



reason
FOUNDATION

OTHER PEOPLE'S MONEY: CAN INVESTING PUBLIC EMPLOYEE PENSION ASSETS TO FURTHER NONFINANCIAL GOALS EVER BE CONSISTENT WITH FIDUCIARY PRINCIPLES?

by Larry Pollack
Project Director: Zachary Christensen

May 2023





reason
FOUNDATION

Reason Foundation’s mission is to advance a free society by developing, applying, and promoting libertarian principles, including individual liberty, free markets, and the rule of law. We use journalism and public policy research to influence the frameworks and actions of policymakers, journalists, and opinion leaders.

Reason Foundation’s nonpartisan public policy research promotes choice, competition, and a dynamic market economy as the foundation for human dignity and progress. Reason produces rigorous, peer-reviewed research and directly engages the policy process, seeking strategies that emphasize cooperation, flexibility, local knowledge, and results. Through practical and innovative approaches to complex problems, Reason seeks to change the way people think about issues, and promote policies that allow and encourage individuals and voluntary institutions to flourish.

Reason Foundation is a tax-exempt research and education organization as defined under IRS code 501(c)(3). Reason Foundation is supported by voluntary contributions from individuals, foundations, and corporations. The views are those of the author, not necessarily those of Reason Foundation or its trustees.

EXECUTIVE SUMMARY

Fiduciaries are people responsible for managing money on behalf of others. The fundamental fiduciary duty of *loyalty* evolved over centuries, and in the context of pension plans sponsored by state and local governments (“public pension plans”) requires investing solely in plan members’ and taxpayers’ best interests for the exclusive purpose of providing pension benefits and defraying reasonable expenses. This duty is based on the notion that investing and spending money on behalf of others comes with a responsibility to act with an undivided loyalty to those for whom the money was set aside.

“

... the approximately \$4 trillion in the trusts of public pension plans may tempt public officials and others who wish to promote—or, alternatively, punish those who promote—high-profile causes.

”

But the approximately \$4 trillion in the trusts of public pension plans may tempt public officials and others who wish to promote—or, alternatively, punish those who promote—high-profile causes. For example, in recent years, government officials in both California and Texas, political polar opposites, have acted to undermine the fiduciary principle of loyalty. California Gov. Gavin Newsom’s Executive Order N-19-19 describes its goal “to

leverage the pension portfolio to advance climate leadership,”¹ and a 2021 Texas law prohibits investing with companies that “boycott” energy companies to send “a strong message to both Washington and Wall Street that if you boycott Texas Energy, then Texas will boycott you.”² Both actions, and others like them, attempt to use pension assets for purposes other than to provide pension benefits, violating the fundamental fiduciary principle of loyalty.

The misuse of pension money in the public and private sectors has a long history. The Employee Retirement Income Security Act (ERISA), signed into law by President Gerald Ford in 1974, codified fiduciary principles for U.S. private sector retirement plans nearly 50 years ago and is used as a prototype for pension fiduciary rules in state law and elsewhere. Dueling sets of ERISA regulations issued within a two-year period during the Trump and Biden administrations consistently reinforced the principle of loyalty. State legislation and executive actions, however, have weakened and undermined it, even where it is codified elsewhere in state law.



Dueling sets of ERISA regulations issued within a two-year period during the Trump and Biden administrations consistently reinforced the principle of loyalty. State legislation and executive actions, however, have weakened and undermined it, even where it is codified elsewhere in state law.



Thirty million plan members rely on public pension funds for financial security in their old age. The promises to plan members represent an enormous financial obligation of the taxpayers in the states and municipalities that sponsor these plans. If investment returns fall short of a plan’s goals, then taxpayers and future employees will be obligated to make up the difference through higher contribution rates.

¹ Gavin Newsom, “Executive Order N-19-19,” Executive Department State of California, 20 Sep. 2019 <https://www.gov.ca.gov/wp-content/uploads/2019/09/9.20.19-Climate-EO-N-19-19.pdf>

² Dave Davies and Rachel Martin, “Texas ban on firms that don’t invest in firearms and fossil fuels is costing taxpayers,” NPR.org, National Public Radio, 1 Sep 2022, <https://www.npr.org/2022/09/01/1120457153/texas-ban-on-firms-who-dont-invest-in-firearms-and-fossil-fuels-are-cost-taxpaye> (accessed 8 Mar. 2023)

The exclusive purpose of pension funds is to provide pension benefits. Using pension funds to further nonfinancial goals is not consistent with that purpose, even if it happens to be a byproduct. This basic understanding has been lost in the recent politically polarized public debates around ESG investing—investing that takes into account environmental, social, and governance factors and not just financial considerations.

It is critically important that fiduciary principles be reaffirmed and strengthened in public pension plans. The potential cost of not doing so to taxpayers, who are ultimately responsible for making good on public pension promises, runs into trillions of dollars. Getting on track will likely require a combination of ensuring the qualifications of plan fiduciaries responsible for investing, holding fiduciaries accountable for acting in accordance with fiduciary principles, limiting the ability of nonfiduciaries to undermine and interfere with fiduciaries, and separating the fiduciary function of investment management from settlor functions like setting funding policy and determining benefit levels.

TABLE OF CONTENTS

PART 1	INTRODUCTION	1
PART 2	WHAT THE MONEY IS FOR AND WHO CONTROLS IT	4
	2.1 Why fund at all?	4
	2.2 Who controls the money?	5
PART 3	FIDUCIARY GUIDING PRINCIPLES	7
	3.1 Loyalty and Prudence	7
	3.2 Duty of loyalty addresses agency risk	8
	3.3 Loyalty is about intent	9
	3.4 Equivalence between investments and expenditures	10
PART 4	CUSTOMARY ADDITIONAL PRACTICES CONSIDERED APPROPRIATE FOR FIDUCIARIES	11
	4.1 Practice #1: Delegating fiduciary responsibility to experts	11
	4.2 Practice #2: Holding fiduciaries personally liable to plan principals for breaches of duty ...	12
	4.3 Practice #3: Acting in accordance with a good-faith interpretation of law and plan provisions	12
PART 5	INCENTIVES AND PRESSURE TO SKIRT FIDUCIARY PRINCIPLES	14
	5.1 Financial and political incentives and temptations	14
	5.2 Historical examples of misuse and corruption	15
	5.3 Case study: California Gov. Gavin Newsom's Executive Order N-19-19	16
	5.4 Case study: Texas law prohibits investing with companies that "boycott" energy companies	18
	5.5 Case study: Kentucky retirement system plan invokes exception from divestment requirement	21
PART 6	THE EMPLOYEE RETIREMENT INCOME SECURITY ACT (ERISA)	23
	6.1 ERISA codified common law principles of fiduciary stewardship	23
	6.2 "Collateral Benefits" – nonfinancial goals in investing and exercising shareholder rights ...	24
	6.3 Prohibitions on self-dealing ("prohibited transactions")	29
	6.4 Personal liability of pension fiduciaries for breach of duty to participants	29
PART 7	CURRENT STATE LAWS AND PROPOSED MODEL LAWS	31
	7.1 Codification of core fiduciary principles in the states	31
	7.2 The Uniform Law Commission (ULC)	32
	7.3 The Uniform Prudent Investors Act (1994)	33
	7.4 The Uniform Management of Public Employee Retirement Systems Act (1997)	33
	7.5 American Legislative Exchange Council's (ALEC): State Government Employee Retirement Protection Act	35
PART 8	TAKEAWAYS AND BEST PRACTICES	37
PART 9	CONCLUSION	42
	ABOUT THE AUTHOR	44

PART 1

INTRODUCTION

State and local governments that sponsor defined benefit pension plans—and often the employee members of those plans—contribute money to a trust from which promised pension benefits are ultimately paid. Pension benefits are earned over members' careers, during which the trust is funded. The assets in those trusts must be invested until promised benefits are paid.

“
The amount of money in state and local pension trusts is enormous, approximately \$4 trillion as of June 2022.

”

The amount of money in state and local pension trusts is enormous, approximately \$4 trillion as of June 2022. This figure is equivalent in dollar amount to:

- More than 15% of annual U.S. gross domestic product; or
- Close to 12% of the December 31, 2022 market capitalization of the S&P 500; or
- Close to 10% of the December 31, 2022 total market capitalization of all U.S. based public companies listed on the New York Stock Exchange plus the Nasdaq Stock Market plus the OTCQX U.S. Market (the tier of stocks traded “over-the-counter,” as

opposed to on an exchange, that is subject to the most stringent level of regulatory requirements), according to Sibilis Research³.

These large pools will continue to be held in pension trusts and must be invested over many decades. As state and local pension plans were, as of fiscal year-end 2021, underfunded in aggregate by somewhere between \$1.1 trillion and \$6.5 trillion,⁴ these asset pools should grow in the future.

The boards of trustees of those pension plans are most often responsible for overseeing investments, though in some cases, oversight is the responsibility of a single government official or a separate entity of investment professionals. Those responsible for investments are “agents” acting on behalf of member and taxpayer “principals.”

