
LEGAL UPDATE

Politics and Economically Targeted Investments

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For the third time in a little over two decades, the Department of Labor (DOL) adjusted the decision-making process that plan fiduciaries must use when deciding whether to invest plan assets in economically targeted investments (ETIs). In Interpretive Bulletin 2015-01,

its latest pronouncement on this topic, the DOL defines ETIs as “investments selected for the economic benefits they create apart from their investment return to the employee benefit plan.” ETIs have also been referred to as environmental, social, and governance (ESG) investing, which can

encompass such initiatives as a labor union's pushing plans to invest in construction projects that will produce more jobs for members, plan investment policies that favor investing in so-called "green companies," and plan investment menus with screens excluding companies that resist shareholder activism or do business with foreign governments whose policies are viewed as unacceptable.

ETI Factors and 401(k) Plans. One might ask how the rules affecting such investments relate to 401(k) plans, which, by and large, are participant-directed, so that the question of whether to direct investments to political or social ends is left to the participant. The answer to this question is that the DOL has concluded that the fiduciary standards applicable to ETIs also apply to the selection of investment alternatives for the menu of an individual account plan, such as a 401(k) plan. ETI issues may also arise in the formulation of a 401(k) plan's investment policy statement, which controls how investment alternatives are chosen and when they should be replaced. Further, in selecting an investment advisor or advisors to help participants manage their accounts, consideration of the advisor's ETI practices will be relevant with respect to whether a plan fiduciary has met its fiduciary duties.

Evolution of Fiduciary Standard. In selecting plan investments, ERISA requires fiduciaries to engage in a prudent decision-making process and to act solely in the interest of participants and beneficiaries for the purpose of providing benefits and paying plan expenses. The extent to which noneconomic incidental benefits can be taken into account in this decision-making process has always been a difficult question. Prior to 1994, the DOL issued a number of advisory opinions and information letters concerning a fiduciary's ability to consider the collateral effects of an ETI. This guidance can be summarized by the statement in Advisory Opinion 1988-16A that "such investments would not be prudent if they provided a plan with less return, in comparison to risk, than comparable investments available to the plan, or if they involved a greater risk to the security of plan assets than other investments offering a similar return."

Advisory Opinion 1988-16A went on to note that, "A decision to make an investment may not be influenced by noneconomic factors unless the investment, when judged solely on its economic value to the plan, would be equal or superior to alternative investments available to the plan." This is sometimes referred to as the "all things being equal" test, because it permits ESG-type factors to be considered by a fiduciary as a tie-breaker once it has been determined that the economic factors are equivalent.

In 1994, Interpretive Bulletin 94-1 tilted in favor of ETIs by correcting what the DOL now terms the "popular misperception" that ETIs were incompatible with ERISA fiduciary obligations. Accordingly, without modifying prior guidance

that the returns and risk of ETI investments, as well as their diversification and liquidity characteristics, must be at least as good as non-ETI investments, the 1994 bulletin concluded that "fiduciary standards applicable to ETIs are no different than the standards applicable to investments generally."

In 2008, the DOL, then under the control of a Republican administration, retreated in the other direction by replacing its 1994 guidance with Interpretive Bulletin 2008-1, which emphasized that "fiduciaries who rely on factors outside the economic interest of the plan in making investment choices and subsequently find their decision challenged 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." (*Italics added.*) The 2008 bulletin also included five examples showing how various ETIs failed the all things being equal test.

Along with the 2008 bulletin's generally dim view of ETIs whose economics did not measure up to those of more traditional investments, the statement that a written economic analysis would be necessary in many cases to support the decision to invest in an ETI allowed ETI proponents to argue that the 2008 bulletin "unduly discouraged fiduciaries from considering ETIs and ESG factors." This complaint was heeded by the current Democratic administration, which has replaced the 2008 bulletin with Interpretive Bulletin 2015-01.

Back to the Future. Interpretive Bulletin 2015-01 simply reinstates the standards set forth in Interpretive Bulletin 1994-1. Thus, if plan fiduciaries select an investment based solely on economic considerations, collateral ESG factors will not cause the investment to be viewed as "inherently suspect" and there will be no need to view ESG goals as tie-breakers. Further, the written analysis requirement, which would have applied if economics alone were not sufficient to justify the investment, has been dropped. Nothing in the new bulletin itself breaks new ground and the "everything being equal" test is reaffirmed.

The preamble to Interpretive Bulletin 2015-01, however, takes things a step further by stating the DOL's belief that ESG-related tools, metrics, and analyses can be used to evaluate an investment's risk or return or choose among otherwise equivalent investments. Up to now, ESG factors have been treated as separate from the economic analysis of an investment. Taken to its logical conclusion, the thought expressed in the preamble could mean that a fiduciary may increase an ETI's expected return in comparisons with traditional investments to reflect a presumed greater likelihood of its success. Since there are no universally accepted standards for quantifying the effect of ESG factors on investment earnings and risk, the preamble appears to have introduced an element of subjectivity into the analysis of ETIs. If the DOL is serious about this

new development, we might expect it to issue rules imposing standards ensuring that the ESG tools and metrics it refers to in the preamble of Interpretive Bulletin 2015-01 are objective.

The Great Game. The restriction and liberalization of the standard for evaluating ETIs has been a hotly contested political issue. When the Republican party has controlled the administration, the emphasis has been on guarding against the subordination of a retirement plan's economic interest to objectives unrelated to providing retirement benefits and defraying expenses. When the DOL has been under the control of the Democratic party, there has been more openness to using plan funds to support public goals as well as retirement benefits. Interpretive Bulletin 2015-01, the latest

move in this game, retains the traditional "all things being equal test," but introduces a disruptive element by suggesting that the basic economic analysis of an ETI can be performed using metrics and tools unique to ETIs. This could put plan fiduciaries in uncharted waters as they try to decide whether investment in an ETI would be permitted. The risk of making the wrong decision is enhanced by the fact that a change in political fortunes could result in the revocation of the latest Interpretive Bulletin.

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