

BENEFITS LAW

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From the Editor

Make Money First—Then Do Good, If You Can: Impact Investing under ERISA

Is it legally prudent to invest ERISA funds to achieve a social purpose? Is it unethical not to?

ERISA fiduciaries are responsible for investing trillions of dollars of retirement money. For some, it is tempting to channel these funds toward investments that benefit society at large, either by avoiding “bad” industries and companies or supporting those that do “good.” The US Department of Labor (DOL) has consistently ruled that such purposeful investing is prudent, but only if the plan doesn’t sacrifice expected return or take on extra risk. As “impact investing” concepts are increasingly being added to investment policies—especially in the non-ERISA realm of endowments, foundations, government pension plans, and the like—it is important to re-examine the DOL’s policy and how it affects the way ERISA fiduciaries invest other peoples’ money.

The ERISA concept is quite simple. Retirement plan assets must be invested prudently, with a proper balancing of risk and return, to achieve the plan’s goal of providing retirement income to participants. Embracing modern portfolio theory, ERISA generally asks fiduciaries to diversify investments and look to the return of the entire portfolio and not individual investments. Further, under ERISA’s “exclusive benefit rule,” the plan must be run for the benefit of participants as participants, and not as employees, retirees, people who are pro or anti a particular cause, or citizens of the world.

Impact investing looks at money management from a different angle. Whether dubbed ESG (environmental, social and governance), SRI (sustainable and responsible investing) or one of the many other titles, impact investing shuns certain types of behavior and companies—think polluters, gun manufacturers, or low-wage payers—and invests

in those that are green, are living-wage payers, and sell products that do not harm. Although a huge oversimplification, the philosophy is that shifting investment dollars will force “bad actors” to mend their ways while the added capital will help the “good actors” to develop nonpolluting energy sources, promote peace and prosperity, and make the world a better place.

The DOL takes a myopic view of an ERISA fiduciary’s duties: a fiduciary may not subordinate retirement plan investments to “unrelated objectives.” Still, no government agency could say it is illegal to do good deeds, so the DOL adds that it’s permissible to consider noneconomic factors in selecting an investment if the investment has equal or superior potential to the alternatives available. In other words a tie goes to the good actor.

Of course, the consideration of whether unrelated objectives may be considered presupposes that they do not have any economic effect. Fortunately for impact investors, several schools of money management believe that the do-good factors have economic as well as societal benefits. Cigarette makers will get sued and polluters forced to remediate and pay heavy penalties, while the living-wage payers achieve higher productivity from happy motivated workers and the green companies save money on power and attract customers. An investment fiduciary that believes that do-good factors will improve long-term performance not only is allowed to take them into account but also has a fiduciary duty to take them into account.

The proper role of impact investing also depends on the type of plan. In a defined benefit plan, all participants eat out of the same pot; choosing a substandard investment based on unrelated objectives could potentially harm all participants if the plan and employer are put in a financial hole so that benefits are frozen to help restore funding, or cut if the plan is underfunded and the employer insolvent. However, it’s another story with most 401(k)s and other defined contribution (DC) plans. With the typical DC, the participants choose from a menu of investments selected by the employer. Adding one or more impact investments to the menu can be a relatively easy and prudent decision for many fiduciaries. First, there are a number of highly rated (by the consulting firms) funds available on most platforms. Second, assuming proper disclosure of the fund’s objectives, strategy, and benchmarks, the fiduciary is leaving the decision to each participant. Finally, the availability of the impact investment may encourage certain participants with a strong social conscience to contribute more to the 401(k) than they otherwise would. On the other hand, participants who do not agree with the fund’s investment or social philosophy can choose other investments.

Everyone wishes to save the world; however, there is little agreement on what that entails or how to go about achieving that goal by

investing retirement plan money. Before using other peoples' money to promote a societal objective, the ERISA fiduciary should first determine that a potential investment is at least as good (economically) as the alternatives.

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