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DOL Updates Guidance on Fiduciary Duties Related To Exercise of Shareholder Rights and Considering ESG Factors

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May 3, 2018 TO: ICI Members

Pension Committee

Pension Operations Advisory Committee SUBJECTS: Pension RE: DOL Updates Guidance on Fiduciary Duties Related to Exercise of Shareholder Rights and Considering ESG Factors

On April 23, 2018, the Department of Labor (DOL) issued Field Assistance Bulletin (FAB) 2018-01^[1], providing guidance to its staff in national and regional offices regarding proxy voting, shareholder engagement, and economically targeted investments by plan fiduciaries. The FAB is intended to “clarify” earlier DOL guidance issued in Interpretative Bulletins (IB) 2016-01 and 2015-01 and is the latest chapter in DOL’s back and forth on how fiduciaries can take environmental, social, and governance (ESG) factors into account when making plan investments and how plan fiduciaries can exercise shareholder rights relating to plan investments.

Addressing ESG factors, the Obama Administration issued IB 2015-01, replacing the Bush Administration’s IB 2008-01, and reinstating the language of the Clinton Administration’s IB 94-01. Similarly, regarding the exercise of shareholder rights, the Obama Administration issued IB 2016-1, replacing the Bush Administration’s IB 2008-2, and reinstating the prior guidance from the Clinton Administration’s IB 94-2 with certain modifications.

ESG Investment

In IB 2015-01, DOL provided supplemental guidance regarding the application of ERISA fiduciary standards to the investment of plan assets in “economically targeted investments” (ETIs)—i.e., investments that are selected for the economic benefits they create in addition to the investment return to the employee benefit plan investor.^[2] DOL explained that the fiduciary standards applicable to ETIs are no different than the standards applicable to plan investments generally. Plan fiduciaries may not sacrifice investment returns or take on additional investment risk as a means of using plan investments to promote collateral social policy goals; however, 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. Further, in some cases, otherwise collateral ESG issues may present material business risk or opportunities to companies, which qualified investment professionals would treat as economic considerations under generally accepted investment theories.

In FAB 2018-01, DOL cautions that “[f]iduciaries must not too readily treat ESG factors as economically relevant to the particular investment choices at issue when making a decision,” that “fiduciaries must always put first the economic interests of the plan in providing retirement benefits,” and that “[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.”

DOL also cautions investment managers and other fiduciaries managing assets of plans whose investment policy statements include policies concerning the use of ESG factors to evaluate investments. Such fiduciaries must comply with the plan’s 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.”

The FAB includes additional cautions directed specifically at participant-directed individual account plans, such as 401(k)s. DOL notes that, when selecting investment options for a 401(k) plan platform, adding an additional option to the menu does not necessarily result in the plan forgoing the inclusion of another investment option. Therefore, “a prudently selected, well managed, and properly diversified ESG-themed investment alternative” may be an appropriate part of an investment menu that includes a broad range of alternatives. However, DOL seems to narrow this position when it cautions in footnote six 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.” DOL raises more significant concerns regarding consideration of ESG factors when selecting a qualified default investment alternative (QDIA) for a plan, which is not analogous to simply offering an additional investment alternative as part of a prudently constructed lineup of investment alternatives from which participants may choose. For example, the fiduciary may violate ERISA’s duty of loyalty if he favors his own policy preferences in selecting an ESG-themed investment option as a QDIA when plan participants and beneficiaries may have differing public policy views. DOL also notes in the FAB that when selecting a QDIA, plan fiduciaries must follow the QDIA regulations, which do not include any suggestion that fiduciaries should choose QDIAs based on collateral public policy goals.

Shareholder Engagement

In IB 2016-1, DOL provided guidance regarding the application of ERISA’s fiduciary standards to the voting of proxies on securities held in employee benefit plans, maintenance of and compliance with statements of investment policy (including proxy voting policy), and the appropriateness of shareholder engagement with corporate management by plan fiduciaries.^[3] In exercising shareholder rights, a plan fiduciary must consider factors that may affect the value of the plan’s investment and not subordinate the interests of the participants and beneficiaries in their retirement income to unrelated objectives, and must carry out this responsibility solely in the interests of the participants and beneficiaries. DOL noted that, in general, a discrete cost-benefit analysis for each proxy

vote or exercise of shareholder rights is not necessarily required in most circumstances, although special circumstances may warrant such analysis. Further, DOL explained in IB 2016-1 that an investment policy is consistent with ERISA if it contemplates activities intended to monitor or influence the management of corporations in which the plan owns stock, where the responsible fiduciary concludes that there is a reasonable expectation that such monitoring or communication with management is likely to enhance the value of the plan's investment in the corporation, after taking into account the costs involved.

In FAB 2018-01, DOL observes that proxy voting and other shareholder engagement typically does not involve a significant expense, and that IB 2016-01 should not be read to permit plans to routinely incur significant expenses for such activities. If a plan fiduciary is considering a routine or substantial expenditure of plan assets for such activities, then this may warrant a documented analysis of the cost of the activity compared to the expected economic benefit.

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endnotes

[1] FAB 2018-01 is *available at* <https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2018-01>; DOL's accompanying news release is *available at* <https://www.dol.gov/newsroom/releases/ebsa/ebsa20180423>.

[2] See ICI Memorandum No. 29448, dated October 27, 2015, available here: https://www.ici.org/my_ici/memorandum/memo29448.

[3] See ICI Memorandum No. 30522, dated January 13, 2017, available here: https://www.ici.org/my_ici/memorandum/memo30522