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Trump's DOL Expresses Its Own Views on ESG Investing

This week's U.S. Department of Labor (DOL) Field Assistance Bulletin (FAB) 2018-01 on environmental, social and governance (ESG) investing seems to have both caught everyone by surprise and caused confusion amongst a good many. This is unfortunate because ESG, with its various connotations, already eludes some. But despite its shortcomings, FAB 2018-01 reflects an unease by the DOL over certain ESG practices and largely clarifies existing fiduciary obligations in this space. Here are our key observations:

- ESG guidance issued by the DOL during the Obama administration in 2015 and 2016 was largely viewed as supportive of including ESG factors in the investment process. For example, Interpretive Bulletin (IB) 2015-01 recognized that an ESG factor can in fact have a close nexus with investment performance, and, therefore, should be considered by a fiduciary like any other material investment factor (e.g., inflation risk) in the usual prudence analysis. This acknowledgement recognized the growing body of research linking ESG factors, such as climate change, with investment performance. In respect of climate change, for example, an issuer may now be facing numerous risks, including stranded asset risk, the prospect of heightened government regulation that disproportionally affects certain industries or sectors (and the resulting litigation) and even the risk that some companies or industries may be rendered obsolete as global markets search for solutions to what is called, the transition to a low-carbon economy. IB 2015-01 also restated the historical test for ESG investing: only when competing investment options serve the plan's interests equally well may a fiduciary use an ESG factor as the tie-breaker. This historical approach, sometimes called the tie-breaker test, was designed to address the early iterations of ESG investing, where the fiduciary would want to pursue an objective *unrelated* to investment performance, such as to spur jobs in the local economy. In

2016, the DOL issued IB 2016-01 in which it permitted plan-funded shareholder engagement if "the responsible fiduciary concludes that there is a reasonable expectation that [such engagement] with management, by the plan alone or together with other shareholders, is likely to enhance the value of the plan's investment in the corporation, after taking into account the costs involved." Issues on which engagement may be appropriate included "the nature of long-term business plans including plans on climate change preparedness and sustainability" and "policies and practices to address environmental or social factors that have an impact on shareholder value."

- FAB 2018-01 preserves the notion that an ESG factor can have a direct link to investment performance and may be added to the investment decision mix with all other material factors, such as volatility and its correlation with other securities in the portfolio. But the DOL cautioned that there must in fact be a real nexus between the ESG factor and shareholder value in order to avoid having to satisfy the tie-breaker test. Fiduciaries will want to build a record in support of the view that a particular factor bears a relationship with investment performance, and carefully consider how much weight to put on that specific factor.

- Though hardly clear, the DOL is seemingly still comfortable with fiduciaries populating plan investment lineups with an ESG-themed investment option, provided the fiduciary can justify its inclusion on prudence grounds. The DOL is definitely wary of a fiduciary's selection of an ESG-themed QDIA, though FAB 2018-01 does not completely close the door on such an investment product. Moreover, the DOL, in expressing skepticism of ESG-related QDIA products, distinguished between "ESG-themed funds (e.g., Socially Responsible Index Fund, Religious Belief Investment Fund, or Environmental and Sustainable Index Fund)," from funds "in which ESG factors may be incorporated… as one of many factors in ordinary portfolio management and shareholder engagement decisions." The former seems to be more concerning to the DOL than the latter. This potentially has the effect of favoring some ESG products and strategies over others.

- The DOL also zeroed-in on shareholder engagement in respect of ESG issues that have a connection to the value of the plan's investment in the company, where the plan may be paying significant expenses for the engagement or development of proxy resolutions. FAB 2018-01 states 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," then that may warrant "a documented analysis of the cost of the shareholder activity compared to the expected economic benefit (gain) over an appropriate investment horizon." It is not evident why the DOL raised a concern over shareholder engagement that results in an ERISA plan incurring significant expenses due to direct engagement with company boards because we are not aware of that being much of a practice (at least as of yet). The DOL may have simply taken notice of other types of institutional investors, such as very large governmental plans, which are pushing for more engagement with corporate boards as an alternative to divestment, for example.

Even with FAB 2018-01, ESG remains an entirely viable investment approach under ERISA, provided it is structured in a way that satisfies the duties of prudence and loyalty. Fiduciaries face a proliferation of data and analytic tools to help identify managers and investment opportunities that are sufficiently attuned to ESG risks and best practices. Nomenclature and disclosure remain sources of concern and confusion among ESG specialists and newcomers alike. ESG's historical association with the pursuit of objectives unrelated to financial performance give the DOL and some fiduciaries pause, but a more nuanced understanding of how ESG factors can shape a portfolio's performance is emerging apace.

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