People responsible for overseeing the investment and disposition of trust money on behalf of others are known as “fiduciaries.” In 1928, Benjamin Cardozo (later a Supreme Court justice), explained the nature of fiduciary responsibility as requiring “something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive ... undivided loyalty ... a level higher than that trodden by the crowd.”⁵

“

... public pension fiduciaries operate in an increasingly political and contentious environment, and one where pension funding comprises a growing share of government budgets.

”

In the public pension plan universe, fiduciaries overseeing investments directly—either managing the money or appointing those who do—are sometimes not free to act in accordance with the fiduciary principles of loyalty and prudence that have evolved over

³ “Total Market Value of the U.S. Stock Market,” sibilisresearch.com, Sibilis Research, 31 Dec. 2022, <https://sibilisresearch.com/data/us-stock-market-value/> (accessed 3 Mar. 2023)

⁴ Oliver Giesecke and Joshua D. Rauh, “Trends in State and Local Pension Funds,” *Annual Review of Financial Economics*, Volume 15, Forthcoming, Stanford University Graduate School of Business Research Paper No. 4258469, Available at SSRN: <https://ssrn.com/abstract=4258469> (31 Oct. 2022)

⁵ *Meinhard v. Salmon*, 164 N.E. 545 (N.Y. 1928) (New York Court of Appeals)

centuries in the context of other types of trusts. Legislative and executive actions may restrict their ability to do so.

Even absent such restrictions, public pension fiduciaries operate in an increasingly political and contentious environment, and one where pension funding comprises a growing share of government budgets. Fiduciaries thus face pressure to aim for high returns that may incline them toward riskier investments—with higher hoped-for future returns paired with lower current contributions—than they would choose if they were simply investing a pot of money to achieve reasonable returns with a prudent amount of risk. This pressure to aim for higher returns probably accounts significantly for the more aggressive portfolios seen in public sector plans versus private sector plans, despite both types of plans being subject to similar fiduciary rules.

This brief is mostly concerned with applying fiduciary *principles* that evolved over centuries in nonpolitical contexts, where the interests of trust principals are paramount. In the context of public pension plans, those fiduciary principles form the relevant basis for judging the appropriateness of taking nonfinancial factors into account in investing pension assets. The extent to which plan investment fiduciaries are able to adhere to those principles forms the proper basis for judging the appropriateness of restrictions imposed by legislation or executive actions.



The extent to which plan investment fiduciaries are able to adhere to those principles forms the proper basis for judging the appropriateness of restrictions imposed by legislation or executive actions.



It is important that the fundamental principles of trust law that have shaped pension conduct not be weakened in the face of the conflicts and temptations that are bound to arise in investing \$4 trillion on behalf of 30 million plan members. To understand why fiduciary principles evolved as they did, it is helpful to start by considering why the money is set aside in the first place.

PART 2

WHAT THE MONEY IS FOR AND WHO CONTROLS IT

2.1

WHY FUND AT ALL?

Pensions are a form of deferred compensation. In exchange for employee services now, in lieu of paying some portion of compensation immediately in cash, employers that sponsor traditional defined benefit (DB) pension plans promise an annuity for life in retirement, often many years in the future. Legally and economically, this form of deferred compensation represents a long-range employer debt to its employees.

Why don't government sponsors of pension plans simply pay the pensions of current retirees as they come due out of the annual operating budget ("pay-as-you-go")? At a high level, there are two reasons to "prefund" pensions into a trust: benefit security for plan participants and intergenerational equity among taxpayers.⁶

⁶ Edward Bartholomew, Jeremy Gold, David G. Pitts, and Larry Pollack, "Financial Economics Principles Applied to Public Pension Plans" (1 Mar. 2018). Available at SSRN: <https://ssrn.com/abstract=3120726> or <http://dx.doi.org/10.2139/ssrn.3120726>

By their (usually) written terms, pension trusts may only be used to pay benefits and related expenses. Setting money aside under these conditions provides security to participants that benefits will be paid regardless of the sponsor's later ability, and willingness, to pay them.

By prefunding future pension benefits for employees while they are still working, the taxpayers who benefit from those employees' services are the same taxpayers paying for them. The cost of services provided today is not borne by the future generation of taxpayers when the benefits are paid.

Once the money is set aside for future use, someone must assume responsibility for managing its investment.

2.2

WHO CONTROLS THE MONEY?

State and local pension plans are generally governed by a board of trustees. National Association of State Retirement Administration (NASRA) data indicate that pension boards range in size between five and 20 with a median membership of nine. On average, about 55% of trustees are plan members elected by their fellow participants and have no particular investment expertise, 15%-20% are ex officio government officials, and the rest are members of the general public. Many boards include trustees appointed by governors and legislators.⁷

“
According to NASRA, in approximately 70% of state-sponsored retirement systems, pension board trustees are responsible for oversight of fund investments...

According to NASRA, in approximately 70% of state-sponsored retirement systems, pension board trustees are responsible for oversight of fund investments, including setting target

⁷ “Composition of Public Retirement System Boards,” National Association of State Retirement Administrators (NASRA), Updated Sep. 2021, Available at: <https://www.nasra.org/files/Topical%20Reports/Governance%20and%20Legislation/Board%20Governance%20Policies/Board%20Composition.pdf>

asset allocations and investment policies, in addition to having other duties such as oversight of plan administration, including “collecting contributions; paying benefits; hiring and firing key employees; ... appointing consultants; ... certifying the contribution rate determined by the actuary and approving key actuarial assumptions such as the investment return used to calculate actuarial contributions.”⁸ In other cases, “that [investment] responsibility is granted either to a sole trustee (as in Connecticut, New York, and North Carolina), or to a separate entity, such as the Massachusetts Pension Reserves Investment Management Board, the Minnesota State Board of Investment, and the Oregon Investment Council.”⁹

There are good reasons to question whether trustee boards have the requisite knowledge and skills to properly oversee plan assets in the face of significant and growing market complexities.¹⁰ But knowledge and skills are insufficient without a principled code of conduct. Established behavioral principles applicable to investing on behalf of others have evolved over centuries.

⁸ Jean-Pierre Aubrey and Carline V. Crawford, *Does Public Pension Board Composition Impact Returns*, Brief SLP#67, (Center for Retirement Research of Boston College, August/November 2019)

⁹ “Governance,” NASRA.org, National Association of State Retirement Administrators (NASRA), <https://www.nasra.org/governance> (accessed 8 Mar. 2023)

¹⁰ For example: Neil Weinberg, “Investing Novices Are Calling the Shots for \$4 Trillion at US Pensions”, Bloomberg News. <https://www.bloomberg.com/news/features/2023-01-04/us-public-pension-plans-run-by-investing-novices-are-on-the-edge-of-a-crisis?sref=RG2d9Zwm> (3 Jan. 2022).

PART 3

FIDUCIARY GUIDING PRINCIPLES

3.1

LOYALTY AND PRUDENCE

These two overarching fiduciary duties pertain to fiduciaries' state of mind and the decision-making process: fiduciaries' actions must be based on **loyalty** to beneficiaries and be exercised with **prudence**. The understanding of "loyalty" is universal and has not changed much over time but what is considered "prudent" varies and has continued to evolve.

In the context of a pension plan, the duty of loyalty is understood to mean investing:

- **Solely in the interest** of plan members
- For the **exclusive purpose** of providing benefits, and defraying costs that are appropriate and reasonable
- Impartially, balancing the needs of member subpopulations (e.g., active participants and retirees), not favoring one over another¹¹

¹¹ James Hawley and Keith Johnson and Edward J. Waitzer, "Reclaiming Fiduciary Duty Balance," *Rotman International Journal of Pension Management* (21 Sep. 2011), Vol. 4, No. 2, 4, Fall 2011, Available at SSRN: <https://ssrn.com/abstract=1935068>

Investing solely in the interest of plan members for the exclusive purpose of providing them pension benefits is an exceptionally restrictive standard. It means that investments are appropriate only if they “will benefit the beneficiary directly by improving risk-adjusted return; and ... the trustee’s exclusive motive ... is to obtain this direct benefit.”¹²

The duty of loyalty is also generally understood to apply to the proxy voting of company shares held by a plan’s trust, which has taken on increasing visibility of late because of shareholder proposals to promote various objectives that may appear not directly related to improving the company’s business. Where a proxy advisory firm such as Institutional Shareholder Services (ISS) or Glass Lewis is used for recommendations or voting, the duty of loyalty would extend to the vetting of recommendations or executed votes made on the plan’s behalf.

With some historical fits and starts, satisfying the duty of prudence is generally understood to require an “expert.” This concept evolved out of a “prudent person” standard (no particular investment expertise needed), which in turn evolved from the notion that investments should all be low-risk, or even chosen from a restricted list of permitted investments. “Modern portfolio theory,” developed first by Harry Markowitz in 1952, later winning him a Nobel prize, has led to the acceptance of risky assets in a well-diversified portfolio to optimize an investor’s risk/return tradeoff.¹³

The duty of prudence, therefore, is often considered to include a requirement to diversify except where “it is clearly prudent not to do so,” which is the specification under ERISA applicable to private sector pension plans.¹⁴ One example of an allowable exception to the diversification requirement under ERISA would be a mostly-bond portfolio that serves as a hedge of market-based liability interest rate risk.

