IslerDare PC

EMPLOYEE BENEFITS UPDATE

June 29, 2018

DOL Narrows Standards for Selecting Socially Responsible Retirement Plan Investments

Executive Summary

On April 23, 2018, the Department of Labor ("DOL") published guidance on the extent to which retirement plan fiduciaries can take into account environmental, social, or governance ("ESG") factors in selecting socially responsible investment funds for a retirement plan's investment line-up. With this fourth piece of guidance issued on this topic over the last fourteen years, the DOL continues to swing the pendulum on how much weight a plan fiduciary should give to ESG factors. This most recent guidance:

- Provides a narrower rationale for permitting the use of ESG factors in selecting investment options than prior DOL guidance;
- Confirms that ESG factors can be used as a tie-breaker, but only if economic interests are the same and any collateral social benefits are not included in the economic analysis;
- Indicates that it may be imprudent in certain circumstances to follow an investment policy statement that includes the use of ESG factors; and
- Clarifies that ESG–themed investment options should not be used as a retirement plan's qualified default investment alternative ("QDIA").

What Your Retirement Plan Fiduciaries Should Do

- Continue to focus on investment return, risk, and fees when selecting investment options and putting the economic interests of the plan first.
- Be cautious when including ESG factors, if any, in your selection of investment funds. Do not assign any economic benefit to ESG factors apart from expected investment returns for the participants in the plan.
- Review your investment policy statement with your legal counsel and/or investment advisor to determine if any changes are needed for consistency with your plan's investment strategy, including the appropriate discussion of ESG factors, if any.
- Review your plan's QDIA and confirm it is not an ESG–themed investment option. If it is, thoroughly analyze whether its selection continues to be prudent under the new DOL guidance, and memorialize that decision in writing.

The Pendulum: DOL's History of ESG Guidance

In 1994, the DOL released Interpretative Bulletin 94-1, which was its initial guidance on whether plan fiduciaries can consider ESG factors and the collateral economic and social benefits of a retirement plan's investment option, apart from the investment return to the plan. This addressed a misconception at the time that selecting an investment based on the economic benefits it creates apart from investment return to the retirement plan (an "Economically Targeted Investment" or "ETI") was incompatible with ERISA's fiduciary guidelines. The DOL said that plan fiduciaries could, in fact, consider these collateral benefits in making an investment selection, as long as the ETI had an expected rate of return that was comparable to that of alternative investments with similar risk characteristics. This has commonly been referred to as the "all things being equal" test.

In 2008, the DOL replaced Interpretive Bulletin 94-1 with Interpretative Bulletin 2008-1, which narrowed the ability of plan fiduciaries to use ESG factors and select ETIs. This guidance stated that a plan fiduciary should only rarely consider ESG factors in selecting plan investments, and that any consideration of such factors should be documented in order to demonstrate compliance with ERISA's rigorous fiduciary standards.

The DOL subsequently loosened the standard again when it replaced Interpretive Bulletin 2008-1 with Interpretive Bulletin 2015-1. The 2015 guidance noted that ESG factors may have a direct relationship to the economic value of an investment, and in these circumstances, the ESG factors are not merely collateral considerations or tie-breakers, but may be included in the fiduciary's analysis of plan investments.

DOL's Latest ESG Position: FAB No. 2018-01

In Field Assistance Bulletin No. 2018-01 (the "FAB"), the DOL swings back to a moderately stricter standard though its instructions to the DOL's national and regional offices about how to interpret the 2015 guidance. Even though the FAB reaffirms some of the "long-standing" principles cited in the 2015 guidance, overall it narrows the standards that plan fiduciaries should utilize when considering ESG factors and investment in ETIs.

General Guidance

The FAB provides a narrow interpretation of the DOL's prior 2015 guidance on when it is appropriate to use ESG factors. The DOL emphasizes that a plan fiduciary must always put the economic interests of the plan first *(i.e.*, financial factors that have a material effect on the rate of return and the risk of an investment), and may not "sacrifice investment return or take on additional investment risk as a means of using plan investments to promote collateral social policy goals." Although prior guidance allowed an ESG factor to be an integral part of the economic analysis when considering an investment option and to serve as a tie-breaker, the FAB now walks this back and provides that using an ESG factor would only be appropriate if the ESG factor could be treated as an economic consideration by itself, meaning that a qualified investment professional would treat the factor as an economic consideration under generally accepted investment theories. Furthermore, the DOL cautions retirement plan fiduciaries against including ESG factors in their assessment of an investment option's economic metrics, even if the ESG factors promote positive market trends or industry growth. The DOL pointedly emphasizes that a plan fiduciary "must not too readily treat ESG factors as economically relevant to the particular investment choices at issue when making a decision."

Investment Policy Statement

In addition to its general guidance on how retirement plan fiduciaries should evaluate ESG factors, the FAB also addresses how ESG factors should be handled in a retirement plan's investment policy statement ("IPS"). Specifically, the FAB notes that although an IPS is <u>permitted</u> to include policies concerning the use of ESG factors, it is not required to do so. Furthermore, the FAB cautions retirement plan fiduciaries that even if an IPS does explicitly address ESG plans and ETIs, it would not always be prudent for the fiduciaries to follow such guidelines.

In setting forth these standards, the DOL noted that an IPS is part of the "documents and instruments governing the plan" in accordance with ERISA. Consequently, retirement plan fiduciaries are required to follow the terms of plan documents, but only to the extent the documents are consistent with ERISA, including the fiduciary duties of prudence and loyalty. Thus, there may be instances where the plan fiduciaries, including any investment manager, must disregard the IPS. It is noteworthy that while the DOL takes the position that an IPS is part of the plan documents, the circuit courts are not in agreement on this point. In light of this uncertainty, it is important to establish and regularly review your IPS, so that at a minimum, it is consistent with your plan operations and investment strategies.

Adding ESG Investments and QDIAs

The FAB clarifies that, under certain facts and circumstances, it could be appropriate to add an ETI or ESG–themed investment option to a retirement plan line-up that reflects the personal values of the plan participant(s), and that doing so would not necessarily imply that the plan had to remove or forgo adding other non-ESG themed investments, as long as the ETI or ESG–themed investment option is prudently selected, well–managed, and properly diversified. However, the DOL is very clear that it would almost never be appropriate to select an ESG–themed investment as a retirement plan's QDIA. Rather, the DOL guidance cautions that such an investment as the QDIA could be seen as favoring the plan fiduciary's own social policy goals or those of a select few, and could be a violation of the duty of prudence and loyalty, since a QDIA should not be selected based on "collateral public policy goals." Even if it could be shown that the selection of a certain ESG–themed investment was appropriate for a particular participant population, the selected QDIA should not provide a lower expected rate of return or a higher level of risk than other available alternatives and should not be riskier than alternative non-ESG target date funds.

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If you would like assistance in determining whether these latest developments on ESG investments may impact the design or operation of your retirement plan and investment policy statement, or if you'd like to discuss your retirement plans generally, please feel free to contact the members of our Employee Benefits group below.

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