Beyond Economically Targeted Investments: Redefining the Legal Framework of Pension Fund Investments in Low-to-Moderate Income Residential Real Estate

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Abstract

This Note first presents the socioeconomic theory underlying the concept of ETIs and outlines the scope of trustees’ fiduciary obligations to plan participants when making investments in residential real estate. It also analyzes relevant case law pertaining to fiduciary duties of pension fund trustees. Next, it compares two conflicting views on the legality of economically targeted investments. Finally, it argues that although the legal framework applicable to the fiduciary obligations of pension fund trustees is inadequate to fully address all challenges to the legality of ETIs, pension fund investments in low-to-moderate income residential real estate can be reconciled with the duties of plan fiduciaries to plan participants and their beneficiaries. It examines several potential strategies aimed at popularizing targeted pension investments in low and moderate income residential real estate. This Note concludes that targeted investments in low and moderate income residential real estate are a valid social objective that pension funds can and should cautiously pursue.

KEYWORDS: ETIs, economically targeted investments, pension funds, exclusive benefit rule
BEYOND ECONOMICALLY TARGETED INVESTMENTS: REDEFINING THE LEGAL FRAMEWORK OF PENSION FUND INVESTMENTS IN LOW-TO-MODERATE INCOME RESIDENTIAL REAL ESTATE

Alec Sauchik*

The test of a first-rate intelligence is the ability to hold two opposed ideas in the mind at the same time, and still retain the ability to function.1

INTRODUCTION

The greatest reservoir of our nation's wealth, pension funds, have long been recognized as a potential source of funds for economic development. It proved extremely difficult, however, to devise a strategy that while providing the influx of capital to various social programs would also guarantee the safety of retirees' assets. Economically targeted investing, an innovative approach based on a concept that, at the time of its development, contradicted mainstream investment ideology, in theory has overcome this potentially insurmountable obstacle. From the beginning, though, this promising yet controversial strategy has met with criticism, which, perhaps more than any other factor, accounted for the fact that economically targeted investments ("ETIs") have never gained wide acceptance among pension fund trustees.

Economically targeted investments are most commonly defined as investments designed to produce a competitive rate of return commensurate with the risk, as well as to create collateral economic benefits for a targeted geographic area, group of people, or sector of the economy.2 Mindful of the significant economic im-

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pact that pension fund investments can have on local development, pension fund trustees find the general concept of investing in their respective states and municipalities attractive.\(^3\) Thus, although the goal of economic development is indeed wisely believed to be a laudable one, the means of achieving it through economically targeted investments by pension funds has always been the subject of heated debate because of concerns that such investments would constitute a wasting of pension assets and hence a violation of trustees' fiduciary duties.\(^4\)

As is often the case with issues related to pensions and retirement benefits, the debate over the legality of economically targeted investments has become extensively politicized. At stake are the gigantic assets of the pension funds in the United States, which in the year 2000 amounted to more than $8 trillion.\(^5\) According to Rich Ferlauto, Associate Director of Constituent Development for the Center for Policy Alternatives, "The largest pool of investment capital available for any type of economic development stimulus now rests in the hands of pension funds . . . ."\(^6\) Taking into account the sensitive nature of the topic, the propriety of investing pension money in infrastructure, affordable housing, and inner-city neighborhoods is understandably a controversial issue.\(^7\)

The concept of ETIs has venerable roots;\(^8\) however, it was not until the Clinton Administration (the "Administration") put it high on its domestic policy agenda that ETIs attracted substantial atten-

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5. See Board of Governors of the Federal Reserve Sys., *Flow of Funds Accounts of the United States* 76 tbl. L.119 (2000) [hereinafter Flow of Funds]. This figure includes total assets of private defined benefit plans and defined contribution plans (including 401(k) type plans, the Federal Employees Retirement System Thrift Savings Plan, and state and local government employee retirement funds). Id.
7. E.g., Rob Norton, *Clinton's Dumbest Ideas; Some Bad Economic Ideas Were Ventilated in the Republican Primaries, But Some of the Very Worst Belong to the Incumbent*, FORTUNE, May 13, 1996, at 45 ("The next-dumbest idea of the Clinton Administration may eventually turn out to be the 'economically targeted investment'").
tion. Former Secretary of Labor Robert Reich, and Assistant Secretary of Labor, Pension and Welfare Benefits Administration Olena Berg, actively promoted economically targeted investments, taking their case to Congress on several occasions and establishing, under the auspices of the Department of Labor, the Clearinghouse of Economically Targeted Investment Opportunities. This activity resonated with liberal voters across the country who intensified pressure on pension funds to assume a more proactive role in developing affordable housing, funding real estate mortgages, and providing venture capital for local businesses. In turn, these attempts to exert pressure on pension fund trustees met with sharp criticism from conservative legislators led by Representative Jim Saxton (R-N.J.), who criticized the Administration for jeopardizing the safety of private and public pension systems.

It was in this context that the trustees of many pension funds in the United States sighed with relief when in the summer of 1994 the Department of Labor released Interpretive Bulletin 94-1 ("the Bulletin" or "I.B. 94-1"), specifically addressing the issue of ETIs. The Bulletin, which was intended to clarify the Department’s position on the legality of ETIs, in effect placed the Administration’s imprimatur on economically targeted investments. In the fall of 1995, however, the House of Representatives passed the Pension Protection Act of 1995 ("H.R. 1594"), prohibiting the Administration from promoting economically targeted investments and voiding I.B. 94-1. Although the companion resolution died in the
Senate,17 H.R. 1594 succeeded in effectively nullifying whatever succeeds the Administration had achieved in popularizing ETIs.

Conservative organizations and the media immediately responded to Congress' shift in attitude toward ETIs. The Institute for Policy Innovation and the Lexington Institute, for example, named Interpretive Bulletin 94-1 one of the ten worst regulations requiring immediate repeal or correction by the 107th Congress.18 As often occurs in the realm of public policy, what many once considered an ingenious solution to a number of social challenges ranging from homelessness to unemployment has become synonymous with the worst-case abuse by Washington's "regulatory monster." Once the subject of national attention,19 the topic of economically targeted investment programs has since acquired a negative connotation.20

Setting politics aside, two basic issues are at the heart of the debate over economically targeted investments: first, whether such investments represent sensible economic and social policy; second, whether ETIs are consistent with the fiduciary obligations of pension fund trustees.21 Supporters of ETIs advocate using pension money as a source of funds for affordable housing, venture capital, encourage economically targeted investments . . . . Interpretive Bulletin 94-1 . . . is null and void and shall have no force or effect.


18. Merrick Carey, America's Worst Regulations, J. OF Com., Mar. 11, 1999, at 5A (maintaining that the Department of Labor regulation in effect permits pension funds to engage in social investing, which results in returns on average two percent lower than prevailing rates).

19. See Charles Ruffel, Faster Growth Ahead, PLAN SPONSOR, May 1996 (analyzing a trend toward increase in the number of alternative investments by pension funds, including economically targeted investments), http://www.assetpub.com/archive/ps/96-05psmay/may96PS48.html.

20. D. Jeanne Patterson, Disappearing ETIs, or Just a New Definition? PENSION & INVESTMENTS, June 10, 1996, at 18.

infrastructure, and job creation by putting money in geographical areas and sectors of the economy overlooked by other investors.\textsuperscript{22} Opponents of economically targeted investments typically point to the lack of empirical data supporting the economic theories underlying the concept of ETIs,\textsuperscript{23} potential political pressures on pension fund sponsors to engage in this type of investments,\textsuperscript{24} and the perceived lack of accountability of trustees engaging in the abuse-prone activity of using pensions for public purposes.\textsuperscript{25} Critics also argue that targeted investments often produce lower returns compared to non-targeted investments.\textsuperscript{26} Invariably, however, critics tie these arguments to the larger question of the consistency of ETIs with fiduciary obligations of pension fund trustees.\textsuperscript{27}

This Note contrasts two conflicting views on the legality of economically targeted investments. Examining the concept of ETI from the perspective of targeted investments in low-to-moderate income residential real estate, the Note identifies various shortcomings of the traditional ETI model. The Note demonstrates how recent developments in pension fund fiduciary laws can revive the interest of pension fund trustees in targeted investments in low-to-moderate income residential real estate, and proposes several policy approaches aimed at increasing pension fund investments in this sector.

\textsuperscript{22} Testimony of Olena Berg, supra note 2.
\textsuperscript{24} Roberta Romano, \textit{Public Pension Fund Activism in Corporate Governance Reconsidered}, 93 \textit{COLUM. L. REV.} 795, 801-04 (1993).
\textsuperscript{25} \textit{See Phone the Department of Labor, supra note 21}, at 351 (suggesting that fund trustees will declare proposed ETIs economically competitive when there is no functioning market to test that declaration: "Historical experience with ETIs further counsels that, once the door is opened to consideration of collateral benefits, such concerns crowd out basic financial criteria.").
\textsuperscript{26} \textit{See John R. Nofsinger, Why Targeted Investing Does Not Make Sense!, FIN. MGMT.}, Sept. 22, 1998 (analyzing the returns of pension plans with and without ETIs and concluding that ETIs earn lower returns after adjusting for risk). \textit{But see Jun Han, Targeting Markets is Popular: A Survey of Pension Real Estate Investment Advisors, REAL EST. FIN.}, Spring 1996, at 66-67 ("There are some obvious benefits associated with targeting geographic markets . . . . It may enhance performance.").
\textsuperscript{27} \textit{See Phone the Department of Labor, supra note 21}, at 342; \textit{see generally Alvin D. Lurie, ETIs: A Scheme for the Rescue of the City and Country with Pension Funds, 5 CORNELL J.L. \\& PUB. POL'Y} 315, 333-37 (1996) (arguing for the creation of a new legal paradigm for governing pension funds which would avoid the perceived conflict with the fiduciary duties); Thomas M. Griffin, Note, \textit{Investing Labor Union Pension Funds in Workers: How ERISA and the Common Law Trust May Benefit Labor by Economically Targeting Investment}, 32 \textit{SUFFOLK U. L. REV.} 11 (1998).
Part I presents the socioeconomic theory underlying the concept of ETIs and outlines the scope of trustees’ fiduciary obligations to plan participants when making investments in residential real estate. This Part also analyzes relevant case law pertaining to fiduciary duties of pension fund trustees. Part II compares two conflicting views on the legality of economically targeted investments. Part III argues that although the legal framework applicable to the fiduciary obligations of pension fund trustees is inadequate to fully address all challenges to the legality of ETIs, pension fund investments in low-to-moderate income residential real estate can be reconciled with the duties of plan fiduciaries to plan participants and their beneficiaries. It examines several potential strategies aimed at popularizing targeted pension investments in low and moderate income residential real estate. This Note concludes that targeted investments in low and moderate income residential real estate are a valid social objective that pension funds can and should cautiously pursue.

