Overcoming Institutional Barriers on the ETI Superhighway

by

Jayne Elizabeth Zanglein

J. Hadley Edgar Professor of Law,
Texas Tech University School of Law
lcjaz@TTACS.TTU.EDU

Prepared for

The Second National Heartland Labor-Capital Conference
April 29-30, 1999
Omni Shoreham Hotel
Washington, D.C.

The high road economy . . . is built up in layers. At the base are families and workplaces. Strong, union families, and progressive public and private employers provide the foundation for building strong communities. Communities that employ workers in high-wage, high-skill jobs and support families with excellent public services form the next layer of the highway. On these high road communities — or Union Cities — states can build progressive, people-first economies.[1]

Similarly, the ETI superhighway is built upon three layers. At the base is trustee education. Educated, informed trustees who understand the investment decision-making process, modern portfolio theory, capital markets, and asset allocation will be in a position to demand that fund advisers consider prudent investments that provide collateral benefits to their members. Established ETI programs which allow trustees to easily invest in an on-going investment program form the next layer of the highway. The third layer is a national center for economically targeted investments which can collect data on established programs and assist regional ETI centers in developing new programs. On these super-highways, pension funds can build a secure retirement system within a strong economy.

I. Introduction

Pension fund assets total $7.4 trillion dollars[2] and are expected to exceed $25 trillion by 2023.[3] Taft-Hartley funds, which are jointly managed by union and employer trustees, invest about $350 billion in assets,[4] while public funds, which typically have some worker representatives, control $2.1 trillion.[5] Pension funds represent 19% of all assets held by American households.[6]

These assets represent financial muscle that pension funds can use to pave the high road to economic development. The AFL-CIO engineered the high road which puts people first, strengthens families, and enhances their quality of life.[7] No longer are union leaders content to stand by while their investment managers use members' pension money to build non-union, to export jobs, and to line the pockets of poorly-performing corporate executives. In the words of Richard L. Trumpka, Secretary-Treasurer of the AFL-CIO, "There is no more important strategy

[1] AFL-CIO HUMAN RESOURCE DEVELOPMENT INSTITUTE, ECONOMIC DEVELOPMENT: A UNION GUIDE TO THE HIGH ROAD at 1(1998).
[2] Vineeta Anand, *Market, Contributions Boost Pension Assets*, PENS. INV., Oct. 19, 1998, at 97.
[3] Vineeta Anand, *Total Assets Predicted – Give or Take $25 Trillion*, PENS. & INV., Oct. 19, 1998, at 97.
[4] Terry Williams, *Big Union Funds Still Avoiding Private Equity*. PENS. & INV., May 4, 1998, at 20.
[5] Vineeta Anand, *Contributions Boost Pension Assets*, PENS & INV., Apr. 6, 1998, at 38.
[6] *Id.*
[7] *See*, ECONOMIC DEVELOPMENT, *supra* note 2, at 1.

for the Labor Movement than harnessing our pension funds and developing capital strategies so we can stop our money from cutting our own throats."[8]

For the past twenty years, a small number of Taft-Hartley pension trustees have been investing pension assets so as to create union jobs and affordable housing. These trustees were inspired by *The North Will Rise Again: Pensions, Politics and Power in the 1980s*.[9] In this controversial book, Randy Barber and Jeremy Rifkin stated that although pensions funds "legally represent the deferred wages of millions of American workers, . . . [they] *are not controlled directly by those who are their beneficiaries*."[10] Labor leaders covenanted to band together to use their pension assets to govern their own destiny. At its 1979 convention, the AFL-CIO resolved to increase pension investment in construction projects built with union labor and vowed to discourage pension funds from investing in anti-union companies. The AFL-CIO further resolved to assume a leadership role in the promotion of job-creating investments.[11]

Public funds, unhampered by ERISA's requirements,[12] were quick to invest in affordable housing, venture capital, and other in-state investments.[13] In 1982, a congressional subcommittee held public hearings to "examine how [public] pension funds can make responsible investments in housing that will benefit both retirees and the construction industry."[14]

Twenty years later, the Industrial Heartland Labor Investment Forum voiced similar concerns:

> The dilemma facing workers is that their own pension funds, as owners of almost one-third of all U.S. financial capital, are behind the scene fueling these activities. They finance overseas plants. They agree to outrageous pay packages for corporate management that have shown only mediocre performance. They reward the slash and burn practices of

[8] *Id.* at 73.
[9] JEREMY RIFKIN & RANDY BARBER, THE NORTH WILL RISE AGAIN: PENSIONS, POLITICS AND POWER IN THE 1980s (1978).
[10] *Id.* at 83.
[11] *AFL-CIO Convention Resolution on Investment of Pension Funds* (Nov. 1979), *reprinted in* AFL-CIO BLDG & CONSTR. TRADES DEP'T, INVESTMENT OF UNION PENSION FUNDS §VII (1980). *See also* AFL-CIO INTERNAL UNION DEP'T, INVESTMENT OF UNION PENSION FUNDS (undated, *circa* 1980).
[12] Although public funds are not governed directly by ERISA's fiduciary duties, most attorneys advise public funds to act in accordance with ERISA, except to the extent it is contrary to state law governing the funds.
[13] *See generally*, INST. FOR FIDUCIARY EDUC., ECONOMICALLY TARGETED INVESTMENTS – A REFERENCE FOR PUBLIC PENSION FUNDS (1993).
[14] *House Committee Holds Hearings on Pension Mortgage Investments*, LAB. & INVESTMENTS (Indus. Union Dep't, AFL-CIO), Oct. 1982, at 2.

> companies that serve up quarterly returns to shareholders. They finance mergers and acquisitions in the name of retirement security. They ignore investments in job-creating ventures, instead preferring to finance leveraged buyouts that mean further layoffs.[15]

Pension funds have encountered detours and set-backs on the high road to economic development. The primary obstacle was, until recently, the Department of Labor. Although the Department acknowledged almost twenty years ago[16] that economically targeted investments could be made consistent with ERISA's standards,[17] the Department aggressively sued many of the trustees involved in the early investment programs.[18] This obstacle was partially removed in 1994 when the Department issued Interpretive Bulletin 94-1 which clarified that a pension plan may choose an investment which has collateral benefits if the investment has a risk-adjusted market rate of return which is equal to or superior to alternative investments.[19]

A second roadblock was established over a period of years as a few public funds gained a reputation for making poor "backyard" investments.[20] Although prudence is not measured by hindsight, these investments were immediately perceived as imprudent investments simply

[15] LABOR INVESTMENT FORUM CONCLUSIONS, SUMMARY OF INDUSTRIAL HEARTLAND LABOR INVESTMENT FORUM: OUR MONEY, OUR JOBS, June 14, 1996, at 14.

[16] Former Assistant Secretary of Labor, Pension and Welfare Benefits Administration, Olena Berg, testified before Congress that "since the enactment of ERISA more than 20 years ago, the Labor Department has consistently interpreted the law to permit plan fiduciaries to invest in ETIs. It is critical to understand, however, that this approval is strictly conditioned upon the requirement that the investment offer a risk-adjusted rate of return that is comparable to the best available investment alternatives and is otherwise appropriate for the plan's portfolio. This is the position that was maintained by the Labor Department under every prior administration and remains the position of the Department today." Testimony of Olena Berg, Assistant Secretary of Labor, Pension and Welfare Benefits Administration, before the Committee on Employer-Employee Relations, Subcommittee on Economic and Educational Opportunities, House of Representatives, June 15, 1995, *reprinted in* FDCH Congressional Testimony, June 15, 1995.

[17] Ian Lanoff, *The Social Investment of Private Pension Plan Assets: May It Be Done Lawfully Under ERISA?* 31 LAB. L. J. 387, 389 (1980) (stating that "[w]hile this section [404(a)] does not exclude the provision of incidental benefits to others, the protection of incidental benefits to others, the protection of retirement income is, and should continue to be, the overriding social objective governing the investment of plan assets.")

[18] *See e.g. Donovan v. Walton*, 607 F.Supp. 1221, 1245 (S.D. Fla. 1985), *aff'd sub nom Brock v. Walton*, 794 F.2d 586 (11th Cir. 1986). The Department continues to use scare tactics on trustees who invest in ETIs. Former Assistant Secretary of Labor, Pension and Welfare Benefits Administration Olena Berg in a Congressional hearing stated emphatically: "[I]t is my hope that a good deal of the misinformation that has been circulating on this topic of late will be dispelled. I want to make it absolutely clear that this administration is opposed to any practice that would subordinate a pension plan's interest in securing the appropriate risk-adjusted rate of return to another purpose, be it social gains or anything else." Testimony of Olena Berg, Assistant Secretary of Labor, Pension and Welfare Benefits Administration, before the Committee on Economic and Educational Opportunities, Subcommittee on Employer-Employee Relations, House of Representatives, June 15, 1995.

[19] 29 C.F.R. §2509.94-1 (1994).

[20] For example, public funds in Connecticut, Kansas, Missouri, and Pennsylvania have made investments that have failed. *See* Daniel J. Mitchell, *Why The Government Should Not Invest Americans' Social Security Money*, THE HERITAGE FOUNDATION BACKGROUNDER, Dec. 23, 1998.

because they did not achieve expected rates of return. Prudence, however, is measured by the process by which the trustees decide to make the investment and not the success of the investment. While it is true that some of the investments made by public funds were not procedurally prudent, this does not mean that ETIs can never be a prudent investment. These criticisms have reemerged as Congress debates whether the Social Security Administration should invest in stock. Critics of ETIs contend that because public funds are not subject to the fiduciary standards of ERISA, "[g]overnment-controlled investing invites 'politically correct' decisions because politicians could forego sound investments in unpopular industries (such as tobacco) to steer money toward feel-good causes that are likely to lose money."[21]

Representative James Saxton, the most vocal opponent of ETIs, describes them as an "illogical, offensive, dangerous and irresponsible policy to pursue."[22] Saxton says, "As far as I'm concerned, private pension savings – the money that millions of Americans are counting on for security in their retirement years – is off limits to the president and any other politician or bureaucrat who attempts to liken the monies to U.S. Treasury dollars."[23] Michael Calabrese counters that "few if any ETIs result from wooly-headed do-gooderism. Most result from the hard-hearted self-interest of pension managers trying to maximize the multiple and very long-term interest of both current retirees and the young workers contributing to the plan who may be 30 or more years away from drawing benefits."[24]

A recent study by the Public Retirement Institute concluded that "public pension funds increasingly are becoming subject to specific prohibitions against investments in specific types of companies: such as alcohol, gambling, tobacco, and adult entertainment."[25] Five states prohibit pension funds from investing overseas, three specifically restrict investments in South Africa, and several others prohibit investments in tobacco companies, businesses in Northern Ireland, and companies involved in infant formula pricing in Third World countries.[26]

---

[21] *Id.*
[22] John A. Barnes, *Should Government Be Directing Pension Funds*?, INVESTOR'S BUS. DAILY, Aug. 21, 1995, at B1.
[23] *Id.*
[24] Michael Calabrese, *Q: Would Economically Targeted Investments Trigger a Pension Crisis?,* INSIGHT, Sept. 16, 1996, at 25.
[25] *Government Investment is Fraught with Peril,* INVESTOR'S BUS. DAILY, Jan. 11, 1999, at A26.
[26] *Id. See also, John Berlau, The Risks of Political Investing*, INVESTOR'S BUS. DAILY, Feb. 2, 1999, at A1.

Lack of education and expertise are pot holes on the high road to investing. Although ETIs are clearly permissible under ERISA provided they do not sacrifice return for collateral benefits, many trustees do not know enough about investment basics to make informed decisions about ETIs. These trustees are also disadvantaged in communications with investment professionals, attorneys, and management trustees who discourage ETIs. Proper education, along with a national network of competent, educated, and willing professionals, will put trustees on a super highway to economically targeted investing.

Transforming this road littered with detours, pot holes and road blocks into a superhighway of ETI investments can be accomplished. Essential to the successful completion of this task are three prerequisites. The first priority is trustee education. Trustees must be educated on capital markets, investment fundamentals, asset allocation, performance benchmarks, fiduciary duties and procedural prudence. The second prerequisite is the encouragement of pension funds to invest in established ETI programs. The third condition is the creation of national center on economically targeted investments which will establish a network of professionals who are willing to work with trustees on new ETI programs and develop a national database on ETIs.

The Department of Labor's encouragement of economically targeted investments has spurred additional interest in ETIs, most particularly from the AFL-CIO and its newly formed Center for Working Capital. However, most Taft-Hartley funds continue to avoid ETIs. This essay will examine the reasons that pension funds trustees shy away from ETIs and will propose solutions that encourage more pension funds to take the ETI superhighway.

II. Capital Gaps which Can Be Filled by Prudent ETIs

Although experts claim that financial markets are efficient, "not all investments are discovered by the market, and the markets do not extend their bounty equally to all investment vehicles, given proper returns."[27] Many commentators suggest that an ETI is not really an ETI

[27] Alvin Lurie, *ETIs: A Scheme for the Rescue of City and County with Pension Funds*, J. PENS. PLANNING & COMPLIANCE 1, at 4 (1996).

unless it meets the needs created by a capital gap. For example, according to a report issued by the Government Accounting Office, "[A]n ETI could have little net effect if the company receiving the ETI merely displaced another company that, without the ETI, would have employed the same people, developed the same product, and created the same level of economic activity. Similarly, an ETI could have little net effect if it merely displaced capital that would have been invested anyway by another investor."[28] Lawrence Litvak has described this process: "Displacement will occur when a pension fund targets projects so well served by capital markets that the fund only competes with private investors rather than supplying additional capital."[29] Litvak continues:

> The key to success is concentrating on sectors and enterprises that have been under-financed due to gaps and inefficiencies in our financial system. . . . Effective yet financially sound development investing first requires identifying situations where the unavailability of capital on competitive terms is impeding development that would otherwise take place.[30]

According to a report issued by the Department of Labor's Advisory Council on Pension Welfare and Benefit Plans, prudent investments exist in an inefficient market and remain unfunded because of information gaps and high administrative costs of consummating and monitoring the deal:[31] "To the extent that capital markets are judged to be tradition-bound, rigid or incapable of funding all 'worthy' investments, making funds available from the pension investment pool is seen as addressing capital gaps that would otherwise impede local economic development."[32]

[28] U.S. DEP'T. OF LABOR, ADVISORY COUNCIL ON PENSION WELFARE AND BENEFIT PLANS, ECONOMICALLY TARGETED INVESTMENTS: AN ERISA POLICY REVIEW (1992), at 9.
[29] LAWRENCE LITVAK, PENSION FUND AND ECONOMIC RENEWAL, at 13 (1981).
[30] *Id.* at 4.
[31] U.S. DEP'T. OF LABOR, ADVISORY COUNCIL ON PENSION WELFARE AND BENEFIT PLANS, ECONOMICALLY TARGETED INVESTMENTS: AN ERISA POLICY REVIEW (1992), at 9.
[32] *Id.* at 3-4.

The report states:

> The added costs of acquiring the information needed to make the investment sound must be incorporated in the required rate of return. If the investment can bear these added costs, the ETI strategy may produce additional economic activity in this region. If it isn't able to bear the added costs, the pension fund must: (1) forego the investment, (2) find a third party willing to subsidize some or all of these extra costs, or (3) accept a lower [but prudent] net return.[33]

"Economically Targeted Investments" (ETIs) have been defined by the Department of Labor as "investments selected for the economic benefits they create apart from their investment return to the employee benefit plan."[34] Collateral benefits obtained through ETIs include "expanded employment opportunities, increased housing availability, improved social service facilities, and strengthened infrastructure."[35] ETIs "create new jobs, provide capital to replace loan funds no longer rolling through the bank pipelines, provide startup businesses with access to capital, finance low-cost housing and improve the infrastructures of the nation, all without sacrificing a return on investments or otherwise jeopardizing the pensions of future retirees."[36]

These are true capital gaps: the failure of the market to finance prudent investments. Many investments, such as socially-screened stock funds, are touted as ETIs even though they do not truly fill an identifiable gap in the capital markets. An example of a true capital gap is the market's failure to provide venture capital and private placement dollars to established, well-run, mid-sized companies:

> [Mid-sized firms] have traditionally relied on debt financing, rather than equity financing, and on private, rather than public capital markets. Private financing sources consist of

[33]*Id.* at 9-10.
[34]Department of Labor Interpretive Bulletin 94-1 on Economically Targeted Investments, 59 Fed. Reg. 32,606 (June 23, 1994), *codified in* 29 C.F.R. § 2509.94-1 (1994).
[35]*Hearing on Pension Investments and Economic Growth Before the Joint Economic Committee*, 103 Cong., 2d Sess. (1994) (testimony of Olena Berg, Assistant Secretary of Labor), *reprinted in* Federal Document Clearing House Congressional Testimony (June 22, 1994).
[36]*Lurie, supra* note 28, at 4.

