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Pension Plan Investments: ERISA Fiduciaries May Consider Environmental, Social, and Governance Factors Related to Economic Value

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Over the past two decades, the U.S. Department of Labor (DOL) has issued a number of advisory opinions and interpretive bulletins on "economically targeted investments" (ETIs). These investments are generally defined as investments selected for the economic or other benefits they create in addition to the investment returns generated for the pension plan. Under this guidance, pension trustees may treat these "ancillary benefits" as a tie-breaker when choosing between investment alternatives, provided that these alternatives are otherwise equal with respect to return, risk, liquidity and diversification. On October 22, 2015, DOL issued Interpretive Bulletin (IB) 2015-01 addressing ETI investments. In this IB, DOL reiterated the validity of the "tie-breaker" test but also provided new guidance. When making investment decisions, plan fiduciaries should consider environmental, social and governance (ESG) factors that have a direct relationship to the economic value of the investment. In these circumstances, these factors are not ancillary considerations or tie breakers; rather, they are "proper components" of the analysis of the economics of the investment.

Fiduciary Duties under ERISA

Under sections 403 and 404 of the Employee Retirement Income Security Act (ERISA), pension plan trustees have a fiduciary duty to hold the assets of an employee benefit plan in trust for the benefit of the plan participants.[1] Generally, a plan fiduciary discharges its duties by providing benefits to participants, acting prudently, and diversifying plan investments to minimize risk.[2] Trustees have two primary fiduciary obligations: the duty of loyalty and the duty of prudence. The first requires a fiduciary to act solely in the interest of the plan's participants and beneficiaries; the second requires a fiduciary to act with reasonable prudence in managing the plan and its assets. These duties are rooted in the common law of trusts, which is the source of ERISA fiduciary standards, as well as the standards applied to most, if not all, public pension trustees in this country. For this reason, state courts look to ERISA and DOL for guidance on state fiduciary standards even though public pension plans are exempt from ERISA as "governmental plans."

[1] 29 U.S.C. §§ 1103–1104.

[2] 29 U.S.C. § 1104.

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Previous DOL Bulletins

In 1994, the DOL issued IB 94-1 to address the issue of ETIs. In the summary section, the DOL explained that plan fiduciaries could invest in an ETI "if the ETI has an expected rate of return that is commensurate to rates of return of alternative investments with similar risk characteristics that are available to the plan, and if the ETI is otherwise an appropriate investment for the plan in terms of such factors as diversification and the investment policy of the plan."[3] This has been called the "all things being equal" test. DOL reasoned that by using this test the economic interests of the plan beneficiaries are protected if the selected investment is economically equivalent to competing investments. Thus, if an ETI had a similar rate of return and risk characteristics as an alternative investment, the plan fiduciary could choose the ETI using ESG (or similar) factors as the "tie breaker."

In 2008, the DOL superseded IB 94-1 with IB 08-01, clarifying that "fiduciaries who rely on factors outside the economic interests of the plan in making investment choices … will rarely be able to demonstrate compliance with ERISA absent a written record demonstrating that a contemporaneous economic analysis showed that the investment alternatives were of equal value."[4] The IB listed several examples of when ETIs were not proper alternatives — when they created risk of large losses, when they lacked diversification or when they did not allow the plan to meet liquidity needs. IB 08-01 effectively required additional due diligence if fiduciaries relied on any collateral factors to influence investment decisions. Thus, DOL appeared to be dissuading plan fiduciaries from making ETIs and from considering similar factors in making investments.

Guidance from IB 2015-01

Because DOL believes the previous IB "unduly discouraged fiduciaries from considering ETIs and ESG factors," the DOL this month withdrew IB 2008-01 and replaced it with IB 2015-01.[5] Under the new IB, DOL articulated four important points of guidance.

First, DOL restated its long-standing "tie-breaker" rule. Pension trustees do not violate their fiduciary duties when making ETIs, provided that the investment is economically equivalent to alternatives. Under this analysis, collateral factors may be used as tie-breakers when choosing between investment alternatives that are otherwise equal with respect to risk characteristics and rate of return.

Second, DOL clarified that fiduciaries may also view ESG factors as central factors in the economic analysis of competing investments and not as simple tie-breakers. As DOL explained, "[e]nvironmental, social, and governance issues may have a direct relationship to the economic value of the plan's investment. In these instances, such issues are not merely collateral considerations or tie-breakers, but rather are proper components of the fiduciary's primary analysis of the economic merits of competing investment choices."[6] Thus,

[3] IB 94-1.
[4] IB 08-01 (emphasis added).
[5] IB 2015-01.
[6] *Id.* (emphasis added).

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"[f]iduciaries need not treat commercially reasonable investments as inherently suspect … merely because they take into consideration environmental, social, or other such factors." [7]

Third, ERISA plans may incorporate ETIs in their investment policies. The DOL clarified that ERISA does not prohibit a fiduciary from "addressing ETIs or incorporating ESG factors in investment policy statements or integrating ESG-related tools, metrics and analyses."

Finally, DOL provided guidance that there is no requirement for special documentation or evaluation of ETIs beyond that required for other investments. The standards applicable to ETIs are no different than the standards applicable to plan investments generally: "the Department believes that fiduciaries responsible for investing plan assets should maintain records sufficient to demonstrate compliance with ERISA's fiduciary provisions. As with any other investments, the appropriate level of documentation would depend on the facts and circumstances." [8]

Conclusion

This new IB is a significant milestone that recognizes the value of environmental, social and governance factors in investing. So long as these factors are "directly related" to the risk, return and liquidity profiles of an investment, plan trustees may appropriately integrate them into the decision making process without compromising their fiduciary duties of loyalty and prudence. These factors are clearly related to many types of investments: The decision to invest in the development of a new deep-water port, for example, should clearly include ESG factors; for securities traded in an efficient public market, the correlation may not be as readily apparent. But even for these investments, DOL has made clear that ESG analytical tools are appropriate so long as they are reasonably prudent. Plan fiduciaries should, therefore, become more comfortable with ETIs and ESG factors following this guidance.

[7] *Id.*
[8] *Id.*

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