3.2 DUTY OF LOYALTY ADDRESSES AGENCY RISK

Trusts comprising assets that are segregated for specified purposes have existed for centuries, and often involve three distinct roles:

1. the settlor that contributes the assets to the trust;

¹² Max M. Schanzenbach and Robert H. Sitkoff, “Reconciling fiduciary duty and social conscience: the law and economics of ESG investing by a trustee,” *Stanford Law Review* 72(2), 381-454 (Feb. 2020).

¹³ For a more extensive summary of the history, see Hawley and Johnson and Waitzer, “Reclaiming Fiduciary Duty Balance.” (Footnote 14)

¹⁴ 29 U.S. Code § 1104(a)(1)(C)

2. the beneficiary for whom the assets are set aside; and
3. the fiduciary that manages and disburses the assets in the best interests of the beneficiary and in satisfaction of the trust's purpose.

Pension fiduciary rules evolved from the “common law of trusts,” principles dating from old English common law, many of which are enshrined in ERISA and various other laws. Although specific rules and applications continue to evolve, the guiding principle of loyalty has remained constant.



There is potential for conflict of interest, or difference in priorities, between people with a financial stake in an operational outcome—the principals—and the different people who are responsible for managing or acting on their behalf—the agents.



The need to stress loyalty arises from the principal-agent problem described in economics literature: There is potential for conflict of interest, or difference in priorities, between people with a financial stake in an operational outcome—the principals—and the different people who are responsible for managing or acting on their behalf—the agents. Fiduciary standards, especially the standard of loyalty, protect plan member and taxpayer principals from their agents pursuing goals or interests inconsistent with maximizing principals' economic welfare.

3.3

LOYALTY IS ABOUT INTENT

State of mind and process—and not just resulting action—determines whether fiduciary principles have been adhered to. The decision in a 2001 lawsuit involving a (non-pension) trust noted: “The fact that the [trustees] might have properly decided to choose the same course of action had they engaged in an unbiased and adequately informed process does not excuse how they went about reaching this course of action.”¹⁵

¹⁵ *McNeil v. Bennett*, 792 A.2d 190 (Del. Ch. 2001)

In other words, loyalty and prudence must be the drivers of the decisions and not an after-the-fact rationalization.

3.4

EQUIVALENCE BETWEEN INVESTMENTS AND EXPENDITURES

Applying loyalty to pension trust expenditures is intuitive to most. No one argues for using trust money to pay for anything other than pension benefits and reasonable related expenses. But the equivalence between inappropriate trust expenditures and investing to achieve nonfinancial objectives seems less well understood.

“
Trust expenditures and the investment of trust assets are two sides of the same stewardship coin.

”

Trust expenditures and the investment of trust assets are two sides of the same stewardship coin. For example, if investment A furthers some nonfinancial goal but returns \$1 million less than investment B, then investing in A is no different from investing in B and then spending \$1 million from the trust toward furthering the same nonfinancial goal. Both cases result in the inappropriate transfer of value out of the pension trust to the furtherance of the nonfinancial goal. If supporting the nonfinancial goal with a trust expenditure violates the principle of loyalty, then so does accepting a lower return.

In addition to the fundamental principles of loyalty and prudence, practical realities have resulted in identifying practices and behaviors thought necessary or reasonable for responsible fiduciary stewardship.

PART 4

CUSTOMARY ADDITIONAL PRACTICES CONSIDERED APPROPRIATE FOR FIDUCIARIES

As noted above, the duty of loyalty has been constant through time, while notions of prudence have evolved. The following practices are now customary and often codified as fiduciary duties or at least permitted behavior.

4.1

PRACTICE #1: DELEGATING FIDUCIARY RESPONSIBILITY TO EXPERTS

Several decades ago, it was not considered acceptable for a trustee to delegate investment responsibility, but these days it is considered preferable to delegate certain functions to experts in light of complicated plans and markets. Delegating may result in shifting some fiduciary responsibilities to other parties such as investment managers. Even in such a case, however, a legal regime may prohibit the delegation of certain high-level responsibilities, like adopting a statement of investment objectives and policies.

Delegating investment authority to others would itself be considered a fiduciary function with responsibilities pertaining to both the original selection and the continual monitoring of the delegates. Delegating fiduciaries are responsible for ensuring that their delegates have necessary skills, and for ensuring the absence of potential conflicts of interest, i.e., for ensuring that the delegate acts in accordance with the duty of loyalty. A certain level of expertise and due diligence is therefore required even when responsibility is being delegated from a desire for greater knowledge and experience.

Along with certain asset management (and other plan managerial) functions, the exercise of shareholder rights, such as proxy voting, may be delegated. In that case, again, the delegating fiduciary is responsible for monitoring the delegate to ensure such exercise is consistent with the duty of loyalty.

4.2

PRACTICE #2: HOLDING FIDUCIARIES PERSONALLY LIABLE TO PLAN PRINCIPALS FOR BREACHES OF DUTY

By the nature of the role, fiduciaries of ordinary non-pension trusts will be held liable to trust beneficiaries for breaches of duty. In some cases, it is considered acceptable for trust language to limit fiduciaries' liability.

For pension trusts, the definition of who is a fiduciary and the duties and responsibilities for which he or she may be held accountable can be murkier. Under ERISA, fiduciaries in private sector plans are personally liable for breaches of duty. In addition, the Uniform Law Commission (see Section 7.2) included a provision for personal liability in the model law: "Uniform Management of Public Employee Retirement Systems Act" (MPERS 1997). Personal liability does not appear prominent in state law today, nor does the issue appear to have been litigated. See below Parts 6.4 (ERISA), 7.4 (MPERS), and Part 8 (Best Practices) for additional discussion on personal liability.

4.3

PRACTICE #3: ACTING IN ACCORDANCE WITH A GOOD-FAITH INTERPRETATION OF LAW AND PLAN PROVISIONS

Holding fiduciaries of an ordinary non-pension trust accountable to act in accordance with trust law and the purpose enshrined in the trust document is a very natural outcome in line with the point of setting up trusts in the first place.

Calculating benefits in accordance with codified plan provisions and following specified administrative procedures are important for the same reason. Also, pension trusts come with certain tax advantages granted for policy reasons, so not following the terms of a plan might call into question the legitimacy of realized tax benefits.

In the context of a public pension plan, it's possible for legislatures to pass laws, or executive branch officers to take actions, that are inconsistent with the core fiduciary principles of loyalty and prudence, for example, by requiring plan investments to be made in pursuit of non-pension-related goals. Ensuring that basic fiduciary principles are not contravened by elected politicians or other government officials is a challenge addressed more in later sections. Unfortunately, there are many pressures and temptations to do so.

PART 5

INCENTIVES AND PRESSURE TO SKIRT FIDUCIARY PRINCIPLES

5.1

FINANCIAL AND POLITICAL INCENTIVES AND TEMPTATIONS

Because valuable pension benefits are paid many years after they are earned and funded, large sums accumulate in pension trusts, including even many trusts that are badly underfunded relative to the liabilities for pensions earned.

These large capital pools provide good livelihoods to many parties including:

- Plan investment officers
- External asset managers of publicly traded securities, as well as private equity firms and other “alternative” asset managers
- Other financial service providers like proxy voting firms, plan auditors and actuaries

The size of the pools of capital in public pension plans means that those who control them have substantial power and economic influence. External asset managers have financial incentives in recommending complex, illiquid, and otherwise high-risk investment strategies because they can charge higher fees. Government officials and politicians may

try steering pension trust money toward politically popular causes, either indirectly through appointed trustees or directly through executive orders and legislation. Where plans are badly underfunded, there will be pressures and temptations to attempt to fill the funding hole by investing aggressively, entailing significant risk, to avoid the need to use tax revenue for contributions.



Government officials and politicians may try steering pension trust money toward politically popular causes, either indirectly through appointed trustees or directly through executive orders and legislation.



These forces and others can make it difficult for trustees and other fiduciaries to remain focused on acting purely on behalf of plan beneficiaries and taxpayers. They have at times resulted in investments inconsistent with fiduciary principles and have even led to corruption.

5.2

HISTORICAL EXAMPLES OF MISUSE AND CORRUPTION

Before ERISA, in the private sector, there was a history of pension fund misuse. Examples included a company's pension fund buying shares of a company that management wished to acquire, and a union welfare fund buying securities of a company that it wished to unionize.¹⁶ An example of outright corruption was the Central States Teamsters Fund's involvement in organized crime's development of Las Vegas. As the *Las Vegas Review-Journal* has described it: "The pension fund was the mob's bank."¹⁷

In public sector plans, practices have included investing in unprofitable "economically targeted" local projects, disallowing "sin" stocks (e.g., tobacco, alcohol, firearms, gambling),

¹⁶ James A. Wooten, *The Employee Retirement Income Security Act of 1974 - A Political History* 1st ed., (Berkeley: University of California Press, 2004). 44.

