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ESGs – Perspectives of the OECD and New US Guidance

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We've been writing about trends in application of environmental, social and governance (ESG) factors in pension investing for a while. For some time, the OECD Working Party on Private Pensions (WPPP) has been exploring the application of the fiduciary rules to ESG investing, including issuing papers arguing that the traditional fiduciary rule may be hindering the application of ESG factors in pension investing and that laws should perhaps move towards the "universal owner" theory of investing (investing to support "global economic health"). In 2017, we commented on some of the new developments at the joint OECD Working Party on Private Pensions (WPPP) meeting with the International Organisation of Pension Supervisors (IOPS), an organization made up of the pension regulators of most countries (though not the US), where one of the topics was a proposed revision to the joint OECD/IOPS "Principles of Private Pension Supervision" to add a provision that pension supervisors identify, monitor and analyze ESG factors that may impact pension funds and pension markets and use this information in the supervision of the funds. During this time there has also been growing emphasis at the WPPP on "value for money" in pension investing. And while this has been going on, ESG investing has also become a part of the directive on cross border pensions in Europe, known as IORP II.

Most recently, the US Department of Labor (DOL) has weighed in with new guidance on ESG factors in pension investing. It is not the first time it has done so – the DOL issued guidance in the area in 1994 (under the Clinton administration), 2008 (the last Bush administration), 2015 (the Obama administration) and now 2018 (the Trump administration). Interestingly, the underlying statute and regulations on pension investing have not changed this entire time. They remain as they did when they came into effect in the mid-1970's. That law, the Employee Retirement Income Security Act of 1974 (ERISA) requires fiduciaries to act "solely" in the interest of a plan's participants and beneficiaries and for the "exclusive purpose" of providing benefits and paying reasonable administrative expenses. Arguably, the pronouncements over the years have made little substantive impact, more signaling minor gradations of emphasis than changes in interpretation. However, the area remains a politically charged one, and thus is constantly debated.

This brings us to the most recent DOL guidance – a fairly informal issuance known as a Field Assistance Bulletin (FAB). The FAB, as it is called, hits several themes, and we will quote from some relevant parts of it to let it speak for itself:

Economically Targeted Investing – Caution About Making Assumptions

First, while DOL continues to acknowledge that ESG factors can be a "tie-breaker" in making investment decisions, it cautions plan fiduciaries against converting factors that could be collateral benefits into relevant investment return economic factors, such as by concluding that the ESG factors "promote positive general market trends or industry growth." Instead, the FAB states that fiduciaries must "not too readily treat ESG factors as economically relevant." In particular, the FAB suggests that ESG must "present material business risk or opportunities that company officers and directors need to manage as part of a business plan and that qualified investment professionals would treat as economic consideration under generally accepted investment theories."

ESG and Defined Contribution Plans

Given the shift form defined benefit (DB) to defined contribution (DC) plans in recent years, it has seemed likely that the application of ESG investing to DC investment line-ups would receive more attention. The FAB addresses the subject, stating that "a prudently selected, well managed, and properly diversified ESG themed investment alternative could be added to the available investment options on a 401(k) plan platform without requiring the plan to forgo adding other non-ESG-themed investment options to the platform." However, DOL then goes on to discourage the use of ESG-themed options as default investments (known in the US as qualified default investment alternatives or QDIAs, often target date funds): "Nothing in the QDIA regulation suggests that fiduciaries should choose QDIAs based on collateral public policy goals." In fact, the DOL hypothesizes that plan participants could have competing views on the benefits of specific forms of ESG investing and that a fiduciary could thus violate his or her duty of loyalty by favoring some participants' views on ESGs over others. DOL also muddies its guidance, though, by distinguishing in a footnote between "non-ESG-themed investment funds" that incorporate ESG factors in investment selection and proxy voting and "ESG-themed funds" (e.g., socially responsible Index funds, religious belief-based investment funds, and environmental and sustainable investment funds), without much explanation.

Expense of Shareholder Engagement Activities

Concerning proxy voting and other shareholder activities, the FAB touches on prior guidance that characterized these activities as permissible because they "typically do not involve a significant expenditure of funds."

In the new FAB, the DOL states that this prior guidance"was not meant to imply that plan fiduciaries, including appointed investment managers, should routinely incur significant plan expenses to, for example, 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 relating to such companies." The DOL cautions fiduciaries who believe there are special circumstances that warrant "routine or substantial" shareholder engagement expenditures to document an "analysis of the cost of the shareholder activity compared to the expected economic benefit (gain) over an appropriate investment horizon." Thus, DOL appears to be signaling that, as a matter of enforcement, it will require additional documentation regarding the economic value of significant expenditures of plan assets for shareholder activism.

Left unsaid is whether this question of "value for money" could be a relevant question in selecting defined contribution plan line-ups to include ESG-themed funds as well.

Conclusion

What will the impact of this new DOL guidance be? It is hard to say at this point, particularly because, as noted above, the underlying law has not changed. But it is unlikely to stop debate on ESGs and pension investing. In our globalized economy, it will be important to watch how these debates taking place in different countries impact each other.

If you have questions about this area of the law, please contact David W. Powell or your regular Groom lawyer.

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