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Everything New is Old Again: A Framework for Economically Targeted Investments and ESG Factors Under the DOL's New (Old) Guidelines

By: Suzanne M. Dugan and Raymond M. Sarola

Public pension funds increasingly look to Economically Targeted Investments (ETI) and Environmental, Social, and Governance (ESG) factors in making investment decisions, both to obtain collateral social benefits and as part of their fundamental risk-return economic analyses. But what fiduciary standards apply to these types of investments? Concerned that its guidance from 2008 had "unduly discouraged" pension funds from making ETIs and considering ESG factors, the U.S. Department of Labor (DOL) last year issued a new Interpretive Bulletin that "reinstated" language from 1994 and took a more favorable view of such investments. The DOL's Interpretive Bulletin 2015-01 does more than simply revert to an earlier time, however – it demonstrates a more evolved and nuanced understanding, particularly of the multiple ways in which ESG factors can be considered in an investment decision. This current guidance acknowledges that factors associated with ETIs and ESG can, in some instances, be properly incorporated into an economic analysis without requiring additional procedural or substantive steps to ensure compliance with fiduciary obligations.

The DOL's updated guidance comes at a critical time, as broadly defined ESG investments are becoming a greater focus of investors across the globe. It has been reported that ESG assets have grown to over $6 trillion, and the signatories of the United Nation's Principles for Responsible Investing have over $59 trillion in assets under management.[1]

This article provides a history of the DOL's guidance on ETIs and ESG factors, explains the 2015 Interpretive Bulletin, and lays out a framework for pension funds' consideration of these investments and investment considerations that includes economic, fiduciary, legal, and governance aspects. While the most appropriate approach to a particular ETI or ESG factor will ultimately be driven by its specifics, this framework highlights best practices and provides courses of action that will allow pension funds to consider ETIs and ESG factors consistent with their fiduciary obligations.[2]

The DOL's Pre-2015 ETI Guidance

In 1994 and again in 2008, the DOL issued Interpretive Bulletins that applied the fiduciary standards of the Employee Retirement Security Income Act (ERISA) to economically targeted investments. Interpretive Bulletins are not legally binding on governmental plans, which are not covered by ERISA, but nonetheless provide the most discrete and useful guidance for public plan fiduciaries in considering ETI[3] and ESG[4] investments. A review of the 1994 Bulletin and the 2008 Bulletin that superseded it, reflects a perspective on ETIs that draws a bright-line distinction between financial investment factors and the "collateral benefits" that ETIs seek to provide. This was the prevailing perspective of the DOL until the 2015 Bulletin was issued last year.

Interpretive Bulletin 94-1: The "All Things Being Equal Test"

Interpretive Bulletin 94-1 ("IB 94-1")[5] was issued on June 23, 1994 and was the DOL's first comprehensive guidance on ETIs. Prior to this bulletin, the DOL had issued responses to specific questions raised by plan fiduciaries regarding the consideration of "non-economic" factors in investment activities, but those responses were largely limited to their particular facts.[6] IB 94-1 was published to "correct a popular misconception" that ETIs were wholly incompatible with ERISA's fiduciary requirements.

Beginning with the baseline fiduciary principles under ERISA — that plan investments be prudently managed for the exclusive benefit of plan participants[7] — the DOL set forth in IB 94-1 what has come to be known as the "all things being equal test" for ETIs:

> [T]he requirements of [ERISA] sections 403 and 404 do not exclude the consideration of collateral benefits in a fiduciary's evaluation of a particular investment opportunity. However, existence of such collateral benefits may be decisive in evaluating an investment only if the fiduciary determines that the investment containing the collateral benefits is expected to provide an investment return to the plan commensurate to alternative investments having similar risks.

This "all things being equal test" expressly permitted the consideration of collateral benefits while reaffirming that the interests of plan participants remain paramount. Only where there was a "tie" between the economic aspects of two potential

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investments could the consideration of collateral benefits from an ETI function as the "tie-breaker" and permit a plan fiduciary to select the ETI because of those collateral benefits.

Interpretive Bulletin 08-1: All Things Are Rarely Equal

In 2008, the DOL issued Interpretive Bulletin 2008-01 ("IB 08-01")[8], which superseded IB 94-1 and expressed the Department's perspective at that time that the situations in which collateral benefits may be used as a "tie-breaker" will be "very limited." The bulletin's language was overtly skeptical of ETIs and viewed the consideration of collateral benefits to be entirely distinguishable from a fund's more traditional financial analysis of potential investments:

At the highest level, pension funds that wish to consider ETIs and ESG investing should set forth in their Investment Policy Statement or similar governing document their investment philosophies and goals with respect to such investments.

> ERISA's plain text thus establishes a clear rule that in the course of discharging their duties, fiduciaries may never subordinate the economic interests of the plan to unrelated objectives, and may not select investments on the basis of any factor outside the economic interest of the plan except in very limited circumstances enumerated below.

