



2015 ERISA GUIDANCE: REMOVING REGULATORY BARRIERS TO UNLOCK IMPACT INVESTMENTS

On October 22, 2015, the U.S. Department of Labor announced [new guidance](#) for private pension funds that will enable fiduciaries to consider economic, environmental, social, and governance concerns in addition to financial return when making investments—unlocking a significant source of new capital for socially responsible businesses and funds.

The US National Advisory Board on Impact Investing (US NAB) supports policies such as this one that elevate rather than impede effective public and private solutions to our most pressing social and environmental challenges. This document is a primer on ERISA and the changing dynamics of fiduciary duty, and it is sourced from the US NAB report, [Private Capital Public Good: How Smart Federal Policy Can Galvanize Impact Investing — and Why It's Urgent](#).

WHAT IS ERISA?

The Employee Retirement Income Security Act of 1974 (ERISA) is a federal law that sets minimum standards for most voluntarily established pension and health plans in private industry to provide protection for individuals in these plans.¹

ERISA requires plans to provide participants with plan information including important information about plan features and funding; provides fiduciary responsibilities for those who manage and control plan assets; requires plans to establish a grievance and appeals process for participants to get benefits from their plans; and gives participants the right to sue for benefits and breaches of fiduciary duty.¹

THE HISTORY OF ERISA: MODERNIZING REGULATION OF FIDUCIARY DUTY

Impact investing is consistent with the role of a responsible fiduciary. Indeed, a long-term understanding of social and environmental impacts is becoming an increasingly important element of making prudent investments. However, some interpretations of fiduciary duty have not kept pace with this understanding. Policy can help to support this trend toward a more inclusive understanding of fiduciary duty. In particular, regulators can clarify ERISA regulations for pension funds and further support the rise of new corporate forms with expanded fiduciary duties.

Under ERISA, which regulates trillions in pension fund investments²—pension plan fiduciaries must act prudently, diversifying their investments to minimize the risk of large losses, and must act for the exclusive benefit of plan participants and beneficiaries.

Over the years, the U.S. Department of Labor (DOL), which enforces these requirements, has provided guidance in its interpretation of the law. In the late 1970s, for example, DOL clarified that investments in venture capital funds could be consistent with ERISA guidelines, helping to launch the industry.

In 1994, building on its long-term informal direction,³ DOL provided formal guidance that plans could consider targeted economic, environmental, and other concerns, so long as doing so was consistent with the fiduciary obligation to the plan participants—that is, providing the same level of return at the same level of risk as comparable investment alternatives.⁴

In 2008, DOL changed its guidance. It said that fiduciaries “may never subordinate the economic interests of the plan to unrelated objectives,” and that they could not make investment decisions based on “any factor outside the economic interest of the plan,” with the exception of rare, specified circumstances.⁵ The changes sent an important signal to investors. Whereas the previous guidance had been taken as a mechanism of supporting impact investments, the 2008 guidance created the opposite impression.⁶

As a result, some investors have been reluctant to take environmental or social factors into account when determining the economic benefit of an investment. For example, a fiduciary might be concerned that consideration of significant environmental disruption from climate change—and the related effects of current and future public policies—might be seen as outside the “economic interest of the plan,” even though it will influence returns within the lifetime of plan participants.

The latest guidance from DOL makes it clear that consideration of targeted economic, environmental, social, and governmental factors is consistent with ERISA’s fiduciary obligations to plan participants because those factors may have a direct relationship to the economic value of the plan’s investment. This change could dramatically increase the private capital available for impact funds and social enterprises. To learn more about the latest ERISA guidance, visit: dol.gov/ebsa.

POLICY IN ACTION: FEDERAL POLICY REVITALIZES VENTURE CAPITAL

In the 1970s, the young field of privately managed venture capital nearly faded away.⁷ However, seeing the potential for unleashing innovation and growth, the US government stepped in with a series of smart policy changes to revive the industry. In 1979, clarifications to ERISA’s “Prudent Man” rule allowed pension funds for the first time to make venture investments. The following year, two new policies increased venture funds’ flexibility: the Small Business Investment Incentive Act removed the need for venture firms to register as investment advisors, while the ERISA “Safe Harbor” regulation clearly stated that VC managers would not be considered plan fiduciaries.

