MAY 2018

DEPARTMENT OF LABOR'S FIELD ASSISTANCE BULLETIN ON ESG INVESTING

On April 23, 2018 the US Department of Labor (DOL) issued Field Assistance Bulletin (FAB) 2018-01 which provides guidance to the national and regional offices of the DOL's Employee Benefits Security Administration for applying Interpretive Bulletins (IBs) 2015-01 and 2016-01, which address ESG investing and proxy voting responsibilities, respectively. While not overturning the prior IBs[1], the FAB strikes a more cautious tone about ESG investing than the IBs, which were issued under the previous administration. In particular, the FAB may warrant attention by plan fiduciaries in the following circumstances (language in quotations in the following bullets is from the FAB):

- *The treatment of ESG factors in investment decision making generally.* The FAB clarifies that ESG factors should be considered based on their economic or financial impact on an investment and non-financial ESG considerations may be used to choose between largely equal alternatives. For example, where a fiduciary is considering the inclusion of ESG factors in the plan's investment policy statement (IPS) it would be sensible to assess whether those factors contribute to an analysis "based solely on economic factors" and that "the weight given to [ESG] factors [is] appropriate to the relative level of risk and return involved compared to other relevant economic factors."

- *The addition of so-called ESG-themed funds[2] to a plan's lineup.* Where a fiduciary is considering adding an ESG-themed fund option to its plan, the FAB indicates that a fiduciary should consider whether the option constitutes "a prudently selected, well managed, and properly diversified ESG-themed investment alternative" and does not "require the plan to remove or forgo adding other non-ESG-themed investment options to the platform."

- *The consideration of an ESG-themed fund as a QDIA.* The FAB suggests that it would not be prudent to designate an ESG-themed Target-Date Fund (TDF) as the plan's Qualified Default Investment Alternative (QDIA) "if the fund would provide a lower expected rate of return than available non-ESG alternative target date funds with commensurate degrees of risk, or if the fund would be riskier than non-ESG alternative available target date funds with commensurate rates of return." As such adding an ESG-themed TDF as a QDIA would be permissible if it has equivalent or better risk/return prospects when compared to available non-ESG-themed alternatives though reasonably demonstrating the risk/return merits of the option would seem to be a prerequisite.

- *The extent to which expenses incurred by the plan in exercising shareholder rights and/or engaging with companies in which the plan owns stock are appropriate.* While the FAB does not alter the DOL's position that proxy voting is a shareholder right which must be exercised by plan fiduciaries and investment managers in accordance with fiduciary duties, including those of prudence, loyalty and impartiality, when considering undertaking a corporate engagement strategy focusing on environment or social issues it is important that the plan fiduciary can justify and substantiate any related "routine or substantial" expenses incurred as being in the economic interests of the plan.

- To the extent a fiduciary has already incorporated ESG factors into its investment process, selected an ESG-themed fund (particularly as a QDIA), and/or engages in active ownership practices, it may be prudent to conduct a review of these processes and practices in view of the recent FAB.

Consistent with a large and growing body of research linking ESG factors to positive company financial performance outcomes[3], Mercer believes that environmental, social and governance (ESG) factors can have a material impact on long-term risk and return outcomes[4] and therefore may be an appropriate consideration for ERISA fiduciaries to take into account when determining how to invest plan assets. Mercer has been advising investors of all types and sizes worldwide on how to incorporate ESG factors into their investment programs for well over a decade. To support provision of this advice, alongside typical outperformance ratings Mercer also assigns ESG ratings to investment strategies as part of its manager research process. This information helps clients distinguish between ESG leaders and laggards and, along with a host of additional analyses, supports the assessment of the merits of different fund options, ESG-themed or otherwise. This being said, Mercer is not a law firm and does not provide legal advice. Clients may wish to consult their ERISA counsel regarding the impact of the FAB, if any, on the fiduciary's investment processes and/or practices.

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FOOTNOTES

[1] A FAB typically cannot change the substance of pre-existing regulations unless it was subject to public notice and comment, which 2018-01 was not (Source: https://www.groom.com/resources/dol-and-esg-investing-evolving-guidance/).

[2] Defined in the FAB as a “e.g. Socially Responsible Index Fund, Religious Belief Investment Fund, or Environmental and Sustainable Investment Fund…[and] distinguished from non-ESG-themed investment funds in which ESG factors may be incorporated in accordance with IB 2015-01 and IB 2016-01 as one of many factors in ordinary portfolio management and shareholder engagement decisions.”

[3] E.g. the 2015 metanalysis linked in this footnote showed that the majority of over 2000 primary studies found a positive correlation between ESG factors and company financial performance and over 90% showed a non-negative relationship: https://www.db.com/newsroom_news/K15090_Academic_Insights_UK_EMEA_RZ_Online_EN_151216_R2a.pdf

[4] https://www.mercer.com/our-thinking/wealth/mercer-investments-beliefs.html

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