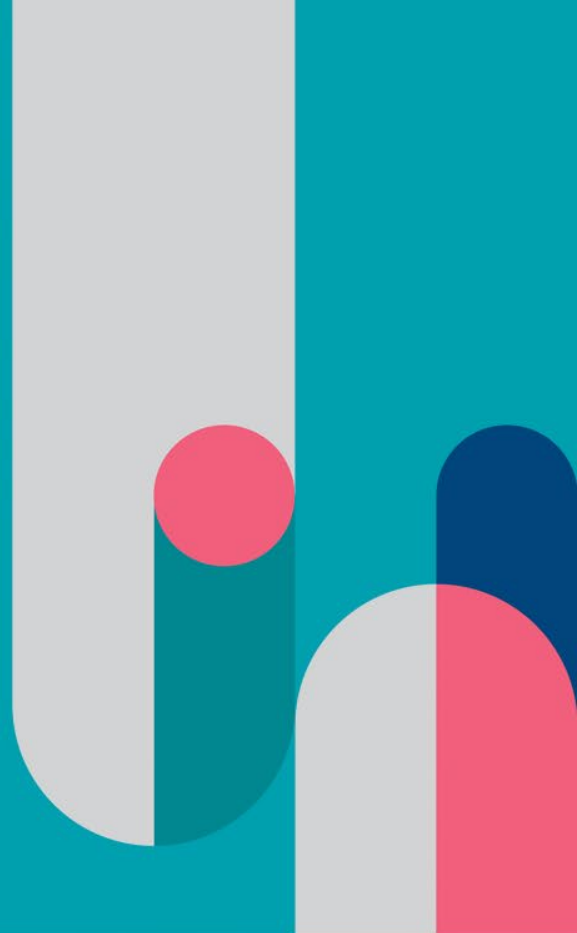




ESG and ERISA: Has the Pendulum Stopped Swinging?