At the same time, capital gains rates were cut twice, from 49.5 percent in 1979 to 20 percent by 1981. Over this period, VC investment skyrocketed from nearly zero to over \$5 billion. Entrepreneurship has never been the same. Today, venture capital-backed companies account for 12 million US jobs and over \$3.1 trillion in revenue (based on 2010 data), according to IHS Global Insight’s 2011 Venture Impact study.⁸ Removing regulatory barriers and providing incentives helped to spur the rebirth and serve as a driver of US innovation.

THE CHANGING DYNAMICS OF FIDUCIARY DUTY

In recent years, numerous examples suggest the changing dynamics of fiduciary duty.

- › Research, such as that conducted by CFA Centre for Financial Market Integrity and the Business Roundtable Institute for Corporate Ethics, studied investor time horizons and concluded that “the obsession with short-term results by investors, asset management firms, and corporate managers collectively leads to the unintended consequences of destroying long-term value, decreasing market efficiency, reducing investment returns, and impeding efforts to strengthen corporate governance.”⁹ For many, this suggests that fiduciary norms that exclude such long-term factors are unjust, particularly from an intergenerational perspective.¹⁰ Education and culture change will be essential to training the next generation of global business leaders about the importance of accounting for long-term risks in their investment decisions.
- › In 2010, the US Securities and Exchange Commission issued guidance on disclosure of climate risk information by publicly listed companies, suggesting that environmental concerns are important potential investment concerns.¹¹
- › The Sustainability Accounting Standards Board (SASB), a nonprofit supported by foundations and corporations, is developing industry-specific sustainability accounting standards to provide investors with insights into factors that will materially influence their financial decision-making.¹²
- › University endowments, private foundations, and others have chosen to incorporate long-term environmental, social, and other factors into their investment strategies. For example, Stanford University recently decided to divest its endowment funds from coal mining companies.¹³
- › Over 1,200 investors with \$34 trillion in assets—including CalPERS, the second-largest public pension fund in the United States,¹⁴ and the Norwegian Government Pension Fund, one of the world’s largest sovereign wealth funds—have joined together to support the United Nations Principles for Responsible Investment. Members of the global network believe that environmental, social, and governance issues pose risks to their portfolios and may harm the interests of their beneficiaries.¹⁵ They see consideration of these factors as an essential component to upholding their fiduciary duty—that is, to maximizing long-term returns for their beneficiaries. They are part of a sea change in financial markets. According to KPMG, 93 percent of the world’s largest 250 companies report on non-financing factors.¹⁶
- › Other countries have altered their fiduciary regulations. For example, South Africa now requires that investors “consider any factor which may materially affect the sustainable long-term performance of the investment, including those of an environmental, social, and governance character.”¹⁷



Footnotes

1. <http://www.dol.gov/dol/topic/health-plans/erisa.htm>
2. Investment Company Institute 2013 “US Total Retirement Market Assets” 2013:Q4
3. <http://www.gpo.gov/fdsys/pkg/FR-1994-06-23/html/94-15162.htm>
4. Interpretive bulletin relating to the fiduciary standard under ERISA in considering economically targeted investments. 59 Fed. Reg. 32, 607 (June 23, 1994)
5. “Fiduciaries who rely on factors outside the economic interests of the plan in making investment choices and subsequently find their decision challenged 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.” Supplemental guidance relating to fiduciary responsibility in considering economically targeted investments. 73 Fed. Reg. 61, 735 (Oct. 17, 2008)
6. Capital Institute, “EBSA’s ‘Rigid Rule’ on ETIs” <<http://www.capitalinstitute.org/node/315>>
7. William D. Bygrave, Jeffry A. Timmons, Venture Capital at the Crossroads, pg 24
8. http://www.nvca.org/index.php?option=com_content&view=article&id=119&Itemid=621
9. Krehmeyer, Orsagh, and Schacht 2006
10. <http://www.reinhartlaw.com/Publications/Documents/art111020%20RIIS.pdf>
11. From SRI to ESG: The Changing World of Responsible Investing
12. <http://www.sasb.org/>
13. <http://news.stanford.edu/news/2014/may/divest-coal-trustees-050714.html>
14. <http://www.unpri.org/signatories/signatories/>
15. <http://www.unpri.org/about-pri/about-pri/>
16. <http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/corporate-responsibility/Documents/corporate-responsibility-reporting-survey-2013.pdf>
17. James Hawley, Keith Johnson, and Ed Waitzer, “Reclaiming Fiduciary Duty Balance,” Rotman International Journal of Pension Management, Volume 4, Issue 2, Fall 2011