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When Does “Socially Responsible” Investing Violate Fiduciary Duty?

by Christopher Carosa, CTFA May 23http://fiduciarynews.com/2017/05/social-investing-violate-fiduciary-duty/

In a letter dated April 11, 2017, Yale Chief Investment Officer David Swensen told Yale’s Advisory Committee on Investor Responsibility that he had removed about $10 million in fossil fuel investments from the University’s roughly $25 billion endowment. In what sounds familiar to those who managed portfolios in the 1980s, the decision may have had less to do with the financial prospects of those companies and more to do with the political opinions of key Yale decision makers. According to an April 13, 2017 article from *The Yale Daily News*, “a passage in the middle of Swensen’s Tuesday letter suggests ideological considerations as well. He described a recent incident in which Yale had traveled ‘very far down the path’ to hiring a new energy manager, but eventually decided to break ties after what Swensen called a ‘divergence of views’ between Yale and the manager over the risk of climate change and how to account for that risk when investing.”

Many believe this raises fiduciary liability concerns. In the past, this may have clearly been the case for assets managed under a trust. Recent activities, including a controversial 2015 Interpretive Bulletin from the past administration, have muddied the waters a bit. Making matters worse, the definition of “socially responsible” investing appears to be evolving from one founded on moral principles to one predicated on partisan issues. Harley L. Bjelland of The ERISA Law Firm in Orange, California, says “socially responsible” investing is “investing that is motivated by ethical purposes and not purely financial.” The point is “socially responsible” investing deliberating accepts the possibility of sub-optimal performance in exchange for a non-monetary reward.

Sometimes that reward is not of this Earth. In the past, it was common for religious organizations to give portfolio managers hired to invest their funds a dictum to avoid purchasing so-called “sin” stocks (e.g., alcohol,

tobacco, and certain entertainment companies). Harking back to this traditional definition, Rob Drury, Executive Director at the Association of Christian Financial Advisors in San Antonio, Texas, says, “Socially responsible investing is investing according to moral or ethical mores. The intent is to invest in a manner where one avoids supporting industries or businesses that violate one’s personal standards.”

There was never a question of breaching one’s fiduciary duty because the investment adviser was hired under these limiting conditions. It’s always been considered appropriate for a client to dictate specifically how his assets should be managed. This situation gets dicey when the grantor of the trust (like a retirement plan sponsor) is not the same person as the beneficiary of the trust (like the retirement plan participant). In cases like this, trust law is quite definitive: trustees have a sole fiduciary duty to the beneficiary, not the grantor.

To avoid this fiduciary liability, “socially responsible” investing is now couched in terms that do not admit to accepting sub-optimal performance. “Socially responsible investing is an investment strategy that focuses on both financial return for the investor and social good for the public,” Robin Solomon, an attorney in the Employee Benefits and Executive Compensation practice of Ivins, Phillips & Barker, in Washington DC, says, “Instead of focusing solely on maximizing financial return, socially responsible funds would weigh the social costs of the investments in terms of environmental impact, human rights, fair trade, corporate governance, and other public policy goals.”

The incorporation of political views into “socially responsible” investing began at least in the 1960s and in earnest during the late 1970s, when students across college campuses (and elsewhere) demonstrated to force their universities to divest their endowments from any company doing business in South Africa. Because nearly all major companies were doing business with that country, such divestiture was seen as at the very least impractical and, at its worse, not in the best interests of the university (to use a phrase that should ring a bell). With the reframing of “socially responsible” for its original moral context to its new political one, the movement has taken to a more flexibility definition.

“Socially responsible investing can mean different things to different people,” says Ben Wells, Partner at Dinsmore & Shohl, LLP in Washington D.C. “As generally understood, it is an investment strategy which seeks to consider factors other than financial return in choosing investments. Generally, such strategies involve the exclusion of investments which are deemed to be unacceptable by the decision maker. For example, during the apartheid era, many investors chose not to invest in South African countries or those doing business with South Africa. There are many different definitions of socially responsible investing which may include a focus on environmental issues, labor issues, income inequality, corporate governance, and even customer satisfaction.”

Is it possible to pin down “socially responsible” investing to a single definition? It appears unlikely. “It means many things to many people,” says Mel O of Hot Moon Financial in Las Vegas, Nevada. “For my clients socially responsible investing would be investing in such sectors as: renewable energy, avoiding sin stocks such as tobacco, liquor and gambling, avoiding companies or stocks that have a presence in countries with human rights violations or poor environmental controls. However, some clients are OK with sin stocks but not human rights violations, so I find it better to let your client define what socially responsible investing is to them.”

A lack of clear definition makes it difficult to rely on a consistent defense strategy should a fiduciary who invests based on “socially responsible” suddenly be accused of breaching his fiduciary duty. Perhaps, then, if we can’t define what the term means, we can identify why people seek to engage in “socially responsible” investing, no matter how they define it. “People engage in socially responsible investing,” says Drury, “so that they will not contribute to industries or business practices that violate their moral or ethical standards.”

Depending on one’s environment, the sense for this moral imperative can be quite great. Mel O says, “Most times it is due to moral concerns. In the state of Nevada I often have clients who don’t wish to invest in the gaming industries because of the way gambling has affected a family member or themselves. Most times the overriding desire is to make their portfolios reflect their moral convictions.”

It’s not unusual to see the traditional idea of “socially responsible” investing provide the reason for practicing it. “There are various reasons why people might choose to engage in socially responsible investing,” says Wells.