Jim Griffin

Dallas/Fort Worth Chapter
November 9, 2023



Dallas/Fort Worth Chapter

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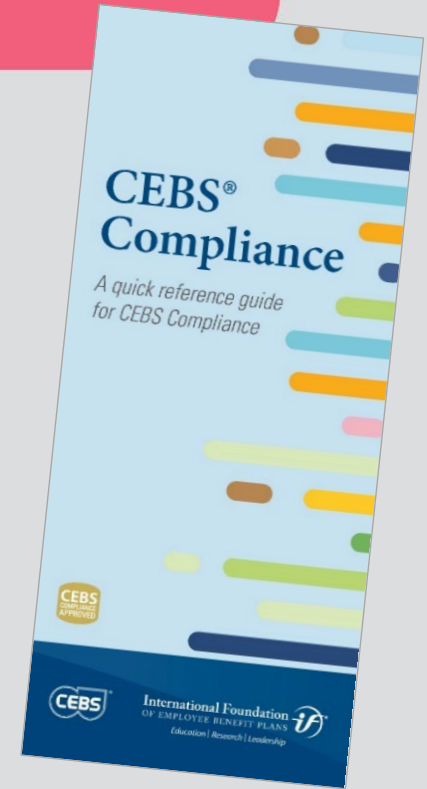
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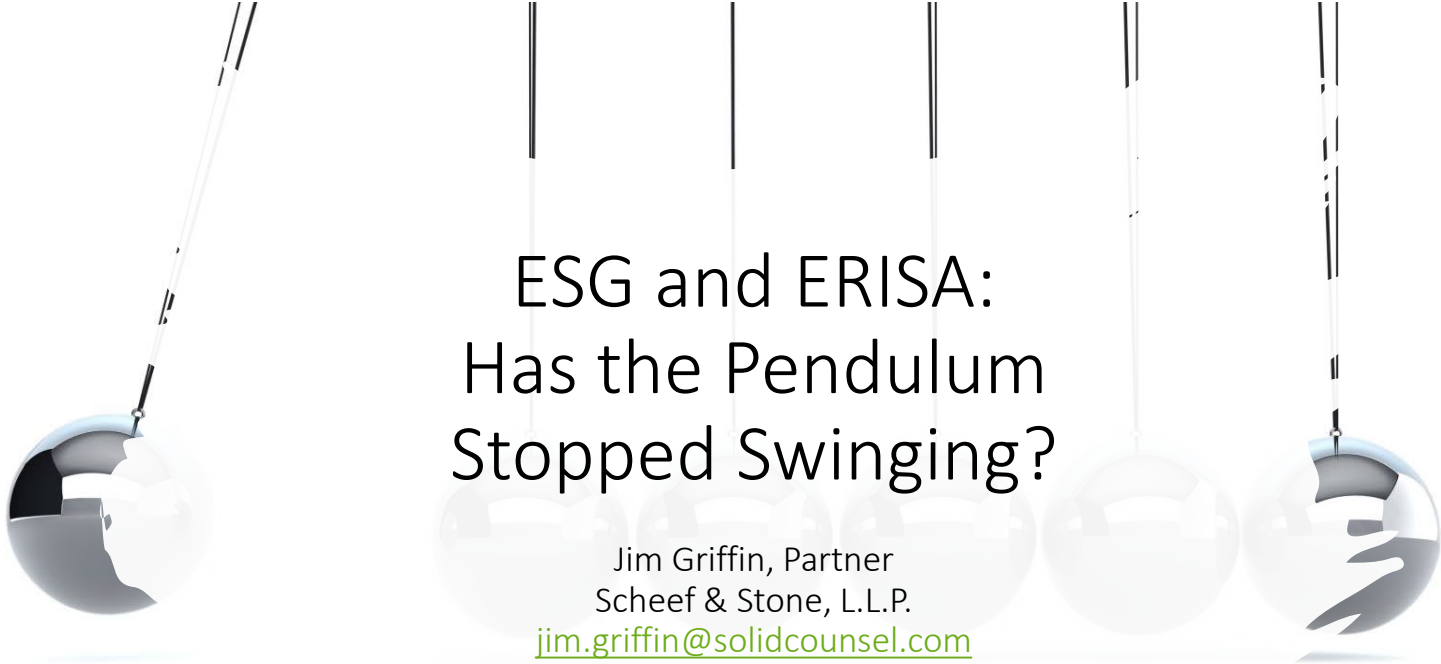
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Today's Speaker & Topic

Jim Griffin

**ESG and ERISA:
Has the Pendulum Stopped Swinging?**



ESG and ERISA: Has the Pendulum Stopped Swinging?

Jim Griffin, Partner
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Presented to:
Dallas/Fort Worth Chapter
ISCEBS

November 9, 2023

ESG

Environmental

- Waste and pollution
- Resource depletion
- Greenhouse gas emission
- Deforestation
- Climate change

Social

- Employee relations and diversity
- Working conditions
- Local communities
- Health and safety
- Conflict