¹⁷ Jeff German, "Hoffa: The Strip's Kingmaker," *Las Vegas Review-Journal*, 20 Sep. 2021
<https://www.reviewjournal.com/crime/jimmy-hoffas-role-in-developing-las-vegas-2407166/>

and promoting union work and homeownership.¹⁸ Outright corruption associated with public plan assets has included bribery and pay-to-play campaign contributions in exchange for steering investment mandates to the contributors.¹⁹

The big public pension investment controversy in more recent times involves ESG (Environmental, Social, Governance) issues. Laws and other actions that compel fiduciaries to act contrary to fundamental fiduciary principles have occurred in states controlled by both Democrats and Republicans.



The big public pension investment controversy in more recent times involves ESG (Environmental, Social, Governance) issues.



5.3

CASE STUDY: CALIFORNIA GOV. GAVIN NEWSOM'S EXECUTIVE ORDER N-19-19²⁰

In September 2019, Newsom issued Executive Order N-19-19 “to require that every aspect of state government redouble its efforts to reduce greenhouse gas emissions and mitigate the impacts of climate change while building a sustainable, inclusive economy.”²¹

The order opens with eight “Whereas” items describing objectives and justifications and recounting California’s many goals and accomplishments relating to climate change, and not one of which mentions the objective of pension benefit security for pension plan members.

¹⁸ Jean-Pierre Aubrey, Anqi Chen, Patrick M. Hubbard, and Alicia Munnell, *ESG Investing and Public Pensions: An Update*, Brief SLP#74, (Center for Retirement Research of Boston College, October 2020)

¹⁹ Danny Hakim and William K. Rashbaum, “Hevesi Pleads Guilty in Pension Case,” *New York Times*, 7 Oct. 2010: <https://www.nytimes.com/2010/10/08/nyregion/08hevesi.html>. Also:

“Investor Bulletin: New Rule to Curb ‘Pay to Play’ Practices,” Securities and Exchange Commission, *sec.gov*, 1 Jul. 2010: <https://www.sec.gov/investor/alerts/paytoplay>

²⁰ Gavin Newsom, “Executive Order N-19-19,” Executive Department State of California, 20 Sep. 2019 <https://www.gov.ca.gov/wp-content/uploads/2019/09/9.20.19-Climate-EO-N-19-19.pdf>

²¹ *Ibid.* 2.

The first “Therefore” made “by virtue of the power and authority vested in [the governor] by the Constitution and Statutes of the State of California” is an order to adjust pension investment policy:

*To leverage the state's \$700 billion [pension] investment portfolio to advance California's climate leadership, protect taxpayers, and support the creation of high-road jobs, the Department of Finance shall create a Climate Investment Framework.*²²

The order goes on to require that investments “shift ... to companies and industry sectors that have greater growth potential based on their focus of reducing carbon emissions and adapting to the impacts of climate change, including but not limited to investments in carbon-neutral, carbon-negative, climate resilient, and clean energy technologies.”

California Constitution, Article XVI - Public Finance, Section 17, lists the standard fiduciary obligations that apply to “the retirement board of a public pension or retirement system” who “shall have plenary authority and fiduciary responsibility for investment of moneys and administration of the system” Further: “The retirement board of a public pension or retirement system shall have the sole and exclusive fiduciary responsibility over the assets of the public pension or retirement system... .”²³ This provision seems to legally (maybe unsuccessfully) insulate the investment policy from political interference.

The same section of the Constitution also declares: “The Legislature may by statute continue to prohibit certain investments by a retirement board where it is in the public interest to do so, and provided that the prohibition satisfies the standards of fiduciary care and loyalty required of a retirement board pursuant to this section.” This section allows the legislature, not the governor, the power to prohibit (not require) certain investments, and only where consistent with the fiduciary duties of care and loyalty.

There is much to be concerned about in this order:

- The “whereas” items and other language make it very clear that climate change is the sole driver of the required changes in the investment portfolio. The claim that the favored investments offer “greater growth potential” because of their environmentally centered focus is indiscriminately broad and claimed without support. If, as implied, the fiduciaries were selecting investments with suboptimal growth potential—for *any* reason—then the most important issue is poor fiduciary

²² Ibid. 2.

²³ CA Constitution art XVI § 17: <https://law.justia.com/constitution/california/article-xvi/section-17/>

stewardship of \$700 billion of state pension assets, the correction of which is not listed as one the order's goals.

- The governor appears to be claiming authority under the California constitution that is specifically granted thereunder to plan fiduciaries using language that attempts to insulate them from the types of political interference exemplified by this executive order.
- “To leverage the pension portfolio to advance climate leadership” is a direct violation of the constitutional requirement and core fiduciary principle that system management be “for the exclusive purposes of providing benefits to, participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system. A retirement board's duty to its participants and their beneficiaries shall take precedence over any other duty.”
- The order, if applied, would hamper the ability to “diversify the investments of the system so as to minimize the risk of loss and to maximize the rate of return, unless under the circumstances it is clearly not prudent to do so.”

The order states: “The Framework shall align with the fiduciary responsibilities of the California Public Employees' Retirement System, California State Teachers' Retirement System and the University of California Retirement Program.” But the substance of the order commands the opposite.

5.4

CASE STUDY: TEXAS LAW PROHIBITS INVESTING WITH COMPANIES THAT “BOYCOTT” ENERGY COMPANIES²⁴

This case study is from a red state with a very different political orientation than Newsom's. Legislation signed into law in 2021 required the state comptroller to develop a list of “financial companies that boycott energy companies” from which Texas public pension plans must divest. The list included BlackRock, the largest asset manager in the world.

There is ample evidence that the law's enactment was driven by a desire to punish disinvestment in the Texas oil industry, and not out of loyalty to plan principals. It seems impossible that loyalty to plan principals can be consistent with forbidding *any* of the

²⁴ 2021 Texas Statutes Government Code Title 8 - Public Retirement Systems, Subtitle A - Provisions Generally Applicable to Public Retirement Systems, Chapter 809 - Prohibition on Investment in Financial Companies That Boycott Certain Energy Companies: <https://statutes.capitol.texas.gov/Docs/GV/htm/GV.809.htm>

myriad investment possibilities offered by the world's largest asset manager. Texas state Sen. Phil King, who introduced the law, was quoted as saying:

Wealthy investment managers are denying capital to energy companies, wielding their money and power with one simple goal in mind—destroying the oil and gas industry. This bill sends a strong message to both Washington and Wall Street that if you boycott Texas Energy, then Texas will boycott you.²⁵

Comptroller Glenn Hegar, who was responsible for creating the list of proscribed investment companies and funds, framed the law as necessary for the economy of Texas:²⁶

If you don't invest in oil and gas, a lot of the fabric, the basic parts of the daily lives that we operate on, regardless of the industry that you work in and work for really those things deteriorate.²⁷

“

Unlike California, the Texas law change appears to be in accordance with the state constitution.

”

Unlike California, the Texas law change appears to be in accordance with the state constitution. Section 67(a)(3) of Article 16 provides in part that “[t]he legislature by law may further restrict the investment discretion of a Board.”²⁸ But technical legality would not mitigate the undermining of the basic fiduciary principle that assets be managed solely in the interest of participants and taxpayers for the exclusive purpose of providing pension benefits, which is codified elsewhere in Texas law.²⁹

²⁵ Dave Davies and Rachel Martin, “Texas ban on firms that don't invest in firearms and fossil fuels is costing taxpayers,” NPR.org, National Public Radio, 1 Sep. 2022, <https://www.npr.org/2022/09/01/1120457153/texas-ban-on-firms-who-dont-invest-in-firearms-and-fossil-fuels-are-cost-taxpaye> (accessed 8 Mar. 2023)

²⁶ See Hegar biography here: <https://comptroller.texas.gov/about/bio.php> (accessed 8 Mar. 2023)

²⁷ Tom Abrams, “State of Texas cuts ties with Environmental and Social Governance companies,” abc13.com, ABC13, 11 Oct. 2022, <https://abc13.com/texas-news-laws-oil-and-gas-esg/12316401/> (accessed 8 Mar. 2023)

²⁸ Article XVI, Section 67 of the Texas Constitution:
https://texaslegalguide.com/Texas_Constitution:Article_XVI,_Section_67

²⁹ 2021 Texas Statutes Government Code Title 8 - Public Retirement Systems, Subtitle A - Provisions Generally Applicable to Public Retirement Systems, Sec. 802.203
<https://statutes.capitol.texas.gov/Docs/GV/htm/GV.802.htm#802.203>

The law provides an exception “if the state governmental entity [i.e., the pension plan] determines that the requirement would be inconsistent with its fiduciary responsibility with respect to the investment of entity assets or other duties imposed by law relating to the investment of entity assets.”³⁰ While it appears that this exception could fairly be invoked in most cases, fiduciaries who do so would surely be subject to political repercussions. And if the fiduciaries in one plan invoked the exception and others did not, it would seem logically impossible for both sets of fiduciaries to be acting appropriately. Further, the law protects from accountability plan fiduciaries who might feel obligated to invoke the exception and yet do not do so, by precluding any “private cause of action ... including [for] breach of fiduciary duty ... in connection with any action ... made or taken in connection with this chapter.”³¹ The way for plan fiduciaries to avoid potential repercussions is to disregard the exception.

