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Employee Benefits & Executive Compensation Alert May 2018

Latest Department of Labor Guidance on Economically Targeted Investments and Shareholder Engagement: Requires Plan Fiduciaries to Step Carefully

In late April, the Department of Labor ("DOL") released FAB 2018-01 addressing and clarifying previous guidance concerning economically targeted investments ("ETIs"), shareholder engagement and proxy voting.[1]

Executive Summary

The general tenor of the 2018 guidance, perhaps reflecting a change in the Administration, is more skeptical of a retirement plan's pursuit of ETIs and other social goals, while not changing the otherwise applicable law that ETI investments are permissible provided they are otherwise financially reasonable and economically prudent.

Background

This issue of ETIs (such as a "carbon free" Section 401(k) plan or other type of retirement plan) has increasingly become a topic of discussion due to a growing focus on this issue by pension plan participants and certain retirement plans (including governmental plans). The DOL first offered guidance in Interpretive Bulletin 94-1 ETIs, and that guidance was confirmed and updated by the DOL in 2015 in Interpretive Bulletin 2015-01.

The issues regarding ETIs (*e.g.* investing in low-income housing), including social responsibility investing (*e.g.*, avoidance of fossil fuel investing), are related in that the plan fiduciaries while investing for the *exclusive benefit of plan participants* are also trying to achieve a collateral goal (lessen the carbon imprint or help the economy of a particular region) and thus have environmental, social or corporate governance ("ESG") factors in play.

DOL Prior Guidance on ETIs

In 2015, the DOL, in its most immediate guidance prior to FAB 2018-01, gave the following advice to fiduciaries considering a "socially responsible fund" as a plan investment or as an investment alternative in a defined contribution plan:

- "fiduciaries may not accept lower expected returns or take on greater risks in order to secure collateral benefits, but may take such benefits into account as "tie-breakers" when investments are otherwise equal with respect to their economic and financial characteristics;" and

- "environmental, social, and governance factors may have a direct relationship to the economic and financial value of an investment [and,] [w]hen they do, these factors are more than just tie-breakers, but rather are proper components of the fiduciary's analysis of the economic and financial merits of competing investment choices." (U.S. Dep't of Labor EBSA New Release 10/22/2015; see also U.S. Dep't of Labor Interpretive Bulletin 2015-01, 29 C.F.R. § 2509.2015-01).

[1] We note that though church and governmental plans are exempt from the provisions of ERISA and the jurisdiction of the Department of Labor, such plans often look to ERISA principles as a benchmark for best practices in meeting common law fiduciary standards in the governance of such plans.

Under the 2015 guidance, the DOL stated that "the fiduciary standards applicable to ETIs are no different than the standards applicable to plan investments generally" (29 C.F.R. § 2509.2015-01). Therefore, just as with any decision to invest plan assets, plan fiduciaries have the burden of showing, in the case of a divestment, that the money diverted from the given investment (*e.g.*, an oil or gas investment fund) will be earmarked for a different investment (*e.g.*, a carbon free investment fund) with the same or superior characteristics of return and risk/reward that the divested investment offered. The new investments must also satisfy the general ERISA fiduciary requirements related to diversification and liquidity.

2018 DOL Guidance on ETIs

The newest FAB chose to emphasize that the Department had previously stated:

> "its longstanding view that, 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 2015 guidance] also reiterated the view that when competing investments serve the plan's economic interests equally well, plan fiduciaries can use such collateral considerations [(i.e., carbon free investing)] as tie-breakers for an investment choice. The preamble of [the 2015 guidance] added: 'if a fiduciary prudently determines that an investment is appropriate based solely on economic considerations, including those that may derive from environmental, social and governance [(ESG)] factors, the fiduciary may take the investment without regard to any collateral benefits the investment may also promote.'" (emphasis added)

However, the DOL has now dialed back its "observation" in that 2015 preamble as "merely recognizing" that there could be some instances where collateral ESG factors could involve business risks or opportunities that are properly treated as economic considerations themselves in evaluating alternative investments, with the weight given to those factors being appropriate to the relative level of risk and return involved compared to other relevant economic factors, and in those limited instances the ESG considerations are more than "mere tie-breakers."