> either bank loans for short term, relatively small needs, or private placement debt for long term larger needs.
>
> . . . [O]ver the past two decades, bank lending activity has declined as individuals have moved their assets out of bank deposits and into more profitable pension funds and mutual funds. At the same time, banks have moved away from industrial and commercial loans, into real estate lending, trust services and other activities. The loss of these two important sources of capital has reduced the ability of mid-sized companies to grow and expand, contributing to plant closures and layoffs.[38]

It is these capital gaps that the Department of Labor encouraged pension funds to fill in its 1994 interpretive bulletin on ETIs.[39]

Interpretive Bulletin 94-1

In 1994, the Department of Labor issued an interpretive bulletin on economically targeted investments[40] in an effort to make clear the Department's long-standing policy that "all things being equal," a pension plan may make an investment which provides a collateral or social benefit.[41] The Department has consistently construed ERISA's requirement that a fiduciary act "solely in the interest of," and "for the exclusive purpose of providing benefits to participants and their beneficiaries"[42] as "prohibiting a fiduciary from subordinating the interests of participants and beneficiaries in their retirement income to unrelated objectives."[43] However, the

[38] ECONOMIC DEVELOPMENT, *supra* note 2, at 74.
[39] Interpretive Bulletin 94-1.
[40] *Id.*
[41] *See* PWBA Advisory Letter from Department of Labor to Gregory Ridella (Dec. 19, 1988) (A.O. 88-16A) (stating that in making investment decisions, plan fiduciaries can be influenced by factors unrelated to the plan's expected investment return only if such investments "would be equal or superior to alternative available investments"); Letter from Department of Labor to George Cox (Jan. 16, 1981) (stating that a fiduciary can consider factors unrelated to investment return only if, in the fiduciary's judgment, the course of action taken would be at least as economically advantageous to the plan as any alternative course of action); Letter from the Department of Labor to James S. Ray (Jan. 16, 1981) (stating that a fiduciary can consider collateral benefits in making an investment decision only if the fiduciary determines that the investment containing the collateral benefits is expected to provide an investment return to the plan commensurate to alternative investments having similar risks).
[42] 29 U.S.C. § 1104 (1999).
[43] Interpretive Bulletin 94-1, 29 C.F.R. §2509.94-1 (1994). *See also* Letter from Department of Labor to Helmuth Fandl, Chairman of the Retirement Board of Avon Products, Inc., at n. 4 (Feb. 23, 1988) (hereinafter *Avon Letter)*, *reprinted in* Pens.

Department's bulletin on economically targeted investments states that a fiduciary may 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."[44]

This imposes no new legal requirements on ETIs. In fact, the Department stated in its bulletin that "[t]he fiduciary standards applicable to ETIs are no different than the standards applicable to plan investments generally."[45] Thus, in order to evaluate the appropriateness of an economically targeted investment, the general fiduciary duties of ERISA must be evaluated. This will be discussed further below. First, the institutional barriers which impede ETIs will be examined.

III. Institutional Barriers Which Impede Pension Funds from Investing in ETIs

Despite strong encouragement by the Department of Labor and AFL-CIO, pension fund trustees are still reluctant to invest in ETIs. Seven misconceptions block the high road to investments:

Rpt. (BNA) Vol. 15, No. 9 at 391 (Feb. 29, 1988) (stating that the exclusive benefit rule prohibits "a fiduciary from subordinating the interests of participants and beneficiaries in their retirement income to unrelated objectives.")

[44]Interpretive Bulletin 94-1.

[45]*Id.*

Seven Misconceptions About ETIs

1. **ETIs are illegal and concessionary.**
2. **ETIs are too time-consuming.**
3. **ETIs are too costly to administer.**
4. **Competent managers are unavailable.**
5. **It is impossible to convince trustees and professionals to invest in ETIs.**
6. **Politics always get in the way.**
7. **There are no appropriate benchmarks by which to measure the performance of ETIs.**

A 1993 study by the Institute for Fiduciary Education concluded that "economically targeted investing is growing only modestly and . . . the subject still elicits strong opinions, both positive and negative, from the pension fund community."[46] In the preamble to the Department of Labor's recent interpretive bulletin on ETIs, the Department recognized that "a perception exists within the investment community that investments in ETIs are incompatible with ERISA's fiduciary obligations."[47] The Department issued the interpretive bulletin "[i]n order to eliminate this misconception"[48] and encourage investment in ETIs.

In its survey on ETIs, the Institute for Fiduciary Education asked 119 public pension funds to list reasons why they have not made economically targeted investments. Thirty-seven percent[49] of the funds stated that the principal reason they did not invest in ETIs is because it conflicts with fiduciary duty.[50] Eleven percent said that ETIs take too much staff time; eleven percent said ETIs are not statutorily authorized; eight percent said they did not invest in ETIs

[46] INST. FOR FIDUCIARY EDUC., ECONOMICALLY TARGETED INVESTMENTS: A REFERENCE FOR PUBLIC PENSION FUNDS (1993).
[47] Interpretive Bulletin 94-1, *supra* note 35. The Institute for Fiduciary Education found that "[t]he most frequent reason expressed by retirement systems for not investing in ETIs was the belief that doing so conflicted with the pension fund's fiduciary duty." INST. FOR FIDUCIARY EDUCATION, *supra* note 46, at Executive Summary.
[48] INST. FOR FIDUCIARY EDUC., *supra* note 46, at Executive Summary.
[49] *Id.* at B-2 (Table B-8).
[50] The survey asked the respondents to list and rank reasons, therefore, some funds reported more than one reason. *Id.*

because "no one asked us to invest in an ETI"; four percent said that their legal counsel had advised against ETIs; and four percent said they found no perceived need for ETIs.[51]

The survey conducted by the Institute for Fiduciary Education listed various aspects of targeted investments and the difficulty involved in the implementation of each aspect. Liquidity and the procurement of a competent asset manager tied as the most difficult aspect of ETIs.[52] Over fourteen percent of plans experienced great difficulty in each of these two areas. Other aspects such as public opinion and participant opinion presented no great difficulty.[53]

Aspect	**% Reporting No Difficulty**	**% Reporting Some Difficulty**	**% Reporting Great Difficulty**
Return/Risk Characteristics	14.3	75.5	10.2
Liquidity Level Requirements	30.6	55.1	14.3
Board Concerns	22.5	70.1	4.0
Internal Staff Considerations	24.5	69.3	6.1
Political Concerns	46.0	48	6.0
Public Opinion	44.1	55.8	0
Participant Opinion	38.3	61.7	0
Litigation	61.7	36.2	2.0
Procurement of a Competent Asset Manager	14.3	71.4	14.3
Expenses of Operation	37.5	60	2.5
Development of a Performance Benchmark	31.7	65.8	2.4
Operating This ETI	29.6	68.1	2.3

A 1998 survey by Goldman, Sachs & Co. and Frank Russell Capital Inc. concluded that the most significant issues for investors are:[54]

[51]*Id.*
[52]*Id.* at 18 (Table 16).
[53]*Id.*
[54]Jennifer Lea Reed, Renee Deger, *Public Plans Lead Private Equity Frenzy*, VENTURE CAP. J., Jan. 1, 1998.

Significant Obstacles	**Percentage Reporting Problems**
Expected returns	43%
Too much capital in the asset class chasing too few opportunities	28%
Cost of investment management	14%
Partnership management time and Commitment	13%
Not having suitable benchmarks for performance	2%

A recent book, Pension Fund Excellence: Creating Value for Stakeholders[55] cites nine barriers to excellence:[56]

Kenith P. Ambachtsheer, D. Don Ezra, Barriers to Excellence in Pension Fund Management: The Views of 50 Senior Pension Executives

Rank	**Barrier**	**Cited (%)**
1	Poor process (including structure, communication, and inertia)	98%
2	Inadequate resources	48%
3	Lack of focus or of clear mission	43%
4	Conservatism	35%
5	Insufficient skills	35%
6	Inadequate technology	13%
7	Conflicting beliefs	8%
8	Difficult markets	8%
9	Lack of innovation	5%
10	Suppliers	5%

[55] KENITH P. AMBACHTSHEER, D. DON EZRA, PENSION FUND EXCELLENCE: CREATING VALUE FOR STAKEHOLDERS (1998).
[56] *Id.* at Table 2.2

Each of the seven misconceptions described earlier will be discussed below in detail.

Misconception #1: ETIs Are Unlawful

Robert Monks, principal of LENS, Inc. and former pension administrator of the Department of Labor notes that since ERISA was enacted, trustees and their attorneys "have been driven chiefly by the fear of legal exposure."[57] Monks paraphrases Ned Regan, former New York State Controller: "No one ever got elected to anything on the basis of successful investment of the state pension plan. The consequences of poor investment are adverse publicity, notoriety and electoral vulnerability. The consequences of spectacular performance are marginal." [58]

Bill Patterson, director of the AFL-CIO Office of Investments agrees that trustees have a tendency to make conservative investments. He notes, "There is a premium for not straying from established investment practices. . . . This is worker money and [the trustees] feel obligated to stay with established formulas for creating wealth."[59] No one has ever been sued by the Department of Labor for making conservative, low-risk, low-return investments. Ambachtsheer and Ezra reached the same conclusion in their survey of Fifty Senior Pension Executives. Conservatism was cited by 35% of the managers as a barrier to pension fund excellence.[60] Similarly, the Institute of Fiduciary Education Survey concluded that 37% of funds did not invest in ETIs because it conflicts with fiduciary duty. This conception is absolutely wrong.

Economically targeted investments will be defined, for the purpose of this paper, as pension fund investments which earn a risk-adjusted market rate of return, provide collateral benefits such as economic development, and provide capital for prudent investments that otherwise might not be financed due to gaps in the capital markets.[61]

---

[57]Testimony of Robert Monks, before the House Economic Subcommittee on Employer-Employee Relations, *Economically Targeted Investments*, June 15, 1995, *reprinted in* FDCH Congressional Testimony, June 15, 1995.
[58]*Id.*
[59]Terry Williams, *Big Union Funds Still Avoiding Private Equity*, PENS. & INV., May 4, 1998, at 20, 23.
[60]AMBACHTSHEER & EZRA, *supra* note 55, at Table 2.2.
[61]This definition is a restatement of ETIs as defined by Isamu Watson and Rich Ferlauto. *See* CENTER FOR POLICY ALTERNATIVES, INVESTMENT INTERMEDIARIES: MODEL STATE PROGRAMS. (1995). The Department of Labor ERISA Advisory Council defines ETIs differently.

ETI Definition

An ETI is an investment which provides collateral benefits to pension participants and their beneficiaries (such as increased jobs, economic development and improved social services) but is selected without taking into consideration the value of collateral benefits. A pension fund may invest in an ETI if the investment has a risk-adjusted market rate of return that is commensurate to rates of return on alternate investments with similar risk characteristics that are available to the plan, and the ETI is otherwise an appropriate investment for the plan taking into account factors such as return, diversification, liquidity, and the investment policy of the plan.

ETIs, as defined above, are legal investments under ERISA. Because it is important to eliminate this misconception, legal parameters of ERISA will be addressed below in detail.

a. The Legal Parameters of ERISA[62]

Because ETIs are governed by the same standards as other plan investments, it is necessary to examine ERISA's fiduciary duties to determine the propriety of an economically targeted investment. The decision to make a plan investment is governed by ERISA's fiduciary duties as defined in ERISA section 404(a)(1).[63] Four separate duties are imposed on plan fiduciaries: the duty to act solely in the interest of plan participants and beneficiaries,[64] to act prudently,[65] to diversify plan assets,[66] and to act in accordance with plan documents:[67]

> [A] fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and --
>
> (A) for the exclusive purpose of:
> (i) providing benefits to participants and their beneficiaries; and
> (ii) defraying reasonable expenses of administering the plan;

[62]This section is adapted from Jayne Elizabeth Zanglein, *High Performance Investing: Harnessing the Power of Pension Funds to Promote Economic Growth and Workplace Integrity*, 11 THE LABOR LAWYER 59 (1995).
[63]29 U.S.C. § 1104(a)(1)(1999).
[64]29 U.S.C. § 1104(a)(1)(A) (1999).
[65]29 U.S.C. § 1104(a)(1)(B) (1999).
[66]29 U.S.C. § 1104(a)(1)(C) (1999).
[67]29 U.S.C. § 1104(a)(1)(D) (1999).

(B) with 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;

(C) by diversifying 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

(D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this title and title IV.[68]

1. The Exclusive Benefit Rule

ERISA section 404(a)(1)(A) requires plan fiduciaries to act solely in the interests of plan participants and beneficiaries and for the exclusive purpose of providing plan benefits and defraying reasonable expenses of plan administration.[69] These two requirements — "solely in the interest" and "exclusive purpose" — combine to form a statutory duty of loyalty. Under this rule, fiduciaries must act "with an eye single to the interests of participants and beneficiaries"[70] and may not place themselves in a position in which they are required to compromise their duty of undivided loyalty to plan participants.[71]

Although the Department has interpreted section 404(a)(1)(A) as prohibiting fiduciaries from subordinating retirement assets to "unrelated objectives,"[72] the Department has never taken the position that all collateral benefits are prohibited.[73] The Department has explicitly stated that:

There is nothing in ERISA, however, 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 or superior to alternative investments otherwise available.[74]

[68]29 U.S.C. § 1104(a)(1) (1999).
[69]29 U.S.C. § 1104(a)(1)(A) (1999).
[70]Donovan v. Bierwirth, 680 F.2d 263, 271 (2d Cir. 1982), *cert. denied*, 459 U.S. 1969 (1982) (citations omitted).
[71]*Id*.
[72]*Avon Letter, supra* note 35.
[73]*See supra*, notes 33 and 35.
[74]Address by Dennis Kass, Assistant Secretary of Labor, Pension and Welfare Benefits Administration, *Current Developments at the Department of Labor*, at the Annual Conference in Las Vegas, Nev., sponsored by the Int'l Found. of Employee Benefit Plans (Nov. 1986), *reprinted in* INT'L FOUND. OF EMPLOYEE BENEFITS PLANS, EMPLOYEE BENEFITS ANNUAL 235, 236 (1987).

On another occasion, a Departmental spokesperson stated that although the exclusive benefit rule "does not exclude the provision of incidental benefits to others, the protection of retirement income is, and should continue to be, the overriding social objective governing the investment of plan assets."[75] The Department has also stated "that under ERISA pension plan investments must be made based upon what is in the economic interest of the plan as a separate and distinct legal entity established for the purpose of providing retirement income, [and] that other considerations can be considered provided that they are incidental and do not compromise the required investment decision."[76]

In advisory opinions, the Department has repeatedly emphasized that plan investments must be made solely in the interest of plan participants and beneficiaries but collateral benefits may be considered if the investment is otherwise "equal or superior to alternative investments available to the plan."[77] In response to an inquiry made on behalf of ULLICO concerning its Mortgage Separate Account J, a mortgage pool for union-built properties, the Department stated that investment in the J Account would be not prudent if it provided the investor "with less return, in comparison to risk, than comparable investments available to the plan, or if it involved a greater risk to the security of plan assets than other investments offering a similar return."[78]

The Department warned that the interests of participants and beneficiaries cannot be subordinated to unrelated objectives.[79] The Department stated that the J Account investments would not violate ERISA section 404 if the loans are offered at "rates prevailing in the overall mortgage market."[80] However, the "decision to make an investment may not be influenced by a desire to stimulate the construction industry and generate employment unless the investment, when judged solely on the basis of its economic value to the plan, would be equal or superior to alternative investments available to the plan."[81] Thus, it is not sufficient to simply charge the

[75]Ian Lanoff, *The Social Investment of Private Pension Plan Assets: May It Be Done Lawfully Under ERISA?*, 31 LAB L. J. 387, 389 (1980).
[76]*Pension Investments: Public Hearing Before the New York State Pension Investment Task Force*, 190-91 (Mar. 3, 1989) (testimony of David Walker, Assistant Secretary for Pension and Welfare Benefits, U.S. Department of Labor) [hereinafter *New York Hearings*].
[77]PWBA Letter to James S. Ray (July 8, 1988).
[78]*Id.*
[79]*Id.*
[80]*Id.*
[81]*Id.*

prevailing rate; the investment must be equal to or better than alternative investments with similar risk and return characteristics.[82]

Courts have agreed with the Department's interpretation of the exclusive benefit rule. In *Donovan v. Walton*,[83] the district court for the Southern District of Florida held that "by adopting the 'exclusive purpose' standard, Congress did not intend to make illegal the fact of life that most often a transaction benefits both parties involved."[84] ERISA "does not prohibit a party other than a plan's participants and beneficiaries from benefitting in some measure from a prudent transaction with the plan."[85]

In *Donovan v. Bierwirth*,[86] the Second Circuit ruled that trustees will not violate their duty of loyalty by "taking action which, after careful and impartial investigation, they reasonably conclude [is] best to promote the interests of participants and beneficiaries simply because it incidentally benefits the corporation, or indeed, themselves . . . ."[87] Similarly, in *Morse v. Stanley*, the Second Circuit held that "[i]t is no violation of a trustee's fiduciary duties to take a course of action which reasonably best promotes the interest of plan participants simply because it incidentally also benefits" another party.[88]

---

[82] *See also* PWBA Letter to Gregory Ridella, Chrysler Corporation (A.O. 88-16A) (Dec. 19, 1988) (in which the Department stated: "A decision to make an investment may not be influenced by non-economic factors unless the investment, when judged solely on the basis of its economic value to the plan, would be equal or superior to alternative investments available to the plan").

[83] 609 F. Supp. 1221 (S.D. Fla. 1985), *aff'd sub nom*., Brock v. Walton, 794 F.2d 586 (11th Cir. 1986).

[84] 609 F. Supp. at 1245. *See also* Martin v. Feilen, 15 Employee Benefits Cas. (BNA) 1545, 1556 (8th Cir. 1992) (holding that an "ESOP fiduciary is not prohibited from being on both sides of a transaction involving the ESOP's assets, but he must serve both masters (or at least the ESOP) with the utmost care and fairness" and "[w]hen a fiduciary has dual loyalties, the prudent person standard requires that he make a careful and impartial investigation of all investment decisions.").

