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"Socially Responsible" Investing Under ERISA: New DOL Guidance

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Fiduciary concerns may have prevented plan committees from considering "economically targeted investments" (ETI) – such as investments that observe environmental, social or governance responsibility (ESG) standards – as alternatives for their plans. Recent ***Department of Labor*** guidance, Interpretive Bulletin 2015-01 (the "Bulletin"), provides helpful clarity and should alleviate many of these concerns. (For convenience, we use the term "plan committee" to refer to the responsible investment fiduciaries of a plan.)

In this Alert, we outline a fiduciary process that committees should follow in evaluating ETIs versus other investment alternatives, based on the key points in the Bulletin.

Key Takeaways for Plan Committees

- ETIs are not "inherently suspect" and do not have to be subjected to "special scrutiny" above that required for other investments, despite how previous DOL guidance has been interpreted.
- Committees can take ESG considerations into account as primary factors when selecting between investment alternatives where those considerations are expected to affect investment returns.
- Committees can also consider ESG features as secondary factors to "break ties" between otherwise-equivalent alternatives (there may be multiple prudent choices available within a particular investment category, e.g., large cap value mutual funds.)
- When selecting investments in part because of ESG considerations, committees need to observe a prudent process to ensure that any ETI selected is reasonably expected to perform as well as other available alternatives within that category with similar risk.

- If a committee is not comfortable selecting ETIs, but wants to accommodate plan participants, it could consider providing a brokerage or mutual fund window through which participants may select investments, including ETIs. (The issue of selecting a brokerage window raises fiduciary considerations that a committee should evaluate. Those considerations are beyond the scope of this Alert.)

What the Bulletin Says

The Bulletin explains: “an economically targeted investment broadly refers to any investment that is selected, in part, for its collateral benefits, apart from the investment return to the employee benefit plan investor.” It goes on to stress that ERISA does not “permit fiduciaries to sacrifice the economic interests of plan participants in receiving their promised benefits in order to promote collateral goals.”

Primary Factors

In the Bulletin’s preamble the DOL explains that, in some cases, ESG factors may be primary considerations:

> *Environmental, 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**…***
>
> *…the Department does not believe ERISA prohibits a fiduciary from addressing ETIs or incorporating ESG factors in investment policy statements or integrating ESG-related tools, metrics and analyses to evaluate an investment’s risk or return…*[Emphasis added]

In other words, committees may consider these types of issues as primary factors in evaluating investment alternatives, where they are expected to affect an investment’s risk/return profile.

Secondary Factors

The Bulletin also confirms that committees can consider environmental, social, governance responsibility and similar considerations as secondary factors to “break ties” between otherwise-equivalent alternatives. The Bulletin reinstates language from an earlier Interpretive Bulletin (94-1), which endorsed this “tie-breaking” approach, and withdraws a 2008 Interpretive Bulletin (2008-01), which the DOL said “has unduly discouraged fiduciaries from considering ETIs and ESG factors….[and] sets a higher but unclear standard of compliance for fiduciaries when considering ESG factors or ETI investments.” Rather, as the Bulletin explains, the fiduciary standards for evaluating ETIs are no different than those for other investments.

Fiduciary Process for Evaluating ETIs

When evaluating whether an ETI is a prudent investment, committees should:

- Consider and compare the ETI against other alternatives with similar risk characteristics (same asset class, similar investment approach, etc.).

- Evaluate each of the alternatives using traditional metrics for considering investments (*e.g.*, expense ratio, past performance, quality of management, etc.).

- Consider whether environmental, social, or governance factors associated with the ETI are "primary factors" that are expected to affect returns either positively – for example, by improving stock performance through unique growth opportunities or reduced litigation risk – or negatively – for example, due to burdensome restrictions.

- Where appropriate, receive input from an independent investment advisor in evaluating the investment alternatives.

- Only select an ETI if either (1) it is superior to the other alternatives in terms of expected risk-adjusted returns; or (2) the available alternatives are effectively indistinguishable in terms of anticipated risk/return, and thus there is a "tie" that the secondary ESG factors can "break."

- Document the committee's decision-making process in its minutes, and retain the materials that were reviewed in the decision-making process (including any input from an investment advisor).

Even though the Bulletin may help encourage the consideration of ESG factors, the DOL admonishes that:

> ***..****.an investment will not be prudent if it would be expected to provide a plan with a lower rate of return than available alternative investments with commensurate degrees of risk or is riskier than alternative available investments with commensurate rates of return.* [Emphasis added]

That is, ETIs should only be selected where a committee can conclude reasonably that future returns are expected to be competitive, relative to risk.

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