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DOL Publishes Guidance on ESG Investment Considerations by Retirement Plans – Takeaways for Managers, Plan Sponsors and Public Companies

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On April 23, 2018, the Department of Labor (the "DOL") issued Field Assistance Bulletin No. 2018-1 (the "FAB") concerning environmental, social and governance ("ESG") investments. The FAB is of interest to asset managers and plan sponsors alike as both groups continue to develop new solutions and procedures for allowing retirement plans to engage with ESG investments. The FAB also is of interest to public companies, which are receiving increasing pressure from investors to take affirmative steps to address environmental and social ("E&S") issues and make additional E&S disclosures. While the substance of the FAB aligns with prior DOL guidance on ESG investing, the tone of the FAB emphasizes the limitations on the degree to which ESG factors may drive investment decisions by plan fiduciaries.

An Overview of the FAB

Consideration of ESG Factors

Similar to past guidance on this issue, the FAB affirms the DOL's longstanding guidance that (i) ERISA fiduciaries may not sacrifice investment returns or assume greater investment risks to promote collateral social policy goals, but ESG factors may serve as "tie-breakers" when evaluating investment opportunities, and (ii) when ESG issues present risks and opportunities that investment professionals would treat as economic considerations, a prudent fiduciary should consider the ESG economic considerations together with other relevant economic factors. However, the FAB also cautions that fiduciaries "must not too readily" treat ESG factors as economically relevant to particular investment choices and that they must properly incorporate economically-relevant ESG factors to reflect their level of risk and return.

One of the more notable aspects of the FAB is the tone, which generally is cooler than the tone of the DOL's 2015 ESG guidance, which stated that, in some instances, ESG economic issues "are proper components of the fiduciary's primary analysis of the economic merits of competing investment choices." That guidance, Interpretive Bulletin 2015-01 ("IB 2015-01"), had sparked a significant degree of industry interest, as it was perceived to broaden the opportunities for ESG-oriented investment products to be incorporated into ERISA plans. Placing the prior guidance in context, the FAB notes that IB 2015-01 reiterated the DOL's longstanding position: "because every investment necessarily causes a plan to forego other investment opportunities, plan fiduciaries are not permitted to sacrifice investment return or take on additional investment risk as a means of using plan investments to promote collateral social policy goals." The FAB also observes that the preamble of IB 2015-01 said: "if a fiduciary prudently determines that an investment is appropriate based solely on economic considerations, including those that may derive from [ESG] factors, the fiduciary may make the investment without regard to any collateral benefits the investment may also promote." In the FAB's characterization, IB 2015-01 "*merely* recognized that there *could* be instances when *otherwise collateral* ESG issues present material business risk or opportunities . . . that investment professionals would treat as economic considerations," which would transform "these ordinarily collateral issues" into appropriate considerations for investment decisions (emphasis added).

The FAB places emphasis on a statement from IB 2015-01's preamble that instances could arise in which "otherwise collateral ESG issues" present risks and opportunities that investment professionals would treat as economic considerations. In other words, for certain products or strategies, ESG issues can be part of the economic appeal (or lack thereof) of an investment, and in those cases the consideration of ESG factors should be considered by a prudent fiduciary "as economic considerations themselves" along with other relevant economic factors. Critically, the weight attached to economic factors arising from ESG issues should be appropriate to their level of risk and return, compared to other relevant economic factors. The FAB then provides this additional guidance:

> Fiduciaries must not too readily treat ESG factors as economically relevant to the particular investment choices at issue when making a decision because it does not ineluctably follow from promoting ESG factors or promoting market trends or industry growth, that an investment is a prudent choice for retirement or other investors.
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> Instead, ERISA fiduciaries must always consider first and foremost the economic interests of the plan in providing retirement benefits. This means that a fiduciary's evaluation of an investment should be focused on financial factors that materially affect the return and risk of an investment, based on investment horizons that are consistent with the plan's investment/funding objectives. . . . .

These "cautions" are simply consequences of the prudent fiduciary standard of care that has always applied under ERISA, and the change in tone from the DOL does not amount to a reversal of existing guidance.[1] Nonetheless, the fact that the FAB was directed to the DOL's Director of Enforcement may reflect the DOL's increased skepticism regarding the quality of fiduciaries' economic analyses of ESG benefits, and may signal a view that a significant number of market participants have been overly ESG-friendly in their implementation of the guidance in IB 2015-01.