[85] 609 F. Supp. at 1245.

[86] 680 F.2d 263 (2d Cir. 1982), *cert. denied*, 459 U.S. 1069 (1982).

[87] *Id.* at 271. In *Trenton v. Scott Paper Co.*, the Third Circuit held that "the fact that a fiduciary's actions incidentally benefit an employer does not necessarily mean that the fiduciary has breached his duty." 832 F.2d 806, 809 (3d Cir. 1987), *cert. denied*, 485 U.S. 1022 (1988).

[88] Morse v. Stanley, 732 F.2d 1139, 1146 (2d Cir. 1984).

> Most violations of the exclusive benefit are blatant. Examples of breach of the duty of loyalty include: Marshall v. Kelly, 465 F. Supp. 341 (W.D. Okla. 1978) (where plan made a loan to a fiduciary); Donovan v. Daugherty, 550 F. Supp. 390 (S.D. Ala. 1982) (when trustees unlawfully extend benefits to themselves); Wright v. Nimmons, 641 F. Supp. 1391, 1402 (S.D. Tex. 1986) (when a fiduciary treats plan assets as if they were his own property); Marshall v. Mercer, 4 Employee Benefits Cas. (BNA) 1523 (N.D. Tex. 1983), *rev'd on other grounds*, 747 F.2d 304 (5th Cir. 1984) (when a trustee fails to take action to collect loans made by the plan to himself and his corporation); Dasler v. E.F. Hutton & Co., 694 F. Supp. 624, 632 (D. Minn. 1988) (when a fiduciary broker churns a plan account to receive greater commissions).

See also Investment of Pension Plan Assets: Hearings Before the Subcomm. on Oversight of the House Comm. on Ways and Means, 100th Cong., 2d Sess. 181 (1988) (testimony of William Posner, Assistant Director; Employee Plans Technical and Actuarial Division. Internal Revenue Service, U.S. Dep't of the Treasury).

Opponents of ETIs such as Representative Jim Saxton oppose ETIs "[b]ecause they violate the law, they lower returns and increase risk for pension beneficiaries."[89] These opponents miss the essential point that ETIs must be prudent and achieve competitive rates of returns. As the leadership of the Service Employees International Union points out "properly designed ETIs are not concessionary investments." Cynthia L. Moore, attorney for the National Council on Teacher Retirement notes:

> Regardless of the merits of the project to the community at large, the fiduciaries' sole concern is to decide whether the project would benefit the members of the plan. If it benefits the members [financially], the fiduciaries may go forward with it. If it does not, but the fiduciaries proceed in any event, they and the plan's members face an array of negative consequences."[90]

Opponents of ETIs often cite the exclusive benefit rule as a legal impediment to economically targeted investments. During congressional hearings on economically targeted investments, Representative Jim Saxon, an ardent opponent of ETIs,[91] asked Secretary of Labor Robert Reich whether the Department's interpretation that collateral benefits are permissible contradicts the exclusive benefit rule.[92] Secretary Reich replied:

The statute says exclusive benefit. Does this mean that we cannot consider these other possible advantages of investment, even assuming that we can get the same risk adjusted rate of return? And the Department, again, in letter after letter, advisory opinion after advisory opinion has said no, that's not what the statute means. Exclusive purpose under the law means that you can't weigh those things against the return, but as long as you perform your obligation as a fiduciary to get that return, it's perfectly appropriate to take into consideration those other things.[93] The exclusive benefit rule does not prohibit economically targeted investments as long as

---

[89]Rep. Jim Saxton, *Economically Targeted Investments*, Testimony before the Joint Economic Committee, House Economic Employer-Employee Relations, June 15, 1995, *reprinted in* Fed. Doc. Clearing House Congressional Testimony.

[90]Statement by Cynthia L. Moore, National Council on Teacher Retirement, before a hearing of the National Conference on State Legislatures, May 6, 1993.

[91]Representative Saxon calls ETIs "PTI" — politically targeted investments. In 1993, he introduced a bill (H.R. 5120) to prevent economically targeted investing. Maria Shao, *Putting Pensions to Work*, BOSTON GLOBE, Nov. 2, 1994, at 45.

[92]*Hearing on Pension Investments and Economic Growth, supra* note 36.

[93]*Id.*

the primary objective of the investment is to make a prudent investment with a competitive rate of return for plan participants and beneficiaries.

2. The Prudence Rule

The prudence rule[94] requires fiduciaries to act with "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."[95] This rule imposes "an extremely high standard of conduct;"[96] this standard is "the highest known to the law."[97]

The Department has created a safe harbor for fiduciaries making investment decisions.[98] If a fiduciary complies with the prudence regulation, the investment will be deemed to be prudent. However, if a fiduciary does not comply with the prudence regulation, the investment is not imprudent per se.[99]

In order to reach the sanctuary of the safe harbor, the fiduciary must act only after giving appropriate consideration to those

> facts and circumstances that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved, including the role the investment or investment course of action plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties.[100]

When considering an investment, the fiduciary must determine whether the investment reasonably furthers the purposes of the plan, taking into consideration the risk of loss and the

[94]29 U.S.C. § 1104(a)(1)(B) (1999).
[95]*Id.*
[96]Marshall v. Mercer, 4 Employee Benefits Cas. (BNA) 1523, 1532 (N.D. Tex. 1983).
[97]*Id.*
[98]Preamble to Rules and Regulations for Fiduciary Responsibility; Investment of Plan Assets under the "Prudence" Rule, 44 Fed. Reg. 37,221 (June 26, 1979).
[99]*Id.*
[100]*Id.*

opportunity for gain.[101] The fiduciary must consider the following factors in relation to the entire portfolio:

(1) the composition of the portfolio with regard to diversification;

(2) the liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan; and,

(3) the projected return of the portfolio relative to the funding objective of the plan.[102]

The Department of Labor has added a fourth factor: "consideration of the expected return on alternative investments with similar risks available to the plan."[103] The Department recently clarified this factor:

> [B]ecause every investment necessarily causes a plan to forego other investment opportunities, an investment will not be prudent if it would be expected to provide a plan with a lower rate of return than available alternative investments with commensurate degrees of risk or is riskier than alternative investments with commensurate rates of return.[104]

Thus, a fiduciary may not sacrifice return to obtain a collateral benefit and proposed investments must be compared with available alternative investments with similar risk and return characteristics.

The Department has also clarified that the prudence rule does not require fiduciaries to invest only in conservative investments. The Department has stated that the

relative riskiness of a specific investment . . . . does not render such investment either *per se* prudent or *per se* imprudent . . . . [T]hus, although securities issued by a small or new company may be a riskier investment than securities issued by a "blue chip" company, the investment in the former company may be entirely proper under the Act's "prudence" rule.[105]

[101] *Id.*
[102] *Id.*
[103] Interpretive Bulletin 94-1, *supra* note 35.
[104] *Id.*
[105] Preamble to Rules and Regulations for Fiduciary Responsibility; Investment of Plan Assets under the "Prudence" Rule, 44 Fed. Reg. 37,221 (June 26, 1976).

The Department has refused to issue a list of legally permissible investments because "no such list could be complete."[106] Indeed, the Department has praised ERISA because it doesn't specify a legal list of permissible investments: "One of the remarkable things about ERISA as a statute has been its flexibility, because it doesn't prescribe exact investment policies."[107]

Some opponents of targeted investing have argued that ERISA requires fiduciaries to make investments which will produce the maximum return for the plan with the least amount of risk.[108] Courts have disagreed, however. In *Foltz v. U.S. News & World Report Inc.*,[109] a district court ruled that ERISA "section 404 creates no exclusive duty of maximizing pecuniary benefits."[110] In *Anderson v. Mortell,*[111] the court observed that a fiduciary has no duty to "achieve the highest possible price" on the sale of securities.[112] More recently, in *Ershick v. United Missouri Bank,*[113] the court held that ERISA does not create a duty to maximize pecuniary benefits.[114] The duty to maximize returns on investment would place an unreasonable and impossible burden on fiduciaries. Return cannot be evaluated in isolation: return depends upon the risk factor involved. Fiduciaries should optimize investment returns in comparison to other available investments with similar risk characteristics. Fiduciaries should never sacrifice investment returns to achieve a collateral objective and the value of the collateral benefit cannot be factored into the rate of return.

Thus, under the prudence rule, it is legally permissible to invest in ETIs under the appropriate circumstances. However, as numerous courts have noted, it is not the success of an investment viewed in hindsight that determines the prudence of the investment.[115] Rather, it is

---

[106]*Id.*
[107]*Hearing on Pension Investments and Economic Growth*, *supra* note 36.
[108]Interpretive Bulletin 94-1, *supra* note 35, makes clear that investments are to be compared to comparable investments: a plan cannot make an investment if the return would be less than other investments of similar risk and the plan cannot make an investment if the risk would be greater than investments of similar return. The bulletin does not require the investment to have the best of both worlds: the highest return and the lowest risk. Instead, the comparison is the highest return of investments with similar risk characteristics.
[109]865 F.2d 364 (D.C. Cir. 1989), *cert. denied*, 490 U.S. 1108 (1989).
[110]*Id.* at 373.
[111]722 F. Supp. 462 (N.D. Ill. 1989).
[112]*Id*. at 470.
[113]12 Employee Benefits Cas. (BNA) 2323 (D. Kan 1990), *aff'd*, 14 Employee Benefits Cas. (BNA) 1848 (10th Cir. 1991).
[114]12 Employee Benefits Cas. (BNA) at 2327.
[115]Debruyne v. Equitable Life Assur. Society, 720 F. Supp. 1342, 1349 (N.D. Ill. 1989), *aff'd*, 920 F.2d 457 (7th Cir. 1990) (stating that "[t]he fiduciary duty . . . . requires prudence not prescience."); GIW Industries, Inc. v. Trevor, Stewart,

the procedural process by which the investment decision was made that determines its prudence. In *Marshall v. Glass/Metal Association and Glaziers and Glass Workers Pension Plan*,[116] the district court for the district of Hawaii held:

> ERISA does not require that a pension plan take no risks with its investments. Virtually every investment entails some degree of risk, and even the most carefully evaluated investments can fail while unpromising investments may succeed. The application of ERISA's prudence standard does not depend upon the ultimate outcome of an investment, but upon the prudence of the fiduciaries under the circumstances prevailing when they make their decision and in light of the alternatives available to them.[117]

The court held that the fiduciaries failed to satisfy the prudence rule "[b]y committing Plan assets without adequate procedures and evaluation of the risks involved and alternatives available."[118] Procedural prudence requires trustees to:

Burton & Jacobsen, Inc., 10 Employee Benefits Cas. (BNA) 2290, 2300 (S.D. Ga. 1989), *aff'd*, 895 F.2d 729 (11th Cir. 1990) (holding that a "court must consider the conduct of the fiduciary not the success of the investment, ... and the court must evaluate the fiduciary's conduct, from the perspective of the 'time of the investment decision' rather than from 'the vantage point of hindsight.'" (citations omitted)); Donovan v. Walton, 609 F. Supp. 1221, 1238 (S.D.Fla. 1985), *aff'd sub nom*., Brock v. Walton, 794 F.2d 586 (11th Cir. 1986) (stating that "[o]ne must resist the knee-jerk reflex to pronounce an investment prudent or imprudent based on the success of the venture, for ERISA is concerned with the soundness of the decision to invest." (quoting Leigh v. Engle, 727 F.2d 113, 124 (7th Cir. 1984)). *See also New York Hearings, supra* note --, at 198 (testimony of David Walker, Ass't Secretary of Labor for Pension and Welfare Benefits Administration, U.S. Dept. of Labor) (stating: "What we don't do in ERISA is we don't second-guess people. We don't employ hindsight").

[116] 507 F. Supp. 378 (D. Haw. 1980).

[117] *Id.* at 384.

[118] *Id. See also* Donovan v. Mazzola, 2 Employee Benefits Cas. (BNA) 2115 (N.D.Cal. 1981), *aff'd*, 716 F.2d 1226 (9th Cir. 1983), *cert. denied*, 464 U.S. 1040 (1984), in which the court held that plan trustees acted imprudently when they made a loan without obtaining or reviewing basic documentation including financial statements, project plans, and an accurate market study. The court also found that the trustees failed to monitor the use of the loan proceeds after the loan was made.

10 Steps to Procedural Prudence

1. **Refuse to Accept Below-Market Rates of Returns.**
2. **Periodically Review Plan Documents to Make Sure the Trustees are Acting in Accordance with Plan Documents.**
3. **Prudently Delegate Investment Duties.**
4. **Prudently Select and Monitor Experts.**
5. **Diligently Investigate the Proposed Investment.**
6. **Diversify Investments.**
7. **Compile a Thorough Paper Trail.**
8. **Act for the Exclusive Benefit of Plan Participants and their Beneficiaries.**
9. **Avoid Conflicts of Interest.**
10. **Avoid Transactions with Parties in Interest.**

For a detailed discussion of procedural prudence *see High-Performance Investing*: *Harnessing the Power of Pension Funds to Promote Economic Growth and Workplace Integrity.*[119]

3. The Diversification Rule

The third requirement imposed by ERISA section 404(a)(1) is the duty to diversify plan assets "so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so."[120] The diversification rule requires trustees to reduce exposure to the risk of large losses:

Diversification of investments is the practice whereby funds are committed to different classes of investments which are characterized by different types of risks. The theory upon which the practice is based is that by allocating funds to different types of investments, the potential losses which might occur in the area due to a particular economic event will be offset by

[119] Jayne Elizabeth Zanglein, *High-Performance Investing: Harnessing the Power of Pension Funds to Promote Economic Growth and Workplace Integrity,* 11 THE LABOR LAWYER 59, 101 - 127 (1995).
[120] 29 U.S.C. § 1104(a)(1)(C) (1999).

gains in another area. Even if such a loss is not offset, its impact is at least limited to a relatively small portion of the fund.

Conversely, by pursuing a strategy of non-diversification, an investor runs a risk of incurring substantial losses if the particular investment vehicle chosen performs badly, or if one of few large investments chosen performs badly. Under such circumstances a particular negative economic event can devastate the entire plan or a great portion thereof.[121]

ERISA's legislative history provides additional guidance:

> A fiduciary usually should not invest the whole or an unduly large proportion of the trust property in a single security. Ordinarily the fiduciary should not invest the whole or an unduly large proportion of the trust property in one type of security or in various types of securities dependent on the success of one enterprise or upon conditions in one locality, since the effect is to increase the risk of large losses . . . . If he is investing in mortgages on real property he should not invest a disproportionate amount of the trust in mortgages in a particular district or on a particular class of property so that a decline in property values in that district or of that class might cause a large loss.[122]

Congress "intended that the geographic dispersion be sufficient so that adverse economic conditions peculiar to one area would not significantly affect the economic status of the plan as a whole."[123] Congress indicated that "[b]y spreading asset purchases throughout a number of varying types of securities or investments, a fiduciary may protect to a certain extent against the fortunes of a particular field of business or industry, and thereby minimize the risk of large losses."[124] The Seventh Circuit has adopted modern portfolio theory:

When investment advisors make decisions they do not view individual investments in isolation. Rather, the goal is to create a diversified portfolio that balances appropriate levels of

[121] Donovan v. Guar. Nat'l Bank, 4 Employee Benefits Cas. (BNA) 1686, 1688 (S.D. W. Va. 1983).
[122] H.R. REP. NO. 1280, 93rd Cong., 2d Sess. 304 (1974), *reprinted in* 1974 U.S.C.C.A.N. 5038, 5085.
[123] *Id.*
[124] GIW Industries, Inc. v. Trevor, Stewart, Burton & Jacobsen, Inc., 10 Employee Benefits Cas. (BNA) 2290, 2303 (S.D. Ga.

risk and return for the investor. The risk of a given investment is neutralized somewhat when the investment is combined with others in a diversified portfolio. The risk inherent in the entire portfolio is less than that of certain assets within the portfolio. Ideally, after diversification only market risk remains. Likewise, the return from a portfolio over time should be more stable than that of isolated investments within that portfolio.[125]

The Department of Labor has not established a maximum percentage that can be invested in one geographic area or one type of investment.[126] Diversification depends upon the facts and circumstances surrounding each plan and investment.[127] Under certain circumstances, the decision not to diversify might be prudent.[128]

In *Donovan v. Mazzola*,[129] the district court for the Northern District of California held that the trustees' general inexperience in real estate loans was not a defense to their imprudent conduct in exposing the pension fund to the large risk of loss resulting from the high concentration of assets in a single type of investment. The loan violated ERISA's diversification rule by subjecting a disproportionate amount (approximately fifty-three percent) of pension fund assets "in a single investment, subject to a common set of risks associated with a single

---

1989), *aff'd*, 895 F.2d 729 (11th Cir. 1990).

[125] Leigh v. Engle, 858 F.2d 361, 368 (7th Cir. 1988), *cert. denied sub nom*., Estate of Johnson v. Engle, 489 U.S. 1078 (1989).

[126] Lanka v. O'Higgins, 810 F. Supp. 379 (N.D.N.Y. 1992). The Conference Report states that "[t]he degree of investment concentration that would violate this requirement to diversify cannot be stated as a fixed percentage, because a prudent fiduciary must consider the facts and circumstances of each case." H.R. REP. No. 1280, 93d Cong., 2d Sess. 304, *reprinted in* 1974 U.S.C.C.A.N. 5038, 5084.