Clearly, a fair reading of the above and the following passage from the 2018 FAB results in a less than full throated endorsement of ESG type investments. As the Department notes:

> "Fiduciaries must not too readily treat ESG factors as economically relevant to the particular investment choices at issue when making a decision. It does not ineluctably follow from the fact that an investment promotes ESG factors, or that it arguably promotes positive general market trends or industry growth, that the investment is a prudent choice for retirement or other investors. Rather, ERISA fiduciaries must always put first the economic interests of the plan in providing retirement benefits. A fiduciary's evaluation of the economics of an investment should be focused on financial factors that have a material effect on the return and risk of an investment based on appropriate investment horizons consistent with the plan's articulated funding and investment objectives." (emphasis supplied)

Participant Directed Investment Fund

With respect to participant directed investment funds in a defined contribution plan setting where there are many investment choices offered, the Department seems more open to have at least some of those investment funds to incorporate ESG goals. As the Department notes in the 2018 FAB:

> "In the case of an investment platform that allows participants and beneficiaries an opportunity to choose from a broad range of investment alternatives, adding one or more funds to a platform in response to participant requests for an investment alternative that reflects their personal values does not necessarily result in the plan forgoing the placement of one or more other non-ESG themed investment alternatives on the platform."

Qualified Default Investment Funds-Proceed with Caution

However, with respect to a qualified default investment fund (QDIF) where a participant who makes no investment choice is defaulted into by the terms of the plan, the Department appears less sanguine in promoting a use of an ESG type fund as a QDIF (the DOL gives examples of ESG funds, including a Socially Responsible Index Fund, a Religious Belief Investment fund, or an Environmental Investment Fund). The Department's cautionary words are as follows:

> "In the case of a qualified default investment alternative (QDIA),[2] however, selection of an investment fund is not analogous to merely offering participants an additional investment alternative as part of a prudently constructed lineup of investment alternatives from which participants may choose. Nothing in the QDIA regulation suggests that fiduciaries should choose QDIAs based on collateral public policy goals. In the QDIA context, the decision to favor the fiduciary's own policy preferences in selecting an ESG-themed investment option for a 401(k)-type plan without regard to possibly different or competing views of plan participants and beneficiaries would raise questions about the fiduciary's compliance with ERISA's duty of loyalty." (emphasis added)

Shareholder Engagement Issues

Though the 2018 FAB concentrated on ETI type issues, it also touched on proxy voting and shareholder engagement by retirement plans. In both areas the same cautionary voices (as in the ETI and ESG area) are sounded. The Department noted that its prior guidance was "not intended to signal that it is appropriate for an individual plan investor to routinely incur significant expenses to engage in direct negotiations with the board or management of publicly held companies with respect to which the plan is just one of many investors."

The Department notes that normally engaging in shareholder activities (including proxy voting) is consistent with fiduciary obligation under ERISA (as such activities may be likely to enhance the economic value of the plan's investment in the company at issue). However, from a reading of the 2018 guidance one should not expect to receive a total carte blanche from the Department with respect to such activities. The DOL chose to reiterate its guidance from a 2016 Interpretive Bulletin (U.S. Dep't of Labor Interpretive Bulletin 2016-01, 29 C.F.R. § 2509.2016-01):

> "[t]he Department has rejected a construction of ERISA that would render ERISA's tight limits on the use of plan assets illusory and that would permit plan fiduciaries to expend trust assets to promote myriad public policy preferences. Rather, plan fiduciaries may not increase expenses, sacrifice investment returns, or reduce the security of plan benefits in order to promote collateral goals."