In this way, IB 08-01 was an application of the "tie-breaker" rule from IB 94-1, but limited by the belief that alternative investment options will rarely be economically equivalent. IB 08-01 directs plan fiduciaries to undertake "a quantitative and qualitative analysis of the economic impact on the plan" of competing investment alternatives before concluding that such alternatives are equal.

The likely motivation for IB 08-01 was the DOL's concern that absent express restrictions on fiduciaries' consideration of collateral benefits, plan assets could be diverted from the exclusive benefit of plan participants to "promote myriad public policy preferences."

The 2015 Interpretive Bulletin

The DOL issued Interpretative Bulletin 2015-01 ("IB 15-01")[9] on October 26, 2015, out of a stated concern that IB 08-01 had "unduly discouraged" the consideration of ETIs and ESG factors. Specifically, the DOL believed that "the 2008 guidance may be dissuading fiduciaries from (1) pursuing investment strategies that consider environmental, social, and governance factors, even where they are used solely to evaluate the economic benefits of investments and identify economically superior investments, and (2) investing in ETIs even where economically equivalent." Accordingly, it withdrew IB 08-01 and reinstated the language from IB 94-01, while providing insight into how and in what circumstances plan fiduciaries can consider ESG factors in investment decision-making.

The language and tone of this bulletin was markedly different from the two prior, and uses the term "ESG" for the first time. Notably, the DOL did not restrict its characterization of historically "non-economic" factors to "collateral benefits," but spoke in terms of environmental, social, and governance issues that affect the "economic merits" of investment analysis:

> 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.

In acknowledging that ESG factors are not always "collateral" to economic analyses but may instead be important components of such analyses, the DOL informed fiduciaries that the consideration of ESG factors does not automatically trigger "special scrutiny" or cause otherwise reasonable investments to become "inherently suspect."

The DOL's guidance as expressed in IB 15-01 has evolved along with the global investment community's understanding of ETIs and the proper role of ESG factors. No longer are environmental, social, and governance factors summarily relegated to "non-economic" status and demanding of additional substantive and procedural requirements. Instead, where these factors influence the economic merits of a potential investment, they can and should be considered in the same manner as other, more traditional financial aspects.

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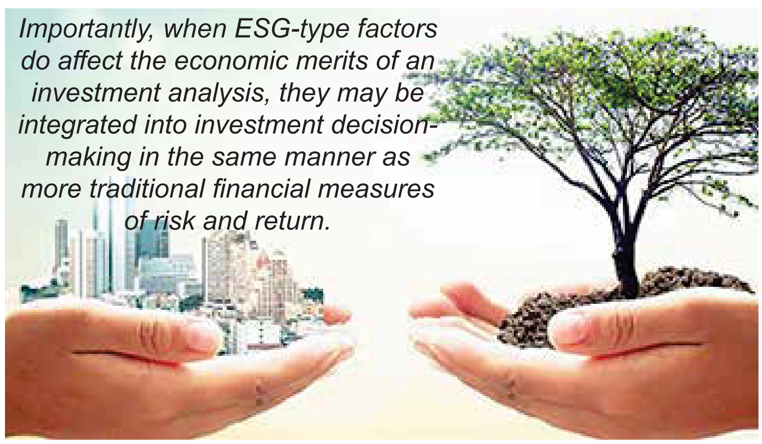
A Framework for ETI and ESG Investments

Pension funds looking to invest in ETIs and to incorporate ESG factors into investment decision-making will benefit from the guidance provided by the DOL in IB 15-01, but in order to implement this guidance will likely need to clarify and make more precise their processes for considering these investments.

At the highest level, pension funds that wish to consider ETIs and ESG investing should set forth in their Investment Policy Statement or similar governing document their investment philosophies and goals with respect to such investments. These policies should be explicit about which fund investments are considered ETI and what collateral benefits they target. When ESG factors are considered, funds should be clear about whether they are seeking to obtain collateral benefits or whether they are seeking to use ESG factors to augment and improve their economic analysis of an investment option.



The reinstated language of IB 94-01 provides the proper consideration of collateral benefits when they do not affect the economic merits of an investment – they may be used only as "tie-breakers" between economically equivalent options. While IB 15-01 has replaced the earlier directive that plan fiduciaries must in all cases document their conclusion that two investment alternatives are equal with a more flexible "facts and circumstances" standard, the best practice for pension funds using collateral benefits as "tie-breakers" is to create a contemporaneous record of their investment decision-making that includes the basis for concluding that the alternatives have equivalent economic merits.

Importantly, when ESG-type factors do affect the economic merits of an investment analysis, they may be integrated into investment decision-making in the same manner as more traditional financial measures of risk and return. IB 15-01 makes clear that in these instances, "there is no need to evaluate collateral goals as tie-breakers." At the same time, pension funds should note that IB 15-01 did not conclude that all ESG factors will always have a direct relationship to the economics of a given investment. Accordingly, pension funds should in these cases be sure to document their basis for determining that one or more ESG factors are sufficiently related to the expected financial performance of a particular investment option.