[127] *See* Marshall v. Glass/Metal Ass'n, 507 F. Supp. 378, 383 (D.Haw. 1980).

[128] ERISA § 404(A)(1)(C) imposes an obligation to diversify "unless under the circumstances it is clearly prudent not to do so." 29 U.S.C. § 1104(a)(1)(C) (1994). *See* Reich v. King, 18 Employee Benefits Cas. (BNA) 1801, 1804 (D. Md. 1994) (trustees have the burden of proving that their decision not to diversify is "clearly prudent"; prudence under the diversification rule is the same as the prudent person rule of ERISA § 404(A)(1)(B)). In *Reich v. King*, the district court denied the Secretary of Labor's motion for summary judgment which claimed that the trustees' failure to diversify is a per se violation of the diversification rule. 18 Employee Benefits Cas. (BNA) at 1806. The trustees had invested 75% of plan assets in mortgages and notes, 72% of which was secured by residential real property in one county. *Id.* at 1802. The remaining mortgages were secured by real estate in three neighboring counties. *Id.* The court refused to grant summary judgment, holding that non-diversification is not a per se violation of the diversification rule and that a material fact existed as to the prudence of the trustees' decision not to diversify. *Id.* at 1805-06. Later, the court granted the trustees' motion to dismiss, holding that the trustees had met the burden of showing that the decision not to diversify was clearly prudent. *Labor Department Loses Lawsuit Over Trustees' Failure to Diversity*, 21 Pens. & Benefits Rep. (BNA) 2281-2282 (Dec. 5, 1994).

[129] 2 Employee Benefits Cas. (BNA) 2115 (N.D. Cal. 1981), *aff'd*, 716 F.2d 1226 (9th Cir. 1983), *cert denied*, 464 U.S. 1040 (1984).

geographic location, a single product type, and the specific project and property involved."[130] The court described the portfolio:

Taken together with assets already invested, and assuming a total portfolio of $20 million by November 20, 1979, the $650,000 loan brought the total proportion of the Fund's total assets invested in the capital market for real estate to approximately 81%; in mortgages, to approximately 73%; and in mortgages on certain specialized properties, to approximately 73%; mortgage loans to one investment to approximately 12%; and in mortgages secured by Northern California real estate, to approximately 47%.[131]

The court compared these percentages to the prevailing standards in the field of institutional portfolio management and found that no more than one-third of institutional portfolio fund assets should have been invested in real estate.[132] The court also stated that plan assets generally should not be invested in a single type of real estate product, but should be diversified by product, location, project, and property.[133]

In *Marshall v. Teamsters Local 282 Pension Trust Fund*,[134] the district court for the Eastern District of New York held that ERISA "requires diversification under circumstances where commitment of a high percentage of the assets of a plan to a particular investment or class of investments casts doubt on the prudence of the investments."[135] Trustees of a Teamsters pension fund invested $20 million in a permanent first mortgage on a ten acre lot on the Las Vegas "Strip," where a hotel and casino were to be erected. Because the loan, which involved 36% of plan assets was so large, the court held that trustees had violated the diversification limit imposed by ERISA.[136]

Additionally, the trustees had violated the trust agreement which limited investments in any one investment to twenty-five percent of the fund's total assets at market value, unless the

---

[130] *Id.* at 2128.
[131] *Id.* at 2128-29.
[132] The court considered testimony of the Department of Labor's expert witness who stated that pension fund assets should be diversified in order to meet the prevailing standards in the field of institutional portfolio management. *Id.* at 2126.
[133] *Id.* at 2128.
[134] 458 F. Supp. 986 (E.D. N.Y. 1978).
[135] *Id.* at 990.
[136] *Id.* at 991.

trustees specifically determined that such limitation would be imprudent.[137] The court held that the trustees had violated the plan document rule.[138]

In *Brock v. Wells Fargo Bank,*[139] trustees were enjoined from making a $4.5 million loan to a real estate developer, where evidence strongly suggested that the trustees had not investigated the investment with the care required by ERISA.[140] Although the loan only equaled thirteen percent of the plan assets, the Department argued that the diversification and prudence rules had been violated.[141] The court granted a preliminary injunction, relying primarily on the failure of the investment.[142] The case was settled and a real estate consultant was retained to monitor the project.[143]

Several cases have involved such high percentages of plan assets in one type of investment it is not surprising that the Department of Labor challenged the investment. In *Freund v. Marshall & Ilsley Bank*,[144] the court noted, "it can hardly be disputed that the investment of virtually all of the Plan's assets in loans to affiliated companies, on its face, represents a complete failure to diversify the investments of the Plan."[145] In *Marshall v. Mercer,*[146] the court observed, "it should be obvious that a concentration of 85% to 90% of the Plan's assets in a single class of investments is little or no diversification at all."[147] In *Marshall v. O'Donnell*,[148] the court held that loans of ninety-nine percent of plan assets to parties in interest violated the diversification rule.[149]

---

[137] *Id.*
[138] *Id.* at 990-92.
[139] 7 Employee Benefits Cas. (BNA) 1221 (N.D. Cal. 1986).
[140] *Id.* at 1221.
[141] *Id.*
[142] *Id.*
[143] *See also* Sandoval v. Simmons, 622 F. Supp. 1174 (C.D. Ill. 1985) in which the court held that an investment of 12% of plan assets constituted non-diversification. However, in contrast to the cases previously cited, in *Sandoval*, the court emphasized the business acumen of the trustee, describing him as a "brilliant, self-made man. . . . [H]is rise in the financial community is something of which legends are made." *Id.* at 1209. Although a violation of ERISA was found based on failure to diversify and conflict of interest, the court focused on the expertise of the trustee in determining whether a violation had occurred.
[144] 485 F. Supp. 629 (W.D. Wis. 1979).
[145] *Id*. at 636.
[146] 4 Employee Benefits Cas. (BNA) 1523 (N.D. Tex. 1983), *rev'd on other grounds*, 747 F.2d 304 (5th Cir. 1984).
[147] *Id.* at 1535.
[148] Civ. Action No. R-81-28 (D.Md., Jan. 28, 1981). *See Litigation: Employee Advised of Nonparticipant Status Prior to ERISA May Not Bring Federal Court Action*, Pens. Rep. (BNA) No. 329, A-13, A-15 (Feb. 16, 1981).
[149] *Id. See also* Freund v. Marshall & Illsley Bank, 485 F. Supp. 629 (W.D.Wis. 1979) (virtually all of plan assets loaned to plan sponsor); Marshall v. Kelly, 465 F.Supp. 341 (W.D.Okla. 1978) (almost 70% of plan assets loaned to sponsor).

Yet, in *Reich v. King*, the district court denied the Secretary of Labor's motion for summary judgment which claimed that the trustees' failure to diversify is a per se violation of the diversification rule.[150] The trustees had invested 75% of plan assets in mortgages and notes, 72% of which was secured by residential real property in one county.[151] The remaining mortgages were secured by real estate in three neighboring counties. The court refused to grant summary judgment, holding that non-diversification is not a per se violation of the diversification rule and that a material fact existed as to the prudence of the trustees' decision not to diversify.[152] Similarly, in *Metzler v. Graham,*[153] the Fifth Circuit held that a fiduciary did not violate the diversification rule by investing 63% of plan assets in a single tract of undeveloped land, where the plan participants were far from retirement age, and the fiduciary had expertise in this type of investment. These cases are anomalies and trustees are advised not to invest a large percentage of plan assets in a single investment.

4. The Plan Document Rule

The final requirement is the plan document rule. ERISA Section 404(a)(1)(D) requires fiduciaries to act "in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions" of ERISA.[154] Plan documents include the plan description, summary plan description, collective bargaining agreement, trust agreement, contract, investment management agreement, investment guidelines, and other instruments under which the plan was established or is operated.[155]

Trustees must frequently review all plan documents to ensure that they do not unintentionally violate any terms of these documents. For example, trustees should review their trust agreement, investment management agreement, and investment guidelines before making any

[150] 18 Employee Benefits Cas. (BNA) at 1806.
[151] *Id.* at 1802.
[152] *Id.* at 1805-06.
[153] 112 F.3d 207 (5th Cir. 1997).
[154] *See e.g.*, ERISA § 104(b)(2), 29 U.S.C. § 1104(b)(2) (1999). Courts have ruled that plan documents also include a deadlock arbitration award, Ironworkers Local 272 v. Bowen, 695 F.2d 531 (11th Cir. 1983); and a memorandum in which the trustees' instructions are described, Clark v. Bank of New York, 687 F. Supp. 863 (S.D.N.Y. 1988). *See also* Schoenholtz v. Doniger, 628 F. Supp. 1420 (S.D.N.Y. 1986); Delgrosso v. Spang & Co., 769 F.2d 928 (3d Cir. 1985), *cert.denied*, U.S. 1140 (1986); Donovan v. Daugherty, 550 F. Supp. 390 (S.D. Ala. 1982); Winpisinger v. Aurora Corp. of Ill., 456 F. Supp. 559 (N.D. Ohio 1978).

investment decisions. This basic ERISA principle was overlooked by Grace Capital, an investment manager for the Fur Manufacturing Industry Retirement Fund.[156] In its investment management agreement with the Fund, Grace Capital agreed to "manage the Account in strict conformity with the investment guidelines promulgated by the Trustees . . . and with all applicable Federal and State laws and regulations."[157] The investment guidelines limited investment in common stocks to "25% of the cost of the securities in the Account."[158] Later, the limitation was increased to 50%.

Although Grace Capital recommended an additional increase in order to invest more than fifty percent in equities, the trustees refused to increase the limit. Over a fifteen month period, equity investments steadily increased from fifty-four percent to eighty-one percent.

The Trustees sued Grace Capital. The court held that by agreeing to act as the Fund's investment manager, Grace Capital had assumed the statutory obligation to act in accordance with plan documents including the investment management agreement.[159] The court further held that Grace Capital had breached its fiduciary duty to the Fund by exceeding the fifty percent limitation established in the investment management agreement. The court rejected the defense raised by Grace Capital that in the investment business, "percentage guidelines merely establish a rough demarcation zone to assist the manager in portfolio allocation."[160]

Similarly, in *Martin v. Harline*,[161] the district court for the District of Utah held that a corporate board of directors violated the plan document rule when they failed to follow plan documents which required them to appoint a committee to assist the plan trustee and to report to the board.[162] The court held that the plan imposed on the directors a duty to oversee the plan trustee and that the directors failed to follow the plan document's requirements in violation of

---

[156] Dardaganis v. Grace Capital, Inc., 664 F. Supp. 105, 107 (S.D.N.Y. 1987), *aff'd in pertinent part*, 889 F.2d 1237 (2d Cir. 1989), *on remand*, 755 F. Supp. 85 (S.D.N.Y. 1991).
[157] *Id.*
[158] *Id.*
[159] *Id.* at 108.
[160] *Id.* at 109.
[161] 15 Employee Benefits Cas. (BNA) 1138 (D. Utah 1992).
[162] *Id.* at 1149.

ERISA section 404(a)(1)(D).[163] The court held that "[u]nder ERISA and the common law, a fiduciary has the fundamental duty to follow the trust document and is liable for losses if he does not do so."[164] The court noted that if a trust agreement defines how a power must be exercised, "the fiduciary must strictly adhere to those terms."[165] Good faith is not a defense and neither is reliance on advice of counsel.[166]

Misconception #2: ETIs are Too Time-Consuming

It is true that direct ETI investments are extremely time-consuming. However, many ETIs are easy to implement.

For example, commingled real estate and mortgage accounts are the simplest forms of ETIs for the investor. They provide liquid, diversified investments with certain guaranteed returns.[167] Open-end commingled real estate pools are similar to open-end mutual funds. Investors can purchase shares at any time; however, most funds restrict the redemption of shares. Because the capital for redemption is derived from the fund itself, if capital is available, shareholders can redeem their shares. If capital is unavailable, the shareholders must wait until enough capital has accumulated.[168] There are many pooled real estate funds in which a pension fund can invest. These will be examined later in greater detail.

---

[163]The violation of the plan document rule was independent of any violation of the prudence rule which also imposes a duty of oversight on the trustees. *Id.*

[164]*Id.* (citing *Dardagnais v. Grace Capital, Inc.*, 889 F.2d 1237, 1241-1242 (2d Cir. 1989)).

[165]*Id.* (citing G. BOGERT, THE LAW OF TRUSTS AND TRUSTEES, § 551 at 7 (2d ed. 1980)).

[166]*Id.*. (citing RESTATEMENT (SECOND) OF TRUSTS AND TRUSTEES. § 201 cmt. b (1959)).

[167]*Hearing on Pension Investments and Economic Growth*, *supra* note -- (testimony of Stephen Coyle, Chief Executive Officer of AFL-CIO Housing Investment Trust).

[168]In contrast, closed-end funds:

> allow a one time infusion of capital at their formation and then are closed to new investors. The funds are blind pools in that there are no assets in the fund prior to the capital contributions of the investors. They usually have a specific term, such as ten years, and earnings and proceeds from sale are distributed rather than reinvested. Investors buy the assets at cost rather than on appraised values since the assets are acquired after the formation of the fund and no new shares are sold thereafter.

> Address by Marc Gertner, *Legal Consideration of Employment-Generating Investments* 20, at the Investment Inst. in Las Vegas, Nev., sponsored by the Int'l Found. of Employee Benefit Plans (Mar. 1989). Before investing in a closed-end pool, trustees should closely examine the pool's investment strategy and the expertise of the manager of the pool.

> Real estate foundations are similar to closed-end pools. While these were popular in the 1980s, their popularity have declined with the advent of newer investment vehicles such as targeted certificates of deposit. For more information on real estate foundations, *see* JAYNE ZANGLEIN, SOLELY IN OUR INTEREST: CREATING MAXIMUM BENEFITS FOR WORKERS THROUGH PRUDENT PENSION INVESTMENTS 102-104 (AFL-CIO LAWYERS COORDINATING COMMITTEE 1992).

As discussed more fully below, pooled venture capital and private placement accounts are also available to fund investors. These funds provide an easy-to-implement ETI investment. In contrast, direct real estate investments and private placements are much more time-consuming investments.

Misconception #3: ETIs are Too Costly

Likewise, it is true that direct ETIs suffer from high administrative costs due to their complexity. Some ETIs are based on investments such as mortgages and mortgage-backed securities, which are "standard, insured and salable in the secondary mortgage markets, providing a liquidity not often found in ETIs."[169] These investments entail less administrative expenses and staff time than other types of ETIs.[170] Additionally, it is easy to find professionals who can develop a customized mortgage-backed securities program.[171]

However, other ETI programs suffer from high administrative costs due to their complexity and the amount of staff time required to develop, implement, and monitor the program.[172] A report issued by the New York State Industrial Cooperation Council in 1990 observed that economically targeted investment programs "can be very time consuming and challenging" to establish and administer.[173] Direct investment programs are difficult to manage and consultants often are not easily available to develop the program. Additionally, many of these programs are illiquid investments.[174]

Many other ETIs, such as pooled funds and linked deposit programs, have very low administrative expenses and are less time-consuming. These investments will be explored later.

---

[169] *Id.*
[170] INST. FOR FIDUCIARY EDUC., *supra* note 46, at 14.
[171] *Id.*.
[172] *Id.*
[173] N.Y. STATE INDUSTRIAL COOPERATION COUNCIL, COMPETITIVE PLUS–ECONOMICALLY TARGETED INVESTMENTS BY PENSION FUNDS 7 (1990). *See* Fran Hawthorne, *Social Investing Gets Down to Business*, INSTITUTIONAL INVESTOR, Sept. 1993, at 98:

> The biggest headache for many pension funds has not been measuring ETIs but creating them. Until recently almost nothing was available off-the-shelf. Each time a pension fund wanted . . . to buy mortgage securities to encourage low-cost housing, it had to reinvent the wheel. And arranging ETIs is a cumbersome process that can involve piecing together funding from various government and nonprofit sources, or working with community groups to screen and train borrowers. It typically takes New York City two years to get an ETI from initial concept to board approval.

[174] INST FOR FIDUCIARY EDUC., *supra* note 46, at 15. Most funds expect to hold an ETI investment (other than mortgage-backed securities) until maturity. *Id.* Some funds avoid the problem of illiquidity by making short-term ETIs: 3 year or 3 month certificates of deposit, or two to five year mortgages. *Id.* About 7.5% of the ETI surveyed were investments that

Misconception #4: Competent Investment Managers Who are Willing to Invest in ETIs are not available.

This misconception is a very difficult hurdle to overcome. Certainly, a multitude of expert professionals routinely invest in venture capital and private placements. They make these investments, however, for sophisticated investors[175] who are not subject to the strict fiduciary requirements of ERISA. A disincentive currently exists for these investment managers to deal with private pension trustees who are unable to make quick investment decisions on complex transactions. Given the choice between a corporate investor and a Taft-Hartley Fund, the investment banker would rather deal with the corporate investor who requires substantially less education and attention, can make rapid decisions, and is subject to less regulation..

This dilemma can be solved, however, by a national network and database of investment managers who are willing to work with union funds. The AFL-CIO has begun to work on this network. Richard Trumpka, Secretary-Treasurer of the AFL-CIO has stated: "We want to learn who our trustees are, so we can communicate with them, educate them, and pair them with worker-friendly actuaries, money-managers, lawyers and other professionals."[176]

Misconception #5: It is too difficult to convince the trustees, their consultants, and management trustees to invest in ETIs.