I. ECONOMICALLY TARGETED INVESTMENTS IN LOW-TO-MODERATE INCOME RESIDENTIAL REAL ESTATE

Although the subject of economically targeted investments has been publicized widely, this subject still creates significant confusion for pension fund trustees.28 This Part discusses socioeconomic and legal issues relevant to economically targeted investments in low-to-moderate income residential real estate. First, it demonstrates the critical need for non-traditional sources of affordable housing financing. Second, it analyzes pension fund investments in various real estate vehicles, and examines pension funds as the source for financing low-to-moderate income residential real estate. Third, it summarizes the fiduciary obligations of pension fund trustees when making real estate investments.

A. Affordable Housing

The need for affordable housing in the United States is at a record high. According to the latest report from the Department of Housing and Urban Development, 5.3 million low-income Ameri-

cans now suffer “worst case housing needs,” paying more than fifty percent of their gross income for rent or living in severely substandard housing.\textsuperscript{29} The dramatic increase in rent prices in the 1990s, particularly in large cities,\textsuperscript{30} led to a housing shortage of unprecedented proportions, with the fastest growth in worst-case households among working families, which increased twenty-four percent between 1991 and 1995.\textsuperscript{31} Although home ownership rates are at an all-time high,\textsuperscript{32} affordable housing is scarcer than ever, with five million families paying half their income in rent.\textsuperscript{33}

According to the report, the crisis is attributable in part to the continuing decline in the affordable housing stock over the past twenty years.\textsuperscript{34} Between 1993 and 1995 alone, approximately 900,000 units affordable to low-income families were lost.\textsuperscript{35} The report also indicates that while the demand for affordable housing is at a record high, federal support for new housing is decreasing.\textsuperscript{36} Substantial cuts to federal housing programs resulted in the backlog in forty cities of approximately one million families on waiting lists for public housing or rent subsidies.\textsuperscript{37} State and local affordable housing programs also suffer from a severe and persistent shortage of funds, and cannot effectively meet affordable housing needs at the local level.\textsuperscript{38} The policy of privatizing the delivery of affordable housing has yet to produce the desired effect.\textsuperscript{39} As the federal and state governments cannot effectively address the problem of affordable housing, the need for alternative sources of affordable housing financing is all too obvious.

\textsuperscript{29} DEP’T OF HOUS. AND URBAN DEV., WAITING IN VAIN: AN UPDATE ON AMERICA’S RENTAL HOUSING CRISIS 1 (1999) [hereinafter WAITING IN VAIN].

\textsuperscript{30} See, e.g., Bruce Lambert, Housing Crisis Confounds a Prosperous City; In New York, Scarcity and High Costs Spur Competing Ideas for a Solution, N.Y. TIMES, July 9, 2000, at 23.

\textsuperscript{31} WAITING IN VAIN, supra note 29, at 2.

\textsuperscript{32} Thomas G. Scott, Home Ownership Rate Reaches Record High, BUS. J., Sept. 1, 2000, at 58.

\textsuperscript{33} See WAITING IN VAIN, supra note 29.

\textsuperscript{34} Id. at 15-16.

\textsuperscript{35} Id. at 15.

\textsuperscript{36} Id. at 16.

\textsuperscript{37} Id.; see also Randy Shaw, There’s No Place Like Home; Yet Washington Ignores the National Housing Crisis, IN THESE TIMES, Nov. 13, 2000, at 24; Marjory Valburn, Housing is Missing in U.S. Campaign, ASIAN WALL ST. J., Sept. 29, 2000, at 8.

\textsuperscript{38} See generally Harold A. McDougall, Affordable Housing for the 1990’s, 20 U. MICH. J.L. REFORM 727 (1987); see also Michael H. Schill, Privatizing Federal Low Income Housing Assistance: The Case of Public Housing, 75 CORNELL L. REV. 878 (1990) (discussing various issues related to privatization of affordable housing).

\textsuperscript{39} See generally Schill, supra note 38.
B. Pension Funds as the Source of Funds for Affordable Housing Investments

In 2000, pension funds in the United States collectively held approximately $8 trillion.\footnote{FLOW OF FUNDS, supra note 5.} Approximately $5 trillion was attributable to private pension funds.\footnote{Id. tbl. L.119.} The assets of defined contribution plans,\footnote{A defined contribution plan is a plan that provides for an individual account for each participant and for benefits based solely on the amount contributed to the participant’s account, and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to such participant’s account. \textit{I.R.C. § 414(i) (2001)}.} which are the fastest growing category of pension funds, reached $2.1 trillion in 1999, up 26.7% from a year ago.\footnote{Christine Williamson, \textit{Slight Bump: Managers’ Assets Barely Rise in 1999; Still, Tax-Exempt Funds Top $7 Trillion}, \textit{PENSIONS AND INVESTMENTS}, May 1, 2000, at 1.} Each year, pension plans allocate on average more than $100 billion in new investments.\footnote{FLOW OF FUNDS, supra note 5, at 31 tbls. F.119 & F.120.}

Historically, pension funds have been conservative investors.\footnote{E.g., Lawrence A. Cunningham, \textit{Conversations from The Warren Buffett Symposium}, 19 \textit{CARDOZO L. REV.} 719, 733 (1997).} Until recently, almost all pension investments were in stocks and fixed income instruments.\footnote{Thomas G. Donlan, \textit{Public Funds Can Be Their Own Worst Enemies}, \textit{BARRON'S}, Oct. 3, 1994, at 53 (discussing the evolution of pension fund investment strategies from relatively unsophisticated to highly complex).} The passage of the Employment Retirement Income Security Act of 1974 ("ERISA"), as amended,\footnote{29 U.S.C. §§ 1101-1467 (1999).} significantly altered the way pension plans allocated funds to various investment classes. ERISA required that pension plans diversify their investments beyond the typical mixture of stocks and fixed-income securities. The purpose of the diversification requirement was to bring pension fund portfolios in line with modern investment guidelines.\footnote{ERISA was enacted in response to a variety of weaknesses in the pension system. \textit{See} Mass. Mut. Life Ins. Co. v. Russel, 473 U.S. 134, 140 n.8 (1985). The statute addressed such problems as unrealistically lengthy periods of participation, penalties for short periods of unemployment, and inadequacy of pension assets to cover liabilities to plan participants, among others. \textit{E.g.}, Parker v. BankAmerica Corp., 50 F.3d 757, 765 (9th Cir. 1995) (noting the twofold policy of ERISA: to protect employees from economic hardship of joblessness and to reward employees for past service to companies); Lewis v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 431 F. Supp. 271, 275-76 (E.D. Pa. 1977) (noting that it is reasonable to assume that Congress, in passing ERISA, intended to protect pension plan participants from agreements to arbitrate or similar agreements, often unilaterally imposed, which "snip and whittle" at federally protected rights).}
In response to the enactment of ERISA, asset classes other than traditional equity and fixed-income securities emerged as indispensable components of pension fund portfolios. ERISA integrated the basic principles of the "Modern Portfolio Theory" ("MPT"), which suggests that a truly diversified portfolio needs to hold investments in all industry segments that comprise a nation's wealth. To achieve risk-return characteristics recommended by the MPT, pension trustees significantly reorganized their plans' portfolios. Various non-traditional asset classes, such as junk bonds and venture capital funds, have become common components of pension fund portfolios. As part of this trend, real estate emerged as one of the most widely held types of pension fund investments. Investment consultants today recommend that pension funds allocate from five to fifteen percent of their portfolios to

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53. As of September 15, 2000, domestic pension funds held $141.9 billion, or 37.5% of the total institutional investments in the domestic real estate equity, and $36.4 billion, or 2.3% of the total investments in the domestic real estate debt. LEND LEASE REAL ESTATE INVESTMENTS & PRICEWATERHOUSECOOPERS, EMERGING TRENDS IN REAL ESTATE 2001 27 Exhibit 3-2 (2001) [hereinafter EMERGING TRENDS 2001].
real estate,\textsuperscript{54} with some studies estimating the optimum real estate allocation percentage in the twelve to twenty percent range.\textsuperscript{55}

However, current levels of real estate allocations by pension funds fall short of these recommendations.\textsuperscript{56} In 1995, defined benefit pension funds\textsuperscript{57} allocated on average 4.5\% of their portfolio to real estate.\textsuperscript{58} Although U.S. pension funds invested $135.4 billion in real estate equity,\textsuperscript{59} and $37.6 billion in real estate debt in 2000,\textsuperscript{60} these figures are still far below the allocation levels that many experts recommend.\textsuperscript{61} Although pension funds have been increasing their real estate investment programs,\textsuperscript{62} experts agree that under-investment in real estate is a serious issue facing pension funds.\textsuperscript{63}

Several disadvantages of real estate contribute to pension fund’s insufficient level of investments in this sector of the economy. The main disadvantage of real estate is the lack of liquidity associated with shares in a real estate investment.\textsuperscript{64} Proper valuation of real estate assets can also present significant challenges.\textsuperscript{65} In addition, because the underlying real estate assets are immobile, the value of real estate investments is more sensitive to changes in local supply-and-demand conditions than the value of common stock investments, which tend to be affected by national supply-and-demand conditions.\textsuperscript{66} The ownership of income-producing real estate may involve significant management functions;\textsuperscript{67} however, the cost of greater managerial control is higher operating fees.\textsuperscript{68} Furthermore,

\begin{itemize}
\item \textsuperscript{54} Johnson & Shepard, supra note 50, at 7.
\item \textsuperscript{55} E.g., Gregory H. Chun et al., Pension-Plan Real Estate Investment in an Asset-Liability Framework, REAL EST. ECON., Oct. 1, 2000, at 467 (reviewing procedures used in estimating the optimal allocation to real estate in a pension-fund portfolio).
\item \textsuperscript{56} Id.
\item \textsuperscript{57} The Internal Revenue Code defines defined benefit plan as a plan other than a plan which provides for an individual account for each participant and for benefits based solely on the amount contributed to the participant’s account, and any income, expense, gains and loses, and any forfeitures of accounts of other participants which may be allocated to such participant’s account. I.R.C. § 414(j) (2001).
\item \textsuperscript{58} Johnson & Shepard, supra note 50, at 7.
\item \textsuperscript{59} FLOW OF FUNDS, supra note 5, at 31 tbls. F.119, F.120
\item \textsuperscript{60} See id.
\item \textsuperscript{61} Public Pension Funds Seen as Big Buyers, REAL EST. ALERT, Mar. 6, 2000, at 1.
\item \textsuperscript{62} Johnson & Shepard, supra note 50, at 10.
\item \textsuperscript{63} Id. at 9.
\item \textsuperscript{64} MICHAEL T. MADISON ET AL., MODERN REAL ESTATE FINANCE AND LAND TRANSFER: A TRANSACTIONAL APPROACH 781 (2d ed. 1999).
\item \textsuperscript{65} Id. at 657-60.
\item \textsuperscript{66} Johnson & Shepard, supra note 50, at 10.
\item \textsuperscript{67} Id.
\item \textsuperscript{68} Id.
\end{itemize}
because pension funds are generally tax-exempt entities, owner-

ship and operation of income-producing real estate may result in undesirable tax consequences like unrelated business taxable in-
come ("UBTI").

