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Department of Labor Clarifies ERISA Fiduciary Requirements With Respect to Economically Targeted Investments and Environmental, Social, and Governance Goals

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Last month, the Department of Labor (the "Department") issued an Interpretive Bulletin 2015-01[1] (the "Bulletin") clarifying the extent to which the Employee Retirement Income Security Act of 1974 ("ERISA") permits fiduciaries to consider environmental, social, and governance ("ESG") factors or "economically targeted investments" ("ETIs") in their plan investment choices. The Department noted that the terms ESG and ETI are evolving but generally described such investments as ones selected, at least in part, "because of the collateral economic or social benefits they may further in addition to their investment returns."

Under this new guidance, plan fiduciaries *should* consider ESG factors when such factors reasonably impact an investment's financial return or risk profile. In addition, the Department recognized that fiduciaries *may* consider ESG factors or ETIs as "tie-breakers" when deciding between investment alternatives that are otherwise equal in terms of risk and return.

CORRECTING A MISPERCEPTION IN CONSIDERING ESG GOALS

In issuing the new Bulletin, the Department sought to correct misperceptions caused by language in its previous Interpretive Bulletin 2008-01, which was seen as unduly discouraging plan fiduciaries from considering ETIs among potential investments, including "socially responsible" mutual funds. As Labor Secretary Thomas Perez succinctly told reporters, the 2008 Bulletin "gave cooties to impact investing."[2] In issuing the Bulletin, the Department rescinded the 2008 Bulletin and reinstated the language of its prior Interpretive Bulletin 94-01 in order to clarify circumstances in which considering ESG factors would be appropriate for ERISA plan fiduciaries.

PARAMOUNT IMPORTANCE OF RETURN AND RISK

The Bulletin reiterated the Department's view that an ERISA plan fiduciary may not subordinate the economic interests of a plan's participants and beneficiaries to ESG objectives. The Department re-emphasized that under ERISA (particularly sections 403 and 404) the focus of a plan fiduciary on rate of return and risk to beneficiaries is paramount: the fiduciary is required to minimize the risk of large losses, as well as to act solely in the interest of the plan's participants and beneficiaries and for the exclusive purpose of providing benefits to the plan's

[1] Link to Bulletin: https://s3.amazonaws.com/public-inspection.federalregister.gov/2015-27146.pdf

[2] Link to Comments : http://www.dol.gov/_sec/media/speeches/20151022_Perez.htm

participants and beneficiaries. Under the Department's view, an investment is not prudent if (i) it would provide a plan's participants and beneficiaries with a lower rate of return than available alternative investments with commensurate risk or (ii) it is riskier than alternative available investments with commensurate rates of return.

TWO OPPORTUNITIES TO CONSIDER ESG GOALS

The new Bulletin clarifies that ERISA plan fiduciaries may appropriately consider ESG factors in two situations:

- The first is when the ESG factors could potentially impact the risk and return profile of an investment opportunity. The Department notes that ESG factors may have a direct impact on the risk and return profile of an investment, and in these instances, such factors are proper considerations in the fiduciaries' analyses. According to impact investors, embedding ESG factors into core investment practices in fact helps to recognize risk and often improves performance. For instance, a Morgan Stanley Institute for Sustainable Investing analysis of more than 10,000 mutual funds over seven years found that those funds considering ESG factors performed as well or better than traditional funds.
- The second is when ESG factors are used as "tie-breakers" in selecting between otherwise equal investment opportunities. The new Bulletin underscores the Department's prior interpretation that ERISA does not prevent plan fiduciaries from investing in an ETI if it has a commensurate expected rate of return and risk profile as alternative appropriate investment. This is the so-called "all things being equal" test.

DOCUMENTING THE USE OF ESG FACTORS

In rescinding the 2008 Bulletin, the 2015 Bulletin removes the former requirement that fiduciaries making investment decisions based on ESG factors had to document such decisions in a contemporaneous writing that the ESG investment was "truly equal" to competing investment options, which the 2008 Bulletin said would be a determination that fiduciaries would be able to make only "rarely" and in "very limited circumstances." Instead, the new Bulletin notes that fiduciaries should maintain sufficient records demonstrating ERISA compliance with all investment decisions, whether or not involving ESG factors. In addition, the Department believes that since ERISA compliance is inherently a factual question, the appropriate level of documentation with respect to any investment depends on the particular facts and circumstances.

IMPACT ON IMPACT INVESTING

The Department's latest interpretation of ERISA duties could significantly expand the ETI market. With impact investing on the rise, and companies competing over the growing "socially conscious market," the new Bulletin sends a powerful message of the legitimacy of ESG investments, which, for non-ERISA funds, increased dramatically from $202 billion to $4.3 trillion from 2007 to 2014. By removing what Secretary Perez describes as "artificial barriers to investments that promote public good," the Department opens an additional $8.4 trillion in potential ERISA investments to impact funds and, ultimately, to those companies in the impact economy. The resulting increase in available capital is expected to prompt more impact funds to enter the ERISA investment market, strongly suggesting mainstream funds and companies receiving ERISA capital should pay ever closer attention to ESG factors to remain competitive.

TAKEAWAY

For plan fiduciaries looking to reconcile increasing calls for divestment and ESG-responsible choices with their fiduciary duties under ERISA, the Bulletin offers helpful parameters. ERISA requires plan fiduciaries to maximize financial returns while minimizing risk to beneficiaries, and a fiduciary may not subordinate either financial returns or risk profile to ESG goals. However, plan fiduciaries are expected to consider ESG issues when such issues potentially impact financial returns or risk. Further, plan fiduciaries may consider ESG goals when deciding among investments with commensurate financial return and risk characteristics in the nature of a tie-breaker factor between otherwise comparable choices. For renewable energy advocates, their next step may be persuading ERISA fiduciaries that climate change increases the risk profile and decreases the expected profitability of fossil fuel investments.

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