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Are the Reports that the DOL Guidance Will Lead to the Demise of ESG-Focused Plans Greatly Exaggerated?

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Last week the U.S. Department of Labor (DOL) **issued a bulletin (the Bulletin)** on its prior interpretations related to considerations of ESG factors by ERISA plan fiduciaries. Since then there has been some speculation that perhaps the positions outlined in the Bulletin would act as a speed bump to the increasing focus by investors on ESG matters at public companies.

As background, ERISA requires plan fiduciaries to act solely in the interest of plan participants and beneficiaries for the exclusive purpose of providing benefits to such persons and to discharge their fiduciary duties with the care, skill, prudence and diligence a prudent person would use under similar circumstances. Companies should be aware that the Bulletin is applicable only to fiduciaries of ERISA plans, which include private sector company-sponsored retirement plans (such as a company's own defined benefit pension plans and 401(k) plans) and union pension plans. Managers of private investment funds are bound by the Bulletin only if their funds are subject to ERISA (many private investment funds are not). Managers of mutual funds and governmental pension funds are not bound by the Bulletin as these funds are not subject to ERISA and therefore not subject to DOL oversight.

Effect on Investment Decisions. The Bulletin makes clear that plan fiduciaries in managing and investing plan assets cannot assume greater investment risks, or sacrifice investment returns, to fulfill social policy goals. The Bulletin states that this is a longstanding DOL position. The economic interests of the plan in providing retirement benefits must always be at the forefront of investment decisions. But social policy issues, which might otherwise be considered "collateral issues," could be treated by plan fiduciaries like any other economic consideration when those issues present material business risk or opportunities that officers and directors need to manage as part of their companies' business plans.

In other words, plan fiduciaries cannot focus on ESG factors solely to benefit the greater societal good, or assume that ESG factors that promote positive market trends are by their nature economically relevant. However, ESG factors or tools, metrics or analyses can be evaluated if fiduciaries believe they would impact an investment's risk or return.

Effect on Proxy Voting and Shareholder Engagements. Fiduciaries can participate in proxy voting and other shareholder engagement activities if there is a reasonable expectation that such activities are likely to enhance the economic value of the investment after taking into account the costs involved. The Bulletin indicates that when the plan is just one of many investors, it may not be appropriate to "incur significant expense to engage in direct negotiations with the board or management," or for plan fiduciaries to incur such expenses to "fund advocacy, press, or mailing campaigns on shareholder resolutions, call special shareholder meetings, or initiate or actively sponsor proxy fights on environmental or social issues."

But the Bulletin, which uses variations of "significant" seven times in its brief four and a half pages, also states that there may be times when it would be a "prudent approach" to spend reasonable expenditures to actively engage with company management, if it involved, for example, "significantly indexed portfolios" and important ESG issues that present "significant operational risks and costs" to businesses that are "clearly connected" to long-term value creation. In essence, the cost of the activity must be justified relative to the expected economic benefit.

Increase in ESG Fund Activity. **As the WSJ reported**, assets invested in ESG funds are up nearly 60% from the prior year, **as private equity** and **hedge funds** have also started participating in these offerings. ESG funds are being marketed by Wall Street as a "bankable trend." However, few 401(k) plans, or just 2.4%, offer ESG funds as an

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investment option and the Bulletin’s primary impact may be in limiting those offerings when retirement assets are involved.

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