Testimony of Professor Max Schanzenbach
Subcommittee on Health, Employment, Labor, and Pensions
"Investing for the Future: Honoring ERISA's Promise to Investors"
Wednesday, April 30, 2025, 10:15 a.m.

Chairman Allen, Ranking Member DeSaulnier, and members of the Subcommittee, thank you for the opportunity to appear before you today to discuss the issues surrounding investing for non-pecuniary reasons and proposed legislation amending the Employee Retirement Income Security Act of 1974 (ERISA). I am Max Schanzenbach, Seigle Family Professor of Law at Northwestern University. I joined Northwestern as an assistant professor of law in 2003 after finishing a clerkship on the Sixth Circuit Court of Appeals and was promoted to full professor in 2006. In 2015, I was named the Seigle Family Professor of Law at Northwestern University. From 2011 to 2016, I was the co-editor-in-chief of the *American Law and Economics Review*. I have recently joined the American College of Trusts and Estates Counsel as an academic fellow.

In my opinion, the *Protecting Prudent Investment of Retirement Savings Act* clarifies critical fiduciary obligations under ERISA while enacting sensible, measured reforms. My testimony and conclusions reflect opinions I have developed over my career based on my research of fiduciary investment law and policy. Broadly speaking, my research is in the law-and-economics tradition. I make use of economic theory and statistical methods to assess the real-world effects of law and legal institutions. Fiduciary investment has been a core part of my academic research. In particular, in "Reconciling Fiduciary Duty and Social Conscience," published in *Stanford Law Review* (2020), coauthor Robert Sitkoff and I argue that ESG investing is permitted for fiduciaries under the same conditions as any other active investing strategy, and ESG investing for risk and return is neither favored nor disfavored under traditional trust law. In that work, we also defend on policy grounds ERISA's prohibition of the consideration of non-pecuniary factors as both sound policy and consistent with Supreme Court precedent. The *Protecting Prudent Investment of Retirement Savings Act* is consistent with these principles.

The Purpose of ERISA

In the course of my research, I have developed a profound respect for the regulatory framework of ERISA. ERISA provides working Americans with tax-favored retirement savings and access to America's deep and efficient capital markets. Presently, ERISA plans, both retirement and welfare, hold an estimated $14 trillion in assets. This is a tremendous pool of savings for investment and is essential to our nation's prosperity. But those retirement savings must be protected to maintain worker confidence and to ensure the best possible retirement. To this end, ERISA requires investment managers to abide by the fiduciary obligations of loyalty and care.

ERISA's Guardrails: Fiduciary Obligation

The ERISA retirement savings framework has generally worked to the great advantage of American workers in part because of the fiduciary obligations imposed on those who have discretionary authority or control over the plan assets. In the now-dominant defined contribution plans, workers are free to choose their own investments within a menu of mutual funds curated by the investment fiduciary. The investment fiduciary does not bear liability for a participant's selection of investments from that menu if it has offered a menu of investment options chosen and monitored consistent with fiduciary obligations of prudence and loyalty.

Thus, workers saving for retirement can rest on some assurance that the investment options have been prudently and loyally chosen, while retaining the freedom to choose within a curated investment menu. In addition, investment fiduciaries may offer a "brokerage window" investment option that allows plan participants the opportunity to access additional mutual funds or individual investments outside the plan menu.

Although ERISA preserves freedom of choice for plan participants, the fiduciary duties of loyalty and prudence imposed by ERISA are important guardrails. This framework keeps ERISA plan sponsors laser-focused on providing beneficiaries with diversification and proper risk and return. A plan fiduciary's duty of loyalty precludes considering outside interests. ERISA's duty of prudence is of equal importance. For example, significant litigation has arisen over fees charged under ERISA plans. Some employers were lax in their obligations of ongoing monitoring and allowed mutual fund share classes to be offered even though participants could have had the identical fund with lower fees. In doing so, they were not disloyal, but imprudent. Liability ensued, and recent evidence is that costs are decreasing in ERISA plans.

Another important safeguard is the advent of Qualified Default Investment Alternatives (QDIA). A QDIA is a default retirement investment for employees who do not exercise their power of choice. Most investment fiduciaries, consistent with DOL regulations concerning QDIAs and fiduciary obligations, have chosen to offer low-cost target-date retirement funds that automatically adjust the risk of the portfolio as retirement draws near. These low-cost, highly diversified funds are widely regarded as having improved the retirement savings of millions of Americans. QDIAs are particularly important because employers are allowed to automatically enroll employees into retirement plans. The great majority of these auto-enrolled employees do not actively choose investments and so wind up in the QDIA.