Patrick Cronin, financial manager of the Milwaukee Employee Retirement System observes that "it would be problematic to find an investment manager who had particular skill investing in ETIs."[177] This common complaint can only be resolved through education. Trustees must be confident in understanding the legal requirements of ERISA and in understanding proposed investment transaction. A solid education will allow trustees to refer uncooperative

matured in one year or less. *Id.*

[175] I use the term"sophisticated" as used in securities regulation, i.e. a wealthy investor who is able to risk the loss of the investment and has access to information about the transaction.

[176] FORUM KEYNOTE SPEAKER: RICHARD TRUMPKA, SUMMARY OF INDUSTRIAL HEARTLAND LABOR INVESTMENT FORUM: OUR MONEY, OUR JOBS, June 14, 1996, at 10.

[177] Phil Levine, *Where There's a Will, There's an ETI,* PENS. & INV., Nov. 10, 1997, at 52.

trustees and advisers to consultants who are more experienced and knowledgeable with respect to ERISA investment decision-making.

Trustees must also be confident enough to demand that an uncooperative trustee or consultant identify the specific obstacle he perceives. The trustee can, in coordination with other knowledgeable consultants, assist the reluctant trustee in overcoming misplaced fears about ETIs.

By the same token, the reluctant trustee should be encouraged to attend educational workshops on the technical aspects of investing in ETIs. The more knowledgeable the trustee is, the better he or she can serve the fund as a fiduciary.

Misconception #6: Politics Always Get in the Way

Public pension funds have been criticized for yielding to political pressures to make unsound investments. Unfortunately, a long list of unsuccessful investments made by public pension funds can easily be chronicled. Although the failure of the investment is not indicative of the prudence of the investment, losses are routinely publicized by critics.

For example, the Heritage Foundation has compiled a handy list of failed public fund investments which the Foundation uses as evidence that public funds are susceptible to cronyism and political manipulation.[178] The list includes the following examples:

- The Missouri State Employees' Retirement System established a venture capital fund for new businesses in the state. It was shut down three years later following poor returns and two lawsuits.

- Pennsylvania school teachers and state employees saw $70 million of their fund invested in a new plan for Volkswagen. The investment since then lost more than half its value.

- The Kansas Public Employees' Retirement System lost $65 million by investing in a Kansas-based Home Savings Association. The fund also lost $14 million by investing in Tallgrass Technologies and squandered nearly $8 million in a steel plant. Total losses of workers' money from ETIs will be between $138 million and $236 million.[179]

[178] Daniel J. Mitchell, *Why the Government Should Not Invest Americans' Social Security Money*, THE HERITAGE FOUNDATION BACKGROUNDER, Dec. 23, 1998.

[179] KaPERS recently returned to ETI investing after a hiatus. The Fund has developed new guidelines to prevent a reoccurrence of its previous disaster which made it the "poster child for the S & L fiasco." David Snow, *Burned Once, KaPERS Again Targets Alternatives*, BUYOUTS, Dec. 7, 1998. The Fund now limits alternative investments to 5%,

- The Connecticut State Trust Fund poured $25 million of workers' money into Colt Manufacturing, a local company that went bankrupt three years later.[180]

These high-visibility cases have provided good ammunition to opponents of economically targeted investments. These cases, however, are distinguishable for three reasons: (1) the investments were made by public funds whose investments are governed by state law rather than ERISA's fiduciary duties; (2) the investments are being judged solely by rate of return, a standard that even the Department of Labor does not use. Instead, the Department measures the prudence of the investment by the thoroughness of the procedural prudence exercised by the trustees at the time the investment decision was made; and (3) the examples cited above are venture capital investments which characteristically are very risky, but when successful earn a very high rate of return over a long time horizon. Venture capital investments often do not make a profit for several years and are commonly evaluated after ten years.

Misconception #7: There are no appropriate benchmarks by which to measure ETI performance

According to a recent survey, only two percent of public funds surveyed are concerned about the lack of a suitable benchmark for performance.[181] Concern about benchmarks has diminished as the use of benchmarks becomes more standardized for ETIs.

ETIs are more difficult to evaluate than traditional investments because there are few established performance benchmarks for these investments. As an example, an equity manager can compare her stock returns to the S & P 500, the Dow Jones Industrial Average, the Wilshire 5000, Russell 2000, and other stock indices. It is more difficult, but not impossible, to develop benchmarks for ETIs.

allocated as follows: 30-55% in buyout funds and corporate finance, 20-35% to venture capital funds, 10-15% to mezzanine funds, 10-20% to distressed funds, and 0-5% in natural resources. *Id.* The Fund "has not ruled out direct investing or private placements" but if it does enter these markets "it will only be with much intervention and monitoring." *Id.*

[180] *Id.*

[181] Jennifer Lea Reed, Renee Deger, *Public Plan Leads Private Equity Frenzy*, VENTURE CAP. J., Jan. 1, 1998.

In its survey of public ETI programs, the Institute for Fiduciary Education compiled a list of benchmarks used by public funds to measure the performance of venture capital funds. Benchmarks used include:

- Total Return of 20%
- S & P 500 Stock Index
- 17% annual rate of return on the corporate portfolio
- 5% over the S & P Stock Index

Some funds however, use a benchmark specific to venture capital such as:

- The rate of return achieved by the fund's external manager for venture capital
- Venture economics vintage year benchmarks
- Venture capital market returns.

One fund simply uses the same benchmark for the asset class as a whole.

A 1995 report issued by the General Accounting Office concluded that ETIs maintained by the seven public funds surveyed [182] earned rates of return similar to the selected benchmarks:[183]

> For example, on the average, expected yields on ETI bond purchases were somewhat higher than those on comparably rated bonds with like maturity and sector characteristics . . . . For the most part, private placements had expected yields somewhat above those similarly rated bonds of like sector and maturity.[184]

[182]Colorado, Massachusetts, Minnesota, New York City, Pennsylvania, Wisconsin, and Wyoming.

[183]GAO, PUBLIC PENSION PLANS – EVALUATION OF ECONOMICALLY TARGETED INVESTMENT PROGRAMS (1995), *reprinted at* <gao at frwebgate.access.gpo.gov).

[184]*Id.*. The GAO report noted, however, that "interim financial yields on venture capital investments were less encouraging. Interim returns on 10 of the 16 funds we examined lagged industry median returns, although the returns of the older funds more closely mirrored those of the overall market." *Id.*

The GAO was "cautiously optimistic"[185] about the "ability of public pension plans to earn reasonable financial returns through their ETI programs."[186] The report compared ETI returns to benchmarks:[187]

Summary of ETI Expected Yields Relative to Benchmarks

ETI program	# of Investments	Benchmark	Average Spread to benchmark (in basis points)
Bonds	3	Similarly rated bonds with like maturity and sector features	93
Fixed rate loans	86	Treasury Securities of a like security	27
Variable rate loans	62	3 mo. T-Bills	355
Private Placements	34	Similarly rated bonds with like maturity and sector features	52
CD Programs: 3 - 6- month	3	3- and 6- mo. secondary market CD rates	1
CD Programs: 3-year	12	3-yr Treasury Securities	N/A
Venture capital	16	Vintage year – analysis by Venture	N/A

Some trustees contend that it is too difficult to quantify the collateral benefits created by ETIs. This argument is best left unaddressed. Properly designed ETIs are not concessionary. In order to be prudent, an ETI must be equal or superior to a traditional investment when the risk-adjusted rates of return are compared. Therefore, from a legal perspective, it is unnecessary, and perhaps undesirable, to quantify collateral benefits.[188]

[185]The GAO noted that the funds surveyed were selected for their past success and, therefore, a conclusion cannot be reached that "all pension plans can easily construct ETI programs that will realize returns similar to those of alternative investments with similar risk characteristics." *Id.*
[186]*Id.*
[187]*Id.*
[188]*But see* WORK GROUP ON PENSION INVESTMENTS, ADVISORY COUNCIL ON PENSION AND WELFARE BENEFIT PLANS, U.S. DEP'T OF LABOR, ECONOMICALLY TARGETED INVESTMENTS: AN ERISA POLICY REVIEW, (Nov. 1992) at 15 (stating that "[a]s long as the combined return from the direct investment return plus the collateral benefit is greater than or equal to the prevailing

IV. Removing Institutional Barriers

Three steps are crucial to the removal of institutional barriers to ETIs. First, trustees and their advisors need to be educated on investment strategies for employee benefit plans. A solid educational program must cover ERISA fundamentals, investment basics, fiduciary duties, and shareholder activism.

Second, trustees must be encouraged to start investing in ETIs though established pooled programs. These programs offer the advantage of being easily evaluated for prudence, easily administered and monitored, and expedient, liquid investments with low transactional costs. This removes all of the institutional barriers: #1 (they are prudent and lawful); #2 (they are not inordinately time-consuming); #3 (transaction costs are low); #4 (it is not difficult to find an investment manager who will implement them); #5 (they are established programs and therefore should be more easily "sellable" to the trustees and consultants; #6 (they are relatively apolitical); and #7 (performance benchmarks are provided).

Third, a national center for ETI investments must be developed, staffed, and funded. Regional centers should develop programs and report to the national center which will maintain a database on ETIs and a network of professionals who are willing to work with trustees on ETIs.

Each of these issues will be examined below.

A. Education of Trustees and Their Advisors

Education and control of fund professionals is of paramount importance:

> Now is the time for workers to stop believing financial professionals who tell them, they face a choice between a job and a pension. Instead, they must identify their own capital resources and demand a voice in how they operate.[189]

rate, the plan participant could be better off.")

[189]SUMMARY OF HEARTLAND INDUSTRIAL LABOR INVESTMENT FORUM, *supra* note 16, at 14.

The George Meany Center/National Labor College, in conjunction with the National Coordinating Committee for Multi-employer Plans and the AFL-CIO's Center for Working Capital has taken the lead in trustee education.

The George Meany Center for Labor Studies offers a four course certificate program in Investment Strategies and Fiduciary Duties of Employee Benefit Plans. Courses include:

Certificate Program in Investment Strategies and Fiduciary Duties of Employee Benefit Plans

Fundamentals of ERISA	differences between defined benefit and defined contribution plans, plan objectives, actuarial factors, hurdle rates, plan time horizon, and laddered investments.
Investment Strategies	asset classes, historical risk/return measures, diversification, modern portfolio theory, asset allocation, capital markets, fee structures, communication with investment professionals, selecting performance benchmarks, monitoring professionals, and developing an investment policy statement.
Fiduciary Duties	the exclusive benefit rule, the prudence rule, diversification, complying with plan documents, avoiding prohibited transactions, conducting a fiduciary audit, and documenting procedural prudence.
Shareholder Activism	identifying shareholder proposals that have an economic impact on plan-held stock, developing proxy voting guidelines, monitoring proxy votes, submitting shareholder proposals, developing proxy voting guidelines, monitoring corporate performance, and coordinating shareholder activism.

Robert Georgine, president of the NCCMP, and co-developer of the program, says that the program is designed to "enhance trustees' skills by giving them the background and knowledge necessary to implement an investment program that is in the overall best long-term interest of the participants and beneficiaries they serve. This program can and will flourish into a high-powered educational resource for the stewards of working capital."[190] Sandra March, a trustee of the New York City Teachers' Retirement System comments:

[190]*Id.* at 7.

Too few funds provide trustees with the education they need to make sure plan assets are managed as well as an owner runs his or her business. Our trustees need to be educated well enough to be able to stand up and pose questions that will knock the socks off any investment manager who is trying to sell a fund some nonsense. The Meany Center program is a step in the right direction.[191]

The Center for Working Capital has started to serve as a liaison between trustees and consultants. The Center has established four advisory panels:

- investment consultants
- asset managers
- legal service providers
- financial advisors[192]

The Advisory Panels will:

- provide resources for trustee support
- create working groups on specific investment issues
- participate in annual meetings
- enhance communications between professionals and funds[193]

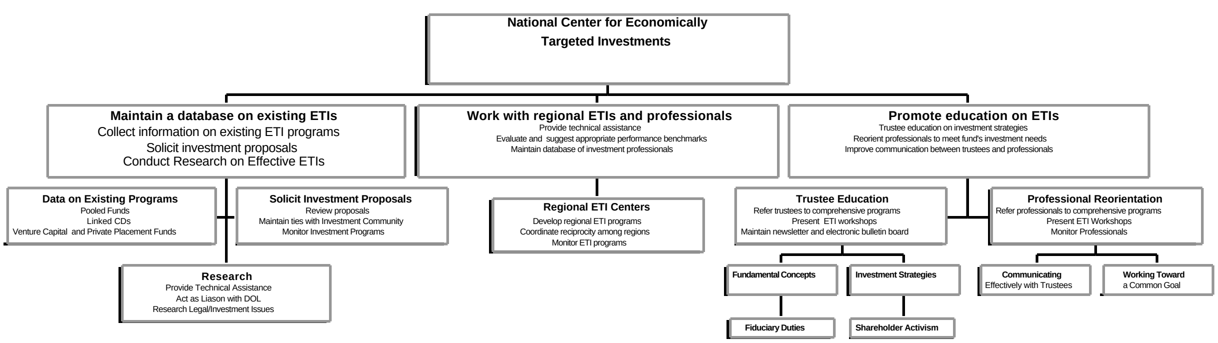
The panels will provide technical assistance on worker-oriented investment approaches. Membership is open to professionals who serve union, Taft-Hartley, and public pension funds who “support the principle that worker savings can and should be invested in ways that promote a sustainable economic future for themselves and their communities.”[194] The panel will “provide a forum for a serious dialogue among [professionals], labor principals, and trustees over the best way of achieving worker investment and economic goals.”[195]

[191]*Id.*
[192]AFL-CIO, Investment Managers Leadership Panel (Aug. 1997) at tab 1.
[193]*Id.*
[194]*Id.*. at tab 2.
[195]*Id.*

The AFL-CIO will establish performance standards for each of these professional groups. For example, investment managers who work with the Center for Working Capital will be expected to:

- promote consistency with workers' long-term economic interests through "high road corporate competitiveness strategies;
- support good corporate governance practices through shareholder advocacy;
- offer investments that create long-term shareholder and economic value by taking a "high road" approach to corporate competitiveness;
- participate in working committees, composed of labor principals and trustees, to develop critiques of current investment trends and support worker oriented initiatives;
- act as an advocate for worker interests in public policy discussions.[196]

A comprehensive educational package should include:



B. Provide Support for Established ETI Pooled Programs

Pension fund trustees who are new to economically targeted investing may wish to start their ETI program by investing in well-established ETI programs like HIT, BIT, MFS, and MEPT. These programs are easy to evaluate, offer solid returns, and are liquid investments.

[196]*Id.* at tab 1 and tab 2.

Trustees may also wish to start linked deposit programs and then work up to venture capital and private placements funds. Examples of each of these types of investments are provided below.[197]

1. Pooled Funds

The AFL-CIO sponsors the Housing Investment Trust (HIT) and the Building Investment Trust (BIT). These programs have invested over $2 billion in real estate projects, funded the construction of more than 33,000 housing units, and created more than 19,000 union construction jobs.[198] According to the AFL-CIO 1993 Convention Report, "[t]he Housing Investment Trust and Building Investment Trust consistently provide secure investments with competitive returns while generating employment, increasing the nation's housing stock and spurring local community development."[199] The Building Investment Trust has earned an annualized return of 7.8% since inception.[200]

The AFL-CIO Housing Investment Trust is a pooled, commingled real estate fund that invests in union-built housing.[201] The Building Investment Trust invests in commercial and industrial ventures.[202] The two funds have combined assets in excess of $2 billion.[203] More than 400 pension funds invest in the Trusts.[204] The Trusts provide resources to build union construction that otherwise would not be built. Steven Coyle, CEO of the Housing Investment Trust "views HIT's rapidly growing $1.4 billion pension fund portfolio as proof that financial and social objectives are not mutually exclusive."[205] Over a five year period, HIT plans to invest in 150 to 200 union projects which are expected to create 30,000-40,000 new housing units and

[197]This section is an updated version of the material in Jayne Elizabeth Zanglein, *High-Performance Investing*, 11 LAB. LAWYER 59, 68 -74, 79 -86 (1995).

[198]Jill Hodges and Neal St. Anthony, *Investing for 2 goals; Pension Funds are Urged to Meet Social Goals While Fulfilling Their Fiduciary Duty*, STAR TRIBUNE, Oct. 29, 1993, col. 6., at 1D; Terry Williams, *1997 A Good Year For Union-Property Advisers*, PENS. & INV., Feb. 9, 1998, at 17.

[199]*Id.* HIT's five-year net annualized rate of return was 11.2% as of December 31, 1993. *Hearing on Pension Investments and Economic Growth, supra* note 36 (testimony of Stephen Coyle, Chief Executive Officer of AFL-CIO Housing Investment Trust).

[200]Helen Kanovsky, General Counsel for AFL-CIO Housing Investment Trust, Address before the Center for Policy Alternatives Conference on Economically Targeted Investments: Creating Community Capital, Mar. 22, 1995.

[201]*Hearing on Pension Investments and Economic Growth*, *supra* note 36 (testimony of Stephen Coyle, Chief Executive Officer of AFL-CIO Housing Investment Trust).

[202]*Id.*

[203]Terry Williams, *1997 A Good Year For Union-Property Advisers*, PENS. & INV., Feb. 9, 1998, at 17.

[204]*Hearing on Pension Investments and Economic Growth*, *supra* note 36 (testimony of Stephen Coyle, Chief Executive Officer of AFL-CIO Housing Investment Trust).

