401(k) Investments

New Life for Socially Responsible Investing: New DOL Guidance May Help the Growth of SRI in Retirement Plans

On October 22, 2015, the Department of Labor (DOL) published Interpretive Bulletin 2015-01, overriding 2008 guidance that effectively prohibited the use of social, environmental, religious, or moral considerations in retirement plan investing. The Bulletin breathes new life into the possibility of "socially responsible" investing, with the caveat that the burden of fiduciary prudence is undiminished.

BY PETE SWISHER

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Why should a Muslim or Jew be forced to invest in securities that charge interest (forbidden under the rules of both religions, though in different ways), or a Southern Baptist to invest in casinos and distilleries? Why should an environmentally conscious investor be forced to invest in strip mines or companies that pollute? Why should a pacifist have to invest in companies that manufacture guns? Why should any investor be prohibited from considering whether companies in which one invests treat their workers humanely or behave justly? In short, why should anyone be prohibited from considering his or her own closely held beliefs as part of making investment choices?

The DOL's answer, until October 22, 2015, was that such considerations were mostly inappropriate for fiduciaries, and only economic considerations were permitted, with rare exceptions. In the 2015 Bulletin it appears to pain the DOL that people thought this was what they meant, but it is, more or less, what they said. Under the previous guidance on socially responsible investing (SRI) in Interpretive Bulletin (IB) 2008-1:

> ERISA's [The Employee Retirement Income Security Act of 1974, as amended] plain text thus establishes a clear rule that…fiduciaries…may not select investments on the basis of any factor outside the economic interest of the plan except in very limited circumstances…
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> And, "The Department rejects a construction of ERISA that would render the Act's tight limits on the use of plan assets illusory, and that would permit plan fiduciaries to expend ERISA trust assets to promote myriad public policy preferences…" [29 CFR § 2509.2008-1]

This is strong, discouraging language; the 2015 Bulletin is much more favorable.

Terminology

In the 2015 Bulletin, the DOL uses the term "economically targeted investments" as a catch-all to describe any investment involving "socially conscious" screening, for which several terms might be used. SRI ("socially responsible investing," but also "sustainable, responsible, and impact" investing depending on source) is perhaps the most common catch-all term in common usage, and the abbreviation ESG describes environmental, social, and governance factors, including religious or moral considerations, used when screening securities or money managers. Use of the term "economically targeted investments" (ETI) in the investment world has generally been limited to government programs aimed at helping targeted groups or locations, such as investment in low-income housing developments that receive special tax treatment.

ETI has generally not been used in any other context to refer to the broader spectrum of socially conscious investing, but the DOL uses ETI in this broader sense in the 2015 Bulletin, probably because ETIs were the focus of the 1994 guidance on which they base the 2015 revision. Commentators might, therefore, choose to follow suit and begin replacing the term "SRI" with "ETI," but this column continues to use SRI to describe the "socially responsible" approach to investing and ESG to describe the factors used when screening investments. [29 CFR § 2509.94-1, Interpretive Bulletin 94-1]

Summary of the 2015 vs. 2008 Guidance

The 2015 Bulletin does not provide a safe harbor, but it signals a level of acceptance of SRI that was utterly lacking in previous guidance and offers a relatively simple formula for using SRI—just follow the same rules you do for all other investments. It does so by:

- Rescinding the 2008 guidance;
- Replacing it with language based upon the original 1994 guidance; and
- Clarifying the DOL's more favorable stance via the Preamble.

The 2008 Bulletin created a test for SRI that was virtually impossible for a cautious fiduciary to pass with confidence. It may be described as the "equal value" doctrine:

> "… because every investment necessarily causes a plan to forgo other investment opportunities, an investment will not be prudent if it would be expected to provide a plan with a lower rate of return than available alternatives with commensurate degrees of risk or is riskier than alternative available investments with commensurate rates of return…Situations may arise, however, in which two or more investment alternatives are of **equal economic value** to a plan." But before choosing an SRI investment, "…fiduciaries must have first concluded that the alternative options are **truly equal**." [Emphasis added.]

The 2008 Bulletin appears to disapprove of the very notion of SRI. ("The Department rejects a construction of ERISA that would…permit plan fiduciaries to expend ERISA trust assets to promote myriad public policy preferences.") The "equal value" doctrine can easily be construed, via a *reductio ad absurdum* that is not so absurd in light of this unfavorable language, as making it unsafe to choose an SRI fund if there is even a single alternative investment that looks better. And in a universe of over 20,000 funds, there is always something that looks better.

