Client Alert

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Department of Labor Issues New Guidance on ESG Investing

On April 23, 2018, the Department of Labor ("DOL") released Field Assistance Bulletin 2018-01 (the "FAB"). The FAB has particular significance for retirement plan fiduciaries who make investment and proxy voting decisions that derive from so-called Environmental, Social, and Governance ("ESG") concerns. This Alert considers the potential impact of the FAB on publicly traded companies.

Background

In recent years, ESG issues have become ubiquitous in discussions about corporate governance at public companies in the United States and around the world. Although the US Securities and Exchange Commission is the primary federal regulator of investment advisors and registered investment companies and has a prominent role in the oversight of many asset managers, the DOL's oversight of plan fiduciaries subject to the Employee Retirement Income Security Act of 1974 ("ERISA") also affords the latter agency with significant responsibility for the oversight of institutional investors.

Generally speaking, ERISA covers two types of pension plans: defined benefit plans and defined contribution plans. Defined benefit pension plans affiliated with labor unions are covered by ERISA, which is significant because several of these plans regularly engage in shareholder activism. Examples of defined contribution plans include 401(k) plans, 403(b) plans, employee stock ownership plans, and profit-sharing plans.

ERISA, however, does not cover retirement plans established or maintained by governmental entities, churches for their employees, or plans which are maintained solely to comply with applicable workers' compensation, unemployment, or disability laws. Accordingly, state, county, and municipal retirement plans are generally not subject to ERISA. These kinds of plans, particularly in a handful of states, have become prominent shareholder activists on ESG issues, but are not subject to the FAB or ERISA fiduciary standards more broadly.

For those private-sector plans subject to ERISA, Title I of ERISA lays out minimum standards that govern plan operations, including the fiduciary duties regarding decisions about voting proxies and exercising shareholder rights. The fiduciary standard applies to persons or entities that exercise discretionary control or authority over plan management or plan assets, anyone with discretionary authority or responsibility for the administration of a plan, or anyone who provides investment advice to a plan for compensation or has any authority or responsibility to do so.

Beginning with the Clinton administration in 1994, the DOL began issuing interpretive bulletins explaining the ERISA duties of plan fiduciaries when they make investment decisions. The 1994 bulletins were modified by a pair of releases under the Bush administration in 2008, which were in turn superseded under the Obama administration in 2015 and 2016. DOL's Interpretive Bulletin 2015-01 relates to so-called "economically targeted investments" (which includes ESG investments),[1] and Interpretive Bulletin 2016-01 concerns the exercise of shareholder rights and written statements of investment policy. The

[1] DOL defines "economically targeted investments" to include investments selected for the economic benefits they create apart from their investment return to the employee benefit plan.

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2015 and 2016 bulletins in many ways returned to principles articulated in 1994, and in this respect raised some controversy among public companies.

DOL has for many years held the position that ERISA fiduciaries may not sacrifice investment returns or assume greater investment risks as a means of promoting collateral social policy goals. In Interpretive Bulletin 2015-01, DOL reiterated that, because every investment necessarily causes a plan to forgo 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, including ESG factors. Interpretive Bulletin 2015-01 also reiterated DOL's position that when competing investments serve the plan's economic interests equally well, plan fiduciaries are permitted to use such collateral considerations as so-called "tie-breakers" for an investment choice.

Overview of the FAB

The FAB clarifies that with Interpretive Bulletin 2015-01, DOL merely recognized that there could be instances when otherwise collateral ESG issues present material business risk or opportunities to companies. In such instances, the FAB reasons that company officers and directors need to manage those issues as part of the company's business plan, and that qualified investment professionals would treat them as economic considerations under generally accepted investment theories. In such situations, according to the FAB, 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. According to DOL, in these instances, the factors are more than mere "tie-breakers." To the extent ESG factors involve business risks or opportunities that are properly treated as economic considerations themselves in evaluating alternative investments, the FAB notes that 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.

With the FAB, DOL also cautions that fiduciaries must not too readily treat ESG factors as economically relevant to the particular investment choices at issue when making a decision. In this respect, the DOL believes 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.

Proxy Voting

The FAB repeats DOL's longstanding view that plan fiduciaries should engage in traditional and customary proxy voting activities in discharging their fiduciary obligation to prudently manage plan investments. DOL observed in the preamble to Interpretive Bulletin 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.

In Interpretive Bulletin 2016-01, DOL 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. The FAB cautions, however, that Interpretive Bulletin 2016-01 was not intended to signal that it is appropriate for an individual plan investor routinely to 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 FAB expresses DOL's belief that Interpretive Bulletin 2016-01 was not meant to imply that plan fiduciaries, including appointed investment managers, should routinely incur significant plan expenses to, for example, fund

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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 FAB's Potential Impact on Public Companies

The FAB has received mixed reactions from various corporate governance commentators. Some observers believe the FAB reflects a significant change in direction that will adversely affect investors' ability to pursue ESG matters. Other observers believe its effects will be much more limited and, in large part, reaffirm the fiduciary principle that to advance the economic interests of plan participants ERISA fiduciaries must consider cost-benefit analyses in managing investment portfolios. Indeed, some investor advocates have suggested that the FAB is entirely consistent with ESG investing principles.

Nevertheless, the FAB appears to walk back Interpretive Bulletins 2015-01 and 2016-01, albeit in subtle ways. As a technical matter, the FAB is styled as a memorandum for DOL's Director of Enforcement, which is typically the case with all field assistance bulletins, and perhaps signals an increased interest in enforcement activity on this front. To date, we are not aware of any enforcement actions that DOL has initiated against plan fiduciaries in respect of ESG investment activities on a breach of fiduciary duty theory.

The FAB is perhaps most notable for the types of investors for whom it does not apply. As indicated above, state, county, and other municipal pension funds are not subject to ERISA and are not bound by DOL pronouncements. Thus, the FAB has no mandatory effect on the many such pension plans that now regularly engage in shareholder activism on ESG issues. Likewise, registered mutual funds are not subject to ERISA, and many activist hedge funds limit their pool of investors so as to avoid becoming subject to ERISA. Moreover, ERISA does not apply to plans organized for the benefit of persons living outside the United States, which serves to exempt from its coverage the growing number of foreign pension plans that engage in shareholder activism at US public companies.

Even with respect to asset managers who are subject to ERISA, it remains to be seen whether the FAB will significantly curtail shareholder activism in the ESG space. Shareholder proposals under SEC Rule 14a-8, for example, are not directly addressed by the FAB. In addition, many of the plan fiduciaries subject to ERISA are not the type of activists who regularly incur the kinds of significant expenses giving rise to DOL's concerns.

There is another potential reason why the FAB may not have drastic effects. Although empirical evidence on many topics is absent or inconclusive, there is a growing sentiment that some (but certainly not all) ESG factors can present financial risks to various companies, depending on the factor and its relative materiality, the industry, and a company's particular circumstances.

To address potential shareholder activism on ESG issues, we continue to urge public companies to be proactive in engaging their own shareholders, particularly when there is a large institutional base. Knowing shareholders' voting policies and key issues is essential. Regular outreach on ESG topics can be part of a larger strategy devoted to establishing credibility and continuing a dialogue with investors focused on these issues. In many cases, ESG investors who believe that a given company is genuine in addressing their concerns are more likely to turn their attention to other portfolio companies who may not be as far along. Accordingly, the new FAB has the potential to affect levels of activism and voting patterns by plan fiduciaries related to ESG activities and shareholder proposals more broadly.

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