[205]*Gregory Sandler, HIT Puts the Union Label on America's Housing,* MULTIFAMILY EXECUTIVE, May 1997 at 54, 56.

38,000 jobs.[206] Coyle says that he "knows he can't put a roof over every homeless family's collective head, he views his job at HIT as a way to at least put a lot of roofs over a lot of heads."[207] HIT has consistently outperformed benchmarks: 5.6% in 1996, 7.5% over five years and 9.4% over ten years.[208]

The AFL-CIO Investment Trust has teamed up with the Department of Housing and Urban Development and Fannie Mae to form the National Partnership for Community Investment.[209] The Partnership expects to fund construction of up to 12,000 affordable housing units and 1 million square feet of commercial real estate.[210] The Partnership expects to invest $660 million in affordable housing and community development in twenty-seven cities.[211] The Partnership predicts that this construction will create 20,000 new jobs in construction and related industries.[212] HUD Secretary Henry Cisneros stated that the project "brings resources together in a creative way and provides the opportunity for pension funds to invest in people and rebuild communities."[213] The pension funds which invest in the project will invest in a mortgage-backed security, not in the housing itself.[214]

The Multi-Employer Property Trust, a union-oriented real estate fund founded in 1982, now has assets of $1.4 billion.[215] The Trust invests in 100% union built construction.[216] The Fund's 5.6% annualized rate of return over the five year period ending September 30, 1993 made it one of the top performing open-end commingled real estate equity funds.[217] MEPT has created more than 12 million hours of new work for building trades members.[218] The Fund targets its

[206]*Id.*
[207]*Id.* at 55.
[208]*Id.* at 56.
[209]*Job Creation, Affordable Housing Goal of Union Pension Partnership*, 20 Pens. & Ben. Daily (BNA) 1370 (June 28, 1993).
[210]*Id.*
[211]ECONOMIC DEVELOPMENT, *supra* note 2, at 76.
[212]*Id.*
[213]*Job Creation, Affordable Housing Goal of Union Pension Partnership*, 20 Pens. & Ben. Daily (BNA) 1370 (June 28, 1993).
[214]*Id.*
[215]*1997 A Good Year, supra* note 203.
[216]*6 Commit $24 Million to MEPT Fund*, PENS. & INV., Aug. 22, 1994, at 43.
[217]Joel Chernoff and Christine Philip, *Pension Funds Under Pressure: Push for Targeted Investments Increases Under Clinton*, PENS. & INV., Feb. 22, 1993, at 1.
[218]MEPT Fact Sheet (undated).

investments to the geographical area of plan participants.[219] The Fund allows investors to withdraw or make new investments on quarterly valuation dates.[220]

Banks and insurance companies have also sponsored pooled funds that make economically targeted investments. Union Labor Life Insurance Company (ULLICO) started the "J for Jobs" program in 1977.[221] The Fund has assets of $800 million.[222] In 1997, J for Jobs had gross returns of 10.1%, and new loan commitments of $450 million.[223] 6.6 million square feet were under construction, creating 8,700 full-time union construction jobs.[224] Since its inception in 1977, J for Jobs has produced $1.2 billion in construction loans, with a gross annualized return of 9.3%, and created 34.9 million hours of union work.[225] Every one million dollars invested by the J for Jobs program creates 32,000 hours of construction work.[226] J for Jobs provides "mortgage commitments [which are] contingent on all construction work on the project being done by unionized contractors and subcontractors."[227] Robert Georgine, chairman and chief executive officer of ULLICO states "all mortgages are committed at market rates so participating pension funds get a competitive return on their investments."[228] The Fund had a ten year annualized rate of return of 9.75% for the period ending June 30, 1994.[229] In fact, the J for Jobs program was one of the top performers in Pension & Investments' Performance Evaluation Report for the open-end fund universe.[230] This stellar performance caused one reporter to comment: "The perception that loans made by Taft-Hartley pensions to real estate projects built with union labor are more concerned with making work than making money is being eradicated by the steady performance [of these funds]."[231]

219 *Id.*
220 *Id.*
221 *Union Pension Funds Moving to Support Projects that Hire Only Organized Labor*, 18 Pens. Rep. (BNA) 577 (Mar. 25, 1991).
222 Michael Steed, ULLICO, Address before the Center for Policy Alternatives Conference on Economically Targeted Investments: Creating Community Capital, Mar. 22, 1995.
223 1997 ULLICO Annual Report at 15.
224 *Id.*
225 *Id.*
226 *Id.*
227 *Financing For Real Estate Projects*, NAT'L MORTGAGE NEWS, Sept. 19, 1994, at 29.
228 *Id.*
229 *Id.*
230 Terry Williams, *Union Realty Funds Make Successful Showing*, PENS. & INV., August 23, 1993, at 16. The Fund's prior ten-year annualized return of 10% placed the fund as the second top-performer over the ten year period ending March 31, 1993. *Id.*
231 *Id.*

Prudential Realty Group's Union Mortgage Account (UMA) with assets of $235 million is another top performer with an annualized return of 12.5% for the twelve months ending March 31, 1998.[232] UMA "is an open-end commingled account which invests primarily in fixed-rate mortgages and construction loans on properties to be built or substantially renovated by contractors employing one hundred percent union labor."[233] Kevin R. Smith, a UMA portfolio manager states, "The objective of the Account is to provide stable income returns from quality investments which stimulate union construction."[234] Where possible, UMA will invest a participating fund's deposits in the geographic jurisdiction of the participating plan.[235]

Several new funds have emerged recently. The CIGNA America Fund was created in 1994 with a goal of generating a "competitive rate-of-return to a union pension plan while also making loans supporting enterprises with a substantial unionized work force."[236] Since its inception, the fund has invested more than $242 million in enterprises which support organized labor.[237] The Fund "invests only in U.S.-based operations to maintain and create jobs and provide capital to union employees."[238]

Mellon Bank Corporation established a subsidiary, Access Capital Strategies Corporation, in late 1994 to make economically targeted investments for pension fund clients.[239] Last summer, American Capital Strategies unveiled the ACS Community Investment Fund which will "serve as a conduit or investment vehicle to encourage community and economic development."[240] The Fund plans to "purchase securities from [Community Reinvestment Act]

[232] *Prudential Fund Provides Permanent Financing for Office Buildings Near Cleveland*, BUS. WIRE, June 19, 1998.
[233] PRUDENTIAL REAL ESTATE INVESTORS, MORTGAGE INVESTING FOR JOINTLY TRUSTEED PLANS (undated brochure *circa* 1990).
[234] *Id.*
[235] *Id.*
[236] *CIGNA Expects Expanded Union Interest in Retirement Savings*, PR NEWSWIRE, Nov. 30, 1994. Robert L. Whalen, portfolio manager for the CIGNA America Fund states:

> We will continue to pool . . . a mix of privately placed and publicly traded securities. Each loan from the Fund must, in one way or another, support organized labor. Investment quality loans will be made to entities employing union labor, for new project financing employing union labor, and to firms engaged in leasing of union-made products.

CIGNA Fund to Promote Future of Organized Labor Tops $60 Million, PR NEWSWIRE, Sept. 2, 1994.
[237] *CIGNA Expects Expanded Union Interest, supra* note 236.
[238] *Id.*
[239] *Mellon Establishes New Registered Investment Adviser Subsidiary to Make Economically Targeted Investments*, PR NEWSWIRE (Nov. 18, 1994).
[240] Joshua Brockman, *Mutual Fund Scrutinizes Loans Made Under CRA*, AMERICAN BANKER, July 7, 1998.

loans that might include commercial real estate loans, small business association loans, one-to-four-family residential mortgages, multi-family residential loans, and others that qualify."[241]

Massachusetts Financial Services Co. recently established the MFS Union Standard Trust which has two open-end mutual funds designed for investment by union pension funds: the Union Standard Equity Fund and the Union Standard Fixed-Income Fund.[242] The funds will invest in "companies with expanding employment opportunities, increasing the availability of affordable housing, building or improving schools or health-care facilities, or assisting minority or women-owned businesses."[243] The MFS Union Standard Equity Fund has investments of $106 million and an average, annualized rate of return of 23.9 since inception in 1994.[244]

This partial listing of commingled open-end ETI funds shows that ample opportunities exist for pension funds that wish to make targeted investments. The funds are attractive as they are simple, liquid, diversified investments. However, some pension funds would prefer to take a more active role in investments. Linked deposits are a first step toward a more active role.

2. Linked Deposits

Many funds in the construction industry have discovered that they can create union jobs and affordable housing with minimal risk by negotiating targeted certificates of deposit with local banks. In Brooklyn, New York, three employee benefit plans deposited more than $20 million in certificates of deposit at Brooklyn's Crosslands Savings Bank at competitive rates of return in an effort to create low risk affordable housing.[245]

The certificates of deposit financed a project by the Brooklyn Ecumenical Cooperatives, a coalition of thirty-six churches, one synagogue, and two hospitals to construct 114 apartments:

---

[241] *Id.*
[242] *Union-Oriented Funds Designed for Pension Plans*, PLAIN DEALER, May 16, 1994, at 2C.
[243] *Id.* When selecting companies to invest in, the Funds:

> will consider the degree to which a company's work force is unionized, whether the company manufactures products on a union boycott list, whether the company is or has been involved in strikes or lock-outs and whether the company has demonstrated a pattern of non-compliance with applicable labor or health and safety laws.

Id.
[244] Ken Berzof, *Mutual Funds With a Causes: Is Investing Pegged to a Group of Special Interest Wise?*, LOUISVILLE COURIER-JOURNAL, Jan. 25, 1999.
[245] *Union Made, Union Paid*, CITY LIMITS, Oct. 1988, at 10, col. 1.

forty-nine market rate condominiums, thirty-four moderate income condominiums, and thirty-one low-income, limited-equity cooperative apartments ranging between $5,000 and $15,000. The low-income units are subsidized by the State of New York Housing Trust Fund.[246] This investment, which earned competitive rates for certificates of deposit, provided the union pension funds with collateral benefits–jobs for their members and affordable housing.

Public pension funds have used targeted CDs to create small-business loan pools. Colorado has established a program in which "the State's pension puts assets into FDIC-insured certificates of deposit. These resources are then used to provide small businesses with much-needed long-term fixed-rate financing at a reasonable cost."[247]

North Dakota also maintains a linked certificate of deposit program:

> The [small business] loans are made by [the] bank of North Dakota . . ., issuing certificates of deposits to cover the loans. The program is a revolving fund: As the money is paid back, repayments go right back out as loans. Demand has been brisk, with the amount lent out by the bank growing from $200 million in 1993 to more than $800 million today.
>
> . . . Since most of the borrowers are paying interest rates tied to ten-year Treasuries, the ETI returns rise as interest rates go up, just as (presumably) the index fund returns are dropping. Nor does the plan sponsor have to worry about the debt being repaid, because the bank, which is netting a minuscule 25 basis points on the loans, guarantees repayment of the CDs in ten annual installments.[248]

The Pennsylvania Treasury Department also has created a linked deposit program to support economic development.[249] The goal of the program "is to help create and retain jobs by

---

[246] *New York-Based Funds to Finance Rehabilitation*, LAB. & INVESTMENTS (Indus. Union Dep't, AFL-CIO), Dec. 1987 - Jan. 1988, 1, at 2.

[247] *Pension Investments: Public Hearings Before the New York State Pension Investment Task Force* 245 (1989) (testimony of Sally Hernandez-Piniero, then Executive Director, NYC Financial Services Corp.)

[248] Barry Rehfeld, *The New Wave*, INSTIT'L INVESTOR, Dec. 1998, at 39.

[249] This discussion of the Pennsylvania Treasury Department program is adapted from SOLELY IN OUR INTEREST, *supra*, note 168, at 133-134.

placing deposits of Commonwealth funds in banks and savings & loan associations that will, in turn make specific loans to new or expanding small businesses in Pennsylvania."[250] Since its inception, the program has created or saved more than 12,000 jobs in Pennsylvania through investments in excess of $120 million.[251]

The eligibility requirements include the following:

- Loan proceeds must be used for the establishment, expansion, or acquisition of a business located and operating within the Commonwealth of Pennsylvania.
- The business must be organized for profit.
- The company must employ fewer than 150 people at the time of the application.
- An application form documenting the number of jobs to be created or retained must be submitted.[252]

Companies that meet these eligibility requirements must go through a simple application procedure. First, the company applies for a business loan from a bank or savings and loan association. The bank evaluates the loan according to its own lending criteria. If the loan is approved, the bank forwards a linked deposit application to the Pennsylvania Treasury Department. The Treasury Department evaluates applications and allocates funds based on three criteria:

(1) The number of jobs created or saved.

(2) The ratio of jobs created or saved to dollars loaned (at least one full-time job, or its equivalent, should be created or saved for every $15,000 to $25,000 loaned).

(3) The level of economic need in a given region.[253]

---

[250] PENNSYLVANIA TREASURY DEPARTMENT, THE PENNSYLVANIA TREASURY DEPARTMENT'S LINKED DEPOSIT PROGRAM (undated brochure) [hereinafter LINKED DEPOSIT PROGRAM].

[251] Catherine Baker Knoll, State Treasurer, Commonwealth of Massachusetts, *Treasury Bank Programs*, Dec. 1, 1992. *See* also *Treasurer Catherine Baker Knoll Announces the Treasury Department's $100 Million 'Invest in Pennsylvania' Local Bank Program*, PR NEWSWIRE (Jan. 30, 1991) [hereinafter *Local Bank Program*]; *Pension Funds Should Target Investments to Boost State's Economy*, Pens. & Benefits Daily (BNA), Nov. 12, 1991.

[252] LINKED DEPOSIT PROGRAM, *supra* note 250.

[253] *Id.*

The Treasury Department then “purchases a certificate of deposit (CD) in the eligible lending institution at an interest rate of 100 basis points (one percent) below either the bank’s posted one-year CD rate or the average CD rate statewide, whichever is the higher rate.”[254] The deposit is fully insured or collateralized. The loan rate is “determined by the bank based on its usual credit considerations. That rate is then discounted by an amount equal to the reduction applied to the CD rate.”[255] The term of the certificate of deposit cannot exceed seven years, and rates are adjusted annually.[256]

In 1991, Pennsylvania started an “Invest in Pennsylvania” local bank program which is designed to invest state retirement assets in Pennsylvania “Main Streets . . . instead of Wall Street.”[257] The program allows the state pension funds to purchase fully collateralized certificates of deposit from Pennsylvania banks. The “one-year CD purchases will provide funds to depositories to invest in job creation and retention in their communities.”[258] Over $100 million of pension fund assets have been invested in this program.[259]

These types of programs cannot be implemented by private pension plans if they involve a reduced rate of return; however, the procedure utilized in Pennsylvania’s Linked Deposit Program provides useful information on the structure of linked deposit or targeted CD programs. Pension plans may wish to create targeted CD or linked deposit programs that guarantee rates commensurate with the rates offered by comparable certificates of deposit or which offer competitive returns that are subsidized by government agencies or non-profit organizations.

3. Venture Capital

Private pension funds account for about one-third of the capital raised by venture capital funds.[260] In 1994, pension funds invested between $15 billion and $18 billion in venture

[254] Private funds governed by ERISA cannot invest assets at below-market rates. 29 U.S.C. § 1108(b)(1)(1999).
[255] Linked Deposit Program, *supra* note 250.
[256] Missouri has a similar program which is even more concessionary: the interest rate is 2-3% lower than the market rate. *See* Missouri First Linked Deposits, <http://www.e-center.org/missouri2.htm>.
[257] *Local Bank Program, supra* note 251.
[258] *Id.*
[259] Catherine Baker Knoll, Treasurer, Commonwealth of Pennsylvania (Undated, untitled fact sheet, circa 1992).
[260] *Venture Capital in the 80’s: An Institutional Investor’s Perspective*, VENTURE CAP. J., Dec. 1994. In 1984, private pension funds committed over $1 billion in private venture capital funds. *Id.*

capital.[261] A 1993 survey by the Center for Policy Alternatives found that 23% of state-wide retirement systems surveyed invest in venture capital.[262] According to a 1997 report issued by Goldman, Sachs & Co. and Frank Russell Capital, Inc., public pension plans have increased their commitment to alternative investments by 31% from 1995 to 1997.[263] 83% of the funds surveyed reported that returns have met their expectations. Pension funds are attracted to venture capital because it provides "double-barreled benefits":[264] it creates jobs and yields high investment returns.

Venture capital is equity financing usually supplied to small, emerging firms by investors who anticipate a substantial return on their investment when the company matures. Although venture capital is a high-risk investment, historically, small, emerging businesses have produced higher returns than traditional investments.[265] This compensates the investors for the higher risk.

Venture capital requires long-term investment since it usually takes between five and ten years for the investment to mature. Because of the long-term nature of their liabilities, defined benefit plans can commit to long-term investments and, therefore, are particularly well suited to venture capital investments.

Although venture capital funds offer attractive returns, there are some drawbacks. Money is "invested at considerable risk of loss in potentially highly profitable enterprises. . . . Unseasoned, untried and unproven people, products and programs represent a potentially perilous pathway for fiduciaries who operate within a 'prudent expert' environment."[266] Venture capital investment is considered "'probably the highest-risk investing' done by . . . pension funds."[267]

---

[261] *Rep. Jefferson, Panelists Examine Pension Funding for Minority Firms*, Pens. & Benefits Daily (BNA), Sept. 19, 1994. Public pension funds "accounted for 48% of total pension fund investment in venture capital in 1992." Mercedes M. Cardona, *Investors Returning to Venture Capital Market*, PENS. & INV., Nov. 15, 1993, at 10.