To illustrate the potential consequences of slipping up, after the law was passed, the Texas Employees Retirement System (ERS) was publicly scolded by Texas Lt. Gov. Dan Patrick for voting proxies in favor of shareholder proposals requesting Bank of America, Citigroup, Goldman Sachs and Wells Fargo to eliminate funding for fossil fuel projects. The votes were apparently cast on behalf of ERS by Institutional Share Services (ISS) to which ERS delegates proxy voting. Lt. Gov. Patrick’s statement expressed “outrage” regarding the votes that “go against the spirit” of the new law and went on to say: “Our various investment funds’ focus should be on getting the best return on their funds. If companies they invest in take positions that harm Texas, they need to re-evaluate those investments.”³²

“

The fiduciary duty of loyalty requires investing solely for the benefit of the plan membership and taxpayers. Protecting the competitive position of state businesses is not within fiduciaries’ ambit even if it is within Lt. Gov. Patrick’s.

”

³⁰ Ibid. Sec. 809.005

³¹ Ibid. Sec. 809.004

³² Lt. Gov. Dan Patrick, “Statement on Employee Retirement System of Texas’ Shareholder Resolution Proxy Votes,” State of Texas Lieutenant Governor, 2 May 2022: <https://www.ltgov.texas.gov/2022/05/02/lt-gov-dan-patrick-statement-on-employee-retirement-system-of-texas-shareholder-resolution-proxy-votes/> (accessed 8 Mar. 2023)

But it's not inconceivable that "getting the best return" in a pension plan may in some cases *require* the fund to "take positions that harm Texas." The fiduciary duty of loyalty requires investing solely for the benefit of the plan membership and taxpayers. Protecting the competitive position of state businesses is not within fiduciaries' ambit even if it is within Lt. Gov. Patrick's. There may come a time when plan fiduciaries reasonably believe it prudent not to invest in a company or industry that is significant in the Texas economy. This is not to say that, in this case, ERS's delegation and lack of monitoring pertaining to ISS was appropriate. But if Mr. Patrick's concern was the proper fiduciary behavior of the state's pension plan trustees, then instead of focusing on how the shares were voted, it would have been more appropriate to call out the under-monitoring of the voting delegates, arguably a violation of fiduciary responsibility that plan officials had already identified as in need of addressing.³³

5.5

CASE STUDY: KENTUCKY RETIREMENT SYSTEM PLAN INVOKES EXCEPTION FROM DIVESTMENT REQUIREMENT

The Kentucky law signed by the governor on April 8, 2022, is very similar to the Texas law.³⁴ On January 3, 2023, Kentucky State Treasurer Allison Ball issued a list of financial companies with which investing is prohibited based on her determination that they were boycotting energy companies.³⁵

The County Employees Retirement System (CERS) comprises 64% of the membership of the three Kentucky Retirement Systems (KRS).³⁶ In a letter dated February 13, 2023 from Betty Pendergrass, the chair of CERS, to Ball, CERS claimed exemption from the law's divestment requirement under a provision similar to the Texas exemption provision described above, on the grounds that divesting would be "inconsistent with its fiduciary responsibilities with respect to the investment of CERS assets or other duties imposed by law relating to the

³³ Christine Williamson, "Texas Employees catches flak for proxy votes against financing fossil fuel projects," *Pensions & Investments*, 3 May 2022: <https://www.pionline.com/esg/texas-employees-catches-flak-proxy-votes-against-financing-fossil-fuel-projects>

³⁴ Senate Bill 205 adding KY Rev Stat § 41.470 through 41.476, Kentucky General Assembly, 8 Apr. 2022: <https://apps.legislature.ky.gov/record/22rs/sb205.html>

³⁵ Betty Pendergrass, Letter to Kentucky State Treasurer Allison Ball, County Employees Retirement System, 13 Feb. 2023: <https://si-interactive.s3.amazonaws.com/prod/ai-cio-com/wp-content/uploads/2023/02/15115238/Letter-to-Treasurer-Ball.pdf>

³⁶ Jennifer Burnett, "KY Public Pensions 101: Who is in CERS?" The Kentucky Association of Counties, kaco.org, 2018. <https://kaco.org/articles/ky-public-pensions-101-who-is-in-cers/>

investment of CERS assets”.³⁷ As of this writing, it remains to be seen how this will play out. Will CERS ultimately divest? Will the other two components of KRS follow suit and claim exemption? Will this inspire retirement systems in other states with similar laws to claim exemption, effectively nullifying those laws?



The California and Texas case studies show states at opposite ends of the political spectrum subordinating fiduciary principles to goals unrelated to providing pension benefits, and imposing constraints that limit the ability to invest optimally.



The California and Texas case studies show states at opposite ends of the political spectrum subordinating fiduciary principles to goals unrelated to providing pension benefits, and imposing constraints that limit the ability to invest optimally. The Kentucky case study shows a similar law to the Texas law, with the notable difference that one of the state retirement plans invoked the provision allowing it to claim exemption from the divestment requirement as necessary to fulfill its fiduciary obligations.

It seems unlikely that any of these laws would pass muster under the provisions of ERISA and the regulatory guidance thereunder that apply to private sector retirement plans. Because of its long history of comprehensively addressing fiduciary issues, ERISA, and the regulations thereunder, serve as a prototype for codifying pension fiduciary issues in jurisdictions beyond ERISA's purview.

³⁷ Ibid.

PART 6

THE EMPLOYEE RETIREMENT INCOME SECURITY ACT (ERISA)

6.1

ERISA CODIFIED COMMON LAW PRINCIPLES OF FIDUCIARY STEWARDSHIP

ERISA is a sprawling law that regulates U.S. employer-sponsored retirement and welfare plans. It includes detailed rules regarding who is considered a fiduciary, and fiduciaries' duties and responsibilities. Many provisions of ERISA, including those pertaining to fiduciary responsibilities, do not apply to public pension plans out of deference to state and local government sovereignty. Nevertheless, developments under ERISA are informative as to how thinking has changed over time and how the prototypical pension law in the U.S. has addressed the same temptations and pressures that public plans are debating.

“
ERISA was oriented toward maximizing plan participants' benefit security.

”

ERISA was oriented toward maximizing plan participants' benefit security. It codified many aspects of common law fiduciary principles that apply to trusts including the aforementioned duties of loyalty and prudence. It requires that a plan identify a "named fiduciary" and specifies the functions of plan management, including those pertaining to investments, that result in the party performing those functions being a fiduciary. ERISA specifies when certain service providers and other hired experts and asset managers to whom duties are delegated become designated co-fiduciaries. ERISA is said to have a "functional" definition of fiduciary.

6.2

"COLLATERAL BENEFITS"—NONFINANCIAL GOALS IN INVESTING AND EXERCISING SHAREHOLDER RIGHTS

Despite the principle of loyalty calling for investing solely in plan members' (and, for public plans, taxpayers') best interests for the exclusive purpose of providing pension benefits and defraying reasonable expenses, there is a history, which predates current controversies around ESG investing, in both the public sector and the private sector, of investing pension assets to further nonfinancial goals. It is common for proponents of using nonfinancial factors to point to fiduciary principles in support of their position, or at least claim that they are not being violated. Justifications often include one or more of the following:

- An investment that benefits society at large, or plan member (or union) employment, or the local economy where plan members work is, logically, for the good of plan members.
- An investment chosen after considering nonfinancial factors is equally as good as another that would have been chosen without considering nonfinancial factors, so no harm, no foul. The nonfinancial factors are just "tiebreakers" that satisfy an "all else being equal" test.
- A factor under consideration that appears to be nonfinancial is, in fact, financial. The inevitable direction of society means investments based on the factor will return more than investments that do not take that factor into account. (This line of reasoning has become popular among ESG investing proponents.)

The Department of Labor has been addressing the issue of nonfinancial investment goals for years through subregulatory and regulatory guidance under Section 404 of ERISA, which codifies the duties of loyalty and prudence explicitly:

[A] fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and ... for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan ... with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims ... by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so ... and in accordance with the documents and instruments governing the plan... .

A history of previous regulatory and subregulatory Department of Labor (DOL) guidance is summarized in the preamble to DOL regulations published in the Federal Register on December 1, 2022, called “Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights,” from which the following summary is largely taken. This regulation superseded regulations issued only two years prior during the Trump administration, at the very end of its term.

The 2022 regulation was issued pursuant to a January 20, 2021 Executive Order (E.O. 13990) titled “Protecting Public Health and the Environment and Restoring Science to Tackle the Climate Crisis.” The E.O. issue date was the first day of the Biden presidency, reflecting a sense of urgency, and the title makes clear President Biden’s strong interest in environmental issues, which would seem to have presaged a significant policy shift in favor of allowing ESG investing.

“

... the overriding theme of the history described in the regulation’s preamble is that, over the years, despite very different attitudes among several administrations of both major parties, the bar has remained very high for considering nonfinancial factors in plan investments.

”

Yet the overriding theme of the history described in the regulation’s preamble is that, over the years, despite very different attitudes among several administrations of both major

parties, the bar has remained very high for considering nonfinancial factors in plan investments. The regulators have remained mostly true to a strict reading of the duties of loyalty and prudence.