ESG Investing, Non-Pecuniary Factors, and ERISA

ERISA's fiduciary guardrails have been tested by the advent of so-called ESG investing. Socially responsible investing has long been with us. Prior to the 1990s, proponents of socially responsible investment largely appealed to doing good—they spoke to investors' ethical, moral, and social responsibilities to others. Providing collateral social benefits to third parties is not consistent with the duty of loyalty under ERISA, and avoiding financially sound investments is not consistent with the duty of prudence. For these reasons, socially responsible investing was widely regarded as forbidden under ERISA.

However, beginning in the late 1990s/early 2000s, proponents of social investing rebranded it in two ways. First, they recast the movement as "ESG" investing by adding governance metrics (the "G" in "ESG"). The quality of a corporation's governance is an uncontroversial factor in assessing investment opportunities, thus lending credence to claims that ESG investing could improve portfolio performance. Second, proponents of ESG, pointing to a raft of empirical studies, claimed that environmental and social considerations could also improve portfolio performance. Instead of avoiding the fossil fuel industry for environmental benefits, for example, ESG proponents argued that reduced exposure to fossil fuels would improve returns because the associated litigation and regulatory risks of that sector are underestimated by the market. Thus, ESG investing evolved from social investing into an active investment strategy that purported to seek profit. This rebranding has muddled the goal of ESG investing. Is it to improve financial performance or achieve a social benefit?

During this same period, the Department of Labor issued several subregulatory guidances and later, regulatory guidances, on the use of non-pecuniary factors under ERISA, often focusing on whether the use of non-pecuniary factors as a "tiebreaker" was permissible. Some of this guidance lacked clarity or was misconstrued as reversing earlier guidance. Agency rulemaking in 2020 and 2022 further exacerbated this problem. The 2020 Trump Rule was misconstrued as opposing sound financial evaluation of ESG factors in investing, while the 2022 Biden Administration rule was understood to endorse impact investing or investing for collateral benefits. In truth, both rules reiterated the basic premise that ERISA required investing for financial reasons only. But the issue was clouded in two ways. The original proposals, which were changed following the notice-and-comment period, critiqued (Trump Rule) or endorsed (Biden Rule) ESG investing. The final rules were more circumspect but still elicited some confusion. For example, the regulatory text of the final Biden Rule refers only once to ESG investing, and states that ESG factors "may" be "relevant to a risk and return analysis," depending "on the individual facts and circumstances." Of course, this statement is true for all investment factors, ESG or otherwise, so one wonders why pointing it out was necessary in the first place.

A legitimate source of concern is the Biden and Trump Rule's dueling approaches to the tie breaker. The Trump Rule requires a plan fiduciary to document that two investments are financially indistinguishable before invoking the tiebreaker rule for collateral benefit. This essentially places the burden of proof on the fiduciary, which is appropriate given the rarity of an actual tie and the mixed motives a fiduciary may have in asserting it. The Biden Rule, on the other hand, allows a fiduciary to consider collateral benefits when choosing among or between investment alternatives that "equally serve the financial interests of the plan over the appropriate time horizon." There are two problems with the Biden Rule's language. First, the plan does not have financial interests. Its beneficiaries do. The beneficiaries must be benefited by the investment choices. Considering ERISA's language and Supreme Court precedent, courts should read the phrase "financial interests of the plan" to mean its beneficiaries, but I am unsure they will. The second concern is the use of the phrase "appropriate time horizon." The long-run financial success of ESG factors is often pointed to by ESG advocates, and this language may be a nod to that view. However, time-horizon is not a reasonable concept as applied to a readily marketable individual security. If the security's future value is not reflected in its current price, the security is a buy or sell opportunity whether the underpricing is from near-term or long-term factors (appropriately discounted to present value). Moreover, plan beneficiaries have very different time horizons, ranging from young workers to the currently retired. Not everyone is in pursuit of "long-term" value. Holding investments for current retirees that may not show their true value for decades is not a sound strategy.

The Proposed Legislation

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I believe that the *Protecting Prudent Investment of Retirement Savings Act* improves ERISA regulations by providing needed clarity regarding the use of non-financial factors in ERISA investments while adopting modest reforms that strengthen ERISA's fiduciary guardrails.