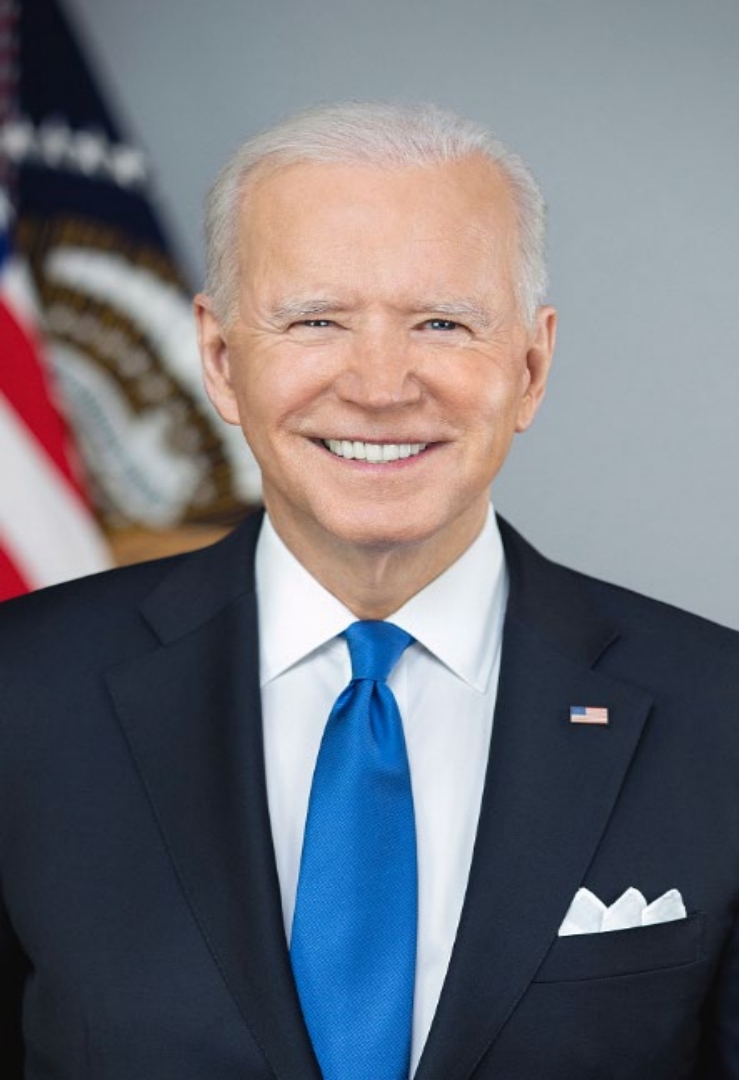
Governance

- Tax strategy
- Executive remuneration
- Donations and political lobbying
- Corruption and bribery
- Board diversity and structure

2020 Final Rules

- Fiduciary Duties Regarding Proxy Voting & Shareholder Rights
 - 85 Fed. Reg. 81,658
 - December 16, 2020
- Financial Factors in Selecting Plan Investments
 - 85 Fed. Reg. 72,846
 - November 13, 2020





2022 Final Rules

- Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights
 - 87 Fed. Reg. 73,822
 - December 1, 2022
- Effective January 30, 2023

2022 Final Rule Highlights

- A fiduciary is permitted, but not required, to consider the economic effects of climate change and other ESG factors on the investment at issue—Prudence (b)(4)
- A fiduciary may consider “collateral benefits” when competing investments equally serve the financial interest of the plan—Loyalty (c)(2)
 - Remove the documentation requirement
 - Remove the “indistinguishable” requirement
 - Add “appropriate investment/time horizon”
- A fiduciary may consider participant preference—Loyalty (c)(3)
- Repealed the ban on use of ESG in QDIAs

(b)(4)—Prudence

A fiduciary's determination with respect to an investment or investment course of action must be based on factors that the fiduciary reasonably determines are **relevant** to a risk and return analysis, using **appropriate investment horizons** consistent with the plan's investment objectives and taking into account the funding policy of the plan established pursuant to section 402(b)(1) of ERISA. **Risk and return factors may include the economic effects of climate change and other environmental, social, or governance factors on the particular investment or investment course of action.** Whether any particular consideration is a risk-return factor depends on the individual facts and circumstances. The weight given to any factor by a fiduciary should appropriately reflect a reasonable assessment of its impact on risk-return.

(c)(2)—Loyalty

If a fiduciary prudently concludes that competing investments, or competing investment courses of action, **equally serve** the financial interests of the plan over the **appropriate time horizon**, the fiduciary is not prohibited from selecting the investment, or investment course of action, based on **collateral benefits** other than investment returns. A fiduciary may not, however, accept expected reduced returns or greater risks to secure such additional benefits.