Interpretive Bulletin 94-1 (IB 94-1, from 1994) included DOL guidance around “economically targeted investments” (ETIs) chosen for their “collateral benefits.” That guidance allowed for ETIs to be a tiebreaker when “competing investments [including the ETI] serve the plan’s economic interests reasonably well.”

Interpretive Bulletins (IB) 2008-01 and 2015-01, each of which superseded the last, both endorsed a similar “all things being equal” standard, and “cautioned that fiduciaries violate ERISA if they accept reduced expected returns or greater risks to secure social, environmental, or other policy goals.”

Field Assistance Bulletin (FAB) 2018-01 noted that ESG considerations could themselves be “risk-return’ factors affecting the economic merits of [an] investment.” Yet, FAB 2018-01 also noted that fiduciaries “must not too readily treat ESG factors as economically relevant to the particular investment choices at issue when making a decision.” The bulletin instructs, “Rather, ERISA fiduciaries must always put first the economic interests of the plan in providing retirement benefits.”³⁸

The preamble of the 2022 Biden administration rule states:

[T]he Department emphasizes that the final rule does not change two longstanding principles. First, the final rule retains the core principle that the duties of prudence and loyalty require ERISA plan fiduciaries to focus on relevant risk-return factors and not subordinate the interests of participants and beneficiaries (such as by sacrificing investment returns or taking on additional investment risk) to objectives unrelated to the provision of benefits under the plan.

It is clear from the two preambles that both the Trump-era and Biden-era rules were reacting to the growing prominence of ESG investing, and that the Trump administration was skeptical and the Biden administration was more enthusiastic. The language of the actual regulation in both cases, however, is written generally. Both have very strong language pertaining to the priority of economic factors, which the Trump-era rules refer to

³⁸ This last quote is from the preamble of the 2022 regulation describing FAB 2018-01.

as “pecuniary” and the Biden-era rules as “risk-return.” The Harvard Law School Forum on Corporate Governance called the changes from Trump to Biden “cosmetic,” noting:

The final Trump Rule did not use the term “ESG.” The regulatory text of the final Biden Rule refers once to ESG investing, but only to state that ESG factors “may” be “relevant to a risk and return analysis,” depending “on the individual facts and circumstances.” This statement is true for all investment factors, ESG or otherwise.³⁹

Notwithstanding headlines to the contrary, the fiduciary standards specified in the regulatory language is barely distinguishable in meaning:

Trump Administration—November 2020 ⁴⁰	Biden Administration—December 2022 ⁴¹
<p>“...solely in the interests of the participants and beneficiaries, for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan, and with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.”</p>	<p>[language is identical]</p>
<p>“A fiduciary’s evaluation of an investment or investment course of action must be based only on pecuniary factors, except as provided in paragraph (c)(2) of this section. ...”</p> <p>“A fiduciary may not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to other objectives, and may not sacrifice investment return or take on additional investment risk to promote non-pecuniary</p>	<p>“A fiduciary may not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to other objectives, and may not sacrifice investment return or take on additional investment risk to promote benefits or goals unrelated to interests of the participants and beneficiaries in their retirement income or financial benefits under the plan.”</p>

³⁹ Max M. Schanzenbach (Northwestern Pritzker School of Law) and Robert H. Sitkoff (Harvard Law School), “ESG Investing After the DOL Rule on ‘Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights,” corpgov.law.harvard.edu, Harvard Law School Forum on Corporate Governance, 2 Feb. 2023: <https://corpgov.law.harvard.edu/2023/02/02/esg-investing-after-the-dol-rule-on-prudence-and-loyalty-in-selecting-plan-investments-and-exercising-shareholder-rights/>

⁴⁰ Federal Register, Vol. 85, No. 220, November 13, 2020, starting on page 72846.

⁴¹ Federal Register, Vol. 87, No. 230, December 1, 2022, starting on page 73822.

Trump Administration—November 2020 ⁴⁰	Biden Administration—December 2022 ⁴¹
<p>benefits or goals. The weight given to any pecuniary factor by a fiduciary should appropriately reflect a prudent assessment of its impact on risk-return.”</p> <p>But</p> <p>“[(c)(2)] Notwithstanding the requirements of paragraph (c)(1) of this section [the above], when choosing between or among investment alternatives that the plan fiduciary is unable to distinguish on the basis of pecuniary factors alone, the fiduciary may use non-pecuniary factors as the deciding factor in the investment decision provided that the fiduciary documents:...”</p>	<p>But</p> <p>“[(c)(2)] If a fiduciary prudently concludes that competing investments, or competing investment courses of action, equally serve the financial interests of the plan over the appropriate time horizon, the fiduciary is not prohibited from selecting the investment, or investment course of action, based on collateral benefits other than investment returns. A fiduciary may not, however, accept expected reduced returns or greater risks to secure such additional benefits.”</p>

Without the headings in the table above, it would be difficult or impossible to distinguish which version of the regulation is considered pro-ESG and which anti-ESG. While the difference in perspective is very apparent from the respective preambles, the substance of the regulatory language does not seem significantly different, although arguably the Trump-era “unable to distinguish” standard is slightly stronger than the Biden-era “equally serve” language. And the difference in tone in the preambles suggests possibly different levels of intended enforcement efforts and focus, but that can change even absent changes in the regulation.

The Trump-era rules do explicitly require detailed documentation of the reasoning and analysis supporting the choice between the otherwise non-distinguishable alternatives, while the Biden rules do not, but sound fiduciary practice is considered to always require significant documentation.

Similarly, the differences in the rules pertaining to proxy voting and the use of proxy voting services appear minor and technical.⁴² Both versions of the regulation have the following identical language:

⁴² The Biden administration version of the proxy rules is in the same regulatory package as the other rules. The Trump administration version was issued separately: Federal Register, Vol. 85, No. 242, December 16, 2020, starting on page 81658.

When deciding whether to exercise shareholder rights and when exercising such rights, including the voting of proxies, fiduciaries must carry out their duties prudently and solely in the interests of the participants and beneficiaries and for the exclusive purpose of providing benefits to participants and beneficiaries and defraying the reasonable expenses of administering the plan.

Both versions have similarly strict requirements pertaining to confirming and continuing to monitor that third party delegates and advisors are aligned with the sponsor's duty of loyalty.

6.3

PROHIBITIONS ON SELF-DEALING ("PROHIBITED TRANSACTIONS")

ERISA differs from some other regulatory regimes in singling out prohibited self-dealing transactions as a special type of fiduciary breach. Many prohibited transactions might also be impermissible under other ERISA requirements or common law. But the authors of ERISA wanted to specifically limit certain transactions between a "party of interest" and its related retirement plans even if an argument of prudence and loyalty could be made. Examples of such prohibited transactions between a plan and a party of interest include loans, sale or exchange or lease of property, or a plan holding excessive securities of the employer. It is possible at times to apply for and receive permission for otherwise prohibited transactions from the DOL.

There is likely little need for this type of prohibition in public pension plans. See the discussion in Section 7.4.

6.4

PERSONAL LIABILITY OF PENSION FIDUCIARIES FOR BREACH OF DUTY TO PARTICIPANTS

ERISA imposes personal liability on fiduciaries to reimburse the plan for losses resulting from a breach of duty. Punitive damages cannot be imposed. A fiduciary's liability can be mitigated through delegation of responsibility to others, liability insurance, or indemnification by others, e.g., the plan sponsor. As an affirmative defense against this liability, fiduciaries can demonstrate that they took due care by retaining documentation of work materials that informed major decisions. Plan provisions may not be written to limit

this liability, however, and plan assets may not be used to indemnify fiduciaries for liability resulting from a breach of duty.



ERISA imposes personal liability on fiduciaries to reimburse the plan for losses resulting from a breach of duty.



It does not appear that state laws assign liability to individuals with respect to public plans to any significant degree. Section 7.4 discusses its inclusion in a model law issued by the Uniform Law Commission and there is further discussion of this topic in Part 8.

PART 7

CURRENT STATE LAWS AND PROPOSED MODEL LAWS

Part 6 described the rules under ERISA that apply to private sector retirement plans, including recent changes. This part discusses some of the current rules throughout the states as well as model laws that have been drafted by the Uniform Law Commission (adopted to varying degrees) and a model law proposed recently by the American Legislative Exchange Council (ALEC).

7.1

CODIFICATION OF CORE FIDUCIARY PRINCIPLES IN THE STATES

Fiduciary guiding principles are currently recognized in the laws of the majority of states. A 2017 study by Pew found:⁴³

⁴³ Greg Mennis, "Basic Legal Protections Vary Widely for Participants in Public Retirement Plans," The Pew Charitable Trusts, [pewtrusts.org](https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2017/11/basic-legal-protections-vary-widely-for-participants-in-public-retirement-plans) (21 Nov. 2017): <https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2017/11/basic-legal-protections-vary-widely-for-participants-in-public-retirement-plans>

- 35 states had codified rules requiring that investments be *solely in the interest* of plan members (which is a requirement for all private sector pension plans under ERISA)
- Every state had codified rules requiring investments to be for the *exclusive purpose* of providing benefits
- 47 states had codified the *prudent investor* rule
- 39 states explicitly require that investments be diversified

Nevertheless, various organizations have drafted model laws to facilitate standardizing what they believe to be best practices.