Despite the low liquidity of its underlying assets and the difficulty of its valuation, real estate is a financially attractive invest-
ment. Institutional investors like pension funds can realize high rates of return on equity or debt real estate investments, in many cases exceeding typical returns of fixed-income securities. A number of studies have demonstrated that real estate returns exhibit less volatility than corporate equities or bonds, and that their returns are partially "hedged" during periods of high inflation. This characteristic of real estate as an effective hedge against inflation makes this asset class an effective tool in controlling the overall long-term performance of a pension fund portfolio.

Recognizing the advantages of real estate and its significance for the nation's capital markets, pension funds consider it an important long-term asset class. Typically, private pension funds and state retirement systems invest in real estate on the equity (stock) and

70. Dorothy Walton, Tax Law Lends Relief for Real Estate Investment; Revenue Reconciliation Act of 1993, J. OF PROP. MGMT., Jan. 1994, at 62 (observing that potential sources of UBTI include rents and gains from real estate that has been acquired for debt).
71. E.g., RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. o (1992) ("There may be good reasons for a particular trust to hold equity positions in real estate, provided the particular investment or investment program fits the circumstances and purposes of the trust and can otherwise be handled in a prudent manner.").
72. EMERGING TRENDS 2001, supra note 53 at 18 Exhibit 2-3 (rating asset class investment potential for 2001); see also G. Andrews Smith, Real Estate Resurgence Expected, But No Bell Will Alert Investors, PENSION WORLD, Feb. 1992, at 46 (summarizing the findings of a comparison study prepared by Evaluation Associates Inc., Norwalk, Conn., indicating that real estate outperformed stocks in eight of the twenty years beginning December 30, 1970, and outperformed bonds in ten years out of twenty).
73. See generally MADISON, supra note 64 at 662 (citing Joseph Gyourko & J. Siegel, Long-Term Return Characteristics of Income-Producing Real Estate, REAL EST. FIN. J., Spring 1994, at 14).
74. See, e.g., RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. o (1992) ("Because of its importance as a part of the country's capital markets, real estate is a potentially valuable ingredient of a diversification strategy, especially in light of its limited covariance with publicly traded equity and debt securities . . . . With thoughtful selection of properties or structuring of ownership positions, a trustee can organize the elements of the return toward the enhancement of either income productivity or principal appreciation, as might be desired for a particular trust portfolio.").
on the debt (bond) sides. Depending on the fund's strategy and needs, pension fund trustees typically consider a number of factors in establishing real estate investment guidelines. These factors influence selection of the types of investments and ownership vehicles. Pension funds can choose one or more of the following real estate investment vehicles: separate account or commingled fund; public and/or private investment; title holding corporation; group trust; limited liability company; limited or general partnership; or joint venture. Pension funds also invest in various debt instruments secured by real estate, such as individual and pooled mortgages.

The advancement of securitization has revolutionized the process of real estate investing. Real estate investment trusts ("REITs") on the equity side and mortgage-backed securities ("MBSs") on the debt side have addressed such problems associated with the ownership of real estate assets as low liquidity and difficulties in valuation. REITs and MBSs allow investors to participate in the real estate market without exposure to disadvantages associated with more traditional forms of real estate ownership.

C. Economically Targeted Investments

In formulating investment guidelines, pension fund trustees take into consideration many factors related to the fund's purpose of providing guaranteed retirement benefits to plan participants. The primary characteristic governing the selection of plan investments is a risk-adjusted rate of return. Retirement systems plan in advance for their obligations and payouts to plan participants, and adjust portfolio allocations for liquidity.

76. See EMERGING TRENDS 2001, supra note 53.
77. Johnson & Shepard, supra note 50, at 12.
78. See generally MADISON, supra note 64, at 757-75 (discussing various factors relevant to the selection of real estate ownership vehicles).
79. Id.
80. Johnson & Shepard, supra note 50, at 10, 14; see also Joseph Philip Forte, Capital Markets Mortgage: A Ratable Model for Main Street and Wall Street, 31 REAL PROP. PROB. & TR. J. 489, 514 (1996).
81. See generally MADISON, supra note 64, at 781-85.
82. Stanley L. Iezman, Complying With ERISA: A Primer for Pension Plan Trustees, REAL EST. REV., Spring 1997, at 19.
83. Johnson & Shepard, supra note 50, at 12.
84. Id.
tion of a plan’s assets is also an important consideration for pension fund managers.  

Pension funds have long recognized that, in addition to financial returns, pension investments often generate desirable collateral benefits. Depending on the type and structure of the investments, the benefits may include job creation, increased housing stock, and community and business development. A pension fund trustee can choose to invest in local projects to produce desirable developmental effect for the states and municipalities where the plan is located. Positive attention from taxpayers supplements the amount of collateral gains a pension fund ultimately receives from such endeavors.

Although the strategy of local investing is of old vintage, with a few notable exceptions pension funds have only recently begun establishing investment programs specifically targeting particular sectors of the economy or a geographical locality. The Clinton Administration was instrumental in popularizing this strategy later branded economically targeted investing. Gradually, the pension fund community has become more interested in developmental investing, with as many as forty-five out of the 119 largest public pension funds participating in ETIs by 1993. Yet despite the Administration’s promotion and a strong message by the Department of Labor in the form of Interpretive Bulletin 94-1, allocations to ETIs remained negligible. In fact, at the peak of the interest in

85. Id.
86. E.g., Pension Investments and Economic Growth, Testimony Before the Joint Econ. Comm., 103rd Cong. (1994) (testimony of Dr. William Dale Crist, President, California Public Employees’ Retirement System, Board of Administration), reprinted in FED. DOCUMENT CLEARING HOUSE CONG. TESTIMONY (June 22, 1994) (“[I]t is not just acceptable to consider what are referred to as the collateral economic benefits of any investment, it would be imprudent not to include such considerations in the investment decision making process.”); see also Testimony of Robert Reich, supra note 10 (“Pension funds... are positioned like no other force in the American economy to raise incomes and spark new jobs.”)
87. Testimony of Olena Berg, supra note 2.
88. Bennett, supra note 8.
89. E.g., Neal R. Pierce & Jerry Hagstrom, Unions, Frostbelt Seek More Control Over Pension Fund Investments, Nat’l J., Jan. 27, 1979, at 145 (indicating that as of 1979 a number of unions had been experimenting with alternative investment strategies, including targeted investments).
90. See Patterson, supra note 20, at 18.
92. Patterson, supra note 20, at 18.
ETIs, private pension funds almost universally avoided them. As the attacks on the legality of ETIs intensified, culminating with H.R. 1594, pension fund trustees' interest in this type of investment declined. Although in 1995 as few as twenty of the largest public retirement systems held almost $30 billion invested in various ETI programs, this figure has since significantly declined, with the proportion of ETIs to other pension fund allocations continuously decreasing.

D. Fiduciary Obligations of Pension Fund Trustees and Other Fiduciaries

The reluctance of pension fund trustees to allocate funds to economically targeted investments is attributable, at least in part, to the uncertainty over the consistency of such investments with the fiduciary obligations of pension fund trustees. The purpose of pension funds is to provide safe retirement income to plan participants. To ensure the safety of a plan's assets, pension fund fiduciaries must follow the appropriate standards of care.

Various laws governing fiduciary obligations of pension plan fiduciaries stem from principles embedded in the common law of

93. Phone the Department of Labor, supra note 21, at 350.
95. Patterson, supra note 20, at 18.
96. See id.
97. Id.
98. ERISA recognizes that in certain circumstances, a person who renders investment advice or other services to a plan, or who has the authority or responsibility to do so, is a plan fiduciary. 29 U.S.C. § 1002(21)(A)(ii) (1999); Interpretive Bulletins Relating to Participant Investment Education, 29 C.F.R. § 2509.96-1 (1999).
99. According to the 1993 survey of the 119 largest public pension funds by the Institute for Fiduciary Education, thirty-seven percent of respondents reported that the principal reason why they did not invest in economically targeted investments was because of the perceived conflicts with fiduciary duties; eleven percent referred to concerns over disproportionate amount of staff time required for such investments; eleven percent said that ETIs were not statutorily authorized; eight percent said that they did not invest in ETIs because "no one asked us to invest in an ETI"; four percent said their legal counsel had advised against ETIs; and four percent said they perceived no need for ETIs. Only 45 of the 119 funds invested in ETIs. Inst. for Fiduciary Educ., Economically Targeted Investments, A Reference For Public Pension Funds B-2 tbl. B-8 (1992); see also Protecting Retirees, supra note 21, at 53.
101. For a broad-spectrum discussion of the fiduciary obligations of pension fund trustees under ERISA, see Jacob Friedman et al., The Pension Answer Book: Special Supplement; Fiduciary Responsibility Under ERISA (1993).
trusts. Such principles of fiduciary obligations have historically served to limit the conduct of plan fiduciaries in making investments. At common law, pension fund sponsors owe plan participants the duty of loyalty and prudence. Governed by these standards, pension fund sponsors may not use institutional assets to foster purposes other than the financial good of the parties toward whom fiduciary duties run. Additionally, prior to the enactment of ERISA, prototypes for its fiduciary care standards were also evolving under the Internal Revenue Code ("the Code"), which sets forth rules that pension funds, in order to maintain their tax-exempt status, must follow in making investments.

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103. E.g., Harvard College v. Amory, 26 Mass. 446, 461 (1830).

[All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.


105. E.g., Blankenship v. Boyle, 329 F. Supp. 1089 (D.D.C. 1971) (holding that the fiduciaries of the United Mine Workers of America Welfare & Retirement Fund were liable for damages caused by keeping large sums of cash with the National Bank of Washington on a no-interest basis).

106. The Internal Revenue Code states that to qualify for a tax-exempt status, the trust instrument under a pension plan must make it impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, purposes other than for the exclusive benefit of [the employer's] employees or their beneficiaries.


Additionally, the exclusive benefit rule applies to investments, and requires that the investment meet the following criteria:

(1) the cost must not exceed fair market value at time of purchase;
(2) a fair return commensurate with the prevailing rate must be provided;
(3) sufficient liquidity must be maintained to permit distributions in accordance with the terms of the plan; and
(4) the safeguards and diversity that a prudent investor would adhere to must be present.

Although the common law of trusts currently applies only to private trusts, ERISA regulates private pension funds and Taft-Hartley union funds. In drafting ERISA, Congress refrained from precisely defining the fiduciary duties of plan fiduciaries, viewing basic principles of fiduciary care as codification of principles developed and applied in the common law of trusts. Congress, however, explicitly ordered courts to interpret these fiduciary standards "bearing in mind the special nature and purpose of employee benefit plans." Furthermore, Congress adopted the I.R.S. guidelines for determining whether fiduciaries were acting for the exclusive benefit of the participants as the core of the new fiduciary standards, so that, to the extent that a fiduciary meets the prudent man rule of ERISA, he is deemed to meet the exclusive benefit requirements of the Code.

