Moving DoL's fiduciary standards into the 21st Century: The case of ERISA investing

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Introduction

The U.S. Department of Labor has generated lots of attention by proposing to impose a fiduciary duty standard on those who advise/sell IRA and other retirement products, in an effort to reduce conflicts of interest. Since, under the Employee Retirement Income Security Act (ERISA), DoL decides what "fiduciary duties" means and it hasn't had much experience with the financial services industry, financial service firms are understandably nervous. DoL's statements that it will be smart about its actions haven't assuaged their fears that DoL will, intentionally or not, put some financial advisors and firms out of business.

I argued in *Pensions & Investments*[1] that one way DoL might provide concrete evidence of sound judgment on fiduciary matters would be to repeal some of the mistakes of the past. One obvious candidate would be to correct its 2008 overregulation of investment professionals who direct investments of traditional ERISA defined benefit pension plans.

Such plans invest more than $3 trillion. For most of the past 40 years, DoL recognized that pension professionals have well-established and high standards, and refrained from trying to tell those professionals what investments to make or not make, or how to act as the major institutional shareholders they are.

In 2008, however, under political pressure from some parts of the business community to discourage shareholder activism, DoL reversed course. Under the new "guidance," DoL told ERISA investors that they shouldn't exercise their rights as shareholders unless they first do a cost-benefit analysis showing that voting would have a net positive return – a showing that is virtually impossible to make a priori. At the same time, DoL imposed similar procedural requirements to prevent ERISA investors from making targeted investments or taking into consideration environmental, social, or business governance factors that might help their local communities. DoL imposed these requirements in the waning days of an administration, with no prior discussion or public comment.

In recent years, some institutional investors have urged DoL to undo this interference in professional investing and let pension plans and professionals use own their best judgment. If DoL does so, it would be a sign that they're keeping politics out of pension regulation and recognizing that ERISA pension funds can and should be recognized for the professional organizations they are. That sensitivity to existing professional standards could bode well for a thoughtful, practical result in the IRA rulemaking, too.

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[1] "Undoing ill-advised guidance to improve fiduciary standards", *Pensions & Investments,* August 24, 2015

What is Fiduciary Duty & Why Does it Matter?

ERISA, enacted 40 years ago, imposed a few new requirements on employers who chose to offer pensions to their employees: pension promises had to vest, they had to be funded in advance, and the funds were to be held in a trust.

Adopting the law of trusts, ERISA provided that pension fund trustees and administrators should be fiduciaries[2]. A fiduciary duty is one of the strictest standards of care recognized in U.S. law. It covers a lawyer's relationship with her/his client, a director and a company's shareholders, and other relationships that must be beyond reproach. Trustees, like other fiduciaries, are legally required to act only on behalf of the trust's beneficiaries. They may not profit from the relationship except as expressly allowed in advance and may not have any conflicting interests.

ERISA did not specify in much detail how this fiduciary duty[3] was to be implemented: it said fiduciaries should be judged according to the standards of a prudent investor, that investments should be diversified, and that pension funds needed to be invested for the benefit of participants (so the employer couldn't use them as a corporate or personal piggy bank).

The U.S. Department of Labor is authorized to interpret fiduciary duty under ERISA. It does so by issuing regulations, by issuing informal "guidance" in the form of bulletins and letters, or most often by being silent and leaving decisions to the judgments of private lawyers and courts via litigation.

Evolution of Professional Pension Fund Investing

Among the earliest forms of institutional investment, private defined benefit (DB) pension fund assets now exceed $3 trillion. Over the decades, the practices of pension funds have evolved in response to changes in financial theory, markets, technology and changing standards of prudence. Prior to the 1970's, for example, public equities were considered by some to be too risky for pension funds; thereafter, they became the dominant form of investment, accounting for 60 percent or more of some funds. Pension funds have since been a major source of the capital that started real estate investment trusts (REITs), private equity, venture capital, commodities and other hedge funds. They continue to be active institutional investors and both the state-of-the-art and typical practices have continued to evolve as well.