[2] The Department's QDIA regulation at 29 CFR § 2550.404c-5 establishes conditions under which a participant or beneficiary in a participant-directed individual account plan will be deemed to have exercised control over assets in his or her account when, in the absence of investment directions from the participant or beneficiary, the plan invests all or part of a participant's or beneficiary's account in a QDIA. When a plan complies with the regulation, plan fiduciaries are not liable under Part 4 of ERISA for any loss or by reason of any breach which results from such participant's or beneficiary's exercise of control, but the plan fiduciaries remain responsible for the prudent selection and monitoring of the QDIA.

The Department FAB concludes on a rather chilling (intentionally?) note that:

> "If a plan fiduciary is considering a routine or substantial expenditure of plan assets to actively engage with management on environmental or social factors, either directly or through the plan's investment manager, that may well constitute the type of "special circumstances" that the IB 2016-01 preamble described as warranting a documented analysis of the cost of the shareholder activity compared to the expected economic benefit (gain) over an appropriate investment horizon."

Obviously, if the above analysis is to be applied, a plan fiduciary will need greater documentation (which may generate greater expenses) to justify the ESG investment potentially making those investments less likely.

Conclusion and Take Away Points

In summary, plan fiduciaries should be aware of the DOL's position that a decision to designate an investment alternative may not be influenced by non-economic factors unless the investment ultimately chosen for the plan, when judged solely on the basis of its economic value, would be equal to or superior to alternative available investments. Similarly, proxy voting and shareholder governance initiative activities (and the plan expenses related thereto) should also be viewed in the context of the overall best economic interests of plan participants. Finally, with the issuance of FAB 2018-01, we would anticipate plan ETI and ESG investments will receive closer scrutiny by the Department.

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FIELD ASSISTANCE BULLETIN NO. 2018-01

DATE: APRIL 23, 2018

MEMORANDUM FOR: MABEL CAPOLONGO, DIRECTOR OF ENFORCEMENT
REGIONAL DIRECTORS

FROM: JOHN J. CANARY
DIRECTOR OF REGULATIONS AND INTERPRETATIONS

SUBJECT: INTERPRETIVE BULLETINS 2016-01 AND 2015-01

This Field Assistance Bulletin provides guidance to the Employee Benefits Security Administration's national and regional offices to assist in addressing questions they may receive from plan fiduciaries and other interested stakeholders about Interpretive Bulletin 2016-01[1] (relating to the exercise of shareholder rights and written statements of investment policy), and Interpretive Bulletin 2015-01[2] (relating to "economically targeted investments" (ETIs)).

I. Background

Title I of the Employee Retirement Income Security Act of 1974 (ERISA) establishes minimum standards that govern the operation of private-sector employee benefit plans, including fiduciary responsibility rules. The Department's longstanding position is that the fiduciary act of managing plan assets that involve shares of corporate stock includes making decisions about voting proxies and exercising shareholder rights. To assist plan fiduciaries in understanding their obligations under ERISA, the Department issued IB 2016-01. The Department has a similarly longstanding position that ERISA fiduciaries may not sacrifice investment returns or assume greater investment risks as a means of promoting collateral social policy goals. IB 2015-01 contains the Department's interpretation of ERISA sections 403 and 404 as applied to employee benefit plan investments in economically targeted investments (that is, investments selected for the economic benefits they create apart from their investment return to the employee benefit plan).

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[1] Interpretive Bulletin 2016-01 (IB 2016-01), including a preamble, was published in the Federal Register at 81 FR 95879 (Dec. 29, 2016), and is codified at 29 CFR § 2509.2016-01. In 1994, the Department of Labor issued its first Interpretive Bulletin 94–2 (IB 94–2) on this subject which collected and summarized views the Department previously expressed in several interpretive letters. In 2008, the Department replaced IB 94–2 with Interpretive Bulletin 2008–2 (IB 2008-2). The Department's intent was to clarify and update the guidance in IB 94–2, and to reflect interpretive positions issued after 1994 on shareholder activism and socially-directed proxy voting initiatives. In 2016, the Department replaced IB 2008-2 with IB 2016-01.