1. **ERISA**

ERISA establishes fiduciary duties for private pension fund fiduciaries, and the rules under which investments are allowed. It applies to any pension fund maintained by an employer or union that affects interstate commerce, other than: (1) a government plan; (2) a church plan; (3) a plan maintained outside of the United States primarily for the benefit of nonresident aliens; or (4) an unfounded excess benefit plan. ERISA requires that a plan fiduciary discharge his duties with respect to an employee benefit plan solely in the interest of the plan's participants and beneficiaries. For private pension funds, the primary sections relevant to economically targeted investments are Section 404 (loyalty and prudence), and Section 408 (diversification) of ERISA.

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111. Id.


113. Id. § 1003(a) (enumerating the types of covered employee benefit plans).

114. Id. § 1104(a)(1)(A) (codifying the Exclusive Benefit Rule).

115. Id. § 1104 (establishing the fiduciary obligations of plan fiduciaries).

116. Id. § 1104(a)(1)(C) (establishing the portfolio diversification requirement).
In analyzing a potential investment, a plan sponsor's fiduciary duties require her to consider (a) whether the investment is prudent within the meaning of Section 404, and (b) whether the investment complies with the Exclusive Benefit Rule. Furthermore, the investment must not be one of the prohibited transactions, and must not lead to inadequate diversification of the plan's portfolio.

a. The Prudence Requirement

Pension plan investments must satisfy the prudence requirement of ERISA. In discharging her duties with respect to plan investments, a plan fiduciary must 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." The prudence requirement of Section 404 of ERISA is flexible, taking into consideration the "character and aims" of the fund served by a fiduciary in evaluating the adequacy of the fiduciary's independent investigation and ultimate investment selection.

Trustees and other fiduciaries must satisfy the substantive and the procedural components of Section 404 of ERISA. Procedural prudence requires a fiduciary to make an independent inquiry into the merits of a particular investment decision. Thus, a trustee's lack of familiarity with an investment is no excuse for making

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117. Infra Part D(1)(b).
119. Id. § 1108 (enumerating exemptions from the list of prohibited transactions); id. § 1104(a)(1)(C).
120. Id. § 1104(a)(1)(B) (establishing the prudence requirement).
121. Id.
122. In re UniSys Sav. Plan Lit., 74 F.3d 420, 434 (3d Cir. 1996) (quoting Donovan v. Cunningham, 716 F.2d 1455, 1467 (5th Cir. 1983))
123. Iezman, supra note 82, at 18 ("[ERISA] requires trustees to exercise procedural prudence in making investment decisions and to evaluate investment decisions with substantive prudence.").
124. Laborers Nat'l Pension Fund v. N. Trust Quantitative Advisors, Inc., 173 F.3d 313 (5th Cir. 1999) (holding that a plan fiduciary complied with ERISA's prudent man standard when he utilized proper methods to investigate, evaluate and structure the investment, acted in a manner as would others familiar with such matters, and exercised independent judgment when making investment decisions); see also Hunter v. Caliber Sys. Inc., 220 F.3d 702, 723 (6th Cir. 2000) (holding that the test determining whether a fiduciary has satisfied his duty of prudence is whether individual trustees, at the time they engaged in challenged transactions, employed appropriate methods to investigate the merits of their investments and to structure their investments).
an imprudent investment.\textsuperscript{125} The substantive component requires that under an objective standard of prudence, trustees are judged according to the standards of others acting in a like capacity and familiar with such matters.\textsuperscript{126} Accordingly, where trustees are unqualified to evaluate the soundness of a proposed investment, their duty is to seek outside assistance.\textsuperscript{127}

Until recently, courts had focused their inquiry under the prudent man rule on a review of the fiduciary’s independent investigation of the merits of particular investments.\textsuperscript{128} In measuring trustees’ conduct under the prudent man standard, a court typically inquired whether they, at the time they engaged in the challenged transaction, employed the appropriate methods for investigating the merits of the investment and structuring the investment.\textsuperscript{129}

The inquiry under the prudence requirement of ERISA has undergone substantial transformation in recent years. At least one court has interpreted the prudence requirement of ERISA in light of modern portfolio theory.\textsuperscript{130} Laborers National Pension Fund v. Northern Trust Quantitive Advisors, Inc.\textsuperscript{131} involved investments in stripped interest-only mortgage-backed securities (“IOs”), which give the right to the interest payments on a mortgage pool, and stop producing income if mortgages are refinanced. In the early 1990s, many IO investments lost money due to an unprecedented level of mortgage refinancing,\textsuperscript{132} including the investment by the

\textsuperscript{125} Lanka v. O’Higgins, 810 F. Supp. 379, 387 (N.D.N.Y. 1992) (stating that a fiduciary's subjective, good-faith belief in investment does not insulate him from charges that he acted imprudently).

\textsuperscript{126} United States v. Mason Tenders Dist. Council., 909 F. Supp. 891 (S.D.N.Y. 1995) (finding that ERISA’s prudence standard is not that of a prudent lay person, but rather that of a prudent fiduciary with experience dealing with similar enterprise).

\textsuperscript{127} Harley v. 3M, 42 F. Supp 2d. 898 (D.C. Minn. 1999) (noting that if a fiduciary lacks the education, experience or skills to conduct a reasonable, independent investigation of the risks and other characteristics of a proposed investment, the fiduciary must seek independent advice).

\textsuperscript{128} Donovan v. Cunningham, 716 F.2d 1455 (5th Cir. 1983) (holding that in evaluating individual investments, fiduciaries are entitled to rely on expertise of others; however, fiduciaries are responsible for ensuring that the information upon which the expert’s opinion is based is complete and up to date).

\textsuperscript{129} Donovan v. Mazzola, 716 F.2d 1226 (9th Cir. 1983) (holding that union pension fund trustees violated their fiduciary obligations under ERISA by granting a loan to a union’s convalescent fund, of which they were also trustees, at below-market interest rate).

\textsuperscript{130} See supra note 49 and accompanying text for a discussion of the Modern Portfolio Theory.

\textsuperscript{131} 173 F.3d 313 (5th Cir. 1999).

\textsuperscript{132} Id. at 316.
The suit alleged that the fiduciary, the defendant advisory company, disregarded investment guidelines, which required that investments be made that would "preserve principal while recognizing the need for income and appreciation with a minimal risk." The guidelines also required that fund assets be diversified among different investment categories, including real estate, money market instruments, and other appropriate investments. The district court held that the investments violated the "spirit" of those guidelines because they involved risk to the principal, maintaining that "it does not matter that other investment consultants in the industry held the opinion that IOs were appropriate for modern investment portfolios or that the portfolio as a whole made an adequate return." The United States Court of Appeals for the Fifth Circuit reversed, pointing out that stocks, real estate, and other investments approved by the investment guidelines also involved risk to principal. Interpreting the Department of Labor regulations concerning investment prudence, it further held that a fiduciary is "required to act as a prudent investment manager under the modern portfolio theory rather than under the common law of trusts standards which examined each investment with an eye toward its individual riskiness." The court concluded that analyzing each investment in isolation would run counter to ERISA's commitment to modern portfolio theory which focuses on the portfolio as a whole.

ERISA contains no specific language on economically targeted investments. The Department of Labor, which is charged with enforcing ERISA's fiduciary obligations, set forth the regulatory interpretation of ERISA's Prudent Man Rule in ERISA Regulation No. 2550.404a-1. Under the standards established in that regulation, taking into consideration collateral benefits of economically targeted investments is consistent with the Prudent Man Rule.

133. Id.
134. Id. at 321.
135. Id.
137. 173 F.3d at 321.
138. Id. at 316.
139. Id.
140. 29 U.S.C. § 1021 (1999) (imposing an obligation on the Secretary of Labor to police employee benefit plans); 29 U.S.C. § 1135 (1999) (empowering the Secretary of Labor to prescribe regulations "as he finds necessary or appropriate to carry out the provisions of [ERISA]").
141. 29 C.F.R. § 2550.404a-1 (1999).
as long as the fiduciary has complied with its procedural and substantive fiduciary duties, and believes that the risk-adjusted return on the investment is equal or greater than that otherwise available from other similar investments.\(^{142}\)

\[b. \text{Exclusive Benefit Rule}\]

Economically targeted investments, like any other kind of pension fund investments, must satisfy the Exclusive Benefit Rule of ERISA.\(^{143}\) Sections 403 and 404 of ERISA require that fund investments be made for the exclusive benefit of plan participants.\(^{144}\) The exclusive benefit requirement is different than the common law duty of loyalty in that it imposes obligations on trustees over and above those imposed by the prohibitions against self-dealing.\(^{145}\) It prohibits a fiduciary from granting preferences between participants or between beneficiaries in discharging his duties with respect to the administration of a plan,\(^{146}\) and requires that a trustee exercise his discretion in serving the interests of all participants.\(^{147}\)

ERISA does not prohibit decisions by plan sponsors that have the obvious primary purpose and effect of benefiting employees but also the incidental side effect of being prudent from the employers' economic perspective.\(^{148}\) From the legislative history of ERISA, it is clear that Congress did not intend the Act to penalize employers for exercising their discretion to make rational economic decisions in the best interests of both the employer and the

\(^{142}\) See Brock v. Walton, 794 F.2d 586 (11th Cir. 1986).

\(^{143}\) Iezman, \textit{supra} note 82, at 24.


\(^{145}\) See, e.g., Daniel Fischel & John H. Langbein, \textit{ERISA's Fundamental Contradiction: The Exclusive Benefit Rule}, 55 U. Chi. L. Rev. 1105, 1109 (1988) (arguing that the exclusive benefit rule of ERISA, which has its origin in tax law, is broader than the duty of loyalty of the common law).

\(^{146}\) Winpisinger v. Aurora Corp. of Ill., Precision Castings Div., 456 F. Supp. 559, 566 (N.D. Ohio 1978) (holding that 29 U.S.C.A. §§ 1001, 1104(a)(1), (a)(1)(A), requiring a fiduciary to discharge his duties with respect to a plan "solely in the interest of the participants and beneficiaries" forbid the fiduciary, in discharge of his duties with respect to plan, from granting preference as between plan's participants or as between plan's beneficiaries).