ERISA Highlights

Plans, Participants and Assets

747,000 retirement plans

2.5 million health plans

673,000 other welfare benefit plans

152 million workers

\$12 trillion in plan assets

Participant Demand for ESG

- Often or exclusively use investments that take ESG factors into account (CNBC, 2021)
 - 33% of Millennials—age 27 to 42
 - 19% of Gen Z—age 11 to 26
 - 16% of Gen X—age 43 to 58
 - 2% of Baby Boomers—age 59 to 77
- 69% of DC plan participants said that they would increase their overall contribution rate if they were offered an ESG option (Schroders, 2021)
- 20% of DB and DC plans consider ESG factors (Callan, 2021)
- 36% of 100+ participant plans use ESG (Morningstar comment letter)
- 5% of 401(K) plans have at last 1 ESG themed investment (PSCA, 2021)

ERISA 403(c) Use of Plan Assets

The assets of a plan shall never inure to the benefit of any employer and shall be held for the exclusive purposes of providing benefits to participants in the plan and their beneficiaries and defraying reasonable expenses of administering the plan.

ERISA 404(a)(1)

Fiduciary Duties

A fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and—

(A) for the exclusive purpose of:

(i) providing benefits to participants and their beneficiaries; and

(ii) defraying reasonable expenses of administering the plan;

(B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;

(C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and

(D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this title and title IV.

DOL Sub-Regulatory Guidance

- **DOL Adv. Op. 88-16A**—A decision to make an investment may not be influenced by non-economic factors unless the investment, when judged solely on the basis of its economic value to the plan, would be equal or superior to alternative investments available to the plan
- **I.B. 1994-01**—a fiduciary may not subordinate the interests of participants in their retirement income to unrelated objectives, but a fiduciary may select an economically targeted investment that serves economic objectives in addition to providing a comparable risk and rate of return
- **I.B. 2008-01**—fiduciaries may not select investments on the basis of any factor outside the economic interest of the plan **except in very limited circumstances**
- **I.B. 2015-01**—increased flexibility to use collateral factors, including ESG factors, in a fiduciary's investment decision-making
- **FAB 2018-01**— limiting consideration of ESG as an economic consideration

Selected Supreme Court ERISA Decisions

- **Fifth Third Bancorp v. Dudenhoeffer**, 573 U.S. 409, 421 (2014)—The term “benefits” in ERISA refers to financial benefits (such as retirement income) and does not cover nonpecuniary benefits
- **Tibble v. Edison Int’l**, 575 U.S. 523 (2015)—A fiduciary has a continuing duty to monitor investments and remove imprudent ones
- **Thole v. U.S. Bank, N.A.**, 590 U.S. ____ (2015)—Plaintiffs had no Article III standing to assert claims for investment loss in a defined benefit pension plan
- **Hughes v. Northwestern University**, 595 U.S. ____ (2022)—courts must give due regard to the **range of reasonable judgments** a fiduciary may make based on her experience and expertise

ESG: Names & Meaning



ESG By Any Other Name

- Environmental, Social and Governance
- Socially Responsible Investing
- Impact Investing
- Mission-Related Investing
- Standing For Something More
- Supporting Societal Change Through Investing
- Sustainability Investing
- Economically Targeted Investing
- People Over Profits

ESG

Environmental

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Social

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- Health and safety
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Governance

- Tax strategy
- Executive remuneration
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- Board diversity and structure

Financial Factors Listed In the Preamble

- operating and financial history
- capital structure
- long-term business plans
- debt load
- capital expenditures
- price-to-earnings ratios
- operating margins
- projections of future earnings
- sales
- inventories
- accounts receivable
- quality of goods and products
- customer base
- supply chains
- barriers to entry

Special Interest Groups on Both Sides

FOR USE OF ESG

- International Sustainability Standards Board (ISSB)
- Principles of Responsible Investment (PRI) (affiliated with UN)
- Forum For Sustainable and Responsible Investment
- Net Zero Asset Manager
- Climate Action 100+
- As You Sow

AGAINST USE OF ESG

- Marble Freedom Trust
- CRC Advisors
- Consumers' Research
- Heritage Foundation
- State Financial Officers Foundation
- American Accountability Foundation
- American Legislative Exchange Council
- 1792 Exchange

Litigation and Legislation





American Airlines 401(k) Lawsuit (filed June 2, 2023)

“Many American workers don’t realize that their hard-earned money is being used against them. Firms whose job is to deliver investment returns are instead **weaponizing retirement funds**, public pensions and other investments in pursuit of nakedly ideological goals. It is perhaps the most severe breach of the fiduciary standard in American history.”