Historically, DoL Fiduciary Guidance on Investing was Limited and General

As befits an organization staffed primarily by lawyers and not by investors, DoL's guidance to ERISA fiduciaries on investing was very general: the published regulation reiterated the "prudent man" standard and said that fiduciaries should consider risk/return, portfolio diversification, and a plan's liquidity needs.[4] However, DoL in late 2008 intervened with detailed procedures designed to prevent the use by ERISA plans of practices that were already established by other institutional investors:

Exercising Shareholders' Rights

Pension funds and other institutional investors have become the owners of much of the equity of U.S. corporations. The size of their holdings and the increasing transparency of markets has led many institutional investors to conclude that they can no longer rely solely on the traditional response to dissatisfaction with a particular company -- selling its shares -- because doing so moves markets and further reduces the value of those shares. As a result, many institutional investors began instead to act by exercising their rights as shareholders. Pension funds are not an exception: they can and should be able to vote for or against slates of directors and for or against shareholder resolutions. In the 1980s and 1990s, pension funds voted with other institutional investors to support reforms in corporate governance and other actions. These led to now-standard corporate governance practices such as independent compensation committees.

Most institutional investors consider the exercise of shareholder rights as a way to enhance shareholder value and returns. Blackrock, the world's largest asset manager, said "As a fiduciary asset manager, we have a duty to act in our clients' best interests. This includes protecting and enhancing the value of our clients'

[2] 29 U.S.C. §1101-1104

[3] 29 U.S.C. §1104(a)

[4] 29 CFR 2550.404a-1 et seq. There were more detailed prescriptions for investment in employer securities to avoid potential conflicts, but those are not relevant here.

assets—that is, the companies in which we invest on their behalf—by promoting good corporate governance."[5]

Making Targeted Investments or Considering Environmental, Social or Governance in Investments

Pension funds, as a major source of capital, have also been asked to invest in ways that offer collateral benefits (i.e., benefits in addition to the economic investment return). In some instances, they are asked to make economically targeted investments (ETIs) – investments that would create job opportunities for the participants of a particular fund (e.g., funding infrastructure projects that would create construction jobs). ETIs are controversial because they open the possibility that a pension fund might make an investment to help current workers by accepting lower returns to the retirees. Nonetheless, many funds have been able to undertake them and DoL generally took the view that fiduciaries could do so *if* the investment offered comparable risk-adjusted returns *and* portfolio diversity and liquidity were taken into account.

In other cases, pension funds were asked to incorporate environmental, social, or governance (ESG) factors into their investment decisions. So-called "green investments" are a case in point. Although climate change has thus far had only a limited effect on current market valuations, many institutional investors expect that it will and have begun making investments accordingly. Some responded by investing a portion of the portfolio in alternative energy investments or in local water infrastructure; others by assigning a different allocation to traditional energy companies. Most of the investment firms and funds that incorporate these considerations don't consider themselves uneconomic; rather, they believe that these considerations will ultimately be reflected in securities markets and improve long-term returns.[6] There's plenty of evidence for this view: environmental concerns have increasingly been translated into changes both in legal requirements and in business practice. Similarly, substandard conditions and treatment of workers by their suppliers has led to changes by many consumer firms. Views about corporate governance continue to evolve and pension funds and other institutional investors have been an important reason why.

Consideration of environmental, social, and governance factors is very much a trend, but ESG is far from universally accepted and there are no universal standards of practice. Many institutional investors prefer to stay with short-term returns, believing that the markets do a better job of anticipating longer-term effects than can they. (It's also easier to justify investment fees and compensation by measurable current market returns. This challenge is not limited to green investments: venture capital and private equity investing have a similar inability reliably to measure results by marking to current markets.)

For more than 30 years after the passage of ERISA, DoL simply repeated the general standards. The Department was, appropriately, deferential to professional investors and, though repeatedly invited, did not try to prescribe *how* ERISA fiduciaries should act in these areas. During the Reagan administration, Assistant Secretary of Labor Dennis Cass said, "*There is nothing in ERISA…requiring that an investment decision be wholly uninfluenced by the desire to achieve social or incidental objectives if the investment, when judged solely on the basis of its economic value to the plan, is equal … to alternative investments….*"[7]

In 1994, *in response to written claims that ERISA precluded economically-targeted investments, DoL disagreed* and formalized some of its guidance in a bulletin,[8] saying ERISA "do[es] not prevent plan fiduciaries from deciding to invest plan assets in an ETI if the ETI has an expected rate of return that is commensurate to rates of return of alternative investments with similar risk characteristics that are available to the plan, and if the ETI is otherwise an appropriate investment for the plan in terms of such factors as diversification and the investment policy of the plan." DoL noted that economically-targeted investments were intended to provide economic benefits "in addition to the investment return."

