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FIDUCIARY UPDATE

Using ESG Factors in ERISA Plans

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On April 23, 2018, the U.S. Department of Labor (DOL) published Field Assistance Bulletin No. 2018-01 (FAB), addressing the use of environmental, social, and governance (ESG) factors in Employee Retirement Income Security Act of 1974 (ERISA) plans, in particular 401(k) plans. This is the second DOL publication focused on ESG within three years, so clearly it's an important topic for the new administration.

So, where does this leave a 401(k) plan fiduciary who is looking to integrate ESG into its fund line-up? Why did DOL feel the need to publish guidance on a topic it recently addressed? What has changed?

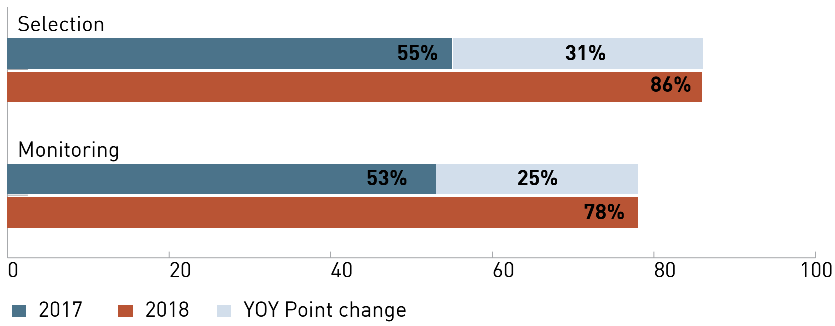
Overall, this bulletin continues the long-standing DOL position that fiduciaries may not sacrifice investment return to promote collateral or social goals. Using this as a guiding star, ERISA plan fiduciaries considering investing plan assets using ESG factors should be able to navigate safely through these fiduciary waters.

This article describes today's ESG funds, discusses the history of DOL's evolving views, and provides a general overview of ERISA fiduciary duty. Finally, it provides a framework for fiduciaries to follow if they would like to add ESG funds to their line-ups.

Figure 1

INCREASING USE OF ESG IN SELECTION AND MONITORING OF MANAGERS

ASSET OWNERS CONSIDERING ESG/ACTIVE OWNERSHIP IN THE SELECTION AND MONITORING OF EXTERNAL MANAGERS



Source: UN PRI, "Annual Report 2018," page 7, https://www.unpri.org/annual-report-2018

WHAT IS ESG INVESTING?

Environmental, social, and governance is quite a mouthful. This is the most widely used term now in use to describe investment strategy that utilizes qualitative factors beyond simple financial metrics to inform active management decisions. Investopedia defines ESG in the following way:

- Environmental criteria describe how a company performs as a steward of the natural environment.
- Social criteria examine how a company manages relationships with its employees, suppliers, customers, and the communities where it operates.
- Governance deals with a company's leadership, executive pay, audits and internal controls, and shareholder rights.

Using non-financial criteria to evaluate an investment has a long history. At least since the 1950s, trade unions have used their capital to invest in projects that would benefit their members. DOL has called these types of investments economically targeted investments (ETIs).

In the 1970s, asset owners faced calls for disinvestment in South Africa due to the apartheid regime. Many mission-based organizations, e.g., churches, also used disinvestment principles to express their beliefs by excluding investments in certain sectors, e.g., gambling, liquor, guns, tobacco, the sex industry, etc., also known as "sin stocks." Terms such as "socially responsible investing" and "green investing" were used to describe various themes used to screen stocks. As with many trends in the investment industry, an index was born, legitimizing this style of investing; initially it was called the Domini 400 Social Index and it's now known as the MSCI KLD 400 Social Index. In 2006, the United Nations (UN) even got into the game with the launch of the Principles for Responsible Investment (PRI), a partnership of two UN groups—UN Environmental Programme Finance Initiative and UN Global Compact.

Figure 1 shows that asset owners increasingly are considering ESG in their selection and monitoring of external managers.