\(^{147}\) Talarico v. United Furniture Workers Pension Fund, 479 F. Supp. 1072, 1081 (1979) (holding that under 29 U.S.C.A. § 1004(a)(1)(A), trustees of a union pension fund had an obligation to protect fund and its participants and beneficiaries, and were also obligated to exercise their discretion to serve interests of all participants in the fund).

preservation of the benefit fund.\textsuperscript{149} Thus, trustees of a plan do not violate their fiduciary duties by taking action that, after careful and impartial investigation, they reasonably conclude best promotes the interests of participants and beneficiaries, simply because the action incidentally benefits the employer or themselves. However, their decisions must be made with an eye fixed exclusively on the interests of the participants and beneficiaries.\textsuperscript{150}

In 1994, the Department of Labor responded to the concerns of the pension investment community by clarifying the issue of whether the Exclusive Benefit Rule of ERISA prohibits investments that have the primary purpose and effect of benefiting plan participants as well as the incidental effect of stimulating economic development. In \textit{I.B. 94-1},\textsuperscript{151} the Department of Labor interpreted the Exclusive Benefit Rule of Sections 403 and 404 of ERISA as permitting the practice of economically targeted investments.\textsuperscript{152} The Department of Labor declared that ERISA permits the consideration of non-financial factors in selecting investments to the extent that the risk-to-return ratio on such investments is at least as favorable as other available investments.\textsuperscript{153}

However, several courts have disagreed with the Department of Labor’s position in \textit{I.B. 94-1} and several other advisory opinions that ERISA’s Exclusive Benefit Rule is not violated as long as fiduciaries do not subordinate the interests of participants to unrelated objectives.\textsuperscript{154} In \textit{Leigh v. Engle},\textsuperscript{155} for example, the court evaluated a portfolio’s individual investments in isolation where plan assets were used for corporate purposes, despite the fact that the aggregate investment resulted in a seventy-two percent return. In some contexts, however, courts have found collateral economic benefits acceptable. For example, in \textit{First National Bank of Blue

\textsuperscript{149} Id. at 550.
\textsuperscript{150} Donovan v. Bierwirth, 680 F.2d 263 (2d Cir. 1982).
\textsuperscript{151} 29 C.F.R. § 2509.94-1 (1999).
\textsuperscript{152} Id.
\textsuperscript{153} Id.
\textsuperscript{154} The Department of Labor had previously stated this position in ERISA Op. Letter No. 88-16A (Dec. 19, 1988), 1988 WL 222716, at *3 ("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.") and in Op. Letter No. 85-36A (Oct. 23, 1985) 1985 WL 32830, at *2 ("A 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."). It has also stated this position in several private opinion letters. Id.
\textsuperscript{155} 858 F.2d 361, 368 (7th Cir. 1988)
Island ESOP v. Board of Governors of the Federal Reserve System, the Seventh Circuit held that employee stock ownership plans ("ESOPs"), which are invested primarily in the stock of the sponsoring employer and are intended to provide a collateral benefit for the sponsoring employer and for plan participants in the form of worker ownership, are permissible under ERISA. However, courts have not yet addressed the applicability of the Exclusive Benefit Rule of ERISA to economically targeted investments.

2. Regulations of State and Local Retirement Systems

State and municipal retirement systems are excluded from coverage under ERISA. Typically, the investment of assets of these retirement systems is governed by state statutes and the common law of trusts. Case law also provides guidance on the issue of fiduciary obligations of pension fund trustees. The primary fiduciary duties relevant to economically targeted investments are the common law duty of prudence, the duty of loyalty, and the duty to follow the investment provisions of a statute or trust. Many states have incorporated the common law standards into their statutory schemes governing public pension funds. Furthermore, several states have enacted statutes enumerating the transactions in which state retirement systems may engage.

156. 802 F.2d 291 (7th Cir. 1986).
161. Id. § 170 (establishing the duty of loyalty).
162. Id. § 228 (establishing the duty to follow trust documents).
though statutes regulating state and municipal retirement systems have common characteristics, they are nonetheless different in many important respects.\textsuperscript{165}

While not directly applicable to public pension funds, ERISA serves as an important legal guide to public fund fiduciaries. Several states have modeled their public pension codes on ERISA.\textsuperscript{166} Additionally, the exclusive purpose requirement\textsuperscript{167} and the prohibited transactions rule\textsuperscript{168} of the Internal Revenue Code apply to state retirement systems.

3. \textit{Uniform Management of Public Employee Retirement Systems Act}

Diverse as they are, the legal restrictions that many states and localities impose on retirement systems are less stringent than those contained in ERISA.\textsuperscript{169} Furthermore, standards for vesting, funding, and permissibility of investments also vary significantly from one state to another.\textsuperscript{170} In prescribing fiduciary standards for trustees of the retirement systems, several states use a standard based on the common law of trusts,\textsuperscript{171} which considers individual investments in isolation rather than in the context of the whole portfolio.\textsuperscript{172} Confounding the situation is the fact that state statutes and municipal ordinances generally provide that public officials of their respective state or municipality be named trustees of that state or municipality's retirement systems.\textsuperscript{173} This situation is a source of potential political conflicts, creating concerns over the accountability of trustees for the investment decisions they make.

The National Conference of Commissioners on Uniform State Law, citing the need for a uniform act to modernize, clarify, and add to the rules governing the management of public retirement

\begin{itemize}
\item \textsuperscript{165} Moore, supra note 159 at vi-ix.
\item \textsuperscript{166} See generally id.
\item \textsuperscript{167} I.R.C. § 401(a)(2) (2000).
\item \textsuperscript{168} Id. § 503(b).
\item \textsuperscript{171} Moore, supra note 159 at vii.
\item \textsuperscript{172} See supra Part ID(1)(a).
\item \textsuperscript{173} E.g., Cal. Gov't Code § 20090 (West Supp. 2001) (members of the Board of Administrators of the Public Employees' Retirement System include the State Controller and the State Treasurer); N.Y. Retire. & Soc. Sec. Law § 422 (McKinney 1999) (prescribing the duties of the State Comptroller as the sole trustee of the New York Common Retirement Fund).
\end{itemize}
systems, drafted the Uniform Management of Public Employee Retirement Systems Act ("UMPERSA"). The purpose of UMPERSA was to facilitate the incorporation of modern investment practices into state law regulating the management of public employee retirement systems. It was further intended to ensure greater accountability of fiduciaries and to strengthen the reporting and disclosure requirements. The Act emphasized that many states rely on outdated legal principles which inhibit or prevent the employment of modern investment practices. According to its drafters, the Act’s adoption would prevent the loss of billions of dollars in investment opportunities.

The drafters of UMPERSA recognized that although the pension participants and beneficiaries are the immediate beneficiaries of a state retirement fund, the ultimate beneficiaries are the state’s taxpayers. The drafters specifically addressed the legality of economically targeted investments, noting that several states already permit economically targeted investments, while others allow some form of social investment practices, typically in dealing with countries like Cuba or South Africa. UMPERSA calls for the adoption of a standard similar to the one set forth in I.B. 94-1, allowing pension fund trustees to consider collateral benefits resulting from investments that have risk-return characteristics at least equal to other alternative investments of the same class. To date, only a few states have expressed interest in adopting the Act.

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177. Id.
178. Id.
179. Id.
181. Id. § 8(a)(5) cmt.
II. ARGUMENTS IN SUPPORT OF AND IN OPPOSITION TO ECONOMICALLY TARGETED INVESTMENTS

The legality of economically targeted investments has been hotly debated since they were first proposed in the early 1990s. Putting aside partisan rhetoric, the argument revolves around two interconnected issues: (1) whether ETIs are economically feasible for pension funds and (2) whether they cause pension fund trustees to violate their fiduciary obligations toward plan participants and their beneficiaries.

This Part contrasts two conflicting views on the legality of economically targeted investments. First, it distinguishes ETIs from social investments. Second, it presents the theory of capital gaps underlying the concept of economically targeted investments and reviews the legal arguments in support of ETIs. Third, it presents the view against the legality of ETIs. Finally, it demonstrates how criticism of the policy of economically targeted investing has caused a significant decline in pension fund trustees' interest in this investing strategy.

A. ETIs Distinguished from Socially Responsible Investing

Economically targeted investments are frequently confused with socially responsible investing. However, the two are distinct in several respects. Socially responsible investments generally are characterized as those made with a social cause in mind and typically result in reduced returns and less than optimum diversifica-

183. Cindy Skrzycki, To GOP, 'Targeted Investments' Are Just Retiree Robbery, WASH. POST, June 2, 1995, at F01 ("Pension experts say there are at least as many opinions on the quality and risks of ETIs as there are supporters and critics of them."); see also Lurie, supra note 27; Protecting Retirees, supra note 21; Phone the Department of Labor, supra note 21.

184. Compare Phone the Department of Labor, supra note 21, at 336 ("The ETI concept is unsound as a matter of policy and logic and is incomparable with ERISA's statutory standards governing pension trustees' investment decisions.") with Protecting Retirees, supra note 21, at 47 ("Critics of economically targeted investments argue that these investments are illegal under ERISA. But clearly this is not the case.").

185. Lewis D. Solomon & Karen C. Coe, Social Investments by Nonprofit Corporations and Charitable Trusts: A Legal and Business Primer for Foundation Managers and Other Nonprofit Fiduciaries, 66 UMKC L. REV. 213, 214 (1997) ("[S]ocial investing is the systematic incorporation of ethical values and objectives in the investment decision-making process. Over the last 80 years, these values and objectives—sometimes referred to as 'social screens'—have evolved from simple exclusionary policies to highly nuanced evaluations of corporate behavior."). (quoting Peter D. Kinder, Social Investing's Strength Lies in Readiness to Deal With the World's Tough Questions, PENSION WORLD, Apr. 1993, at 11).

186. Testimony of Robert Reich, supra note 10.
tion.\textsuperscript{187} Pension fund trustees have been criticized for engaging in such investments under political pressure.\textsuperscript{188} By contrast, at least in theory, economically targeted investments do not sacrifice the interests of plan participants for larger social goals, and are aimed at achieving "a public or social benefit as well as [a] financial gain for participants."\textsuperscript{189}

Policies underlying social investments have traditionally been based on one of the two theories.\textsuperscript{190} The first advocates accepting lower returns while investing in socially desirable projects, allowing that potential investment returns for an individual might suffer in order to benefit the rest of society.\textsuperscript{191} Critics have rightly noted that substituting the interests of society in general for those of plan participants violates fiduciary duties, and may result in administrative and judicial remedies for plan participants, civil and criminal penalties for the fund trustees, as well as potential plan disqualification.\textsuperscript{192}

The second theory is that of disinvestment.\textsuperscript{193} This policy, which calls for avoiding certain types of investments, has been commonly used by a number of institutional investors in the U.S. over a period of years.\textsuperscript{194} For example, several states and municipalities have at one point enacted statutes prohibiting state retirement systems from investing in companies doing business with South Af-
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rica, Burma, and others engaging in widespread human rights abuses.\textsuperscript{195} Other screening mechanisms have required the exclusion of investments in tobacco companies or companies employing ecologically unfriendly technologies.\textsuperscript{196}

Although concerns over heightened risk involving investments in certain countries or industries may sometimes justify disinvestment,\textsuperscript{197} this policy is not without its critics.\textsuperscript{198} When the policy of disinvestment effectively denies a pension plan reasonable investment alternatives or adequate diversification, ERISA may prohibit this practice.\textsuperscript{199} Critics maintain that excluding investment possibilities solely on social grounds without considering their economic and financial merit is inconsistent with trustees' fiduciary obligations.\textsuperscript{200}

Moreover, critics have noted that socially responsible investments are frequently made under political pressure.\textsuperscript{201} These investments then turn into politically targeted investments when trustees who have been pressured by special interest groups to accept below-market returns attempt to justify their investment choices by pointing to the perceived benefit to society in lieu of benefits to plan participants and their beneficiaries.\textsuperscript{202}

B. Arguments in Support of Economically Targeted Investments

Proponents of economically targeted investments have advanced several arguments in favor of ETIs' legality, distinguishing them from socially responsible investments. These arguments are predicated on the unique nature of pension funds, which allows trustees


\textsuperscript{196} Cross, supra note 190, at 934-35.