"Religious organizations, for example, may choose not to invest in companies which engage in what they deem to be immoral behavior (for example, a Catholic organization might choose not to invest in any entity that performs abortions.) Others would like to promote some social good, for example, reduction in income in equality or affecting climate change. In general, people choose to engage in social responsible investing to avoid having their funds applied to a cause or result which they believe to be inappropriate or unacceptable."

Others take perhaps a bit more of a worldly view when it comes to describing the motives of those who wish to invest in a way they deem "socially responsible." Bjelland says they do it "to feel good about themselves." But he warns there's a difference between an individual doing it with his own assets and a fiduciary doing it with other peoples' money. He says, "A fiduciary might consider social responsibility as 'a' factor, but rarely can it legally be 'the' factor in making an investment."

While correct for traditional trust relationships, Bjelland's "a" factor vs. "the" factor operational definition was recently thrown for a loop when it comes to retirement plans. In 2015, in an attempt to remove some of the legal obstacles with using retirement funds to promote public policy advocacy, the DOL redefined how plan sponsors so motivated by popular issues can use their employees' money for political purposes. "Companies (or individual) engage in socially responsible investing when they feel strongly about a particular public policy goal," says Solomon. "In a sense, it is 'putting your money where your mouth is.' Under ERISA, plan fiduciaries are required to evaluate socially responsible investing as they would any other investment. In the past, the DOL has stated that fiduciaries could not sacrifice the financial interests of participants in order to promote social, environmental, or other public policy causes; fiduciaries could only consider these collateral goals as 'tie-breakers' when all else is equal. In Interpretive Bulletin 2015-01, the DOL acknowledged that its past view had the unintended effect of discouraging socially responsible investing. The DOL now clarifies that environmental, social and governance factors may have a direct relationship to the economic value of investments, and that fiduciaries can consider these factors as part of its economic analysis (i.e., not just as a tie-breaker)."

It's not known if this will become yet another Obama regulatory decree that will find itself rescinded by the new administration. The Interpretive Bulletin could certainly be seen as controversial because it permits plan sponsors to lobby for certain public policies through the use of employee retirement money. Indeed, the 2015 Obama administration Interpretive Bulletin was crafted specifically to reverse the 2008 Bush administration Interpretive Bulletin that advised pension plan trustees to act "solely in the interests of participants and beneficiaries."

In the end, it's clear we remain in a very grey area when it comes to the potential for conflicts-of-interest between one's fiduciary duty and "socially responsible" investing. We're already beginning to see some of the damage to retirees in well publicized forays into "socially responsible" investing. "As I recall," says Bjelland, "CalPERS is a renowned socially responsible investor and while that was really 'socially responsible' in the Clinton Years, I have heard that they are in big trouble today, often because of those 'socially responsible' investments."

In her July 22, 2016 Manhattan Institute commentary "There's Nothing 'Socially Responsible' About Low Pension Returns," Diana Furchtgott-Roth wrote "With the California Public Employees Retirement System reporting the lowest annual gain since 2009, it's time to review the effectiveness of its socially responsible investment policy for California's taxpayers. CalPERS grew by only 0.6% in the fiscal year ending June 30, 2016. This follows last year's below-target return of 2.4%. California pays its pensions on a defined-benefit basis. In order to meet those costs, CalPERS must grow substantially more rapidly than inflation. So California taxpayers are on the hook for paying hundreds of billions of dollars in unfunded liabilities. In contrast, CalPERS' average return over the past 20 years has been 7.8 percent. But this year's disappointing results, driven by the fund's recent push for socially responsible investing, look set to bring that healthy clip to a crawl."

CalPERS' problems with "socially responsible" investing actually predate the Clinton presidency. According to a report by the Pension Consulting Alliance, ("Academic and Market Research on Divestment," May 2014) while CalPERS itself admits to substantial losses due to its South Africa divestment, an independent review estimated those losses to be three times greater. "CalPERS' divestment from companies doing business in South

Africa began in January 1987 and was lifted in 1994. CalPERS estimates that there were $529 million in financial losses to the fund attributable to this divestment action, including commission costs, market impact and opportunity costs for the entire divestment period. In May, 2007, Wilshire estimated that if those $529 million in foregone funds would have earned the overall rate of return of the fund during all subsequent periods, the total impact of CalPERS' South Africa divestment as of December 31, 2006 would have been $1.86 billion. This cost includes all applicable and appropriate costs (actual transaction costs, market impact and opportunity costs) since the original divestment in 1987."

These real-time reports from the nation's largest state-run pension plan flies in the face of recent academic studies, themselves contradicting earlier studies, that appear to justify "socially responsible" investing. "There have been several academic studies on socially responsible/sustainable investment performance," says Wells. "There is a 2017 study entitled 'Demystifying Responsible Investment Performance' which was jointly produced by the United Nations Environment Programme and the Mercer Consulting Firm. This report analyzes and summarizes a number of other academic studies and is generally favorable to the idea that socially responsible investing does not hinder performance. There is also research which questions the value of socially responsible investing, including a study by professor David Vogel of The University of California, Berkley who authored a study entitled 'The Market for Virtue: The Potential and Limits of Corporate Social Responsibility,' (Brookings Institution, 2005). Dr. Vogel was recently quoted in a February 28, 2016 article in *The Wall Street Journal* as a counterpoint to a discussion by Dr. Alex Edmans of the London School of Economics who pointed out the benefits of socially responsible investing."

While "socially responsible" investing appears to be, well, "socially responsible," it goes without saying there are risks when one plays politics with other peoples' money. The depths of the ensuing fiduciary liability will only be tested when the tort bar brings the matter to court. Until then, fiduciaries may wish to proceed with caution.

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