FYI®
For Your Information®
US

Volume 41 | Issue 30 | April 27, 2018

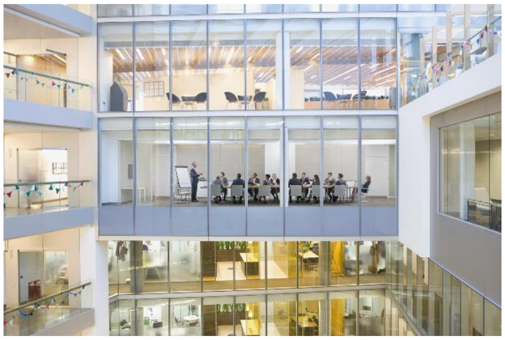
DOL (Again) Clarifies Standards on Economically Targeted Investments and Shareholder Activities

DOL recently cautioned fiduciaries against "too readily" characterizing environmental, social and governance factors as economically relevant considerations in selecting funds for the plan's investment lineup. The agency also emphasized that proxy voting and other shareholder activities do not typically involve plan expenditures — and that fiduciaries contemplating routine or substantial spending of plan funds to actively engage with management on environmental or social factors should document the analysis of the cost of this activity compared to the anticipated economic benefit. This guidance serves as a reminder for fiduciaries to examine ETI-related investments, and document a cost/benefit analysis of any routine or substantial expenses connected with shareholder activism.

Background

ERISA fiduciaries must administer plans prudently according to their terms, and for the exclusive benefit of participants and beneficiaries. The management of plan assets that include corporate stock, which involves decisions on the voting of proxies and other exercises of shareholder rights, is a fiduciary action subject to ERISA.

Over the years, DOL has addressed the interaction of fiduciary standards with the selection of economically targeted investments (ETIs) — meaning, those featuring "collateral economic or social benefits" in addition to investment returns. This type of investing is also referred to as "environmental, social and governance" (ESG) investing. DOL has also articulated views on shareholder activism and socially directed shareholder policy voting initiatives on the part of retirement plans.



DOL has vacillated on its approach on these topics, however, based on the party in control of the White House. Under the Clinton administration in 1994, DOL said a fiduciary can invest plan assets in an ETI (1) with an expected rate of return commensurate to rates of return of alternative investments with similar risk characteristics, and (2) that is otherwise an appropriate plan investment (referred to as the "all things being equal" test). It also affirmed that the interests of participants and beneficiaries may involve shareholder activities intended to influence corporate activities that enhance the value of the plan's investments. Under the Bush administration in 2008, the DOL issued guidance emphasizing the need to focus on the investment's economic value to the plan. DOL under the Obama administration took the view that the 2008 guidance "unduly discouraged" fiduciaries from considering ESG factors and essentially reinstated the principles in its 1994 guidance. (See our January 11, 2017 *For Your Information*.)

Everything Old is New Again?

In Field Assistance Bulletin 2018-01 and an accompanying news release, the DOL under the Trump administration again addressed ETI-related topics — this time warning fiduciaries against too readily treating ESG factors as economically relevant considerations.

ESG Investment Considerations

In the new guidance, DOL articulates the following points on ETIs:

- **Caution in treating ESG factors as economically relevant.** Fiduciaries' first priority must be the economic interests of the plan in providing retirement benefits — meaning those that have a material effect on the risk and return of an investment, based on appropriate investment horizons and consistent with the plan's funding and investment objectives. While ESG factors can be economically relevant, fiduciaries should not "too readily" treat them as such. An investment is not necessarily prudent because it promotes ESG factors or "arguably promotes general market trends or industry growth."
- **Limits of investment policy statements.** Investment policy statements can, but do not need to, contain ESG-related guidelines or tools. Additionally, a fiduciary should not comply with the investment policy statement — with regard to ESG factors or otherwise — in an instance where doing so would be imprudent.
- **ETI need not replace non-ESG themed investment.** A plan that allows participants and beneficiaries to choose from a broad range of investment alternatives does not necessarily need to remove a non-ETI alternative in order to add a "prudently selected, well managed, and properly diversified ESG-themed" investment to a 401(k) plan lineup.
- **Concerns with ETI as the QDIA.** The decision to "favor the fiduciary's own policy preferences" in selecting an ETI as the plan's qualified default investment option (QDIA) "without regard to possibly different or competing views of plan participants or beneficiaries" could "raise questions about the fiduciary's compliance with ERISA's duty of loyalty." Even if such factors could be appropriate in light of the plan population, an ESG-themed fund is never a prudent QDIA if it cannot meet the "all things being equal" test.

  Comment. The DOL has not previously expressed the idea that offering an ETI as a QDIA could be imprudent because it conflicts with participants' or beneficiaries' views, even if the ETI meets the "all things being equal" test.

ESG-factor investing is on the rise.

According to the **Global Sustainable Investment Alliance**, ETIs accounted for approximately $23 trillion at the start of 2016, up 25% since 2014. However, QDIAs generally adopt a target-date structure and use indexed, rather than managed, funds as their structural base — making ETIs uncommon QDIAs.

Shareholder Engagement Activities

The DOL confirmed that shareholder activities designed to monitor or influence the management of corporations in which the plan owns stock can be consistent with fiduciary duties if there is a "reasonable expectation that such activities (by the plan alone or together with other shareholders) are likely to enhance the economic value of the plan's investment" in the company, considering the costs involved. It is increasingly common for plans to take these actions, the DOL acknowledged, on topics like corporate governance, managing environmental risks, human capital, facilities, stakeholder relations, long-term access to critical resources, board profiles, related-party transactions, executive compensation, and long-term business plans.

However, proxy voting and other shareholder activities do not typically involve significant expenditures either by individual plan investors or the plan itself. Fiduciaries considering "routine or substantial" expenditures of plan assets to actively engage with management on environmental or social factors — either directly or through the plan's investment manager — should document the analysis of the cost of this activity compared with the anticipated economic benefit.

In Closing

This guidance reiterates the need for fiduciaries to carefully scrutinize any ETI-related investments — and to be sure to document their review. They should also take a close look at any expenses connected with shareholder activism that could be viewed as routine or substantial, and prepare to defend the benefits of these actions in light of their costs.

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