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Fiduciary Duty Guardrails: How the Recent DOL Guidance Impacts Consideration of ESG Factors in Investment Decisions and Shareholder Engagement

On April 23, 2018, the U.S. Department of Labor ("DOL") issued Field Assistance Bulletin 2018 01 ("FAB 2018 01"), the latest guidance from the DOL regarding the integration of environmental, social and governance ("ESG") factors into investment decision making and shareholder engagement. FAB 2018 01 conveys a cautionary tone but does not materially deviate from prior DOL guidance supporting integration of economically material ESG considerations.

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Evolution of ESG

The integration of ESG factors into investment policy statements and the selection of advisors and investment managers has become a hot topic as investor fiduciaries grapple with a convincing—and growing—body of empirical evidence that consideration of financially material ESG factors is associated with improved long term company performance.[1] Institutional investors are also confronted with increasing stakeholder and/or social pressure to divest or retain controversial holdings, or to actively engage in corporate governance initiatives. Set against this changing landscape, investor fiduciaries are increasingly concerned about the changing parameters of appropriate fiduciary consideration given to investment alternatives. Whether you are an early adopter of ESG principles or are just now considering integration of ESG factors into your investment analysis, it is important to understand the guardrails of an appropriate fiduciary analysis.

ERISA Requirements; Prior DOL Guidance

As a core principle, the Employee Retirement Income Security Act of 1974, as amended ("ERISA") requires fiduciaries to discharge their duties solely in the interests of participants and beneficiaries, with the care, skill, prudence and diligence of a prudent person.[2] When making investment decisions, ERISA prohibits a fiduciary from subordinating the interests of its participants and beneficiaries in favor of unrelated objectives.[3] ESG factors may be appropriately considered, to the extent they have a direct relationship to economic value. In Interpretive Bulletin 2015 01 ("IB 2015 01"), the DOL clarified that plan fiduciaries should appropriately consider factors, including ESG factors that could potentially influence risk and return. The DOL explained that, where relevant to the economic analysis, ESG factors "are not merely collateral considerations or tie breakers, but rather are *proper components of the fiduciary's primary analysis of the economic merits of competing investment choices*."[4]

In subsequent guidance, Interpretive Bulletin 2016-01 ("IB 2016-01"), the DOL addressed shareholder engagement activities. The DOL stated that activities intended to monitor or influence management of corporations (*e.g.*, proxy voting and shareholder engagement on governance or environmental risks) are acceptable, provided that the fiduciaries reasonably conclude that the activities are likely to enhance the value of the plan's investments after taking into account the costs.[5]

The DOL's most recent pronouncement on ESG, FAB 2018 01, does not materially deviate from prior guidance, though it does strike a more cautionary tone. Investor fiduciaries should be careful not to overreact to FAB 2018 01, as it *interprets* rather than *overturns* interpretive bulletins issued in 2015 and 2016.

Investment Decisions

FAB 2018 01 emphasizes the need for a fiduciary to analyze the economic impact of material ESG factors on an investment, as opposed to the larger impact on "general market trends or industry growth."[6] FAB 2018 01 *confirms that ESG factors can present material investment considerations which fall within an investor fiduciary's primary risk/return analysis and do not constitute collateral social policy goals*. FAB 2018 01 restates the DOL's 2015 and 2016 guidance that integration of material ESG factors into investment and proxy voting policies and decisions is consistent with fiduciary duty. For example, it recognizes:

> 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."
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> 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.[7]

However, FAB 2018 01 also cautions there are *fiduciary duty guardrails* which make it inappropriate for an ERISA plan fiduciary to forego return or take on added risk in pursuit of collateral social policy goals. The DOL cautions that investment analyses must start from an evaluation of financial factors that have a material effect on return and risk over appropriate time horizons (*i.e.*, usually including over the long term). A prudent approach should not favor a particular belief or policy without first determining its financial materiality over those time horizons. (Although FAB 2018 01 does not explicitly state such, this should apply equally to conservative and liberal beliefs.) The 2015 and 2016 Interpretive Bulletins did nothing to repeal this standard fiduciary obligation. FAB 2018 01 puts it this way:

> 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.