\textsuperscript{197} Lurie, supra note 27, at 349-50; Solomon & Coe, supra note 185, at 224 ("The immediate loss resulting from divesting a security could be justified, even under the prudent investor rule, if the trustee concludes that the potential economic loss would be far more damaging to the income and safety of the trust corpus.") (quoting Kan. Op. Att'y Gen. No. 85-153 (1985) available in WL 204845).

\textsuperscript{198} Lurie, supra note 27, at 350.

\textsuperscript{199} Id.

\textsuperscript{200} Id. ("[A]ny plan which for so-called social purposes excludes investment possibilities without consideration of their economic and financial merit is showing insufficient care for and disloyalty to individuals covered by the plans. Fiduciaries following such a course would . . . be acting at their peril.").

\textsuperscript{201} Romano, supra note 188, at 802.

\textsuperscript{202} Id.
to profitably invest in inefficient markets\textsuperscript{203} without jeopardizing the safety of the retirement benefits of plan participants. ETI supporters contend that the Department of Labor has had a longstanding policy of supporting these types of investments\textsuperscript{204} and that the legality of ETIs has been recognized in the Uniform Management of Public Employee Retirement Systems Act.\textsuperscript{205}

1. Capital Gaps

The theoretical underpinning of the concept of ETIs is the theory of "capital gaps," which postulates that various socioeconomic conditions create market inefficiencies\textsuperscript{206} in several sectors of the economy, including affordable housing in inner-cities and minority businesses,\textsuperscript{207} causing traditional lenders to withhold funds from these markets. According to proponents of economically targeted investments, pension funds are well positioned to engage in developmental investing because they can effectively identify and close such capital gaps.\textsuperscript{208} Pension funds, unlike many other institutional investors, generally do not require high liquidity from their investments due to highly predictable payment obligations. Thus, they can identify somewhat less liquid investment opportunities that combine economic development with unimpeded provision of retirement benefits in traditionally underfinanced sectors of the economy.\textsuperscript{209}

Close scrutiny of potential investment opportunities

\textsuperscript{203} Economic evidence shows that, from a typical investment perspective, the major capital markets are highly efficient in the sense that available information is rapidly digested and reflected in the market prices of securities. See, e.g., Jeffrey N. Gordon & Lewis A. Kornhauser, \textit{Efficient Markets, Costly Information and Securities Research}, 60 N.Y.U. L. REV. 761, 770 (1985). However, modern research also suggests that some inefficiencies remain, even in the most efficient of markets. See, e.g., Stanford J. Grossman & Joseph E. Stiglitz, \textit{On the Impossibility of Informationally Efficient Markets}, 70 AM. ECON. REV. 393 (1980).

\textsuperscript{204} \textit{Protecting Retirees}, supra note 21, at 47 ("[T]he Department has never stated that all incidental or collateral benefits are prohibited.").


\textsuperscript{208} \textit{Lawrence Litvak}, \textit{Pension Funds & Economic Renewal} 9 (1981).

\textsuperscript{209} \textit{Id.} at 120.
in these sectors of the economy may reveal potential collateral benefits in the form of economic development, job creation, and the like.\textsuperscript{210} According to the proponents of ETIs, in order to satisfy their fiduciary obligations to plan participants, pension funds should invest in such projects only after carefully considering all of the economic characteristics of such potential investments and concluding they are capable of producing market rates of return.

The concept of capital gaps is predicated on the existence of market inefficiencies and information asymmetries.\textsuperscript{211} For various reasons, such inefficiencies abound in the United States.\textsuperscript{212} The proponents of ETIs have testified before Congress on several occasions regarding specific instances of capital gaps in various sectors of the economy including affordable housing and venture capital.\textsuperscript{213} According to Professor Zanglein, traditional investors frequently "[a]void capital investments in certain sectors for various reasons, ranging from human nature reflected in express discrimination or lack of empathy, to dynamic shifts in savings patterns over the course of years and a transfer of capital assets from local banks to pension funds managed by national investment managers."\textsuperscript{214} By definition, economically targeted investments are niche projects that take advantage of local conditions,\textsuperscript{215} being too small to attract large institutional investors, but well-suited for local pension funds.

Several factors account for the existence of a capital gap in affordable housing. First, putting together an affordable housing deal is relatively difficult and requires specialized expertise that many institutional investors lack. Secondly, because affordable housing projects are generally local in nature, many such projects remain unfunded because large institutional investors like national insurance companies and investment banks do not know of their existence. Even before issuing \textit{I.B. 94-1}, the Department of Labor had established a clearinghouse for economically targeted investment opportunities, which was intended to screen investment opportunities suitable for pension funds.\textsuperscript{216} Under pressure from

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{210} Id. at 121-24.
\item \textsuperscript{211} See Hylton, \textit{supra} note 207, at 208-18 (discussing the asymmetric information theory, and arguing that it accounts for discriminatory lending practices facing inner-city developers).
\item \textsuperscript{212} \textit{Litvak, supra} note 208 at 9-16.
\item \textsuperscript{213} \textit{Testimony of Olena Berg, supra} note 2.
\item \textsuperscript{214} \textit{Protecting Retirees, supra} note 21, at 52.
\item \textsuperscript{215} Id. at 53.
\item \textsuperscript{216} \textit{Testimony of Olena Berg, supra} note 2.
\end{enumerate}
\end{footnotesize}
congressional republicans and conservative organizations,\textsuperscript{217} the financing for the government-run clearinghouse was discontinued, and the project was replaced with one run by a private organization.\textsuperscript{218}

2. \textit{Economically Targeted Investments Do Not Violate Fiduciary Obligations of Pension Fund Trustees}

According to a 1993 study by the Institute for Fiduciary Education, pension fund trustees refrain from making ETIs due to a perceived conflict with their fiduciary duties to plan participants.\textsuperscript{219} It is this misconception that the pro-ETI commentators vigorously sought to refute.\textsuperscript{220}

Proponents of economically targeted investments argue these investments are consistent with the fiduciary obligations of pension fund fiduciaries.\textsuperscript{221} They reaffirm the general principle that all pension fund investments must be prudent.\textsuperscript{222} According to the proponents of ETIs, The Department of Labor, which is charged with enforcing the compliance of private pension funds with the fiduciary requirements found in ERISA, has been consistently supporting the legality of ETIs.\textsuperscript{223}

3. \textit{The Department of Labor's Position on Economically Targeted Investments}

The critics of economically targeted investments maintain that by allowing pension fund fiduciaries to consider investments producing collateral benefits, the Department of Labor unnecessarily


\textsuperscript{218} Hamilton Securities Gets DOL Contract to Establish First Clearinghouse on ETIs, \textit{21 Pens. & Benefits Rep.} 1925 (1994).

\textsuperscript{219} \textit{Protecting Retirees, supra} note 21, at 53 ("Thirty-seven percent of the funds stated that the principal reason they did not invest in ETIs is because of perceived conflicts with fiduciary duties.") (quoting \textit{Institute for Fiduciary Education, supra} note 99, at B-2 tbl. B-8)).


\textsuperscript{221} \textit{Protecting Retirees, supra} note 21, at 50 ("[A] fiduciary can choose an investment that offers a collateral benefit if the fiduciary has acted prudently and has received a competitive rate of return.").

\textsuperscript{222} Id.; see also Lurie, \textit{supra} note 27, at 330.

\textsuperscript{223} \textit{Protecting Retirees, supra} note 21, at 48-50, 51-52. Professor Zanglein maintains that "[t]he basic statement of philosophy [on incidental benefits] has remained virtually unchanged over the last twenty years." \textit{Id.} at 48.
diluted the exclusive benefit requirement of ERISA in *I.B. 94-1*. Proponents of ETIs refute this contention, maintaining that in *I.B. 94-1*, the Department of Labor explained and reinforced the policy it had been consistently following since the Carter Administration. Specifically, *I.B. 94-1* refers to several Department of Labor advisory opinions and letters, which consistently maintained that pension fund fiduciaries can be influenced by factors unrelated to the plan's expected investment returns. According to Olena Berg, the former Assistant Labor Secretary for Pensions and Welfare Benefits, the new clarification expressed in *I.B. 94-1* was no change from the status quo, and broke no new ground.

### C. Arguments in Opposition to ETIs

#### 1. *Economically Targeted Investments Are Economically Unsound*

Critics of economically targeted investments believe that ETIs are economically unsound. They argue that, contrary to the universally accepted notion of the efficiency of capital markets, the concept of economically targeted investments is based on the flawed argument that certain competitive investments will remain unfunded due to a number of factors beyond the market characteristics of such investments. Criticizing the notion of exploiting inefficient markets, opponents of ETIs point out that in a free-market society scarce resources must be used efficiently. If economically targeted investments carry market rates of return, then, through the regular operation of the market, investors will fund such projects. If markets where certain investment opportunities exist are inefficient, then such opportunities are overpriced or oth-

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224. See Critical Analysis, supra note 23, at 41 (“[B]y what authority can DOL administrators dilute the statutory directive that pension trustees foster only the retirement benefits of participants and their beneficiaries?”).

225. Protecting Retirees, supra note 21, at 48.

226. Supra note 214 and accompanying text; Protecting Retirees, supra note 21, at 48.


228. *E.g.*, Thomas A. Smith, *Institutions and Entrepreneurs in American Corporate Finance*, 85 CAL. L. REV. 1, 32 (1997) (“ETIs appear to introduce a bias into portfolio selection that has a systematic effect on portfolio performance.”); Phone the Department of Labor, supra note 21, at 336 (“The ETI concept is unsound as a matter of policy and logic . . . .”).


230. See Critical Analysis, supra note 23, at 40-41; Phone the Department of Labor, supra note 21, at 338.

231. Nofsinger, supra note 229.
erwise not attractive, and investment in such projects will be detri-
mental to plan participants.\footnote{232}{Critical Analysis, supra note 23, at 40.}

These critics also point out that while the definition of economi-
cally targeted investments refers to market rates of returns, the
proper evaluation of such potential returns is possible only in effi-
cient markets.\footnote{233}{Phone the Department of Labor, supra note 21, at 339.} They argue that to ensure that ETIs provide com-
petitive returns, markets must be well-functioning, with sufficiently
delineated characteristics, to permit accurate performance valuation.\footnote{234}{Id.} Conversely, in poorly-functioning markets, there is a dis-
tinct possibility, due to reduced discipline of investors and insuffi-
cient disclosure, that market rates will be below prevailing
levels.\footnote{235}{Id.; Critical Analysis, supra note 23, at 40.}

Critics also contend that the policy of economically targeted in-
vestment may lead to pension capital being redirected from legiti-
mate and well-performing investments toward politically motivated
investments in underperforming projects.\footnote{236}{Smith, supra note 228, at 31 ("Despite the name, ETIs are investments made
on political, not economic, grounds."); Phone the Department of Labor, supra note 21, at 349.} This risk is particu-
larly high with public employee retirement systems, which typically
maintain close ties with the state governments.\footnote{237}{Id.} They argue that
should the investments underperform, to justify lower returns, pen-
sion fund trustees would refer to collateral benefits arguably real-
ized from such projects.\footnote{238}{Id.} According to the critics, the
Department of Labor implicitly signaled to pension fund trustees
they can factor in collateral returns in their investment selection
practices as long as such investments are branded as ETIs.\footnote{239}{Id.}

Finally, critics maintain that as a matter of policy it is more desir-
able to correct market inefficiencies, rather than to inspire pension
fund managers to invest in inefficient markets.\footnote{240}{Id. at 339.} When market
failures are corrected, investors other than pension funds would be
attracted to such markets.\footnote{241}{Id.}
2. *Economically Targeted Investments Violate Fiduciary Obligations of Pension Fund Trustees*

At the heart of the argument against ETIs lies the view that these investments violate the fiduciary obligations of pension fund trustees. Critics maintain that economically targeted investments violate ERISA section 404(a)(1)(A)(i) which requires pension fiduciaries to act solely in the interests of the plan's participants and beneficiaries and for the exclusive purpose of providing benefits to participants and their beneficiaries. They point out that historically the definition of a benefit has been a narrow one, with retirement, disability and death payments being the only plan distributions qualifying as benefits to plan participants. Thus, the definition of benefits does not extend to collateral benefits to plan participants.