[2] Interpretive Bulletin 2015-01 (IB 2015-01), including a preamble, was published in the Federal Register at 80 FR 65135 (Oct. 26, 2015), and is codified at 29 CFR § 2509.2015-01. The Department's guidance in this area went through a similar iterative process as IB 2016-01. Specifically, the Department issued its first Interpretive Bulletin on this subject in 1994, Interpretive Bulletin 94–1 (IB 94-1). In 2008, the Department replaced IB 94–1 with Interpretive Bulletin 2008–1 (IB 2008-01). In 2015, the Department replaced IB 2008-1 with IB 2015-01.

II. ESG Investment Considerations

In General

In IB 2015-01, the Department reiterated its longstanding view that, 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. IB 2015-01 also reiterated the view that when competing investments serve the plan's economic interests equally well, plan fiduciaries can use such collateral considerations as tie-breakers for an investment choice. The preamble of IB 2015-01 added: "if a fiduciary prudently determines that an investment is appropriate based solely on economic considerations, including those that may derive from environmental, social and governance [(ESG)] factors, the fiduciary may make the investment without regard to any collateral benefits the investment may also promote."[3]

In making that observation, the Department merely recognized that there could be instances when otherwise collateral ESG issues present material business risk or opportunities to companies that company officers and directors need to manage as part of the company's business plan and that qualified investment professionals would treat as economic considerations under generally accepted investment theories. In such situations, these ordinarily collateral issues are themselves appropriate economic considerations, and thus should be considered by a prudent fiduciary along with other relevant economic factors to evaluate the risk and return profiles of alternative investments. In other words, in these instances, the factors are more than mere tie-breakers. To the extent ESG factors, in fact, involve business risks or opportunities that are properly treated as economic considerations themselves in evaluating alternative investments, the weight given to those factors should also be appropriate to the relative level of risk and return involved compared to other relevant economic factors.

Fiduciaries must not too readily treat ESG factors as economically relevant to the particular investment choices at issue when making a decision. It does not ineluctably follow from the fact that an investment promotes ESG factors, or that it arguably promotes positive general market trends or industry growth, that the investment is a prudent choice for retirement or other investors. Rather, ERISA fiduciaries must always put first the economic interests of the plan in providing retirement benefits. A fiduciary's evaluation of the economics of an investment should be focused on financial factors that have a material effect on the return and risk of an investment based on appropriate investment horizons consistent with the plan's articulated funding and investment objectives.

In IB 2016-01, the Department noted that investment policy statements are permitted to include policies concerning the use of ESG factors to evaluate investments, or on integrating ESG-related tools, metrics, or analyses to evaluate an investment's risk or return.[4] That discussion in the IB does not reflect a view that investment policy statements must contain guidelines on ESG investments or integrating ESG-related tools to comply with ERISA. Moreover, the IB does not imply that if an investment policy statement contains such guidelines then fiduciaries managing plan assets, including appointed ERISA

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[3] 80 FR 65135, 65136.

[4] Investment policy statements are frequently adopted by plans, often as part of the plan's engagement of an ERISA section 3(38) investment manager. An investment policy is a written statement that provides investment managers and other plan fiduciaries responsible for plan investments with guidelines or general instructions concerning investment management decisions, including proxy voting. The creation and adoption of an investment policy is itself an exercise of fiduciary responsibility, which is subject to ERISA's fiduciary duties.

section 3(38) investment managers, must always adhere to them. A statement of investment policy is part of the "documents and instruments governing the plan" within the meaning of ERISA section 404(a)(1)(D),[5] and an investment manager or other plan fiduciary to whom such an investment policy applies is required to comply with the policy, but only insofar as the policy is consistent with Titles I and IV of ERISA (including the core fiduciary obligations of prudence and loyalty). Thus, if it is imprudent to comply with the investment policy statement in a particular instance, the manager must disregard it.

