Socially Conscious Investment Mandates and ERISA

A WHITE PAPER BY

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One significant way to do so that is steadily gaining in popularity is the practice of including religious or socially conscious investment alternatives in the company's qualified plan. But while this practice may make sense morally and personally, retirement plan law does not recognize social criteria as valid determinants of prudent investing. To the degree a sponsor wishes to adopt a socially conscious "mandate" for plan investments, therefore, these investments are subject to the same fiduciary criteria as any other investments—no special exceptions are allowed.

Executive Summary

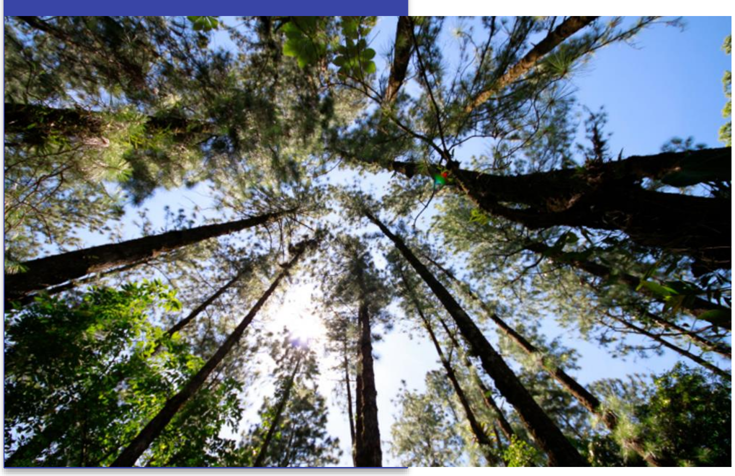
Plan sponsors often place a high value on the ability to back their personal convictions with appropriate action—to live their beliefs.

Background

ERISA Section 404(a) is the "prudent man rule" for retirement plans, and comes from the common law of trust (see also the Uniform Prudent Investor Act and the American Law Institute's Third Restatement of Trust). Among other requirements, it calls for fiduciaries to follow a prudent process in the selection, monitoring, and retention/replacement of investments for the plan. Prudence is only generally described in 404(a), but has been much more fully described in advisory opinions, court cases, textbooks, and regulations. The short version is that procedural prudence is a difficult, tedious business that is intended to improve the odds of good investment performance while limiting risks. For a single great reference on the minimum standards expected in a prudent process, see the latest version of Prudent Investment Practices: A Handbook for Fiduciaries, published by the Center for Fiduciary Studies, available via [www.fi360.com.](http://www.fi360.com)

Manager Mandates

When a client levies certain requirements on a manager, the requirements are called "mandates." An example would be a mandate from a client to limit plan investments to "blue chip" stocks, or to avoid investing in foreign stocks. Similarly mandates can be based on moral or religious principles.



There exist a number of mutual funds with such mandates: environmentally friendly funds; funds that avoid investments in companies deemed in violation of moral principles of various Christian denominations; funds that avoid any investments paying interest or violating other moral principles of Islam ("Halal" funds).

The Problem With Manager Mandates Under ERISA

Procedural prudence does not leave room for applying lesser standards to some investments than for others. For example, it would not be appropriate for a Texas corporation's 401(k) trustee to require all Large Company Blend managers to be in the top 50% of peer group, then turn around and make an exception for all Texas managers (though as a former resident of Houston I can tell you that most Texans would view the notion of their ever being in the bottom 50% of anything as preposterous). Suppose that Fund A falls to 60th percentile in peer group for three and five year performance when the IPS requires 50th percentile; failing to fire Fund A would be a breach of fiduciary duty.

The problem with socially conscious funds is the same problem you have with making a special exception for Texas managers: there is no allowance for loosening of investment policy for certain "preferred" investments. If the Calvert Social Equity fund falls to the 70th percentile, how does a fiduciary justify the decision to keep it? It can't be done on the basis of fiduciary prudence; the argument for keeping the fund is simply that the plan fiduciary PREFERS a socially conscious investment to other funds, even when the results or investment policy clearly require replacing the socially conscious investment.

On the other hand, one can make an argument that aligning one's morals with one's plan investments is not imprudent, especially in a participant-directed plan where there is a non-socially conscious alternative for each category in which the fiduciary allows a socially conscious fund. But this is merely an argument, and a risky one.

The Worst Case Scenario

Suppose the fiduciary chooses the Calvert Fund, then Calvert suddenly implodes for some reason—late trading, compensation scandals, lousy performance, whatever. Suppose that a participant retires who had $5,000 in the fund, but the value is now only $3,000 when it would have been $4,000 in the non-socially conscious alternative. The participant complains to an attorney, who asks questions then files a class action lawsuit on behalf of ALL participants in the plan who held the Calvert fund. The claim is that the fiduciary still had an obligation to oversee the prudence of the investment regardless of the mandate for social consciousness. Such a claim could well prevail in court.

Advocating Socially Conscious Investing Under ERISA

Try this link: http://www.asyousow.org/publications/powerproxy.pdf as well as the website of www.asyousow.com itself for a great source of information on socially conscious investing and shareholder activism. The handbook on proxy voting gives insight into how those advocating socially conscious investing make the case for it under ERISA: they note that proxy voting is a duty under ERISA, and point to an Interpretive Bulletin to that effect, yet the IB in question merely addresses proxy voting as it relates to prudent investing. The guidebook states, correctly, that faith-based or socially conscious investing is not inconsistent with ERISA, but the article also confirms that ERISA's strict prudence standards must still be met.

Robert A.G. Monks has written numerous articles and books where he eloquently states the economic arguments in favor of socially oriented shareholder activism. Try his website, www.ragm.com, and in particular look at the articles on social investing at http://www.ragm.com/books/poweracc/chapter6.html. One of the papers available on the site notes that, "Social investing is the result of the clash of two competing policies. We want to guarantee workers a retirement income, and to do that the laws speak the language of trust law. But employees want to retire into a world free from pollution and injustice. And why should their money be used to support something they oppose?"

The key is that ERISA "speaks the language of trust law" in determining how the investments must be selected and monitored, and that trust law does not contemplate any deviation from prudence for social purposes. So social investing is permitted but receives no special treatment—socially responsible investments must meet the same criteria as any other investments within a prudent process.

What To Do

The reasonable solution is to subject socially conscious investments to the EXACT SAME CRITERIA as all other plan investments and perhaps also to offer non-socially conscious alternatives in each affected asset class. The downside of this approach is that there are only a handful of socially conscious funds, so it becomes extremely difficult to find replacement choices in a given asset class if and when a socially conscious manager is fired for failing to meet IPS criteria. The upside is that this is the only approach that clearly satisfies procedural prudence: any other approach requires the fiduciary to make a case for applying LESSER standards to socially conscious funds and defending this in court as prudent...seemingly a very unwise move for a corporate board concerned about protecting the company, much less a fiduciary who is personally liable under ERISA §409(a) if he or she fails to act solely in the best interest of participants and beneficiaries.