Attaining the maximum benefit from ETIs and the consideration of ESG factors requires the coordination among many aspects of public pension fund governance. Boards of trustees will set big-picture ETI and ESG goals, and investment staff and consultants will analyze potential investments in light of those goals. General Counsel and outside attorneys will advise as to the necessary considerations and procedures to comply with fiduciary requirements and other relevant laws. In addition, those responsible for pension funds' corporate governance and shareholder activism programs can provide critical expertise on specific ESG factors and their relationship to the financial performance of a company. The more coordinated these efforts are, the greater the ability of a pension fund to realize the full range of economic, social, and governance benefits it seeks.

Conclusion

IB 2015-1 is the latest addition to the DOL's evolving guidance on ETIs and ESG factors. The 1994 bulletin clarified that ETIs are not automatically excluded from consideration and that collateral benefits can be considered as "tie-breakers." The 2008 bulletin warned plan fiduciaries that the situations in which equivalent investments may be distinguished on the basis of collateral "tie-breakers" will be rare. The DOL now recognizes the more complicated overlap between ETI and ESG factors on one hand, and what was historically considered a purely "economic" analysis on the other. Accordingly, the nuanced approach of IB 15-01 directs plan fiduciaries to identify the exact way in which ESG factors are being considered, and states that when applied as part of an economic analysis, ESG factors should be treated just like other financial considerations.

While the 2015 bulletin is welcome news for plans that view ETI and ESG as important aspects of their investment policy, it also

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demands attention and precision in the way pension funds treat ESG factors. This article presents a framework for pension funds that wish to continue or expand their ETI and ESG programs. In so doing, they may recognize that certain aspects of this new approach are familiar, even while improving their policies and practices for the future.

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ENDNOTES

[1] See Principles for Responsible Investment, "*Signatory base AUM hits $59 trillion*," available at **https://www.unpri.org/page/signatory-base-aum-hits-59-trillion**; The Forum for Sustainable and Responsible Investment, "Fast Facts," available at **http://www.ussif.org/content.asp?contentid=40**.

[2] This article focuses on the implications of Interpretive Bulletin 2015-01 for defined benefit public pension plans. The standards set forth in IB 2015-01 similarly apply to the selection of "socially-responsible" investment options offered by defined contribution plans.

[3] The 2015 Interpretive Bulletin notes that a consistent definition for ETI remains elusive and sometimes overlaps with terms like "socially responsible investing," as well as ESG. Nonetheless, the bulletin provides an appropriate definition of ETI: "any investment that is selected, in part, for its collateral benefits, apart from the investment return to the employee benefit plan investor."

[4] "ESG" is also difficult to define, and perhaps can be done most usefully by including examples of considerations that fall under its heading – transparency and disclosure; corporate governance; human rights and civil liberties; energy efficiency; discrimination based on personal characteristics; workers' rights; etc. (See e.g., CalSTRS Investment Policy for Mitigating Environmental, Social and Governance Risks (ESG), at A-23).

[5] 59 Fed. Reg. 32606 (June 23, 1994).

[6] See e.g., IB 94-1 at n. 7.

[7] ERISA Section 403 requires that the assets of a retirement plan be held in trust for the "exclusive purposes of providing benefits to participants in the plan and their beneficiaries and defraying reasonable expenses of administering the plan." 29 U.S.C. § 1103(c). Section 404 further requires that fiduciaries administering a retirement plan act with prudence and diversify plan investments to minimize the risk of large losses. 29 U.S.C. § 1104(a). These requirements are consistent with the general statutory and common law fiduciary obligations of those charged with administering public pension plans.

[8] 73 Fed. Reg. 61734 (Oct. 17, 2008).

[9] 80 Fed. Reg. 65135 (Oct. 26, 2015).

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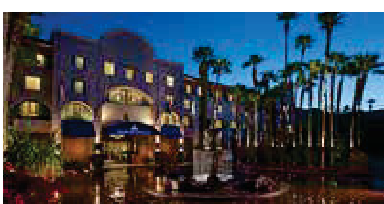
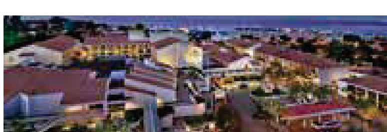
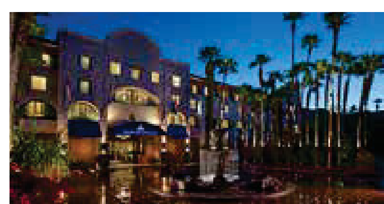


2017 Winter Seminar
Tempe, AZ (Tempe Mission Palms Hotel)
February 22 - February 24, 2017

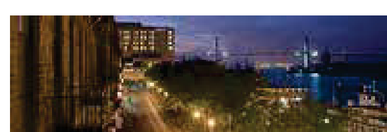


2017 Legal Education Conference
Monterey, CA (Portola Hotel)
June 27 - June 30, 2017
New Attorney Session on June 27th

2018



2018 Winter Seminar
Tempe, AZ (Tempe Mission Palms Hotel)
February 21 - February 23, 2018



2018 Legal Education Conference
Savannah, GA (Savannah Hyatt Regency)
June 26 - June 29, 2018
New Attorney Session on June 26th

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