Investment managers following ESG principles are using ESG factors to provide additional insight into the future performance of a stock (see sidebar on active managers). The thesis goes something like this: If Company XYZ is addressing ESG issues in its day-to-day business better than its competitors, we would expect Company XYZ to outperform its competitors. Compare this to prior iterations of ESG, historically using the name socially responsible investing (SRI). SRI typically was a binary decision:

1. If a firm was considered not responsible, then its allocation in a fund was zero (0) percent.
2. If a firm was considered responsible, then its allocation in a fund would be determined by other typical active management factors.

Modern versions of ESG have integrated ESG factors in a more nuanced manner to provide active managers with a fuller picture of how to allocate capital in their funds.

BACKGROUND

EVOLVING DOL VIEWPOINT

Most fiduciaries take a very cautious posture regarding new developments. Most fiduciaries are not early adopters and tend to be very wary when it comes to ERISA qualified plans. Typically, fiduciaries look for regulators to define the playing field, particularly what is out-of-bounds, and then they look to stay well within bounds. For ESG, the playing field has not been very well defined, so most fiduciaries have kept their distance from this area. But in 2015, DOL provided fiduciaries with much more clarity around ESG issues. However, the Trump administration must have felt that the 2015 guidance went too far, i.e., was too welcoming to ESG. So, in 2018, the DOL issued an updated perspective with the newest FAB. Overall, the newest guidance really does not change anything, it just reminds 401(k) plan fiduciaries not to use plan assets for non-ERISA purposes, e.g., social or environmental goals. Overall, plan fiduciaries should feel comfortable when considering adding ESG funds to their line-ups: Just do it for the right reasons and proceed prudently.

HOW DO ACTIVE MANAGERS DO THEIR JOBS?

In general, all active managers—even those who do not consider themselves quants—start the investment process with a quantitative analysis of the investable universe. This analysis—basic versions are available through your retail broker (e.g., Schwab, TD Ameritrade)—provide a scoring on a variety of factors. The art of active management is to use these scores plus the manager's insights into markets on future trends, demographics, etc., to select investments expected to outperform a particular benchmark that the manager is trying to beat. Because all we know for certain are the past and current market prices for a security, managers basically are trading securities back and forth based on expected future earnings of a firm.

WHY THE CONFUSION?

The DOL view, or at least the perception of its view, has changed over time from openly discouraging fiduciaries from considering such investments in 2008 to a more welcoming tone in 2015 to a more measured, cautious view in 2018. As far back as 1994, DOL struggled to provide a clear picture of its view on the subject and published Interpretative Bulletin 94-01 "to correct a popular misconception … that investments in ETIs are incompatible with ERISA's fiduciary obligations."

So it's easy to see why fiduciaries are being extra cautious when deciding whether to add ESG funds to their line-ups, let alone let them be the default option for a 401(k) plan. The DOL interpretive bulletins from 1994, 2008, and 2015 are discussed in detail below.

Interpretive Bulletin 94-01 (IB 94-01)

The stated objective of IB 94-01 is "to correct a popular misconception … that investments in ETIs are incompatible with ERISA's fiduciary obligations." IB 94-01 explained how a fiduciary should evaluate a possible investment in an ETI. Basically, it advised that if an ETI had an expected return with similar risk as an alternative investment, then the fiduciary could select the ETI provided it met diversification and other investment criteria applicable to the plan. Some practitioners have called this standard the "all things being equal" test.

Interpretive Bulletin 2008-01 (IB 2008-01)

Fourteen years later, DOL issued IB 2008-01 in an effort to clarify its position on ETIs.

At the time, multi-employer plans (MEPs), i.e., plans that cover an entire industry (such as the construction industry) in a region or nationwide, were calling for the use of ETIs. IB 2008-01 cited a specific example of an MEP that wanted to make an investment in a project that would provide jobs to its participants. Even though the investment provided a market-rate risk and return profile, the plan already had other investments in the local area and this new investment would increase its concentration risk—thus exposing the plan to possible large loss due to lack of diversification. IB 2008-01 cited this increased concentration risk as the reason why a fiduciary may not choose this investment.