Marlo Oaks & Todd Russ, Editorial, A Historic Breach of Fiduciary Duty, Wall Street Journal, May 15, 2023

- 
- American Century Sustainable Equity Fund I
 - Artisan Sustainable Emerging Markets Fund
 - Brown Advisory Sustainable Growth Fund
 - Domini Impact International Equity Fund
 - Green Century Balanced Fund
 - Parnassus Mid Cap Growth
 - Parnassus Mid Cap Fund Institutional
 - Parnassus Endeavor Fund
 - Pax Small Cap Fund
 - Pax Elevate Global Women's Leadership Fund
 - PFG BR Equity ESG Strategy Fund Class R Shares
 - Praxis Growth Index Fund
 - USAA Sustainable World Fund

AMG GW&K ESG Bond Fund
Boston Trust Walden Small Cap Fund
CCM Community Impact Bond Fund
Firsthand Alternative Energy Fund
JPMorgan U.S. Sustainable Leaders Fund
Parnassus Core Equity Investor Fund
Parnassus Fixed Income Fund
Pax Large Cap Fund
Pax Sustainable Allocation Fund
Pax Global Environmental Markets
PFG Invesco Thematic ESG Strategy
Shelton Green Alpha Fund

Investment Company ESG Policy Mandates Reflected in Proxy Voting

- Examples
 - Divesting in oil & gas stocks
 - Banning plastics
 - Requiring “net zero” emissions
 - Imposing “diversity” quotas in hiring
- “None of the proposals were supported by management at the targeted companies, and the investment managers’ votes were typically made without the approval, or even the awareness of Plan participants.”

Congressional Action

- H.J. Res. 30 providing for Congressional disapproval of the 2022 Regulations
- House, February 28, 2023, 216-204 in favor of resolution
- Senate, March 1, 2023, 50-46 in favor of resolution
- President, March 20, 2023, Vetoed
- House, March 23, 2023, 219-200 failed to override the President's veto

Message to the House of Representatives President's Veto of H.J. Res 30

- There is extensive evidence showing that environmental, social, and governance factors can have a material impact on markets, industries, and businesses. But the Republican-led resolution would force retirement managers to ignore these relevant risk factors, disregarding the principles of free markets and jeopardizing the life savings of working families and retirees. In fact, this resolution would prevent retirement plan fiduciaries from taking into account factors, such as the physical risks of climate change and poor corporate governance, that could affect investment returns.
- Retirement plan fiduciaries should be able to consider any factor that maximizes financial returns for retirees across the country. That is not controversial — that is common sense.

Republican Attorney General Litigation

- Utah v. Walsh
- U.S. District Court, Northern District of Texas, Amarillo Division
- Filed January 26, 2023
- 2:23-cv-00016-Z
- 25-state coalition
- On appeal to 5th Circuit in New Orleans
- Final Rule leaves undefined both
 - E, S, & G
 - Time period
- Considering ESG will complicate and increase monitoring costs
- Final Rule will restrict access to capital
- Allows fiduciaries and investment managers to pursue their own ESG policy preferences

Alleged Defects of the 2022 Final Rule

- Exceeds DOL's statutory authority in violation of ERISA and the APA
 - Arbitrary & capricious
 - Override ERISA's plain text
 - Conflicts with ERISA's undivided loyalty requirements, including the "exclusive benefit" rule and "sole benefit" rule
 - Dudenhoeffer's interpretation focusing on financial benefits and not any nonpecuniary benefit
 - Congress did not leave room for ESG in ERISA
- Major question doctrine
 - Given the sheer magnitude of the assets that the 2022 Final Rule would affect, courts should hesitate before finding that DOL has authority to permit consideration of ESG

