest in the issue and active stakeholder involvement,

The DOL announced on March 10, 2021, that it would reexamine the 2020 rule and suspend enforcement. The DOL stated that the new regulatory project was undertaken in response to E.O. 14,030.[3] Additionally the project sought to clarify the application of ERISA's fiduciary duties of prudence and loyalty to selecting investments, including selecting QDIAs, due to the DOL's view that the 2020 rule had created a chilling effect with respect to the consideration of climate change and other ESG factors.

The DOL stated that the 2020 rule created uncertainty and was having the undesirable effect of discouraging plan fiduciaries' consideration of climate change and other ESG factors in investment decisions, even in cases where it was in the financial interest of plans to take such considerations into account. The DOL also expressed concern that fiduciaries would be deterred from taking steps that other marketplace investors may take to enhance investment value or improve portfolio resilience against the potential financial risks associated with climate change and other ESG factors.

The DOL emphasized that it was not changing the long-standing principle that ERISA requires plan fiduciaries to focus on relevant risk-return factors and not subordinate the interests of participants and beneficiaries, by sacrificing investment returns or taking on additional investment risk, to objectives unrelated to the provision of benefits under the plan.

The final rule removed the pecuniary terminology in the 2020 rule, stating that it was causing confusion and having a chilling effect on financially beneficial choices. The DOL said the final rule would clarify that a fiduciary's determination with respect to an investment must be based on factors that the fiduciary reasonably determines are relevant to a risk/return analysis, and that such factors may include the economic effects of climate change and other ESG factors.

[3] Executive Order No. 14,030, (2021) - Climate-Related Financial Risk: A Roadmap for Safeguarding the U.S. Economy. Sec. (4)(b): "Resilience of Life Savings and Pensions. In furtherance of the policy set forth in section 1 of this order and consistent with applicable law and subject to the availability of appropriations, the Secretary of Labor shall…consider publishing, by September 2021, for notice and comment a proposed rule to suspend, revise, or rescind "Financial Factors in Selecting Plan Investments," 85 Fed. Reg. 72846 (November 13, 2020)".

The rule also removed documentation and compliance requirements added by the 2020 rule related to utilization of the tie-breaker rule. In addition, it removed the ban on the selection of an ESG-themed fund as a QDIA.

One of the most notable features of the 2022 final rule was a significant deviation from the proposed rule. The proposed rule included a provision that the analysis by the fiduciary of projected investment return ‘‘may often require” an evaluation of the economic effects of climate change and other ESG factors. In response to public comments, the DOL replaced the ‘‘may often require” formulation with a provision in the final rule that the investment analysis “may include” the economic effects of climate change and other ESG factors.

Conclusion

The Department of Labor has grappled with issues related to retirement plan investment and collateral benefits throughout the nearly five decades of ERISA. The form of guidance and nuances, as well as preamble language and emphasis, have varied across the years and administrations, but the fundamental principle has remained. The north star of ERISA, embodied in the statutory text, is that fiduciaries must discharge their duties with respect to a plan solely in the interest of, and for the exclusive purpose of providing benefits to, the participants and their beneficiaries. The interest of participants and beneficiaries in their retirement income must remain the overriding concern of ERISA plan fiduciaries.

This committee has always taken a leading role in promoting a strong and stable retirement system as a worthy social goal. It has invested heavily in tax subsidies and incentives for the establishment and maintenance of healthy and reliable workplace retirement savings plans. The DOL and the IRS are entrusted to engage in robust and effective compliance oversight with the goal of ensuring well managed plans for the benefit of participants and beneficiaries. The guidance across the years reflects these core values and goals.