IB 2008-01 also addressed adopting an investment policy that uses environmental criteria—"green screens." It warned fiduciaries that they could not "simply consider investments only in green companies."

IB 2008-01 said that fiduciary consideration of non-economic factors should be "rare and, when considered, should be documented in a manner that demonstrates compliance with ERISA's rigorous fiduciary standards." This language was interpreted by most everyone involved in ERISA plans as essentially prohibiting investment in ESG type funds and projects. The DOL itself later would concede that this IB set a "higher and unclear standard" for fiduciaries reviewing ETIs.

Interpretive Bulletin 2015-01 (IB 2015-01)

With ESG funds gaining traction within the investment universe and research showing that ESG factors improve investment results, DOL revisited the issue in 2015. IB 2015-01 was also the first DOL interpretative bulletin to specifically mention ESG factors, not just ETIs.

In IB 2015-01, DOL stated that IB 2008-01 "unduly discouraged fiduciaries from considering ETIs and ESG factors." Specifically, DOL was concerned that:

> *the 2008 guidance may be dissuading fiduciaries from (1) pursuing investment strategies that consider environmental, social, and governance factors, even when they are used solely to evaluate the economic benefits of investments and identify economically superior investments, and investing in ETIs even where economically superior.*

So, the DOL withdrew IB 2008-01, reinstating IB 94-01.

From a fiduciary standpoint, one could argue that DOL was flip-flopping on this issue. To ensure no misunderstandings, DOL spent more than two pages on just the background in IB 2015-01 and only about half a page on the actual effective language. Clearly, DOL did not want any misunderstandings this time around and wanted to reiterate the core fiduciary standards within ERISA using language set out below:

- The focus of plan fiduciaries on the plan's financial returns and risk to beneficiaries must be paramount.
- Fiduciaries may not use plan assets to promote social, environmental, or other public policy causes at the expense of financial interests of the plan participants.
- Do not permit fiduciaries to sacrifice the economic interests of plan participants … in order to promote collateral goals.

DOL also emphasized that it has consistently recognized that fiduciaries could consider "collateral benefits" as tie-breakers—harkening back to the IB 94-01 "all things being equal" test.

With all this background, IB 2015-01 goes on to address ESG by providing fiduciaries with a road map to complying with ERISA fiduciary standards.

First, IB 2015-01 recognizes ESG as a possibly reasonable investment strategy:

> *Environmental, social and governance issues may have a direct relationship to the economic value of the plan's investment. In these instances, such issues are not merely collateral considerations or tie-breakers, but proper components of the fiduciary's primary analysis of the economic merits of competing investment choices.*

Second, IB 2015-01 distinguishes ESG from prior exclusionary and disinvestment strategies and accepts that ESG can form part of a reasonable overall investment strategy:

> *… if a fiduciary prudently determines that an investment is appropriate based solely on economic considerations, including … environmental, social and governance factors, the fiduciary may make the investment without regard to any collateral benefits …*

Thirdly, IB 2015-01 attempts to remove the perceived stigma attached to ESG due to prior DOL guidance:

> *Fiduciaries need not treat commercially reasonable investments as inherently suspect or in need of special scrutiny merely because they take into consideration environmental, social, or other such factors.*

Finally, because fiduciary standards emphasize process over results, IB 2015-01 clearly states that fiduciaries should use their normal procedures to review ESG investments:

> *… the Department does not construe consideration of ETIs or ESG criteria as presumptively requiring additional documentation or evaluation beyond that required by fiduciary standards applicable to plan investments generally.*

For completeness, IB 2015-01 also included language applicable to 401(k) plans looking for 404(c) compliance. Basically, it stated that all the above applies to those standards as well.