7.2

THE UNIFORM LAW COMMISSION (ULC)

On its website, the Uniform Law Commission describes itself as follows:⁴⁴

The Uniform Law Commission (ULC, also known as the National Conference of Commissioners on Uniform State Laws), established in 1892, provides states with non-partisan, well-conceived and well-drafted legislation that brings clarity and stability to critical areas of state statutory law.

ULC members must be lawyers, qualified to practice law. They are practicing lawyers, judges, legislators and legislative staff and law professors, who have been appointed by state governments as well as the District of Columbia, Puerto Rico and the U.S. Virgin Islands to research, draft and promote enactment of uniform state laws in areas of state law where uniformity is desirable and practical.

It has drafted two model laws that could pertain to fiduciary obligations in the context of pension plans:

- (1) The Uniform Prudent Investors Act; and
- (2) The Uniform Management of Public Employee Retirement Systems Act.

⁴⁴ "About Us," Uniformlaws.org, Uniform Law Commission: <https://www.uniformlaws.org/aboutulc/overview> (accessed 8 Mar. 2023)

7.3

THE UNIFORM PRUDENT INVESTORS ACT (1994)⁴⁵

The Uniform Prudent Investors Act (UPIA) was intended to help update trust investment law in consideration of evolving thinking around diversification in accordance with modern portfolio theory, delegation of fiduciary responsibility, etc. It “does not undertake to address issues of remedy law or ... damages.” The law was not drafted with pensions specifically in mind. It refers to “private gratuitous trusts” instead, but notes that the model law “also bears on ... pension trusts.”

The discussion and commentary included with the model legislative language expresses the opinion that:

No form of so-called “social investing” is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of trust beneficiaries—for example, by accepting below-market returns—in favor of the interests of the persons supposedly benefitted by pursuing the particular social cause.

The UPIA section of the ULC website notes that some version of UPIA has been adopted by 44 states.

7.4

THE UNIFORM MANAGEMENT OF PUBLIC EMPLOYEE RETIREMENT SYSTEMS ACT (1997)⁴⁶

The Uniform Management of Public Employee Retirement Systems Act (MPERS) is a model law specifically drafted for public pension plans. Only two states have adopted versions, though many of its provisions are probably included in various state laws. The prefatory note of the model Act states the purpose to “modernize, clarify, and make uniform the rules governing the management of public retirement systems”:

First, the Act articulates the fiduciary obligations of trustees and others with discretionary authority over various aspects of a retirement system and ensures that trustees have sufficient authority to fulfill their obligations. ... Second, the Act facilitates

⁴⁵ “Prudent Investor Act,” Uniformlaws.org, Uniform Law Commission: <https://www.uniformlaws.org/committees/community-home?CommunityKey=58f87d0a-3617-4635-a2af-9a4d02d119c9> (accessed 8 Mar. 2023)

⁴⁶ “Management of Public Employee Retirement Systems Act,” Uniformlaws.org, Uniform Law Commission: <https://www.uniformlaws.org/committees/community-home?CommunityKey=683e5c4d-8fd0-4ab9-8ea0-43b0b93ffdd0> (accessed 8 Mar. 2023)

effective monitoring of retirement systems by requiring regular and significant disclosure of the financial and actuarial status of the system, both to participants and beneficiaries directly and to the public.

It closely tracks ERISA in its provisions pertaining to fiduciary responsibilities. Like ERISA, it holds a “trustee or other fiduciary ... personally liable ... for any losses resulting from [a] breach” of fiduciary duty. “Trustee’ means a person who has ultimate authority to manage a retirement system or to invest or manage its assets,” in recognition of the governance structure (by trustee boards) of many public pension plans.

MPERS considered and rejected the specific self-dealing “prohibited transaction” provisions of ERISA (see Section 6.3) on the grounds that any such concerns are covered by the general duties of loyalty and prudence as well as general state conflict of interest laws.

In addition to describing the obligations of fiduciaries, as noted above, MPERS requires copious open public disclosure.

7.4.1 MPERS ATTEMPTS TO INSULATE TRUSTEES FROM POLITICAL PRESSURE

Very significantly, recognizing the possibility that trustees are likely to come under significant political pressure to invest in ways that may not be strictly consistent with core fiduciary principles, MPERS grants the trustees “exclusive authority” to perform their duties. As described in the accompanying commentary:

Trustees are different from other state actors because they are subject to an extensive and stringent set of fiduciary obligations ... [that] both require and justify some level of trustee independence.

7.4.2 MPERS ADDRESSES “COLLATERAL BENEFITS” IN PLAN INVESTMENTS

In Section 8, MPERS addresses the duties of trustees in investments and asset management, stating that trustees “may consider benefits created by an investment in addition to investment return only if the trustee determines that the investment providing these collateral benefits would be prudent even without the collateral benefits.” A literal reading of this model statutory language suggests a loophole of sorts: It requires only prudence and not optimality. However, the “Comment” narrative following Section 8 suggests a restrictive reading is intended.

MPERS was attempting to follow the approach of DOL Interpretive Bulletin 94-1, which was the controlling ERISA guidance at the time MPERS was written. The narrative explaining this MPERS provision states:

[A]s under the Labor Department's interpretive bulletin, an investment would be appropriate under this subsection if it is expected to provide an investment return commensurate with available alternative investments having similar risks. On the other hand, an investment will not be prudent if it is expected to produce a lower expected rate of return than available alternative investments with commensurate risk, or if it is riskier than available alternative investments with commensurate rates of return.

Presumably, in its intention to mirror ERISA provisions, MPERS rules around collateral benefits would closely align with the latest regulation if it were drafted today.

7.5

AMERICAN LEGISLATIVE EXCHANGE COUNCIL'S (ALEC): STATE GOVERNMENT EMPLOYEE RETIREMENT PROTECTION ACT⁴⁷

The State Government Employee Retirement Protection Act is model legislation seemingly narrowly intended to limit ESG-oriented investing in public pension plans. It adopts the pecuniary/non-pecuniary language in the 2020 Trump administration rule that has since been overridden by the 2022 Biden administration rule, though, as noted above, the substantive difference in the regulatory language between the two versions of the ERISA regulation seems minor, with both stressing the greater importance of financial considerations over collateral benefits.

The ALEC model law includes a definition of “pecuniary” that is effectively the same as the definition in the Trump-era regulation and requires adherence to the “sole interest” standard and prudent expert standard of care. It has standard language around diversification and acting in accordance with plan documents “insofar as such documents and instruments are consistent with” the model legislation.

⁴⁷ “State Government Employee Retirement Protection Act,” alec.org, American Legislative Exchange Council (ALEC). 29 Jul. 2022: <https://alec.org/model-policy/state-government-employee-retirement-protection-act/> (accessed 8 Mar. 2023)

The ALEC model law recognizes the possibility that an ESG factor may in fact be pecuniary but it limits the conditions under which it may be considered:

Environmental, social, corporate governance, or other similarly oriented considerations are [allowable] pecuniary factors only if they present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories.

The ALEC model law also prescribes that the proxy voting of plan-owned shares must be in accordance with the “pecuniary interest of plan participants,” which potentially limits the influence of proxy advisory firms or, e.g., third party asset managers, “unless [they have] a practice of, and in writing commit[s] to, follow proxy voting guidelines that are consistent with the fiduciary’s obligation to act based only on pecuniary factors.” Again, the substance tracks the Trump-era regulation, which is not in turn significantly different from the current Biden-era regulation.

Finally, the ALEC model law would give the attorney general powers to enforce the rule, subpoena relevant documents, and compel testimony or affidavits pertaining to adherence.

One difference between the ALEC model law and both the Trump-era and Biden-era regulations is that the ALEC model seems to *never* allow consideration of non-pecuniary factors, even as a tiebreaker or under the Trump-era “unable to distinguish on the basis of pecuniary factors alone” condition. But given the high bar in the ERISA regulations, this difference is likely of little practical importance. Another difference is the ALEC model specifically defines “non-pecuniary”—which is not defined in the Trump-era rule (as “pecuniary” is)—to “include any action taken or factor considered by a fiduciary with any purpose to further environmental, social, or political goals.” Factors not falling under the definition of pecuniary but not specifically defined as non-pecuniary would presumably be proscribed.

PART 8

TAKEAWAYS AND BEST PRACTICES

Preceding parts attempted to describe the generally shared understanding of fiduciary responsibilities. Various takeaways and best practices take shape. The list below is not exhaustive. The takeaways and best practices here are offered for high-level framing of recent controversies and for consideration by policymakers who may be attempting to codify or otherwise reinforce first-principle practices in connection with the investment of public plan assets.

TAKEAWAY #1: Nonfinancial goals in investing are inconsistent with fiduciary principles.

The plain meaning of investing solely in plan members' and taxpayers' best interests for the exclusive purpose of providing pension benefits and defraying reasonable expenses leaves no room for nonfinancial goals. Any investment made even partially based on a nonfinancial goal cannot logically be for the exclusive purpose of providing pension benefits and defraying reasonable expenses, both of which are financial in nature.