According to these critics, the Department of Labor defined benefits too broadly in *I.B. 94-1*, implicitly including socially desirable incidental benefits as a valid consideration in selecting investments. They argue the Department of Labor was not justified in extending the definition of benefits under ERISA. Making incidental benefits to society a legitimate criterion in selecting investments is inconsistent with ERISA and other sources of law governing pension fund investments.

Furthermore, critics of ETIs argue that these investments run a high risk of being imprudent from the standpoint of ERISA. Because ETIs are made in inefficient markets, revealing rates for similar investments cannot be ascertained, especially considering that other investors have overlooked these investments. Therefore, critics argue, investing in such projects is unwise, imprudent, and contrary to the requirements of ERISA.

242. Id. at 342.
243. Id.
244. Id.
245. Id. at 344-45.
246. Id. at 342.
247. Id. at 344-47.
248. Critical Analysis, supra note 23, at 48 n.30; Phone the Department of Labor, supra note 21, at 338; see also S.Q. Della Grotta, *Taking a Look at Pension Funds and the ETIs*, PENSION WORLD, Sept. 1993, at 42 (maintaining that consideration of factors secondary to maximum financial gain is inconsistent with the duty of prudence).
249. Phone the Department of Labor, supra note 21, at 336-39.
250. Id. at 336, 342-47.
III. BEYOND ETIs: MAKING TARGETED INVESTMENTS IN LOW-TO-MODERATE INCOME RESIDENTIAL REAL ESTATE WORK

In examining the debate surrounding the legality of economically targeted investments, it appears that the divide between the proponents and the opponents of ETIs is deep and irreconcilable. While one side argues that taking into consideration interests other than those of plan participants in selecting investments is consistent with the fiduciary obligations of pension fund trustees, the other side categorically rejects this contention, maintaining that even mentioning factors other than the benefit of plan participants violates various fiduciary laws. Despite the Department of Labor’s clarification of its position on economically targeted investments in I.B. 94-1 and the attempt of the drafters of UMPERSA to persuade states to adopt the standard, the uncertainty concerning this fundamental principle of fiduciary obligations is too deeply rooted, and the punishment too severe, for conservatively-minded trustees to universally embrace ETIs. As a result, although pension funds are well-positioned to become major players in the low-to-moderate income residential real estate market, their participation in this sector of the economy has been negligible in proportion to the amount of assets they hold. No less than a radical change in the legislative and regulatory climate is required to bring targeted investments in low-to-moderate income residential real estate into the investing mainstream.

However, this goal will likely be impossible to accomplish within the constraints of the outdated ETI framework. Although the position of the critics on the legality of economically targeted investments appears to be too extreme, the arguments in support of ETIs also suffer from several deficiencies. First, although the Interpretive Bulletin 94-1 declared that ERISA does not prohibit trustees from considering collateral benefits, it failed to adequately delineate situations in which such benefits would be permissible.

251. Lurie, supra note 27; Protecting Retirees, supra note 21.
252. Phone the Department of Labor, supra note 21, at 343.
255. For instance, Alvin Lurie, the Chairman of the New York State Bar Association’s Special Committee on Pension Simplification, maintains that the notion of “exclusivity,” as argued by the critics of ETIs, is misleading and does not reflect the intention of the drafters of ERISA. Lurie, supra note 27, at 330-33.
256. See supra text accompanying notes 150-52.
In other words, it failed to define the attributes of an acceptable ETI. Secondly, it failed to account for the fact that the fiduciaries’ obligations are not extinguished upon making an investment decision, but rather continue to include the duty to monitor the plan’s assets and dispose of underperforming positions.\(^{257}\) Political pressure on pension fund trustees in keeping underperforming investments, coupled with the lack of accountability, can as easily be the source of violations of the exclusive benefit rule and the common law duty of loyalty as if the pressure was exerted on trustees to initially invest in ETIs. Finally, the legal framework of a traditional ETI model does not adequately deal with the issue of incentives for trustees to engage in ETIs.\(^{258}\) These shortcomings of the traditional ETI model contributed to the unceasing debate over the legality of these investments, causing conservative-minded trustees to avoid such transactions.

However, at least with respect to real estate investments, the two positions may not be as divergent as they appear. The onerous fiduciary obligations pension fund trustees face in selecting real estate investments can be reconciled with the policy of targeting low-to-moderate income residential real estate. This, however, may require the revision of the concept of economically targeted investments, and the way pension funds target this market sector. This Part acknowledges various shortcomings of the traditional ETI model that adversely affect the willingness of pension fund trustees to invest in low-to-moderate income residential real estate. It then proposes an alternative approach to conceptualizing pension fund investments in low-to-moderate income residential real estate. It also suggests several policy approaches aimed at making investments in low-to-moderate income residential real estate more attractive to pension funds while guaranteeing the security of pension assets.

A. Shortcomings of the ETI Model as Applicable to Pension Plan Investments in Affordable Housing

Although pension funds have significant potential as a source of capital for economic development, the extent to which they allocate funds to low-to-moderate income residential real estate is negligible in proportion to their portfolios.\(^{259}\) For a number of

\(^{257}\) Iezman, supra note 82, at 21.
\(^{258}\) Patterson, supra note 20.
\(^{259}\) See supra notes 95-97 and accompanying text.
reasons, the interest in targeted investments in affordable residential real estate has been steadily declining in recent years.\textsuperscript{260}

Several factors combine to create conditions adverse to the proliferation of economically targeted investments. First, pension funds are very sensitive to changes in the regulatory climate; the debate over the legality of ETIs has not clarified the issue to the satisfaction of conservatively-minded trustees. Furthermore, no uniform standard exists throughout states, and the existing ETI programs have not been tested in courts. Second, several characteristics of economically targeted investments distinguishing them from other investment types have not allowed ETIs, as a separate investment class, to become an integral part of pension fund portfolios. Finally, the policies of the federal and state governments have not provided pension funds with sufficient incentives to engage in targeted investments in affordable housing.

B. The Issue of the Legality of Targeted Pension Fund Investments Has Not Been Adequately Resolved

The debate over the legality of economically targeted investments has not resolved the issue to the satisfaction of pension fund trustees. Because transactions that are found to be imprudent or in violation of the exclusive benefit requirement are subject to rescission,\textsuperscript{261} and can expose plan fiduciaries to personal liability,\textsuperscript{262} the trustees will continue to factor in the uncertainty over the legality of such investments in their investment decision-making process.

Although the proponents of ETIs argue that these investments are legal under ERISA and the common law of trusts,\textsuperscript{263} this contention is far from clear. For instance, critics of ETIs points out that benefits to plan participants have historically been narrowly

\textsuperscript{260} It is worth noting in this context, however, that pension funds increased allocations to domestic and foreign equity as this sector of the capital market experienced unprecedented growth during late 1990's. As a typical pension plan portfolio has risen in price due to stock appreciation, the percentage of the plan's allocations to real estate relative to the whole portfolio generally decreased. \textit{Flow of Funds}, \textit{supra} note 5 at 49, 76.


\textsuperscript{262} 29 U.S.C. § 1132(c) (1999).

\textsuperscript{263} Lurie, \textit{supra} note 27; \textit{Protecting Retirees, supra} note 21.
BEYOND TARGETED INVESTMENTS

defined, meaning that pension fund trustees would be prohibited under ERISA from selecting investments providing primary benefits to plan participants and their beneficiaries in a form other than retirement or death payments. However, no case law currently exists on the issue of whether plan trustees may consider benefits other than purely financial gains accruing to plan participants or to society in general.

Equally uncertain is the legality of ETIs under the prudent man rule of ERISA and state statutes. Although courts have indicated that pension fund investments do not violate the prudence requirement of ERISA if at the time when such investments were made, they were adequately researched, and the portfolio as a whole provided an adequate return, whether the same reasoning can be extended to targeted investments in inefficient markets is unclear. The unavoidable corollary of investing in inefficient markets is the reduction in opportunity to conduct thorough economic research of such investments. Traditionally defined ETIs in affordable housing are unique projects, with all the risks associated with inefficient markets. Accordingly, due to the limited information available to pension fund trustees, many potentially good investments are rejected at initial stages of investment decision making due to their non-compliance with strict guidelines that pension funds typically establish to ensure compliance with the prudence requirement of ERISA or state laws.

Many potential economically targeted investments in low-to-moderate income residential real estate do not satisfy the currently existing portfolio selection criteria of a number of pension funds. Pension funds, particularly state retirement systems, are notorious for their conservative investment selection practices. Because most traditional economically targeted investments are niche projects involving custom contracts and specialized approaches, many pension plans do not have the requisite experience and skills to undertake them. Pension funds typically employ qualified real estate investment professionals or outside advisors to shift personal liability stemming from making real estate investment decisions;

265. See Protecting Retirees, supra note 21, at 50, 54-55.
266. Protecting Retirees, supra note 21, at 53.
267. E.g., Cunningham, supra note 45, at 733.
268. Protecting Retirees, supra note 21, at 53-54.
269. See generally Iezman, supra note 82, at 20-21.
for certain projects the administrative costs can be prohibitive.\textsuperscript{270} Furthermore, public pension funds operate under tighter budgets than private funds and typically employ fewer investment professionals. The combination of two characteristics—large sums of capital to invest plus fewer qualified investment professionals—has the effect of raising the minimum investment size, in many cases to between $10 and $25 million.\textsuperscript{271} Such high limits disqualify most projects targeted to create local benefits.

