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On October 22 the US Department of Labor ("DOL") issued **Interpretive Bulletin 2015-01** (published in the Federal Register on October 26 and effective on that date) setting forth its supplemental views concerning the legal standard imposed by Sections 403 and 404 of Title I of Part 4 of the Employee Retirement Income Security Act of 1974 ("ERISA") relating to economically targeted investments. In doing so, the DOL took a major step in defining the obligations of managers of trillions of dollars of pension fund assets when addressing the investment risks and opportunities resulting from climate change. In replacing guidance previously issued in 2008 in the form of Interpretive Bulletin 2008-01, the DOL recognized explicitly that environmental, social, and governance issues (so-called ESG factors) may have a direct relationship to the economic value of a pension plan's investment. The prior guidance had led to the perception among some fiduciaries managing pension funds that ESG factors should only be taken into account as "tie-breakers" that could be considered only when investments are otherwise equal in terms of their risk-adjusted return. The DOL's new guidance seeks to correct that misperception. As the DOL states in the preamble to the new guidance, "Environmental, social and governance issues may have a direct relationship to the economic value of the plan's investment. In these instances, such issues are not merely collateral considerations or tie-breakers, but rather are proper components of the fiduciary's primary analysis of the economic merits of competing investment choices."

A number of professional investment managers and consultants have recognized that a consideration of climate change in the context of selecting and monitoring the investments of a pension fund is central to the assessment of each investment's potential risk-adjusted return. As the investment consulting firm, Mercer LLC, stated in its 2015 study, "Investing in a Time of Climate Change," investors need to view climate change as "a new return variable."

Perhaps the most succinct statement of how climate change should be viewed in the process of investing for the long term is found in a 2014 memorandum from David Swensen, CIO of the Yale Investments Office, to the various managers of the Yale University endowment: "A full accounting of the internal and external costs of greenhouse gas emissions will call into question the business models of some investments, which will require especially careful attention….Conversely, fully pricing the externalities created by greenhouse gas emissions will create opportunities for profit."

The challenge for pension fund fiduciaries will be to find ways to measure and monitor the carbon footprints of existing and possible new investments and to assess the ways in which those footprints will affect long-term returns. As noted in the Swensen memorandum, some business models that are called into question if greenhouse gas externalities are fully accounted for include, for example, thermal coal production, tar sands operations, companies that rely on cheap power from coal, and low lying coastal real estate. At the same time, producers of renewable energy and products that facilitate demand shifting or otherwise promote the efficient use of energy may experience favorable long-term risk-adjusted returns, as compared with the questionable business models just noted.

The Sustainability Accounting Standards Board is in the process of developing ways of measuring the magnitude and probability of different types of economic and financial impacts of climate change. As those tools are refined and become applicable to all of the industries in which pension funds might invest, fiduciaries of those funds will be better able to deploy their funds' capital in ways that will ensure their ability to provide future retirement income by more clearly understanding the long-term risks and rewards presented by climate change.

With the DOL's clarified guidance, we expect that large corporate pension funds that have not already begun to include climate change considerations in the investment process will now begin to do so. For state and local government pension funds that fall outside of the DOL's jurisdiction because they are not subject to the ERISA, the new guidance, nonetheless, will be of consequence. The state law requirements that apply to the management of state and local government pension funds generally track very closely the requirements of ERISA, and the DOL's interpretations of ERISA typically are seen as setting standards that fiduciaries of government pension funds should follow as a matter of good practice.

The new guidance also applies to the selection of investment alternatives for 401(k) plans and other defined contribution plans. Thus, a plan fiduciary's decision to offer so-called "socially-responsible" funds among the investment alternatives of a defined contribution plan should be based on the same investment analysis that a fiduciary of a pension fund would use in considering ESG factors when directing fund investments. For example, if the ESG factors taken into account by a mutual fund offered in a 401(k) plan (for example, the carbon footprints of the underlying investments of the mutual fund) are considered to have a direct relationship to the risk-adjusted returns of the mutual fund's investments, then a plan fiduciary's decision to offer such a mutual fund for selection by plan participants would be in compliance with the fiduciary's obligations under ERISA.

We find the prospect of pension fund investors fully embracing the risks and rewards presented by climate change encouraging. Allocating such a significant segment of investment capital in a way that is prudent both for retired employees and for the environment could be the fortunate result of the DOL's recent guidance.

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