The theoretical existence of two investments that are in a risk-return tie, making it appropriate to consider nonfinancial factors to break the tie, is a conceit. Unless the two have the exact same return and risk, and the values are reasonably projected to move one-

for-one, then the fiduciary principle of diversification would call for buying them both. Those who cite this rationale for considering nonfinancial factors owe a real-world example.

The argument that an investment desired for nonfinancial reasons turned out to be the best financial decision after all is only slightly better (which is probably why one hears it more and more in phrases like “from values to value”). If the considerations are purely financial, there is no reason to have the discussion in the first place any more than for any other investment consideration. And as with any other investment, overweighting one’s holdings of it relative to its market weight is implicitly a claim that one knows something that the rest of the market does not and has good reason to believe the market is undervaluing it. (The argument is the same in the opposite direction for underweights.) Given the high profile of the investments for which such claims are made, those are bold claims warranting a high degree of skepticism. Like the tie-breaking argument, this one seems the product of highly motivated reasoning. Those who make it owe substantial analysis that shows a likely market mispricing.

TAKEAWAY #2: Federal rules (ERISA) have remained true to fiduciary principles while state law and practice have violated them in many cases.

For all the efforts made by several administrations over the years, the ERISA rules really haven’t changed much. It’s difficult to imagine a situation that satisfies the Biden rule’s condition for taking nonfinancial factors into account that wouldn’t satisfy the Trump rule’s condition. Both rules placed clear primacy on, and prohibit sacrifices with respect to, financial criteria, and thus hew closely to fundamental fiduciary principles. It therefore seems a good bet that nonfinancial conditions will not play a significant role in the investments of private sector defined benefit plans.

In contrast, on the topic of ESG, there has been a lot of activity at the state level both legislatively and by the executive branches that may result in material changes to investment policy that seem inconsistent with fundamental fiduciary principles, despite the actors paying lip service to those principles. The Texas and California case studies in Part 5 are examples, as is the Kentucky case study, though in that case the thrust of the law appears to have been largely nullified by an apparently courageous board invoking an exception based on its fiduciary responsibilities.

TAKEAWAY #3: Both political parties, taking opposite sides in the current ESG debate at the state level, seem to be acting contrary to fiduciary principles.

Governments may believe they have good reason to encourage or discourage certain behaviors or invest in certain industries, but doing so indirectly through pension plans places a disproportionate cost and/or risk on pension plan members. Regulation of economic activity to achieve societal goals should be done directly and transparently (using taxpayer money as needed) rather than through the back door by using pension money as a tool or a cudgel. The case studies in Part 5 result in pensioners and taxpayers being placed at greater financial risk by limiting the universe of allowable plan investments. However worthy a nonfinancial goal may be, using pension money to effectuate them in such a manner is, at best, a harmful weakening of the ability to invest in accordance with fiduciary principles, and, at worst, an outright violation of those principles.

Based on the takeaways above and evidence presented throughout, three best practices are offered here for consideration.

BEST PRACTICE #1: Allow only well-qualified people with investment knowledge to become investment fiduciaries, codify their responsibilities, and make them personally liable as under ERISA or MPERS.

Investing is complicated and becoming more so with time. Plan investment fiduciaries should have the requisite expertise and experience even where outside asset managers are being used. Fiduciaries should also have some knowledge of liabilities so that investments may be informed by liabilities' financial characteristics. For example, in a plan with full risk-sharing, higher portfolio risk implies more risk (and hopefully potential reward) for plan member principals and a minimal impact on risk for taxpayer principals. In a plan with no risk-sharing, higher portfolio risk means higher risk for taxpayer principals and minimal risk for plan member principals (except possibly for the higher risk of the plan defaulting on its obligations).

ERISA requires fiduciaries to be held personally liable for breaches of duty, as they are in other contexts as well. The same should be true with public pensions. Fiduciaries can purchase or be provided liability insurance, and can follow best practices, including documentation of processes and rationale, that are common in those other contexts to minimize liability and ensure thorough, disciplined decision-making. Sovereign immunity

should not protect fiduciaries from fiduciary liability if they breach their duty, either intentionally or through gross negligence. Plan members, unions, and taxpayers should have standing to sue, as should the attorney general who should also have powers to investigate. Timely, full, public disclosure and documentation regarding major investment decisions, including the hiring of experts or external asset managers, should be made regularly.

Fiduciary principles, including for the voting of proxies and exercise of shareholder rights, should be codified in state constitutions or at least legislatively. This codification can include that nonfinancial considerations are prohibited (mostly—see Best Practice 2) although doing so may be considered redundant with respect to the duty of loyalty. Proxy votes and the reasoning behind them should be made public.

The model provisions under MPERS described in Part 7, modeled on ERISA, is a good place to start for these provisions.

BEST PRACTICE #2: Free fiduciaries from sovereign interference as much as possible.

Fiduciaries are required to abide by law. As we have seen recently, some laws or executive orders result in mandated practices inconsistent with fiduciary principles. Protecting fiduciaries from legal or political pressure to act inconsistently with fundamental fiduciary principles—and ideally reinforcing the requirement to conform with those principles—is critical to ensuring that plans are managed in the best interest of plan member and taxpayer principals.

Along with codifying fiduciary provisions as suggested in Best Practice 1, it would be useful to codify in the state constitution when interference with fiduciary provisions is allowable, by whom, and how it may be effectuated (e.g., through legislation or executive order or by other officials). Codification could explicitly allow fiduciaries to bring suit against an offending government official or body to enforce noninterference.

It might also be useful to provide that usurping officials can be held personally liable on the same terms as fiduciaries (e.g., without recourse to sovereign immunity) when taking such action.

Specifying the exceptional situations where interference is allowed would require some care and could include, for just one example, investments involving the use of slave labor. Such a provision can make it clear that interference is not permitted where the goal is to promote or punish stances on societal issues, or promote local development or anything else that can and should be accomplished by direct regulation or government expenditures and violates fundamental fiduciary principles.

BEST PRACTICE #3: Separate the investment fiduciary function from the settlor functions of setting funding policy, adjusting benefit levels, etc.

As described above, investment fiduciaries often include the same system trustees that may be responsible for other fiduciary functions, such as overseeing plan administration, and possibly for settlor functions like recommending plan contributions and benefit level changes. Where the trustees are overseeing investments alongside funding policy or benefit level changes, the trustees will have conflicts of interest. For example, the trustees may have incentives to pursue aggressive investments to justify a high expected-return discount rate to minimize required contributions.

Eliminating conflicts would lead to better overall practice and likely better funding over time. One possible set-up would be for the investment fiduciaries to be different people from those performing the other functions. The investment fiduciaries would be responsible for setting an investment policy involving relatively low risk. If such a policy resulted in higher needed contributions or the need to adjust benefits, those adjustments would be the responsibility of the settlors performing those functions.

PART 9

CONCLUSION

Recent controversies around the investing of pension assets in both the public and private sectors highlight the extent to which fundamental fiduciary principles have been forgotten or lost. It is critically important that those principles be reaffirmed and strengthened so the large sums that accumulate in pension plans are used for their intended purpose on behalf of the principals for whom the money is set aside, and not used as a slush fund to advance goals unrelated to the providing of pension benefits.

When it comes to public pension investment management, policymakers and fiduciaries who sincerely want to serve their constituents and fulfill their responsibilities would do well if, through all the noise, they test all decisions against the fundamental duty of loyalty that requires investing **solely in plan members' and taxpayers' best interests for the exclusive purpose of providing pension benefits and defraying reasonable expenses.**

The plain implication is that investing pension assets to further nonfinancial goals is not consistent with fiduciary principles. The exclusive purpose of investing pension assets must be to provide pension benefits and defray reasonable expenses—nothing else. This doesn't preclude the possibility that pension plan investments might further a nonfinancial goal, but it cannot be the purpose for making the investment, or for any other fiduciary decision.

The guidance under ERISA that applies to private sector plans has managed to remain true to that principle through competing sets of regulations issued during the Trump and Biden administrations in a span of just two years. Public pension plan legislation and official acts,

on the other hand, in the ongoing wars over ESG, have undermined it. Both sides of increasingly acrimonious arguments pay lip service to those principles while often acting to weaken and undermine them.

Reversing this trend would be helped by: (1) allowing only well-qualified people with investment knowledge to become investment fiduciaries, codifying their responsibilities, and making them personally liable so they can be held accountable; (2) institutionalizing the inability of politicians and other government officials to require or pressure plan fiduciaries to act contrary to fiduciary principles; and (3) walling off the fiduciary function of investing plan assets from the settlor functions of setting benefit levels and contribution policy, to insulate fiduciaries from the pressure to invest more aggressively than a “prudent expert” might.

ABOUT THE AUTHOR

Larry Pollack is the principal at LIP Consulting LLC, a fellow of the Society of Actuaries, a member of the American Academy of Actuaries, and a fellow in the Conference of Consulting Actuaries.

Pollack's career includes more than 20 years in the actuarial consulting industry and nine years in the asset management industry. He is an active volunteer for several Society of Actuaries (SOA) working groups and co-authored a working paper on applying financial economics to public pension plans presented at the 2015 SOA investment symposium. He is the author of the Substack Newsletter *Pension Questions*.