Participant Litigation

- Braun v. Walsh
- U.S. District Court Eastern District Of Wisconsin, Milwaukee Division
- Filed February 21, 2023
- 2:23-cv-00234

Causes of Action

1. APA

- Conflicts with the statutory text and structure of ERISA and decades of case law and is therefore arbitrary, capricious, an abuse of discretion and not in accordance with law
- Violates Constitutional Separation of Powers because the 2022 final rules exceed DOL statutory jurisdiction since DOL does not have authority to make environmental policy

2. ERISA Statutory Claims, 502(a)(1)(B) and (k)

ESG in the SEC



SEC—Proposed Regulations

- **March 2022—Issuer Rule** The SEC proposed rule amendments that would require public companies to provide certain climate-related financial data, and greenhouse gas emissions insights, in public disclosure filings
- **May 2022—Investor Rule** The SEC proposed ESG-focused funds and firms disclose more specifics about their ESG strategies in fund prospectuses and annual reports
 - Integration Funds
 - ESG-Focused Funds
 - Impact Funds
- **Proposed May 2022/Finalized September 2023—Names Rule** Use of ESG in a fund name

ESG Strategy Overview Table

Overview of the Fund's [ESG] strategy	<p>The Fund engages in the following to implement its [ESG] strategy:</p> <ul style="list-style-type: none"><input type="checkbox"/> Tracks an index<input type="checkbox"/> Applies an inclusionary screen<input type="checkbox"/> Applies an exclusionary screen<input type="checkbox"/> Seeks to achieve a specific impact<input type="checkbox"/> Proxy voting<input type="checkbox"/> Engagement with issuers<input type="checkbox"/> Other
How the Fund incorporates [ESG] factors in its investment decisions	
How the Fund votes proxies and/or engages with companies about [ESG] issues	

ESG in the States



Texas Anti-ESG Legislation

- 2021—SB 13 relating to state contracts with and investments in certain companies that boycott energy companies

State Government Entities:

- ERS
- TRS
- TMRS
- TCDR
- TESRS
- Permanent school fund

Texas Comptroller's List
(August 2022)

BLACKROCK, INC
BNP PARIBAS SA
CREDIT SUISSE GROUP AG
DANSKE BANK A/S
JUPITER FUND MANAGEMENT PLC
NORDEA BANK ABP
SCHRODERS PLC
SVENSKA HANDELSBANKEN AB
SWEDBANK AB
UBS GROUP AG



ESG & ERISA: Fiduciary Questions



What does my IPS say
about ESG factors, if
anything?

Do my committee
members need ESG
training?

Is my financial advisor up
to speed on ESG and
ERISA?

Do the investment
options offered under my
plan consider ESG?

Am I keeping minutes and
otherwise documenting
my ESG decisions?

Have I considered other
ESG and non-ESG
options?

Do my fund descriptions
and other
communications for
participants need to be
updated to address ESG?

Would it be safer to use
passive (index) options
only?

Should I add a brokerage
option to my plan to
allow ESG investing?

Can I safely consider an ESG factor if I believe it would be prudent to do so?

Are my fiduciary decisions different for my DB plan than my DC plan?

Should I take a survey of my participants to find out what their ESG preferences are?

Should I add an ESG fund to my plan's investment menu?

Should I add a faith-based fund to my plan's investment menu?

How do I measure whether an ESG fund that I have selected is meeting its ESG benchmark and its financial benchmark?

How do I respond to a request from a participant to consider ESG factors in selecting the choices on my plan's investment menu?

Is it ok to add an ESG fund if it is more expensive than a similar non-ESG fund?

Is it ok to add an ESG fund if its performance is not as good as a similar non-ESG fund?

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Annual Holiday Member Event



- Thursday, 12/14/2023
- Maggiano's