Investment Alternatives in 401(k)-Type Plans and Qualified Default Investment Alternatives

The Department explained in the preamble to IB 2015-01 that the standards set forth in sections 403 and 404 of ERISA apply to a fiduciary's selection of an investment fund as a plan investment or, in the case of an ERISA section 404(c) plan or other individual account plan, a designated investment alternative under the plan. In the case of an investment platform that allows participants and beneficiaries an opportunity to choose from a broad range of investment alternatives, adding one or more funds to a platform in response to participant requests for an investment alternative that reflects their personal values does not necessarily result in the plan forgoing the placement of one or more other non-ESG themed investment alternatives on the platform. Rather, in such a case, a prudently selected, well managed, and properly diversified ESG-themed investment alternative could be added to the available investment options on a 401(k) plan platform without requiring the plan to forgo adding other non-ESG-themed investment options to the platform.[6] In the case of a qualified default investment alternative (QDIA),[7] however, selection of an investment fund is not analogous to merely offering participants an additional investment alternative as part of a prudently constructed lineup of investment alternatives from which participants may choose. Nothing in the QDIA regulation suggests that fiduciaries should choose QDIAs based on collateral public policy goals. In the QDIA context, the decision to favor the fiduciary's own policy preferences in selecting an ESG-themed investment option for a 401(k)-type plan without regard to possibly different or competing views of plan participants and beneficiaries would

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[5] ERISA section 404(a)(1)(D) provides that plan fiduciaries shall discharge their duties in accordance with the "documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions" of Titles I and IV of ERISA.

[6] In other words, in deciding whether and to what extent to make a particular fund available as a designated investment alternative, a fiduciary must ordinarily consider only factors relating to the interests of plan participants and beneficiaries in their retirement income. A decision to designate an investment alternative may not be influenced by non-economic factors unless the investment ultimately chosen for the plan, when judged solely on the basis of its economic value, would be equal to or superior to alternative available investments. For example, a plan fiduciary could adopt an investment policy statement with prudent criteria for selection and retention of designated investment alternatives for an individual account plan that were based solely on economic factors, and apply that policy to all investment options, including potential ESG-themed funds. *See also* Advisory Opinion 98-04A (regarding application of predecessor to IB 2015-01 to the selection of a "socially responsible" mutual fund as an investment alternative in a 401(k) plan).

[7] The Department's QDIA regulation at 29 CFR § 2550.404c-5 establishes conditions under which a participant or beneficiary in a participant-directed individual account plan will be deemed to have exercised control over assets in his or her account when, in the absence of investment directions from the participant or beneficiary, the plan invests all or part of a participant's or beneficiary's account in a QDIA. When a plan complies with the regulation, plan fiduciaries are not liable under Part 4 of ERISA for any loss or by reason of any breach which results from such participant's or beneficiary's exercise of control, but the plan fiduciaries remain responsible for the prudent selection and monitoring of the QDIA. The QDIA regulation describes the attributes necessary for an investment fund, product, model portfolio, or managed account to be a QDIA. Each of the QDIA categories requires that the investment fund, product, model portfolio, or investment management service apply generally accepted investment theories, be diversified so as to minimize the risk of large losses, and be designed to provide varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures.

raise questions about the fiduciary's compliance with ERISA's duty of loyalty.[8] Even if consideration of such factors could be shown to be appropriate in the selection of a QDIA for a particular plan population, however, the plan's fiduciaries would have to ensure compliance with the guidance in IB 2015-01. For example, the selection of a ESG-themed target date fund as a QDIA would not be prudent if the fund would provide a lower expected rate of return than available non-ESG alternative target date funds with commensurate degrees of risk, or if the fund would be riskier than non-ESG alternative available target date funds with commensurate rates of return.

III. Shareholder Engagement Activities

The Department's longstanding view is that plan fiduciaries should engage in traditional and customary proxy voting activities in discharging their fiduciary obligation to prudently manage plan investments. The Department observed in the preamble to IB 2016-01 that, in most cases, proxy voting and other shareholder engagement does not involve a significant expenditure of funds by individual plan investors because the activities are undertaken by institutional investment managers that are appointed as the responsible plan fiduciary pursuant to ERISA sections 402(c)(3), 403(a)(2), and 3(38). The IB noted further that investment managers often engage consultants, including proxy advisory firms, to further reduce individual plan costs of researching proxy matters and exercising shareholder rights.