DoL's guidance on both this and the exercise of shareholder rights was criticized at the time by some business groups and members of Congress, but it remained in effect for the next 14 years. Over that period, pension funds and other institutional investors continued to develop increasingly sophisticated means to achieve returns. Public pension funds and other

[5] From the Blackrock webpage on "Engagement, Proxy Voting & ESG Investment Integration" http://www.blackrock.com/corporate/en-hk/about-us/responsible-investment/engagement-and-proxy-voting

[6] See, e.g., "21st Century Engagement: Investor Strategies for Incorporating ESG Considerations into Corporate Interactions", Blackrock & CERES, 2015.

[7] Address at the Annual Conference of the International Foundation of Employee Benefit Plans (Nov 1986), cited in Zanglein, "*Pensions, Proxies and Power*" 7 The Labor Lawyer 771 (1991), p. 777.

[8] Interpretive Bulletin 94-1, 29 CFR Part 2509, *Federal Register 59:120* (June 23, 1994)

institutional investors developed standards for corporate governance and for their participation in shareholder proxy contests. Members of the institutional investing community also continued to incorporate longer term environmental, social, and governance issues into their investing. For example, recognizing that climate change would have major economic effects, some investors developed concentrated efforts in clean technology and others developed ESG screens for broader portfolios.

October 2008: DoL Acts to Prevent Exercise of Shareholder Rights & Targeted Investment

A few weeks before the 2008 election, apparently responding to business objections to more active shareholder efforts by institutional investors, DoL issued new guidance[9] intended to reverse these actions by ERISA plans.

On green and economically-targeted investments, the 2008 guidance characterized consideration of such investments as "non-economic." It said even considering them should be "rare" and added a new documentation requirement: prior to making such an investment, the plan would be required first to undertake a written quantitative analysis of diversification, liquidity and a risk/return comparison with other investments. The guidance then went on to provide examples of potential economically targeted or environmental investments and explained why each would be a violation of ERISA. Not a single example of a permissible economically-targeted or green investment was presented.

The guidance on the exercise of shareholders rights was even more chilling: it conditioned the exercise by a plan of its rights as a shareholder on a prior analysis and documentation that "the cost of voting (including the cost of research, if necessary, to determine how to vote)" does not "exceed the expected economic benefits of voting." Since ERISA-regulated funds cannot be more than a small percentage of a company's shareholders and most shareholders generally give their proxies to management, the likelihood an ERISA plan's vote will have an economic effect is small, and the likelihood that the plan could predict a significant economic benefit a priori without first incurring the cost of research is virtually nil. In essence the cost-benefit analysis requirement was a condition designed never to be met.

[9] Interpretive Bulletins 29 CFR Part 2509, *Federal Register 73:202* (October 17, 2008)

Will DoL Return to its Traditional Deference to Professional Investors?

With the change of administration, some institutional investors and the U.S. Social Investment Forum petitioned DoL to retract the 2008 guidance and instead let pension professionals invest for the benefit of their participants in ways that reflect the evolving sophistication and practices of institutional investors.

These efforts have continued. In 2013, the U.S. and the other G8 (now G7) nations established a working group on Impact Investing. As part of the effort, the U.S. government convened the National Advisory Board on Impact Investing (NAB), a group of private investors, entrepreneurs, foundations, academics, impact-oriented organizations, nonprofits, intermediaries (such as Goldman Sachs and Morgan Stanley) and federal government officials.[10]

The National Advisory Board recommended that DoL change its ERISA investment guidance to "keep pace" with the evolving standards of fiduciaries and the recognition that "a long-term understanding of social and environmental impacts is becoming an increasingly important element of making prudent investments."[11] Whereas the 2008 DoL guidance actively discouraged green investment, the NAB noted that in 2010, the Securities and Exchange Commission issued guidance to facilitate disclosure of climate change issues. They noted that other countries have explicitly modified their fiduciary standards. For example, South Africa now requires fiduciaries to "consider any factor which may materially affect the sustainable long-term performance of the investment, including those of an environmental, social, and governance character."

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It now seems likely that DoL will reverse at least some of its regulatory limitations on professional investors exercising shareholder rights or making investments that provide collateral economic or other benefits to their beneficiaries. If it does so, that would suggest that DoL

[10] Disclosure: The author was a member of the NAB by virtue of directing the US Pension Benefit Guaranty Corporation, which has an investment portfolio in excess of $80 billion. At another point, the author was also the trustee of an ERISA pension plan.

[11] "*Private Capital, Public Good*", US National Advisory Board on Impact Investing, June 2014 www.NABImpactInvesting.org

is working both to recognize the evolution of fiduciary practices and to respect and work with private institutions exercising their professional judgment in the carrying out of their duties. That, in turn, might make it easier to arrive at a fiduciary standard for those IRA salespeople who currently fear it.