A CLOSER LOOK AT FAB 2018-01

FAB 2018-01 represents the Trump administration's opinion on this subject. As with previous guidance, it starts with the North Star of fiduciary standards, namely that "fiduciaries may not sacrifice investment returns or assume greater investment risks as a means of promoting collateral social policy goals." It then reiterates the position of IB 2015-01:

> *If a fiduciary 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.*

FAB 2018-01 goes on to clarify that these "collateral issues are themselves appropriate economic considerations, and thus should be considered by a prudent fiduciary … In other words, in these instances, the factors are more than mere tie-breakers." Further, it cautions fiduciaries that simply because an investment strategy uses ESG factors does not make it prudent from an ERISA fiduciary standard:

> *It does not ineluctably follow from the fact that an investment promotes ESG factors … that the investment is a prudent choice …*

FAB 2018-01 then addresses the issue of the investment policy statement (IPS), seeking to clarify issues brought up in past investment bulletins. FAB 2018-01 reiterates that investment policy statements do not need to contain guidelines on ESG investments, but that if an IPS does contain ESG guidelines, it may not be prudent for plan fiduciaries, including ERISA Section 3(38) investment managers, to always follow them. Specifically, FAB 2018-01 states that "if it is imprudent to comply with the investment policy statement in a particular instance, the manager must disregard it." It's unclear why DOL provided such a strong statement in this FAB. Perhaps it was worried that a plan sponsor—perhaps a mission-oriented nonprofit—could adopt an IPS saying something like "we will follow ERISA fiduciary standards as well as the ideals outlined in the mission statement of our organization." This type of IPS would seem to go too far; the plan fiduciaries have overreached and the investment manager would not be able to fulfill its duties to the participants.

IMPACT ON 401(K) PLANS

Finally, FAB 2018-01 specifically addresses 401(k) plans by drawing a clear distinction between the fiduciary decisions regarding selection of a qualified default investment alternative (QDIA) and simply adding another investment alternative to the plan line-up. In short, DOL is comfortable with adding a "prudently selected, well managed and properly diversified ESG-themed investment" because it does not require "the plan to forego adding other non-ESG-themed investment options." However, FAB 2018-01 emphasizes that QDIA selection is significantly different—and rightly so—saying, "Nothing in the QDIA regulations suggests that fiduciaries should choose QDIAs based on collateral public policy goals." FAB 2018-01 reiterates that plan fiduciaries looking to select an ESG-themed target-date fund as a QDIA must do so without regard to any other collateral benefits. The ESG-themed target-date fund must stand on its own merits in a straight-up comparison with any other QDIA alternatives. DOL is clearly seeing the choice of QDIA as a critical fiduciary duty that deserves special attention. Using this same logic, plan fiduciaries also would be wise to review their QDIA selection process especially if using the target-date funds of the plan administrator. Any collateral benefits from use of proprietary target-date series may not be considered prudent based on the opinion contained within FAB 2018-01.

WHERE DOES THIS LEAVE ERISA PLAN FIDUCIARIES, ESPECIALLY 401(K) PLAN SPONSORS?

Clearly, ESG investing continues to be a concern for DOL. ESG investment strategies continue to grow, accounting for more than $16 trillion of actively managed equity and more than $26 trillion

BACKGROUND ON DOL REGULATIONS AND GUIDANCE

DOL is tasked with regulating issues affecting employment, including 401(k) and pension plans. In this role, DOL must enforce the employment laws passed by Congress.

To do this, DOL publishes regulations, its highest form of policy making. The process for publishing new regulations is significant. Initial rules are published, public commentary is solicited, updated rules are published, then final rules are published. This process usually is measured in years from start to finish. In many cases, DOL wants to provide guidance on issues but does not want to go through this laborious process. In these cases, DOL can issue guidance using a less-formal method to provide information to pension professionals, attorneys, plan sponsors, and other interested parties.

- Advisory Opinions and Exemptions (e.g., class, individual) are binding on the parties to whom the guidance is issued. Field Assistance Bulletins, Information Letters/Bulletins, and Technical Releases are nonbinding guidance provided to broad audiences (e.g., employers, plan officials, service providers, etc.).
- Interpretive Bulletins (IBs) provide a current sense of the administration's position and do not go through the long review process of regulations. New administrations often publish IBs to "clarify" IBs issued by prior administrations.
- Field Assistance Bulletins (FABs) provide guidance in response to questions that have arisen in field operations, e.g., audits, or questions from fiduciaries or participants. You can almost think of FABs as internal memos that help DOL staff members provide answers to questions they may receive in the course of their work.