First, the proposed legislation rightly clarifies that an investment strategy must be done only for financial purposes. Without naming ESG investing, it puts ESG investing on an equal footing with other active investing strategies. The muddled motives behind ESG-investing have evolved into a strange belief that ESG is magic—that somehow so-called ESG factors can be used to do good and improve risk and return, without tradeoff, and that this will continue forever. That notion is contrary to long-standing financial theory and experience in capital markets. In addition, some of the Department of Labor's back-and-forth rulemaking and guidances misled many people, even some sophisticated actors, into believing that somehow fiduciary obligations are different under ESG investing. They are not. At the same time, nothing in the legislation discourages "risk and return" ESG investing. Few would argue that mass toxic environmental torts, and other legal and regulatory risks, are always immaterial. Active investors may consider such risks.

Second, the proposed legislation continues to allow for the so-called tiebreaker, but under a standard of enhanced documentation. The enhanced documentation requirement ensures that not only loyalty is adhered to but that the costs and benefits of such an investment are regularly assessed—this is the standard of care or prudence. Under such documentation requirements, a fiduciary would have to explain why a tie was present. Doing so will be challenging in liquid financial markets. In such a case, there are arguably no ties. If two investments have the same risk and return attributes, a fiduciary should purchase both and achieve greater diversification. Given the rarity of tiebreakers, placing the burden of proof on the fiduciary to establish one makes complete sense and is a standard approach in the law. In addition, the *Protecting Prudent Investment of Retirement Savings Act* clarifies essential language regarding a tiebreaker.

In the case of a sponsor choosing mutual funds to offer in a plan menu, tiebreakers are somewhat more complicated. One concern is that a fiduciary could claim they did not want to offer too many funds, funds may have very similar risk and return attributes, and thus the fiduciary has invoked the tiebreaker rule to choose funds with social impact because those funds are the financial equivalent of other alternatives. Could an ERISA fiduciary secretly consider non-pecuniary factors, while claiming risk and return as a pretext? Likewise, could it assert a tiebreaker where one really does not exist? Such opportunities depend on the scope of the tie-breaker rule but will be restricted by this legislation. Under enhanced documentation, a fiduciary cannot continue indefinitely with a persistently underperforming ESG (or any other) mutual fund because the fund would not continue to be financially indistinguishable.

Funds that avoid industries or sectors will be very hard to justify. Consider, for example, a so-called screened ESG fund that avoids fossil fuels. Perhaps an ERISA plan sponsor could reasonably argue, at the beginning, that such a fund offered similar risks and returns to other funds because the fossil fuel sector is weak. That ERISA plan sponsor would have to document those reasons—and absolute avoidance of a whole sector runs strongly against modern financial practice and diversification. But more importantly, the sponsor would have to continue to assess the special risks of a fund that imposed such a screen. It is highly unlikely that any sector will offer subpar returns forever—and when that changes fiduciaries will have to drop the fund or face liability.

Third, the legislation prohibits the employer's QDIA from considering non-pecuniary factors. Given the legislation's authorization of a tiebreaker, barring explicitly any non-pecuniary fund from use as a QDIA is a reasonable protective feature for several reasons:

- The QDIA is where investors are placed when they do not specify an investment in the defined contribution plans. As such, they would likely be unaware that the fund relies on non-pecuniary factors and may well disagree with them.
- The "default" investors may be operating on the assumption that the defaults are wisely chosen to provide diversification and appropriate risk and return. Prohibiting funds that rely on non-pecuniary factors protects that reliance.
- There is a lack of clarity around QDIAs and non-pecuniary factors. A Labor Department rule promulgated in the first Trump Administration forbade any fund relying on non-pecuniary factors to be used as a QDIA. The DOL under the Biden administration deleted this prohibition.
- Assuming, absent this legislation, that an ERISA plan sponsor could choose a fund that relies on non-pecuniary factors as a QDIA, well-advised plan sponsors would not do so. QDIAs comprise a large share of savings and their mismanagement would represent an outsized liability, and the use of non-pecuniary fund would increase litigation risk. Not all plan sponsors are sophisticated and well-advised, however, and they rely on investment committees which can make mistakes. A protective rule guards employers as well as workers.

Finally, I strongly recommend to the Subcommittee the *Protecting Prudent Investment of Retirement Savings Act*'s requirement that plan participants using the brokerage window be warned that they are leaving a plan menu chosen under fiduciary obligation. Indeed, brokerage window participants will likely pay the highest fee share class for a mutual fund purchased through the brokerage window. In addition, if they purchase individual securities through the window, they will likely lose some of the benefits of diversification they could obtain in the plan.

Again, I thank the Subcommittee for the opportunity to testify.