The reason that the 2015 Bulletin is favorable to SRI is not that it changes the DOL's fundamental analysis of ERISA—on the contrary, much of the basic language remains—but because the DOL is clearly expressing a newfound comfort level with SRI, if done properly. The key is to know what "properly" means. Compare this 2015 language to that from 2008 above:

> "Fiduciaries may not accept lower expected returns or take on greater risks in order to secure collateral benefits…" (The same basic position as in all prior guidance.)
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> But, "The Department believes that in the seven years since its publication, IB 2008-01 has unduly discouraged fiduciaries from considering ETIs and ESG factors. In particular, the Department is concerned 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. Some fiduciaries believe the 2008 guidance sets a higher but unclear standard of compliance for fiduciaries when they are considering ESG factors or ETI investments."
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> "…if a fiduciary prudently determines that an investment is appropriate based solely on economic considerations, including those that may derive from environmental, social and governance factors, the fiduciary may make the investment without regard to any collateral benefits the investment may also promote. Fiduciaries need not treat commercially reasonable investments as inherently suspect or in need of special scrutiny merely because they take into consideration environmental, social, or other such factors. When a fiduciary prudently concludes that such an investment is justified based solely on the economic merits of the investment, there is no need to evaluate collateral goals as tie-breakers."

One of the concerns raised about the 2008 Bulletin was that it seemed to require a higher documentation and due diligence burden for SRI investments than for others. The 2015 version dispels this:

> … the Department does not construe consideration of ETIs or ESG criteria as presumptively requiring additional

> documentation or evaluation beyond that required by fiduciary standards applicable to plan investments generally.

The key to the 2015 Bulletin is in its clarification that SRI investments may be scrutinized using exactly the same criteria as other investments with safety, and that considering SRI characteristics is allowed:

> The fiduciary standards applicable to ETIs are no different than the standards applicable to plan investments generally. Therefore, if the above requirements [Specifically, the requirements of the DOL's prudence regulation, 29 CFR 2550.404a-1] are met, the selection of an ETI, or the engaging in an investment course of action intended to result in the selection of ETIs, will not violate ERISA's Exclusive Purpose and Prudence requirements.

The 2015 Bulletin says, in essence, "Follow our prudence regulation [29 CFR § 2550.404a-1] the same for SRI as you do for all investments. So long as you do that, SRI is fine." This removes any concern that the 2008 Bulletin's "equal value" doctrine represents a stricter standard for SRI funds than for other investments, and it reverses the Department's fairly stern injunction against even considering ESG factors under most circumstances. This is a significant change, and it appears to pave the way for fiduciaries who wish to embrace an SRI component in their plans.

Liability Exposure from Lagging Returns or Increased Volatility

The problem that remains even after the 2015 Bulletin is that a fund following SRI principles will inevitably underperform various other, non-SRI funds some percentage of the time, and an enterprising plaintiff's attorney might decide that the underperformance is an opportunity for litigation regardless of the prudence of the fiduciaries' decisions. The situation is not dissimilar to that of the "stock drop" lawsuit: there are plaintiff's attorneys who will attack a 401(k) with employer stock if the stock drops 25 percent or more, regardless of the reason for the drop. In the same way that employer stock creates a risk, SRI funds may create a risk.

Framework for a Workable, Socially Responsible Retirement Plan

401(k) Fiduciary Governance: An Advisor's Guide describes a methodology for embracing an SRI approach in a defined contribution plan subject to ERISA. [Pete Swisher, *401(k) Fiduciary Governance: An Advisor's Guide, Third Edition* (American Society of Pension Professionals and Actuaries, 2011)] The following framework builds upon that original framework in light of the 2015 guidance.

SRI Plan Principles

The framework below is based on these principles:

1. People have a right to follow their deeply held beliefs when choosing how, or whether, to invest retirement plan assets.
2. Plan fiduciaries are permitted to consider how to assist employees in following those beliefs with respect to retirement plan investments.
3. Plan fiduciaries should probably avoid imposing on others any investment preferences based on the fiduciaries' own beliefs. A defensible goal, especially in a defined contribution plan, is simply to ensure that participants have a clear path to following their own consciences.
4. Plan fiduciaries must apply exactly the same criteria for the selection and replacement of SRI investments as for all others.