As with all issues relating to fiduciary compliance, we would recommend you seek the advice of qualified ERISA legal counsel.

ERISA FIDUCIARY STANDARD REGARDING INVESTMENTS

Any fiduciary of an ERISA plan, whether a traditional pension plan or a 401(k) plan, is subject to ERISA fiduciary standards. The four principles of ERISA fiduciary standards are:

1. Act solely in the interests of participants and beneficiaries for the exclusive purpose of providing benefits and defraying reasonable expenses.
2. Act with the care, skill, prudence, and diligence that a prudent man familiar with such matters would use—sometimes called the prudent expert rule.
3. Diversify investments so as to minimize large losses.
4. Act in accordance with plan documents.

PARTICIPANT-DIRECTED 401(K) PLANS

Under ERISA Section 404(c), fiduciaries have safe harbor protections. That is, if they comply with ERISA rules, fiduciaries are not to be held responsible for individual participant elections.

QDIA

Following all this, the Pension Protection Act of 2006 provided additional guidance on QDIAs focused on participants who do not exercise their right to make an election. If fiduciaries pick a QDIA, then the fiduciaries would not be held responsible for participants who do not make an active election. Both 404(c) and QDIA regulations hark back to the original fiduciary standards of ERISA from 1974.

of actively managed fixed income, as reported in the UN PRI 2018 annual report. So, this issue is not going away.

FAB 2018-01 seeks to provide more clarity around DOL thinking about how plan fiduciaries can implement ESG investments within the confines of ERISA qualified plans. The primary investment guideline for ERISA fiduciaries continues to be to select prudent, well-diversified funds with reasonable risk-reward tradeoffs. ESG funds should be evaluated alongside other competing fund alternatives—ESG or not—and should be subject to the fiduciary's normal due diligence process. In particular, FAB 2018-01 highlights the extra special concern for QDIA selection.

To illustrate the current DOL point of view, consider the following two possible investment processes that a fiduciary may use to select a QDIA:

Process A: complete universe of potential target-date funds

1. Review all target-date funds available on your recordkeeper's platform with more than three-year track records.
   a. Eight "normal" target-date funds and three "ESG" target-date funds meet this criteria.
2. Review performance, risk, fees, manager tenure, and other factors to meet minimum threshold for plan fiduciary's normal process.
   a. Four "normal" and two "ESG" meet this criteria.
3. Review glide path and other risk metrics specific to QDIA selection and plan's participant profile.
   a. Two "normal" and one "ESG" meet this criteria.
4. Make final selection that best fits plan's needs.
   a. Pick ESG target-date series from Company XYZ.

Process B: ESG only

- Same process as above, except just look at ESG-only target-date funds.
- Final selection: XYZ ESG Target Date Fund

Even though the same result occurred—you picked XYZ's ESG Target Date Fund—FAB 2018-01 suggests that Process B may not be a prudent process because you limited your search to simply ESG target-date funds.

So, by adopting, following, and documenting a prudent investment selection process, fiduciaries should feel confident when evaluating whether to add ESG funds to their plan line-ups.

TARGET-DATE STYLE BIAS—IS ESG ANY DIFFERENT?

When selecting a target-date series, plan sponsors spend most of their time on the asset allocation glide path and overall performance of the fund, and rightly so. Most fiduciaries do not dig very deeply into the underlying funds that make up the actual target-date fund; most are simply satisfied if the overall asset allocation is okay and overall performance is okay. However, with proprietary target-date series that come from one investment family, you also are selecting the style bias of that particular firm. For example, a leading provider of target-date funds has a significant growth bias for all of its equity portfolios, and therefore so do its target-date funds. There is no difference in selecting an ESG target-date fund, which has an ESG bias.

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