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DOL liberalizes views on economically targeted investments

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The U.S. Department of Labor (DOL) has reversed guidance it issued in 2008 with respect to retirement plans' allocating funds to economically targeted investments (ETIs) that consider environmental, social and governance (ESG) factors. It's an about-face for the DOL, and one that plan sponsors should review.

Former Guidance

The DOL defines ETIs as "any investment that is selected, in part, for its collateral benefits, apart from the investment return to the employee benefit plan investor." Interpretive Bulletin (IB) 2015-01 is intended to reassure retirement plan trustees that they have some latitude to invest in ETIs (or give plan participants the opportunity to do so) without violating their fiduciary obligations to participants. The DOL restores the position it had maintained since 1994 until changing it in 2008.

The original 1994 guidance stated that nothing in ERISA's fiduciary standards prevented ETIs if their expected rate of return was "commensurate" with that expected from alternative investments with similar risk characteristics. In addition, ETIs had to be appropriate investments for the plan in terms of diversification and the plan's investment policy. The standard was nicknamed the "all things being equal test."

Tougher Stance

The 1994 standard was later replaced by IB 2008-1. This guidance clarified that fiduciary consideration of collateral, noneconomic factors in selecting plan investments should be rare. It also reminded sponsors to document their decision in a manner that demonstrated compliance with ERISA's fiduciary standards. This guidance essentially stalled ETI investing by retirement plans.

Looking back, the DOL believes its 2008 interpretation unduly discouraged fiduciaries from considering ETIs and ESG factors. IB 2015-1 goes beyond the "all things being equal" standard of IB 1994-1 for fiduciaries considering ETIs.

According to IB 2015-1, plan fiduciaries should consider all factors that potentially influence risk and return. Such factors include environmental, social and governance issues that may have a direct relationship to the economic value of the plan's investment.

For example, in theory, a public company that has strong governance systems in place, and an active board of directors that doesn't always vote according to the CEO's wishes, might, in the long run, outperform another company with weak governance. According to the DOL, fiduciaries can be open to considering such an argument.

Greener Pastures

The same could be true of companies with strong environmental track records. For example, such a company might outperform a competitor with a long history of litigation and penalties for environmental violations because of the hard costs and adverse reputational impacts associated with poor environmental stewardship.

ESG factors can be more than "tie-breakers" when all traditional investment criteria suggest that two possible investments have equal prospects of success. In fact, according to the 2015 guidance, these factors "are proper components of the fiduciary's analysis of the economic merits of competing investment choices."

Similarly, fiduciaries don't have to treat commercially reasonable investments as inherently suspect or in need of special scrutiny merely because they consider environmental, social or other such factors. At the same time, however, when a fiduciary prudently concludes that an investment is justified based solely on the investment's economic merits, there's no need to evaluate ETI goals as tie-breakers.

Finally, IB 2015-1 essentially annulled IB 2008-1's implication that documentation of the justification for choosing an ETI need be particularly rigorous. Now, the DOL won't construe consideration of ETIs or ESG criteria as requiring additional documentation or evaluation beyond that required by fiduciary standards applicable to plan investments generally.

Looking Ahead

With the DOL no longer appearing to frown on ETIs, are they right for your retirement plan? Before you decide, make sure to consult with your benefits specialist and make the decision using the same fiduciary standards as you would for all other investment decisions.

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