Colleran & O'Hara & Mills L.L.P.

50 YEARS OF SERVICE TO THE LABOR MOVEMENT

ERISA Trustee Fiduciary Responsibilities
Economically Targeted Investments

What are Economically Targeted Investments?

Economically Targeted Investments (ETI) are investments selected for the economic benefits they create apart from their investment return to an employee benefit plan.

"The ongoing debate over economically targeted investment is primarily about power and politics and only secondarily about pensions." JE Zanglein 5 Kan. J.L. & Pub. Pol'y 47

RISE UP

REBUILD

RESEARCH

REINVEST

Interactive Audience Response

Who are the obstacles to Economically Targeted Investments?

- DOL Regulators
- Politicians
- Investment Consultants/Managers
- Attorneys

Fiduciary Duty Under E.R.I.S.A.

29 U.S.C. 1104

1. A fiduciary shall discharge his duties solely in the interest of the participants and beneficiaries for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan;

2. Exercise the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;

3. Diversify the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and

4. Act in accordance with the documents and instruments governing the plan.

Procedural Prudence in Investment Decision Making

<u>Procedural Prudence Examples:</u>

- Independent Investigation of the merits of a particular investment.
- Must act as a reasonable prudent person with the interest of all beneficiaries.
- Employ proper methods to investigate, evaluate and structure investments.
- No self-dealing or conflicts.
- Retain experts or independent investment consultants, if necessary.

<u>What about results?</u>

- A fiduciary’s decision will not lead to personal liability if reached through appropriate process and in good faith.

Modern Portfolio Theory

- Modern Portfolio Theory (MPT) is a theory of finance which attempts to maximize portfolio expected return for a given amount of portfolio risk by carefully choosing the proportions of various assets.

- MPT assumes that an investor will act rationally.

- MPT is a "safe harbor" that satisfies fiduciary prudence requirements.

- The "safe harbor" requires that Trustees consider:

    - The composition of the investment portfolio with regard to diversification;

    - The liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan; and

    - The projected return of the portfolio relative to the funding objectives of the plan.

What is an EBSA Interpretive Bulletin?

- Employee Benefits Security Administration (EBSA), is an agency within the US Department of Labor responsible for enforcement and compliance with the Employee Retirement Income Security Act of 1974.

- EBSA's Interpretive Bulletins do not affect public pension plans. By their terms, each bulletin "sets forth the views of the Department of Labor concerning the legal standards imposed..." by ERISA.

- EBSA Interpretive Bulletins do not go through the same process as administrative regulations and therefore lack a regulation's weight. Nonetheless, a court dealing with ERISA would find them influential, if not dispositive, as the view of the agency Congress charged with interpreting the statute.

EBSA's Bulletin relating to fiduciary responsibility in considering economically targeted investments

29 C.F.R. §2509.08-1

- "Economically targeted investments" are "investments selected for the economic benefits they create apart from their investment return to the employee benefit plan."
- In ETI Bulletin 08-1, EBSA adopts what it terms a "rigid rule."
- The guidance set forth in this interpretive bulletin modifies and supersedes the guidance set forth in interpretive bulletin 94–1
- DOL Interpretive Bulletin 94-1 adopted the "All things being Equal Test"

The “Rigid Rule”

29 C.F.R. §2509.08-1

- Only when two alternative investments "are of equal economic value to a plan" may fiduciaries "choose between the investment alternatives on the basis of a factor other than the economic interest of the plan."
- Fiduciaries "will rarely be able to demonstrate compliance with ERISA absent a written record demonstrating that a contemporaneous economic analysis showed that the investment alternatives were of equal value."
- In evaluating the plan portfolio, as well as portions of the portfolio, the fiduciary is required to examine the level of diversification, degree of liquidity, and the potential risk/return in comparison with available alternative investments.

Construction Project Loan

DOL Example - 29 C.F.R. §2509.08-1

Fact Pattern - Interactive Audience Response

A multi-employer plan covering employees in a metropolitan area's construction industry wants to invest in a large loan for a construction project located in the same area because it will create local jobs.

The plan has taken steps to ensure that the loan poses no prohibited transaction issues. The loan carries a return fully commensurate with the risk of nonpayment.

Moreover, the loan's expected return is equal to or greater than construction loans of similar quality that are available to the plan.

The plan has already made several other loans for construction projects in the same metropolitan area.

Construction Project Loan

DOL Example - 29 C.F.R. §2509.08-1

Construction Project Loan

<u>DOL IB 08-1 Opinion</u>:

The fiduciaries may not choose this investment on the basis of the local job creation factor because, <u>due to lack of diversification</u>, the investment is not of equal economic value to the plan.

Collective Investment Fund

DOL Example - 29 C.F.R. §2509.08-1

Fact Pattern - Interactive Audience Response

A collective investment fund, which holds assets of several plans, is designed to invest in commercial real estate constructed or renovated with union labor.

Fiduciaries of plans that invest in the fund determine that the fund's overall risk and return characteristics are as favorable, or more favorable, to the plans as other available investment alternatives that would play a similar role in their plans' portfolios.

Fiduciaries justify their investment choice in the fund by recording their analysis in writing.

Collective Investment Fund

DOL Example - 29 C.F.R. §2509.08-1

Has the Time Come?

- For a New Theory on Fiduciary Duty in Investing?
- Did the Great Recession Undermine the Certainty of the Modern Portfolio Theory?
- Long Term Investments in Environmental, Social and Corporate Governance?

New Theory on Fiduciary Duty in Investing?

- **Initiative For Responsible Investment at Harvard University**: The Trustee Leadership Forum for Retirement Security (TLF) is an applied research collaboration with labor-affiliated trustees of public and Taft-Hartley pension funds, with implications for stakeholders across investment markets.

- Jay Youngdahl, Harvard University Fellow. "The Time Has Come For Sustainable Theory of Fiduciary Duty in Investment"

  http://hausercenter.org/iri/wp-content/uploads/2012/03/Youngdahl-Hoftra-Law-Journal.pdf

Did the Great Recession Undermine the Certainty of the Modern Portfolio Theory?

- The Lost Decade of Investing? Wall Street Journal, October 15, 2009. http://online.wsj.com/article/SB125556534569686215.html

  "Ten years ago, brokers told us to expect an average gain of 7% annually for our buy-and-hold stock portfolios and steady 5% gains for our real estate investments"

- Modern Portfolio Theory assumes investors are rational and markets are efficient. But in the "Real World" --- Risk and Leverage Rule on the Street:

  Black Monday, S & L Crisis, Asian Flu, Long Term Capital Management, Dot.com Bubble, Great Recession, European Debt Crisis.

- "Future Black Swan Events" - A Black Swan is an event that causes a steep drop in the market, usually over a sustained period of time.

Long Term Investments in Environmental, Social and corporate governance

- **Vonda Brunsting**, SEIU Capital Stewardship Program
- **Richard Metcalf**, LiUNA, Director Corporate Affairs

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