[262] CENTER FOR POLICY ALTERNATIVES, ECONOMICALLY TARGETED INVESTING BY STATE-WIDE PUBLIC PENSION FUNDS (1993), at 5.

[263] Jennifer Lea Reed, Renee Deger, *Public Plans Lead Private Equity Frenzy*, VENTURE CAP. J., Jan. 1, 1998.

[264] Maria Shao, *Putting Pensions to Work*, BOSTON GLOBE, Nov. 2, 1994, at 45.

[265] In 1992, venture capital had an average return of 13.9% as compared with 7.7% for common stocks, making it the highest return for any asset category except small-company stocks. Mercedes M. Cardona, *Investors Returning to Venture Capital Market*, PENS. & INV., Nov. 15, 1993, at 10.

[266] EUGENE BURROUGHS, INVESTMENT SUCCESS FOR THE EMPLOYEE BENEFIT PLAN FIDUCIARY 82 (1988).

[267] Gregory Smith, *Sundlun Pushes for Pensions Funds in Venture Capital Plan*, PROVIDENCE JOURNAL-BULLETIN, Aug. 30, 1994, at D-1 (quoting Ivan Vercoutere, of Pacific Corporate Group). Richard Ferlauto, formerly associate director of the Center for Policy Alternative says: "Venture capital . . . can be deadly if not structured correctly." Patricia Limbacher, *Housing a Top Draw for ETIs*, PENS. & INV., Sept. 6, 1993, at 2. The Center recommends that venture capital funds diversify their investments to reduce risk. *Id.*

Pension fund trustees tend to shy away from venture capital and buyouts "because of the technique's historical association with corporate restructurings and job loss."[268] Bill Patterson, of the AFL-CIO Office of Investments agrees: "KKR-type deals have been odious to worker's capital. It is associated with bust-ups."[269] However, the "buyout game of today is different from that of the 1980s. Less debt is used in a buyout, and as a result, fewer jobs are lost."[270] One consultant notes, however, that "the connotation is still there . . . Consultants won't really push private equity to their [Taft-Hartley] client base given the tone of the buyout funds."[271] SEIU leadership has stated: "Historically, Taft-Hatley trustees have been suspicious of private equity accounts because they have been associated with the buyout craze of the 1980s, costing many union members their jobs. That era is over and we now see that private equity products can be job creators and not job destroyers."

Although risky, the Department of Labor has specifically permitted investments in venture capital.[272] ERISA "explicitly allows for untested, unseasoned investments" such as

[268]Terry Williams, *Big Union Funds Still Avoiding Private Equity*, PENS. & INV., May 4, 1998, at 20, 23 (quoting Orim Graves, vice president of Segal Advisors, Inc.).
[269]*Id.*
[270]*Id*. (quoting Orim Graves, vice president, Segal Advisors, Inc.).
[271]*Id.*
[272]The Department of Labor has issued a plan asset rule which defines a venture capital operating company. Definition of "Plan Assets"– Plan Investments, 29 C.F.R. § 2510.3-101 (1994). The entity must invest at least 50 percent of its assets, valued at cost, in venture capital investments or derivative investments and must, in the ordinary course of its business, actually exercise management rights with respect to at least one of the operating companies in which it invests. *Id.* at (d).

The regulations provide an example:

> A plan, P, invests in a limited partnership, V, pursuant to a private offering. There is significant equity participation by the benefit plan investors in V. V acquires equity positions in the companies in which it invests, and, in connection with these investment, V negotiates terms that give it the right to participate in or influence the management of these companies. Some of these investments are in publicly-offered securities acquired in private offerings. During its most recent valuation period, more than 50 percent of V's assets, valued at cost, consisted of investments with respect to which V obtained management rights of the kind described above. V's managers routinely consult informally with, and advise, the management of only one portfolio company with respect to which it has management rights, although it devotes substantial resources to its consultations with that company. With respect to the other portfolio companies, V relies on the managers of other entities to consult with and advise the companies' management. V is a venture capital operating company and therefore P has acquired its limited partnership investment, but has not acquired an interest in any of the underlying assets of V. Thus, none of the managers of V would be fiduciaries with respect to P solely by reason of its investment. In this situation, the mere fact that P does not participate in or influence the management of all of its portfolio companies does not affect its characterization as a venture capital operating company.

Id. at (j)(5).

If the company is not a venture capital operating company, the underlying assets of the company are considered plan assets, and the manager of such company is a fiduciary with respect to the plan. *Id.* at (a)(2). Since ERISA's fiduciary rules apply to all plan assets, this would place an onerous burden on the plan. For example, if the plan wholly owns a business venture, then the operations of the business would be plan assets. The trustees would be required to make venture capital.[273] In the prudence regulation issued by the Department of Labor, the Department observed that the relative risk of a specific investment neither makes it per se prudent nor per se imprudent.[274] In 1989, David Walker, then Assistant Secretary of Labor, stated that "ERISA allows investments in high-risk and/or reduced liquidity vehicles such as venture capital, certain forms of real estate or non-investment grade bonds, as part of an overall investment strategy."[275] However, Walker cautioned that before deciding to make such investment, "the plan fiduciary must determine whether or not its plan is capable of bearing any increased risk or reduced liquidity associated with such investments."[276] In congressional hearings, former Assistant Secretary of Labor Olena Berg reaffirmed the Department's position that venture capital companies can be appropriate pension fund investments.[277]

Venture capital investments are time-consuming, management intensive, and require great skill and expertise.[278] A representative of Pennsylvania Venture Capital, a program implemented by the Pennsylvania Public School Employees' Retirement System, observed that "[t]hese investments require a disproportionate allocation of time to properly monitor and evaluate their performance."[279] Other plan representatives emphasize that venture capital programs must meet strict fiduciary standards.[280]

---

all decisions with respect to the business venture in accordance with ERISA's fiduciary duties.

[273] Interview with Pension Administrator Robert A.G. Monks - Part I, LAB. & INVESTMENTS (Indus. Union Dep't, AFL-CIO), May 1984, at 4. *See also Pension Investments: Public Hearings Before the New York State Pension Investment Task Force* 187 (Mar. 3, 1989) (testimony of David Walker, Assistant Secretary of Labor for Pension and Welfare Benefits, U.S. Dep't of Labor.)

[274] Preamble to Rules and Regulations for Fiduciary Responsibility; Investment of Plan Assets under the "Prudence" Rule, 44 Fed. Reg. 37,221 (June 26, 1979), codified at 29 C.F.R. § 2550.404a-1 (1990).

[275] *Pension Investments: Public Hearings Before the New York State Pension Investment Task Force* 187 (1989) (testimony of David Walker, Assistant Secretary of Labor).

[276] *Id.* at 186.

[277] *Pension Investments and Economic Growth*, *supra* note 36 (testimony of Olena Berg, Assistant Secretary of Labor, U.S. Dep't. of Labor).

[278] *Id.* (testimony Lee Smith, Executive Director, Excelsior Capital).

[279] INST. FOR FIDUCIARY EDUC., *supra* note 46, at 53.

[280] *Id.* As with all pension investments, procedural prudence is important with respect to venture capital investments. One commentator describes the process:

> Investment proposals . . . come to the venture pool through many different networks: associates of firms financed previously, referrals from investment bankers and lawyers familiar with the general partner, and so on. For every thousand proposals received by a venture capital firm, approximately 90 percent are immediately rejected on the basis of their falling outside the group's area of interest or clearly being unviable. The remaining 10 percent receive a first round evaluation, of which ten to fifteen pass muster. A second round evaluation reduces this to three or four. This process may take a few weeks or several months.

LAWRENCE LITVAK, PENSION FUNDS & ECONOMIC RENEWAL 62 (1981).

In 1995, the Union Labor Life Insurance Company (ULLICO) created Private Placement Account P, which identifies small to medium size companies that need capital and employ union employees.[281] For example, Vought Aircraft, which was formed after the bankruptcy of LTV, requested financing from ULLICO.[282] At the time, Vought Aircraft employed 10,000 employees, 5000 of whom were represented by the UAW.[283] ULLICO provided $5 million capital to Vought subject to ratification of the collective bargaining agreement between Vought and the UAW and payment of back benefits.[284] As a result of the financing, 5000 union jobs were saved.[285] The deal was good for ULLICO as well: two years later the company was acquired and ULLICO received a 75% internal rate of return on its investment.[286]

The Fund has completed five transactions and has an internal rate of return in excess of 20%.[287] According to Michael Steed, senior vice president of investment with ULLICO, Private Placement P is "the first and only fund that is created anywhere in the United States with the intent of getting superior returns and maintaining and creating jobs."[288] The fund invests in buyouts, restructurings, private companies and public companies.

Private Placement P "already has invested in shipbuilding, assisted living centers, a construction company and a network communications company for colleges and universities."[289]

Every aspect of the potential investment must be analyzed:

> The venture firm will study the product and attempt to evaluate the feasibility of the manufacturing program, looking at costs, quantities, quality, etc. The market will be surveyed to determine its potential and competitive nature. The ability of the small company to operate effectively will be evaluated. The venture firm will attempt to gain insights into the management and reputation of the company and its products by contacting many informed people -- employees who are no longer with the firm, knowledgeable people in related businesses, suppliers and even competitors (with permission of the small business). Financial analysis will also be applied to the numbers part of the business. Technologies and capacities of the business will be evaluated with varying degrees of thoroughness. Rubel, *Dealing with Venture Capital Firms*, in RUBEL, GUIDE TO VENTURE CAPITAL SOURCES (1977), quoted in LITVAK, *supra*.

[281] Michael Steed, ULLICO, Address before the Center for Policy Alternatives Conference on Economically Targeted Investments: Creating Community Capital, Mar. 22, 1995.
[282] *Id.*
[283] *Id.*
[284] *Id.*
[285] Michael Steed, ULLICO, Address before the Center for Policy Alternatives Conference on Economically Targeted Investments: Creating Community Capital, Mar. 22, 1995.
[286] *Id.*
[287] Terry Williams, *Big Union Funds Still Avoiding Private Equity*, PENS. & INV., May 4, 1998, at 20, 23.
[288] *Id.*
[289] *Money in Motion*, WORKING CAPITAL, Vol. 1, No.1, Fall 1998, at 11.

The program's goals are to "earn a 20 percent internal rate of return, to maintain and create union jobs and generate profits for organized employers."[290]

Assets of KPS Special Situations Fund LP and KPS Supplemental Fund LP total $200 million and the Fund plans to "take controlling interests in under-performing middle-market companies, requiring operational, financial or strategic restructuring, often in cooperation with unions representing the company's employees.[291]

Many public pension funds have started venture capital programs. Massachusetts has aggressively pursued this avenue, "tout[ing] the Bay State as 'The Venture Capital.'"[292] In late 1994, the Massachusetts State Teachers' and Employees' Retirement System (MASTERS) and the Pension Reserves Investment Trust (PRIT) announced plans to establish a $50 million venture capital firm which will invest in small and mid-size Massachusetts companies.[293] Greg White, executive director of the board that administers PRIT says: "We think that directing dollars into Massachusetts will generate jobs. [But] this is not a social program. This is an economically driven program. We want the returns."[294] The fund hopes to earn 15 to 20 percent annually.[295]

PRIT has previous experience with venture capital funds. In 1978, PRIT invested $2 million in the Massachusetts Technology Development Corporation (MTDC), a venture capital firm. MTDC has earned an average annual return of 16%, created about 5,000 jobs, and generated $9.6 million in state tax revenues.[296] Loans are limited to $500,000 and are only made to early-stage companies.[297]

Tennessee boasts about the success of its venture capital program that in ten years created 16,000 new jobs and financed 26 companies with current combined revenues of more than $1 billion.[298] The original $30 million seed money to start the Valley Venture Fund came from a

---

[290] *Id.*
[291] *Id.*
[292] *Putting Pensions to Work, supra* note 264. Massachusetts law requires the state to "invest funds as much as reasonably possible to benefit and expand the economic climate of the Commonwealth, consistent with sound investment policy." *Id.*
[293] *Id.*
[294] *Id.*
[295] *Id.*
[296] THE CENTER FOR POLICY ALTERNATIVES, *supra* note 262, at 25-26.
[297] *Id.*
[298] Pamela E. Foster, *Fund Creates 16,000 New Jobs*, NASHVILLE BUS. J., Aug. 1, 1994, at 1.

settlement received from Gulf Oil Corporation (now Chevron) to compensate ratepayers for overcharges.[299] Pension funds and other investors contributed to the fund which now totals $546 million.[300] Thirty-one percent of the fund is invested in companies at the "conceptualization stage,"[301] 18% is invested in companies which are just starting to do business, and 26% is invested in established companies.[302] The fund will not be able to calculate its total return until it divests all of its investments.[303] Of the portfolio, three investments were "total writeoffs"[304] and the rest appear to be profitable. One investment made a 100% return on its investment.[305]

Oklahoma has developed a novel approach which allows pension funds to invest in low-risk venture capital.[306] The Oklahoma state legislature issued $50 million in state tax credits. The Oklahoma Capital Investment Board (OCIB) uses these tax credits to secure loans made to OCIB by pension funds. OCIB "uses the loan proceeds to invest in venture capital partnerships."[307] OCIB guarantees repayment of the principal and interest on loans made by pension funds. This guarantee is subsidized by a consortium of tax credit purchasers which is required to purchase $3.5 million in tax credits annually, on demand by OCIB.[308] This guarantee arrangement "allows institutional investors to lend funds for OCIB venture investments with very low risk."[309] Essentially, the funds can finance venture capital at a minimal risk because of the tax credit subsidy.

The Boilermakers Union has created a Co-Generation Fund that has financed twenty construction projects to generate one million hours of work for boilermakers and other union members.[310] The Fund has yielded an average annual return of 14% over a five year period.[311]

---

299 *Id.*
300 *Id.* Ironically, Tennessee state law does not permit state pension funds to invest in venture capital, and so the funds invested come from other sources.
301 Less than 2% of all U.S. venture capital is invested in seed companies because of the risk and time commitment involved. Greg Abel, *A Cool $19 Million Bet: Maryland Venture Capital Trust Invests Venture Capital Funds*, BALTIMORE BUS. J., July 29, 1994, at 3.
302 Foster, *supra* note 298.
303 *Id.*
304 *Id.* This is not unusual with respect to venture capital funds. Venture capital is risky; some investments fail. However, the profits from successful investments usually more than offset the writeoffs.
305 *Id.*
306 ISAMU WATSON, RICH FERLAUTO, INVESTMENT INTERMEDIARIES: MODEL STATE PROGRAMS, 12-13 (1995).
307 *Id.*
308 *Id.*
309 *Id.*
310 *Id.*
311 *Id.*

Some venture capital funds have not fared well. Missouri had a bad experience with venture capital. In 1987, the State enacted legislation that required the State Employees Retirement System to invest 3-5% of plan assets in small Missouri businesses.[312] The Retirement System established Missouri Venture Partners, with an ill-suited acronym of MVP, to make small business loans primarily to companies for expansion, but also for start-ups or acquisitions.[313] Investment decisions were made by MVP's general partner without the approval of the Retirement System.[314] Thirty-five million dollars were allocated to the program.[315]

During 1988 and 1989, MVP invested $5.5 million in five companies[316]. Two of the companies filed for bankruptcy in 1989.[317] The Retirement System withdrew from the partnership because it had no investment control.[318] In 1992, the law which required the venture capital investments was repealed.[319]

4. Private Placements

Pension funds also invest in private placements which are risky, high yield investments, often offering as much as 100% returns on investment.[320] Private placements are stock or bond issues sold by a corporation directly to an investor without registration under the Securities Act. They are time-consuming investments.[321] Bill Patterson, director of the AFL-CIO Office of Investments, observes that private equity can "be used as a vehicle for getting capital to

[312]*Id.* at 28. State mandates are unwise. Pension investments must be prudent and a mandate to invest a certain percentage of plan assets in a specified asset category encourages pension funds to invest without adequately assuring the prudence of the investment if prudent investments are unavailable.
[313]*Id.*
[314]*Id.*
[315]CENTER FOR POLICY ALTERNATIVES, *supra* note 262, at 28.
[316]*Id.*
[317]*Id.*
[318]*Id.*
[319]*Id.* A study by the Wharton School shows that public pension funds which are required to make in-state investments achieved returns .8% less than expected. Patricia Limbacher, *In-state Investments Don't Boost Returns; Study Shows Decline of 8 Basis Points*, PENS. & INV., Jan. 24, 1994, at 73. The Department of Labor does not directly govern public funds. Furthermore, the Department has never mandated investments in ETIs. Such a move would be foolish as trustees must have the flexibility to make investments which are best for the fund.
[320]Jennifer Lachanski, *Pension Funds Eye Private Placement Market*, CORP. FIN. WK., Oct. 10, 1994, at 1.
[321]*Hearing on H.R. 2600: Creating a Secondary Market for Business and Economic Development Loans, Before the Subcommittee on Economic Growth and Credit Formation of the Committee on Banking, Finance and Urban Affairs*, 103d Cong., 1st Sess. (1993) (testimony of James W. Brown, Chief of Staff for the Governor, Commonwealth of Pennsylvania), *reprinted in* Federal Document Clearing House Congressional Testimony (Oct. 7, 1993).

companies that are not big enough to access the public market."[322] James W. Brown, Chief of Staff for the Governor of Pennsylvania, testified that:

> [A]t present, there is no easy way for public pension funds to make significant investments in business and commercial loans. Pension funds can buy securities backed by home mortgages or . . . they can buy common stock of large, publicly traded companies. However, their only access to small business loans is through private placements, which are so labor intensive that few are done. The board of a $25 billion fund, which meets every six weeks, has to focus on broad issues such as asset allocation and manager performance. It cannot review and approve more than a few $10 or $15 million business loans as part of a private placement program. Moreover, private placements are illiquid: once bought, they must be held.[323]

Despite these difficulties, some pension funds have invested in private placements. Because private placements are amortized, long-term, fixed interest loans, they can be attractive investments for pension funds:

> Pension funds have long-term liabilities and need to invest in assets that have similar time horizons. Pension funds can make fixed-rate loans because, unlike banks, they aren't subject to fluctuating interest rates on their assets. The interest rates received on private placements are usually higher than those available on similar maturity, publicly-traded corporate bonds. As the funds have grown in size, the drawbacks of private placements--the illiquidity of the investment and the higher risk involved in financing companies of average credit quality–have become more manageable for pension funds.[324]

The Wisconsin Investment Board (WIB) was one of the first retirement funds to implement a private placement program. The program has been in effect for more than twenty

---

[322] Terry Williams, *Big Union Funds Still Avoiding Private Equity*, PENS. & INV., May 4, 1998, at 20, 23.