FAB 2018 01 also confirms "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." However, it notes this does *not* mean investment policy statements must include ESG guidelines. Further, fiduciaries may disregard investment policy statements if they deem it would be imprudent to comply.

Shareholder Engagement

Similarly, FAB 2018 01 generally supports the approach to shareholder engagement outlined in IB 2016 01. In IB 2016 01, the DOL stated shareholder engagement can be consistent with a fiduciary's obligations under ERISA if there is a reasonable expectation that such engagement is likely to enhance the economic value of the plan's investment after taking into account the costs involved. FAB 2018 01 quotes IB 2016 01 in confirming that corporate engagement practices can be prudent:

> [T]here 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.

While engagements connected with long term value creation may be considered prudent, the DOL also cautions that prior guidance was not intended to signal it is appropriate to "routinely incur significant expenses" to engage with public companies.[8] Further, prior guidance was not meant to imply fiduciaries should "routinely incur significant plan expenses to . . . fund advocacy, press or mailing campaigns on shareholder resolutions . . . ."[9] These statements seem to caution against a routine or automatic approach to engagement. The DOL observes again that there are *fiduciary duty guardrails* to keep fiduciaries focused on determining the net economic benefit of *routine or substantial expenditures* for corporate engagement, with attention to benefits over the appropriate time horizons. While this could discourage engagement practices, it seems to merely reinforce the existing principle that investor fiduciaries should always undertake a fact based, deliberative process, informed by qualified expert advice, when executing investment management responsibilities.

Documenting the Process

Fiduciaries are well advised to document their development of ESG policies and/or practices. This is an area that is undergoing rapid change. ESG doubters and believers alike should review the growing amount of new research on ESG materiality and conduct a reasoned analysis when developing proxy voting and engagement practices.

Company ESG engagement practices have always merited the same level of analysis that is used in establishing investment strategy or making security buy and sell decisions. FAB 2018 01 indicates a cost benefit analysis could be required for routine or substantial expenditures of plan assets:

> 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.[10]

Accordingly, it is advisable for fiduciaries to document their processes for determining that a routine or a substantial expenditure of plan assets is indeed warranted.

Finally, FAB 2018 1 does not repeal the 2015 and 2016 Interpretive Bulletins that have reassured fiduciaries acting on current research about the risk and return implications of material ESG factors. FASB 2018 1 can be read as simply observing that *fiduciary duty guardrails* exist to ensure that ERISA fiduciaries and their service providers do not take shortcuts.

In response to FAB 2018 01, fiduciaries may wish to:

- review their investment policies and practices (or investment manager contracts, as relevant) to ensure the fiduciary's consideration of ESG factors is tied to economic factors over an appropriate time horizon, and that such decision making is well documented;
- review their shareholder engagement policies to ensure the decision to engage will enhance the value of investments, after considering costs, and that the decision is well documented; and
- review their proxy voting policies to document academic research findings that connect the proxy voting issue (dual class shares, independent directors, etc.) with economic value.

Concerned fiduciaries may need to establish higher expectations for their service providers and document their ESG related policies and analytical processes. Reinhart's Institutional Investor Services attorneys are experienced in assisting fiduciaries to update their policies.

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[1] *See* Mozaffar Khan et al., *Corporate Sustainability: First Evidence on Materiality*, 91 Accounting Rev. 1697 (2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2575912; Robert G. Eccles and Mirtha D. Kastrapeli, The Investing Enlightenment: How Principle and Pragmatism Can Create Sustainable Value Through ESG (2017), https://arabesque.com/research/Final_The_Investing_Enlightenment.pdf

[2] ERISA § 404(a)(1).

[3] Department of Labor Interpretive Bulletin 94 1.

[4] Department of Labor Interpretive Bulletin 2015 1 (emphasis added).

[5] Department of Labor Interpretive Bulletin 2016-1.

[6] FAB 2018 1.

[7] *Id.*

[8] FAB 2018 1.

[9] FAB 2018 1.

[10] We note FAB 2018 01 uses the phrase "may well" rather than "must," which allows fiduciaries some discretion.