Suggested SRI Framework

1. ***Include non-SRI funds***. Include as designated investment alternatives (DIAs) (the term used by the DOL in various guidance to refer to funds designated by plan fiduciaries for inclusion in a menu of funds for selection by participants in a participant-directed plan) an array of index funds sufficient to allow construction of a diversified portfolio, without consideration of ESG factors. Non-index funds would be fine, but since it makes sense to include a few index funds in a modern menu anyway, using non-index funds for the "non-SRI" portion of a menu might cause the menu to be too large.
2. ***Ensure the non-SRI funds allow proper diversification.*** Ensure that the non-ESG-screened lineup of DIAs is sufficient for participants to build prudent, diversified portfolios. At a minimum, the non-SRI DIAs should meet the "broad range" requirement in the DOL's regulations under ERISA Section 404(c).

3. ***All funds must pass a non-SRI investment policy statement.*** Create and follow an investment policy statement (IPS) with criteria based solely on economic factors, such as expected risk and return. Insist that all DIAs meet these criteria, regardless of ESG factors.
4. ***SRI addendum to the IPS.*** Include an addendum to the IPS that articulates the circumstances under which fiduciaries will include DIAs screened for ESG factors. Get an attorney to help.
5. ***Avoid allowing the fund menu to grow too large.*** Research shows that too many choices can cause participants to avoid making choices or to employ ineffective shortcuts. Embracing SRI might make it more difficult to keep the fund menu small due to the diversity of investment options that may be required.
6. ***SRI education.*** Consider providing educational information for participants as to the nature of SRI, the plan fiduciaries' position with respect to it, and how to take advantage of it in the plan.
7. ***404a-5 disclosures.*** Include in participant disclosures (as required under 29 CFR Section 2550.404a-5) information regarding any ESG screens used in the selection of a DIA. Consider labeling this information prominently—make it hard to miss, not just a footnote. Discuss with an attorney the desirability of including "warning" language that directs participants to the non-ESG-screened funds if they do not wish such factors to be considered in their own portfolios.
8. ***No exceptions.*** Remove ESG-screened funds from the menu in accordance with the investment policy when the policy so dictates, even if there is no suitable replacement that passes the same ESG screens. For example, if the plan has a Large Cap *Halal* DIA (following *Sharia* law for Muslims) and fiduciaries can find no prudent *Halal* replacement, the plan may no longer have a Large Cap *Halal* DIA.
9. ***Consider including a brokerage or fund window.*** Such windows will generally have all the choices a participant might want and are an outlet for ensuring that varying beliefs may be accommodated. On the other hand, research shows that participants tend to misuse brokerage accounts, and funds chosen through a window are often more expensive (due to share class and additional fees associated with the window) than those available as DIAs. So fiduciaries must balance multiple considerations when weighing the prudence of including brokerage or fund windows versus including a particular type of SRI fund as a DIA.

Is an "All SRI" Fund Menu Ok?

If a plan fiduciary feels strongly that the entire fund menu should be subjected to ESG screens, how safe is it to build the menu based solely on DIAs that pass these screens? Is it allowed?

Yes, but there are issues:

- Even if every single participant wants an SRI menu, on whose closely held beliefs will the screens be based? It is unlikely that any participant population will be homogeneous in its beliefs.
- Not everyone wants SRI.
- Since SRI funds will underperform non-SRI funds some percentage of the time (and vice versa, but that's not the issue), the potential for litigation increases.
- In an all-SRI fund menu designed to include certain asset classes, one must find a prudent choice in every asset class. But SRI options are relatively few in the marketplace, and finding replacements that pass all IPS screens may periodically prove difficult, making it more difficult to execute the policy.

On the other hand, there is no legal reason a menu cannot be constructed that meets the demands of both prudence and conscience; it is simply more difficult, and perhaps riskier, to attempt to do so without having non-SRI alternatives.

A Glimpse of an SRI Future

Throughout history, investors have both wittingly and unwittingly lent support to business enterprises of dubious character, such as those based on slavery, child labor, or appalling working conditions. And as an attorney friend likes to say, "The notion that corporations will police themselves is laughable." Yet if every single human refused to invest in companies that do bad things, *those companies could not exist*. Money is a powerful lever, and the number of people who want to make a stand with their dollars is growing. According to the Forum for Sustainable and Responsible Investment, SRI investing tripled from just over $2 billion to nearly $7 billion between 2005 and 2014. [“Fast Facts, Growth of SRI 2005-2014,” *http://ussif.org*]

Whether SRI has the power to change the world or not, it is a legitimate form of investing in which millions of ERISA retirement plan participants are interested. Declining to permit them to follow their consciences in their choice of plan investments makes as much sense as rewarding a vegetarian employee with lunch at a hot dog stand. And while the DOL has not completely removed all obstacles to the consideration of SRI principles when investing plan assets, it has presented the foundation for a workable solution in IB 2015-1. ■