[323] *Id.* Brown recommends securitization of small business loans: "A liquid fixed income security which happens to channel capital into business development and job creation is a win-win situation for public funds." *Id. See also* JeLea Reed, Renee Deger, *Public Plans Lead Equity Frenzy,* VENTURE CAP. J., Jan. 1, 1998.

[324] N.Y. STATE INDUSTRIAL COOPERATION COUNCIL, COMPETITIVE PLUS--ECONOMICALLY TARGETED INVESTMENTS BY PENSION FUNDS, at 25 (1990).

years.[325] Approximately 16% of the fund's assets are invested in private placement loans.[326] The portfolio has assets of $3.4 billion.[327] More than $300 million has been invested in Wisconsin companies.[328] For example, the fund invested in Harley Davidson and Land's End:

> Harley Davidson's turnaround is a well-known story of how American manufacturers can restore their competitiveness. On the verge of bankruptcy when WIB began working with the company, the revived firm is a dramatic success story and an important source of jobs in Wisconsin. The Chicago-based recreational clothing business, Land's End, located a warehouse in Wisconsin in part because of a WIB loan. Land's End went on to borrow a total of $15 million in order to expand its Wisconsin operations.[329]

The Wisconsin Investment Board had an average coupon for the fixed-rate portion of the private placement portfolio of 10.86% as of June 30, 1992.[330]

Other public pension funds have implemented private placement programs. The Retirement Systems of Alabama have a private placement portfolio that has outperformed its corporate and government securities investments.[331] For example, the fund's $100 million investment in the Alabama Pine Pulp Company will yield 12% per year over twenty-two years.[332] The Pennsylvania Public School Employees' Retirement System (PSERS) has allocated $500 million to private placements.[333] So far, it has participated in six private placements.[334]

Likewise, Colorado has established the ACCESS program which is an economic development program under the auspices of the Colorado Housing and Finance Agency (CHFA), which was designed to provide Colorado small businesses with financing for fixed assets."[335] The program operates under the Small Business Administration's 504 loan program. The SBA,

---

[325] *Id.* at 27.
[326] *See id*. $3.5 billion of the $22 billion fund is invested in private placements.
[327] CENTER FOR POLICY ALTERNATIVES, *supra* note 262, at 43.
[328] N.Y. STATE INDUSTRIAL COOPERATION COUNCIL, *supra* note 324, at 27.
[329] *Id.*
[330] CENTER FOR POLICY ALTERNATIVES, *supra* note 262, at 44.
[331] *Id.* at 13.
[332] *Id.*
[333] *Id.* at 36.
[334] *Id.*
[335] *Id.*

through certified development companies (CDCs), loans the company as much as 40 percent of the cost of the project.[336] The company must contribute 10% of the costs and the remaining 50% is secured by private lenders. Once the transaction is in place, "CHFA can purchase a participation of up to ninety percent of each private lender loan. The portion of the loan acquired by CHFA must bear a fixed interest rate, [usually 9.5-9.7%] over a term of ten or twenty years."[337] The remainder of the private loan may have a fixed or variable interest rate. This program "allows CHFA to invest in small businesses with minimal risk" because the loans are secured by a first lien on the borrower's property. The program is financed through the issuance of bonds.

New York created Excelsior Capital Corporation (ECC) to promote investments in ETIs.[338] ECC created the Excelsior Fund program "to promote institutional investment in primarily subordinated debt issued in private placements by New York middle market companies."[339] ECC is an intermediary which

- markets the Fund to potential investors;
- screens potential investments of the Fund;
- provides technical assistance to borrowers; and
- refers qualified investment opportunities to the Fund.[340]

The Excelsior Fund is a limited partnership. The general partner is Alliance Capital Corporation and the pension funds and other institutional investors are limited partners.[341] All investment decisions are made by Alliance. The established programs described above provide a variety of opportunities for pension funds to invest in existing programs.

[336] *Id.*
[337] *Id.*
[338] *Id.*
[339] *Id.*
[340] *Id.*
[341] *Id.*

5. Responsible Contractor Policies

Another form of ETI is the Responsible Contractor Policy. The SEIU, CalPERS, and New York have adopted Responsible Contractor Policies which require all fund real estate holdings, loans, or in the case of the SEIU, which represents custodians, all maintenance contracts, to contain an agreement that all work performed on the Fund property will be done in accordance with all applicable labor laws. For example, the SEIU policy states that:

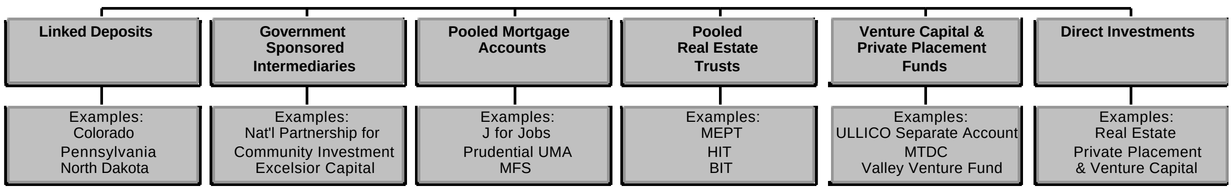
> [i]n order to ensure a competitive return on its real estate investments, the Fund seeks to invest in properties that are well-run and maintained where tenants receive high quality services . . . Assuring the availability of a qualified staff and avoiding labor disruption and costly employee turnover requires employers to pay fair and reasonable compensation, to treat workers fairly and abide by applicable labor laws."[342]

Similarly, the New York Common Retirement Fund has a Contractor Selection Program that emphasizes the Fund's "deep interest in the condition of workers employed by the Fund and its advisors."[343] The policy requires investment managers to hire program contractors who pay "workers a fair wage and a fair benefit as evidenced by payroll and employee records, and who compl[y] with the Fund's minority and women business policy."[344] Such policies can form an important part of an ETI program and allow the fund to leverage its monetary influence to create additional jobs for their members.

6. The Spectrum of ETI Investments

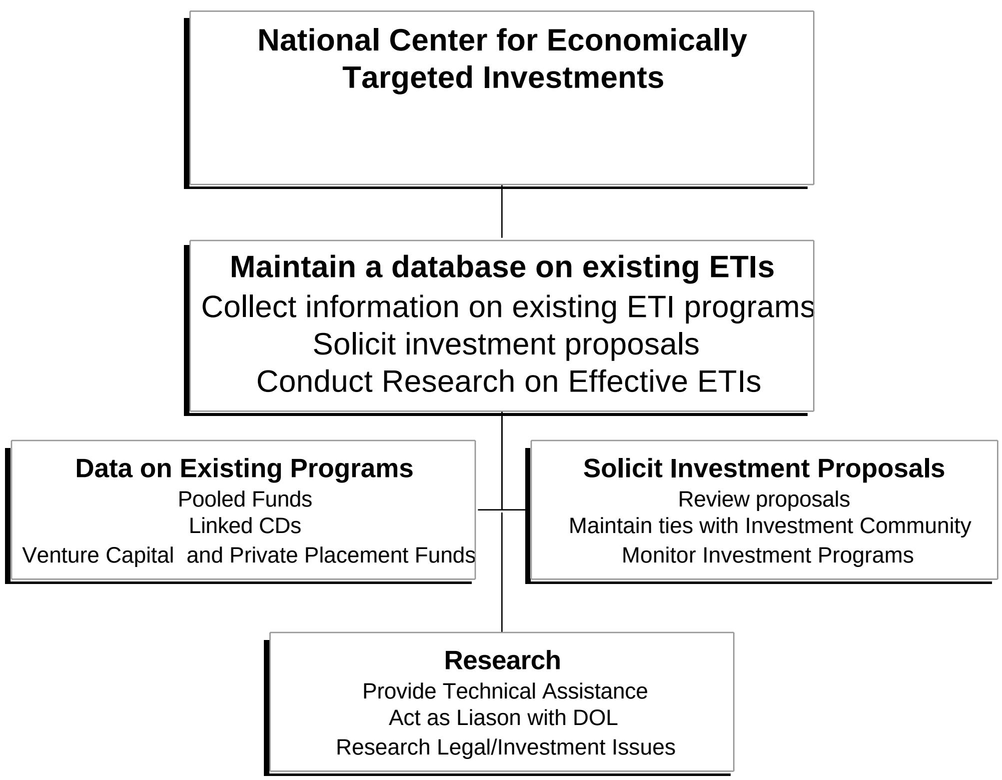
ETIs offer a spectrum of investments from easy-to-implement pooled funds to time-intensive direct investments. The ETI spectrum is represented in the following chart:

[342] SEIU, Responsible Contractor Policy (1998).
[343] New York Common Retirement Fund, Contractor Selection Program (1996).
[344] *Id.*



C. Create a National Center For Economically Targeted Investments

The key to establishing and maintaining a comprehensive national ETI program is the creation of a National Center for Economically Targeted Investments. The Center would provide trustees with a central place to contact to find out about existing programs for guidance on how to develop similar programs in their region. The Center would maintain a database on existing ETIs, solicit investment proposals for national pooled funds, and conduct research on effective ETI programs. A proposed structure is reproduced below:



The Center must be a place where trustees can call to obtain information on established and new pooled investment programs, examples of prototype plans, and a list of upcoming educational programs on ETIs. On request, the Center should act as a liaison between the Department of

Labor and funds which plan to establish an ETI program. This will alleviate concerns about the legality and prudence of ETI investments and potential prohibited transactions (Misconception #1). The Center should be able to put trustees in contact with other trustees who have developed similar programs. The Center should also maintain a panel of investment managers, financial managers, attorneys and consultants who are willing to work with funds to develop ETI programs. (This will address Misconception #4).

The Center can also play a crucial role in developing new pooled programs. This will allow trustees to diversify their investments in a variety of ETIs. It would be useful for the Center to coordinate investments made by regional ETI centers. The national center should negotiate reciprocity agreements between regional centers so that funds can invest in their general geographical region without investing too high a percentage of plan assets in one state or geographic area. (Misconception #6)

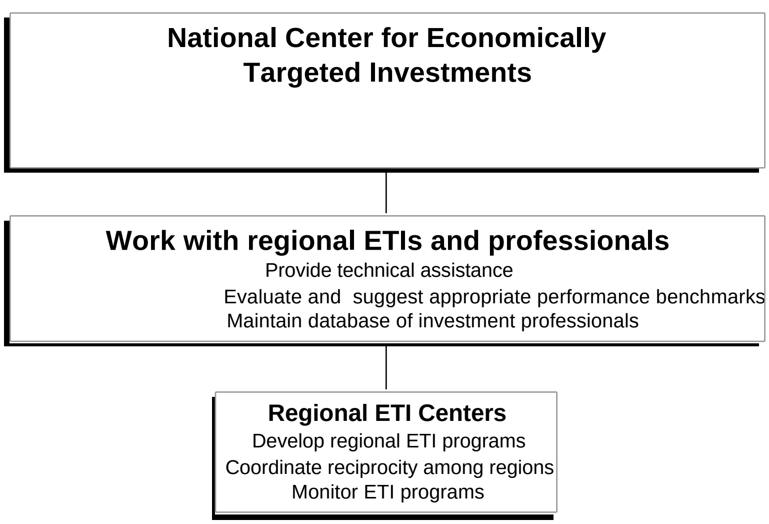
By coordinating efforts among consultants and funds, the Center can alleviate the time constraints involved in many ETIs (Misconception #2) and reduce information costs (Misconception #3).

Finally, the Center can coordinate educational efforts to educate trustees and their advisors that economically targeted investments can be prudent investments under ERISA. (Misconception #5). Educational programs should include the Investment Strategies Program offered through the George Meany Center, introductory and intermediate capital strategies workshops similar to those currently offered through the Center for Working Capital, and advanced intensive programs that will allow trustees to meet and work with investment professionals to design new ETI programs, and to reorient fund professionals to the needs of fund trustees.

The Center for Working Capital (CWC) appears to be willing to fill a role of this sort. However, the CWC is still in its formative stage and it remains to be seen whether it will become a national clearinghouse for ETI investments.

The CWC' s mission is to "foster capital stewardship policies and practices that increase working families' retirement security."[345] The CWC's philosophy is that "the best long-term investment strategies depend on partnerships among shareholders, employees, and communities."[346] The CWC is dedicated to defending the integrity of workers' retirement assets, ensuring that plans are managed in the best interests of beneficiaries and supporting a long-term view of value and the importance of broad-based economic prosperity for the health of benefit funds."[347] The CWC's current focus is on shareholder activism; however, the Center also plans to emphasize ETIs.

The CWC will serve as a meeting place for trustees. The CWC's quarterly newsletter showcases successful ETI programs developed by public and private pension funds. The newsletter also highlights new investment programs and provides information about upcoming educational programs. While the CWC is a good start on the creation of a national center for economically targeted investments, at present it is in its formative stage and it is unclear whether the CWC will have the resources and expertise to be a national leader on ETIs. A national center must be able to work with regional ETIs and professionals, provide technical assistance, evaluate and suggest benchmarks, and maintain a national database of ETI and investment professionals:



[345]John J. Sweeney, *A Letter From the President of the AFL-CIO, WORKING CAPITAL*, Vol. 1, No. 1, at 1 (Fall 1998).
[346]*Id.*

The National Center for Economically Targeted Investments will also coordinate programs established by regional centers. Many regional centers have already been created. For example, the Heartland Labor Capital Project which was created by the Steel Valley Authority and the USWA also "is exploring the creation of a national fund of funds that would link to regionally-based funds."[348] The Steel Valley Authority has suggested the creation of regional investment funds modeled after the Quebec Solidarity Fund, a $1.5 billion (Canadian) fund which invests in venture capital for small to mid-size Quebec firms.[349] The AFL-CIO has implied that this might be a task for the Center for Working Capital.[350]

The Steel Valley Authority (SVA) also is in the process of developing a regional capital pool for investments. The SVA plans to establish a fund which will make "labor friendly investments," i.e. "investments that provide returns on a risk adjusted basis that are equal or superior to alternative available investments, and advance goals supported by organized labor."[351] The Fund plans to solicit investments primarily from Taft-Hartley Pension Funds, as well as union benefit plans, and public plans.[352] Although the Fund is still in its formative stages, it is considering operating as a limited liability corporation[353] and a venture capital operating company.[354] The Fund plans to retain and monitor investment advisors who are responsible for making investment decisions, and administer the Fund.[355]

The Fund anticipates that it will use regional project developers who "would serve as regional advisors who would review the regional market for qualified investment opportunities and evaluate such opportunities."[356] The regional project developers "would then propose appropriate projects to the investment advisor and monitor Fund investments, and possibly

[347]*Id.* at 2.
[348]ECONOMIC DEVELOPMENT, *supra* note 2 at 83.
[349]*Id.* at 81, 83.
[350]*Id.* at 83.
[351]Draft Proposal at 1 (May 2, 1996).
[352]*Id.* at 4.
[353]*Id.* at 7.
[354]*Id.* at 8.
[355]*Id.* at 13.
[356]*Id.* at 15.

participate in the management of operating companies within their region to maximize the Fund's potential return."[357]

A similar project is underway in Wisconsin as the result of a report on the feasibility of economically targeted investments in Wisconsin. The report recommends the establishment of a private intermediary, the Wisconsin Investment Forum, which would allow pension funds to work together to:

- identify promising ETI opportunities;
- solicit proposals from outside managers for products to carry out ETI program objectives;
- co-invest in new programs; and
- monitor the investments.[358]

These and other regional center would play an important role in the creation of a national network of ETIs.

V. Conclusion

Obstacles to ETI investments can be overcome by (1) committing resources to trustee/professional education; (2) encouraging trustees to support established ETI programs; and (3) creating a national center for economically targeted investments which will work with regional centers as well as investment professionals to develop and promote new ETI programs and maintain a database on ETI investments. A proposed structure is reproduced below (figure on next page).

[357] *Id.*

[358] MARC V. LEVINE, THE FEASIBILITY OF ECONOMICALLY TARGETED INVESTING: A WISCONSIN CASE STUDY at 28 (1997); *see also* Phil Levine, *Where There's a Will, There's ETI*, PENS. & INV., Nov. 10, 1997, at 52.