In IB 2016-01, the Department 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 can be consistent with a fiduciary's obligations under ERISA, if the responsible fiduciary concludes 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 that corporation after taking into account the costs involved. In fact, it is increasingly common for investment managers to include proxy voting and shareholder engagement guidelines in their investment policy statements. IB 2016-01 further states that, in various circumstances, plans may have a reasonable expectation that such activities are likely to enhance the value of the plan's investments after taking into account the costs. For example, investment managers often engage with companies to learn about corporate governance practices, or company actions to manage its environmental risks, human capital, facilities, stakeholder relations, and long-term access to critical resources. Other common communications are to share significant concerns about board profiles, related-party transactions, executive compensation, the corporation's long-term business plans, or to discuss overarching principles that the investment manager applies to proxy voting decisions.

All that language in the IB should be read in the context of the Department's observation that proxy voting and other shareholder engagement typically does not involve a significant expenditure of funds by individual plan investors because the activities are generally undertaken by institutional investment managers that are appointed as the responsible plan fiduciary pursuant to ERISA sections 402(c)(3), 403(a)(2), and 3(38).[9] The IB was not intended to signal that it is appropriate for an individual plan investor to routinely incur significant expenses to engage in direct negotiations with the board or management of publicly held companies with respect to which the plan is just one of many investors. Similarly, the IB was not meant to imply that plan fiduciaries, including appointed investment managers,

[8] For purpose of this bulletin, ESG-themed funds (e.g., Socially Responsible Index Fund, Religious Belief Investment Fund, or Environmental and Sustainable Investment Fund), should be distinguished from non-ESG-themed investment funds in which ESG factors may be incorporated in accordance with IB 2015-01 and IB 2016-01 as one of many factors in ordinary portfolio management and shareholder engagement decisions.

[9] 81 FR 95879, 95881.

should routinely incur significant plan expenses to, for example, fund advocacy, press, or mailing campaigns on shareholder resolutions, call special shareholder meetings, or initiate or actively sponsor proxy fights on environmental or social issues relating to such companies.

The Department noted in the IB that there may be circumstances, for example involving significantly indexed portfolios and important corporate governance reform issues, or other environmental or social issues that present significant operational risks and costs to business, and that are clearly connected to long-term value creation for shareholders with respect to which reasonable expenditure of plan assets to more actively engage with company management may be a prudent approach to protecting the value of a plan's investment. But, as stated in the preamble to IB 2016-01, "[t]he Department has rejected a construction of ERISA that would render ERISA's tight limits on the use of plan assets illusory and that would permit plan fiduciaries to expend trust assets to promote myriad public policy preferences. Rather, plan fiduciaries may not increase expenses, sacrifice investment returns, or reduce the security of plan benefits in order to promote collateral goals."[10]

If a plan fiduciary is considering a routine or substantial expenditure of plan assets to actively engage with management on environmental or social factors, either directly or through the plan's investment manager, that may well constitute the type of "special circumstances" that the IB 2016-01 preamble described as warranting a documented analysis of the cost of the shareholder activity compared to the expected economic benefit (gain) over an appropriate investment horizon.

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You may direct any questions about this Field Assistance Bulletin to the Division of Fiduciary Interpretations, Office of Regulations and Interpretations at (202) 693-8510.

[10] *Id.* at 95881. As noted above, a statement of investment policy, including policies on proxy voting or shareholder engagement, is part of the "documents and instruments governing the plan" within the meaning of ERISA section 404(a)(1)(D), and an investment manager or other plan fiduciary to whom such an investment policy applies is required to comply with the policy, but only insofar as the policy is consistent with Titles I and IV of ERISA(including the core fiduciary obligations of prudence and loyalty). Thus, if it is imprudent to comply with a proxy voting or shareholder engagement policy in a particular instance, the plan fiduciary must disregard it and act in accordance with fiduciary obligations under ERISA. ERISA does not shield investment managers or other fiduciaries from liability for imprudent actions taken in compliance with a statement of investment policy.