Investment Alternatives in 401(k)-Type Plans and QDIA

The FAB addresses the incorporation of ESG-oriented products into 401(k)-type plans, where participants and beneficiaries may choose from a broad range of investment alternatives, as well as the more specific topic of the qualified default investment alternative ("QDIA"). The FAB confirms that adding an investment alternative that reflects ESG-oriented "personal values" of participants would be permissible, provided that the ESG-themed investment alternative is prudently selected, well managed and properly diversified, and also that it "does not necessarily result in the plan forgoing the placement of one or more other non-ESG themed investment alternatives on the platform." By contrast, the FAB reflects the above-described skepticism to the prospect of incorporating ESG factors into a QDIA, where participants have no choice. Here the DOL observes the complexities of applying the prudence standards announced in IB 2015-01 and also raises the specter of a breach of ERISA's duty of loyalty where a fiduciary imposes its own policy preferences on plan participants who may have different or competing views.

Shareholder Engagement

The FAB also addresses shareholder engagement. Interpretive Bulletin 2016-01 ("IB 2016-01") stated that an investment policy that contemplates engaging in shareholder activities that are intended to monitor or influence the management of corporations in which the plan owns stock may be consistent with a fiduciary's obligations under ERISA, so long as the fiduciary concludes there is a reasonable expectation that such activities are likely to enhance the economic value of the plan's investment in that corporation after taking into account the costs involved. In another shift in tone, the FAB clarifies that it would be inappropriate for an individual plan investor to routinely incur

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[1] In another restatement of existing guidance on a fiduciary's duties, the FAB states that even in instances where an ERISA plan's investment policy statement contains guidelines incorporating ESG factors, an investment manager must evaluate whether it is consistent with ERISA to comply with the investment policy statement in a particular instance, and if not, the manager must disregard the investment policy statement.

significant expenses to engage in direct negotiations on ESG issues with the board or management of publicly held companies. The FAB further clarifies that IB 2016-01 was not intended to imply that plan fiduciaries should routinely incur significant plan expenses to fund advocacy, campaigns on shareholder resolutions, shareholder meetings, or initiate or actively sponsor proxy fights on ESG issues relating to such companies.

Additional Forthcoming Commentary

The Government Accountability Office has indicated that it will soon be issuing a report on how retirement plans should handle ESG investments. According to the news media, the GAO report may be published as early as May 2018 and will focus on ESG integration parameters by U.S. retirement plans and comparable plans abroad. At a minimum, this report is likely to inform the dialogue around ESG integration in the retirement plan space.

Takeaways for Plans and Asset Managers

Although the FAB does not change the legal principles or framework governing plan participation in ESG investments, it does offer some helpful points for plans and asset managers to consider:

- Asset managers should consider how their ESG products are marketed. It may be easier for a plan fiduciary to select an ESG investment that emphasizes the financial and return aspects of its ESG activities than one that emphasizes the potential social benefits of impact investing.
- Asset managers should review how they characterize the risks of investing in any ESG-oriented or ESG-informed products they manage. In particular, the characterization of lower potential returns might be couched in a manner that provides both adequate warning to investors and sufficient clarity that there is no conscious sacrifice of economic merits to inappropriate collateral considerations.
- Even though the preamble to IB 2015-01 stated that the DOL does not think a plan fiduciary's consideration of ESG criteria requires additional documentation, the tone of the FAB suggests that plan fiduciaries should consider maintaining enhanced records regarding the decision to invest into an ESG product.
- Plan fiduciaries should be explicit regarding whether they are considering the ESG features of a product as economic or non-economic factors.

Takeaways for Public Companies

For public companies, the short answer is that the FAB is unlikely to have an effect on corporate "E&S" initiatives or the velocity of change in this space.

The shareholder engagement guidance in the FAB may result in a modest decrease in E&S shareholder proposals, although it is likely that other investors will fill any void left by plan asset investors. Otherwise, plan asset investors are just one factor driving E&S. E&S also is being driven by business sustainability considerations as well as pressures from non-plan asset investors, non-shareholder stakeholders, including NGOs, commercial customers, consumers and states' attorneys general, as well as other factors. For a more extensive discussion of some of these factors, see our recent Alert here.