In addition to self-imposed investment guidelines, statutory restrictions may further prevent pension funds from investing in inefficient markets. Various statutory schemes based on a more conservative interpretation of fiduciary duties of the trustees of state retirement systems may preempt the discretion vested in the trustees in questions of investment selection.\textsuperscript{272}

However, ERISA, as well as many state statutes regulating retirement systems, contains no explicit language concerning economically targeted investments.\textsuperscript{273} Uncertain about the course of action that Congress might take with respect to future and past economically targeted investments, pension trustees are unwilling to commit funds to decades-long, low-liquidity projects like low-to-moderate income residential real estate, even if such projects promise job creation and increased housing availability in their respective states.\textsuperscript{274}

\textbf{C. The Uncertainty Over the Legality of Targeted Investments Serves As an Additional Risk Factor That Trustees Consider in Making Investment Decisions.}

The strategy of increasing the popularity of pension fund investments in affordable residential real estate depends on the perception concerning their legality. Because targeted affordable residential real estate investments by pension funds (even if not branded as ETIs) generally produce collateral economic bene-

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\textsuperscript{270} Protecting Retirees, supra note 21, at 53 ("The main problem economically targeted investors face is... the excessive information and transactions costs associated with an immature market.") (quoting Teresa Ghilarducci, \textit{U.S. Pension Investment Policy and Perfect Capital Market Theory}, \textit{Challenge}, July 1994, at 4); see also Testimony of Lee Smith, supra note 28.
\textsuperscript{272} See supra Part II(C)(2).
\textsuperscript{273} Supra Part I(D)(1).
\textsuperscript{274} See Patterson, supra note 20, at 18.
\end{flushleft}
fits, it can create the appearance of impropriety on the part of the trustees. In the legislative and regulatory vacuum produced by the lack of a clear standard for assessing the legality of targeted investing, pension fund trustees, wary of the arbitrariness of potential suits for violating fiduciary obligations, will continue to maintain their skepticism of targeted investments.

The primary weakness of the concept of economically targeted investments is the focus on individual capital gaps in local markets that pension funds can identify and close. Pursuant to this strategy, pension fund trustees are required to formulate criteria for determining the existence of capital gaps. Fund trustees need to review potential targeted investments individually, applying their subjective judgment to determine that the project has not been financed due to capital gaps. It is the arbitrariness of these criteria and the lack of trustee accountability that makes pension funds susceptible to political pressure.

It is unquestionable, however, that from a purely economic perspective, investments in low-to-moderate income residential real estate can be valuable additions to pension fund portfolios. As discussed earlier, aside from favorable risk-return characteristics, such investments can be valuable as a hedge against inflation, as well as for diversification purposes. The economic benefits of investing in low-to-moderate income residential real estate in many cases outweigh the increased costs of investment advice and project valuation associated with the novelty and the uniqueness of such investments.

If investment opportunities in low-to-moderate income residential real estate offer clear and readily quantifiable economic benefits to the plan participants, and if pension fund fiduciaries otherwise comply with their legal obligations in making such investments, nothing in the law prevents trustees from investing in such projects. Thus, the contention of critics that the exclusive benefit rule of ERISA is violated when trustees take into consideration benefits in the form of economic stimulus incidental to targeted investments in low-to-moderate income housing, when such investments otherwise satisfy the prudent man rule of ERISA and state laws, is without merit. Since neither ERISA, nor state

275. See supra note 86 and accompanying text.
276. See supra notes 207-214 and accompanying text.
277. MADISON, supra note 64, at 662.
278. Protecting Retirees, supra note 21, at 53-54.
279. Critical Analysis, supra note 23.
laws impose per se restrictions prohibiting pension funds from investing in any particular sector of the economy or in projects located in a targeted geographic area (when such investments are not on the list of prohibited transactions), it must follow that when such incidental benefits come only secondary to the economic considerations, the exclusive benefit rule is not violated.

In many instances potential targeted investments could be clearly imprudent given the aims and philosophy of a particular plan. Investments in low-to-moderate income residential real estate can require extraordinarily high levels of scrutiny due to the unique and complicated nature of residential real estate transactions in inefficient markets, especially when such opportunities are presented to relatively inexperienced and unsophisticated plans. Although potential returns could be significant, the risk associated with such investments would be unjustifiable under that plan's guidelines. Certain pension plans are required to flatly reject such inferior investment opportunities.

Most investment opportunities in affordable housing, however, fall in the gray area where their legality under ERISA and state laws cannot be easily ascertained. As a result, pension funds consider the legal uncertainty of such projects as an additional risk factor. Because the data concerning these investments could be scarce, investment yield and risk estimates could vary broadly. When the economic feasibility of such projects is not obvious, it is unavoidable that under such ambiguous circumstances the trustees would factor the uncertainty over the legality of such projects in their investment decision-making process. In some cases, this additional risk factor would result in disqualifying otherwise economically sound investment opportunities.

The uncertainty over the consistency of targeted investments with the fiduciary obligations of pension fund fiduciaries could, therefore, discourage trustees from making investments that are capable of producing market rates of return. Although trustees are required to exercise sound discretion within legal constraints in selecting fund investments, the matter of the legality of targeted investments is far from settled. Consequently, though pension fund trustees must discharge their duties for the exclusive benefit

280. See generally Iezman, supra note 82, at 20-21.
281. See supra part B.
283. Talcott, supra note 189, at 1036
284. See generally supra part II.
of plan participants, the fact that investments of great social importance are being rejected based on an untested interpretation of the law is difficult to justify. Furthermore, the policy of arbitrary restrictions on otherwise economically sound opportunities may be imprudent and therefore violative of ERISA.\textsuperscript{285}

1. \textit{Reconciling the Trustees' Fiduciary Duties With the Realities of a Targeted Affordable Residential Real Estate Market}

\textit{a. An Enabling Legislation Alone May Not Be Sufficient}

One way of putting to rest many concerns of private pension fund trustees over the legitimacy of ETIs would be the adoption of an amendment to ERISA expressly permitting a broad range of economically targeted investments classes.\textsuperscript{286} Similarly, adopting UMPERSA, which contains language identical to that of I.B. 94-1,\textsuperscript{287} would accomplish this goal on the state level. So far, however, neither Congress nor state legislatures have signaled their intention to move in this direction.\textsuperscript{288}

However, the legislation alone will not prompt a sizable increase in pension investments in in-state low-to-moderate income residential real estate. The fiduciary obligations do not extinguish immediately after the investment has been made.\textsuperscript{289} Assuming that ERISA and state laws expressly permitted economically targeted investments, the onerous requirements of continuous monitoring and performance assessment\textsuperscript{290} would further deter funds from investing in such projects. Generally, such monitoring serves an important purpose – allowing pension fund trustees to identify underperforming assets and promptly dispose of them.\textsuperscript{291} With ec-

\begin{itemize}
  \item 285. Lurie, \textit{supra} note 27, at 350.
  \item 286. According to Lurie, such legislation should indicate at least five attributes of a proper targeted investment:
    \begin{enumerate}
      \item looking solely at economic merits, the investment is suitable for the plan;
      \item the purpose of the investment is to provide for the participants' plan benefits;
      \item the social benefit, while not necessarily subordinate to the other primary purpose of the investment, does not in any way compromise that purpose;
      \item the trustees clearly identify the social benefit;
      \item the targeted investment does not thwart, in any reasonably foreseeable way, the participants receiving their plan benefits.
    \end{enumerate}
    Lurie, \textit{supra} note 27, at 340.
    \item 287. \textit{Supra} part I(D)(3).
  \item 288. \textit{Supra} note 17 and accompanying text; \textit{supra} note 182 and accompanying text.
  \item 289. Iezman, \textit{supra} note 82, at 20-21.
  \item 290. \textit{Id}.
  \item 291. Glennie v. Abitibi-Price Corp., 912 F. Supp. 993, 1004 (W.D. Mich. 1996) ("When a fiduciary does receive negative information regarding a particular invest-
onomically targeted investments, however, the effect could be exactly the opposite. To avoid political repercussions, fund trustees might not be willing to dispose of inadequately performing investments in in-state affordable housing projects, expressly or implicitly invoking social concerns as the justification for these decisions at the expense of plan participants.

D. The Legality of Pension Fund Investments in Securities Backed By Affordable Residential Real Estate Equity and Mortgages.

Investments in securities backed by low-to-moderate income affordable real estate can serve as a workable paradigm for targeted investments in this sector. REITs specializing in investing in affordable residential real estate in the states and regions targeted by pension plans can accomplish this goal on the equity side, while investments in mortgage-based securities collateralized by such properties located in targeted regions would be the solution for funds seeking investments on the debt side.

Targeted investments in securities backed by real estate would resolve many concerns of pension fund trustees who want to pursue developmental investment strategies. The main problem of traditional targeted investments is the potential for the violation of the exclusive benefit rule of ERISA and state statutes due to the arbitrariness inherent in the process of selecting and continuously monitoring such investments. In contrast, investments in REIT shares or MBS do not require pension funds to apply arbitrary criteria to identify and close capital gaps. As in the case of mortgage-backed securities, rating agencies like Standard & Poor's or Moody's Investor, employing computer models to evaluate characteristics of underlying properties, provide investors with an objective measure in the form of investment grade ratings. The high levels of accountability and disclosure required of security-issuers would eliminate the arbitrariness in investment monitoring accompanying direct investments by pension plans. By investing in real estate securities, pension fund trustees can distance themselves from political pressures associated with traditional targeted investment strategies.

\footnote{292. Supra Part III(C).}
\footnote{293. MADISON, supra note 64 at 809.}
\footnote{294. Id.}
However, more than just the creation of well-functioning local secondary markets similar to those in single-family housing is required to attract pensions to developmental investment in low-to-moderate income residential real estate. Because securities based on a pool of multifamily mortgages without credit enhancement will not be purchased, the federal and state governments need to create new and expand existing credit-support and insurance programs to guarantee affordable multifamily loans. Furthermore, the interpretation of the prohibited transactions rule and the prudence requirement of ERISA needs to be extended to include a wider range of real estate-backed securities, like the "B piece" MBSs. In view of recent decisions on the issue of the prudence of pension fund investments in light of modern investment practices, courts are likely to uphold this approach.

**Conclusion**

Remedying the housing crisis plaguing the nation requires innovative solutions. Although higher-end residential real estate investments attract much attention from both Main Street and Wall Street, the demand for low-to-moderate income multifamily residential real estate sharply exceeds the supply. Much of this has to do with the inefficiencies inherent in investing in this sector of real estate, though the lack of financing is also a big factor. Pension funds are well positioned to become a major investor in low-to-moderate income multifamily residential real estate, while benefiting their respective states and localities by improving the local housing situation and creating jobs for local populations. However, the outdated regime of fiduciary regulations contained in ERISA and state statutes significantly hampers active participation of pension funds in developmental investment. The economically targeted investment model has proven inadequate to accommodate pension funds willing to engage in developmental investing. New

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296. Forte, supra note 80, at 492.

297. Id.

298. For a definition of a "B piece" MBS, see id. at 506. See also Claire A. Hill, Securitization: A Low-Cost Sweetener For Lemons, 74 WASH. U. L.Q. 1061, 1070, 1126 n.131 (1996).

299. See supra parts I(D)(1)(a)-(b).
legislation based on modern investment principles and reflecting recent developments in the area of securitization of real estate is required to stimulate pension fund investments in low and moderate-income residential real estate. As a result of such legislation, pension funds would be able to contribute significantly to the economic development of their respective states and to the improvement of housing shortages while also protecting retirees' pension funds.