



EMPLOYEE BENEFITS LAW

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MEMORANDUM

To: Board of Administration
Seattle City Employees' Retirement System

From: Michael Monaco

Date: July 13, 2017

Re: Legal Permissibility of Environmental, Social and Governance ("ESG") Investment Proposals

INTRODUCTION

In accordance with the directions of the Board at its meeting on April 13, 2017, we have conducted a comprehensive reexamination of whether there has been any expansion or change in the legal rules determining the legality of ESG investment proposals. Following a review of relevant legal authorities in Washington State, throughout the United States, and internationally, we conclude that there has been no change in the legal standards that SCERS must follow in considering ESG proposals. Indeed, the ESG legal standards relevant to SCERS have only been reaffirmed by relevant court decisions, legal articles and treaties, model laws, and opinions by other law firms regarding the fiduciary responsibility standards governing retirement plans.

Thus, proposals to SCERS for ESG investments remain subject to the legal standards outlined in the Board's Policy and Procedure for Consideration of Environmental, Social and Governance Investment Proposals, and there is no reasonable prospect of a change in those standards in the foreseeable future.

DETAILED LEGAL ANALYSIS

A. Long-Standing Elements of Fiduciary Responsibility and Legally-Required Analysis of ESG Investment Proposals

The ESG policy that SCERS adopted in 2013 and updated in 2016 follows the well-established legal approach to consideration of ESG investments. That policy states:

The Board's fiduciary obligations to the members of SCERS are paramount. Investment actions that promote an ESG goal such as rewarding workplace

diversity, promoting local industry, or protecting the environment may be considered if the proposed action does not adversely affect investment risk and/or return for SCERS and if the resulting expected return on investment and related risk for the proposed action are economically equivalent to other available investments in the same category. While the Board may give serious consideration to environmental, social and governance issues, the Board must follow its fiduciary obligations and Investment Policy and an investment cannot be selected, rejected, or divested from based solely on those considerations. In addition, where an ESG consideration has a direct relationship to the economic value of an investment, that factor is a proper component of the Board's fiduciary analysis of the economic merit of the investment decision.

....

The Board will give preference to an Investment Manager that advances its ESG goals if the selection results in an expected return on investment and related risk that it is at least economically equivalent to other available Investment Managers in the same category.

These ESG policies have been developed and applied to SCERS because the retirement system's assets are held in trust solely for the benefit of members and their beneficiaries, and because SCERS is subject to strict requirements of fiduciary responsibility under Washington state law.

Seattle Municipal Code (SMC) 4.36.605A states:

The retirement fund shall be a trust fund for the exclusive benefit of the members of the City Employees' Retirement System and their beneficiaries. No part of the corpus or income of the retirement fund shall be used for or diverted to, purposes other than for the exclusive benefit of the members of the system or their beneficiaries and the payment of fees and expenses of maintaining and administering the system.

This structure makes the Board of Administration members function as trustees over SCERS' assets – subject to the duty of loyalty as well as the duty of prudence in SCERS investments. As summarized by the Washington Supreme Court, the duty of loyalty means that the Board “must act with undivided loyalty to the trust beneficiaries, *to the exclusion of all other interests*. . . . It may not sacrifice this goal to pursue other objectives, no matter how laudable those objectives may be.” *Skamania v. State*, 102 Wn.2d 127, 134 (1984) (emphasis added).

Investment and management of SCERS assets is also a matter of fiduciary responsibility under state law. Under state law the Board of Administration must:

act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man or woman 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; shall diversify the investments of the employees' pension system so as

to minimize the risk of large losses; and shall act in accordance with the documents and instruments governing the employees' pension system, insofar as such documents and instruments are consistent with the provisions of this title.

RCW 35.39.060. This is very similar to the fiduciary responsibility of the Washington State Investment Board in investing the state retirement systems' holdings. RCW 43.33A.140.

Because of these directives, it has long been understood by the state, the City of Seattle and SCERS that investment proposals targeted to address environmental, social, and governance issues have to meet the same fiduciary standards of prudent investment as any other investments. For example, addressing proposed divestment from companies doing business in South Africa, in 1985 the Seattle City Attorney's office opined that "[w]hen the return to and the safety of principal from investments are equivalent, trustees may take into account in making trust investments . . . moral, ethical, and social considerations." Opinion 7695 (March 26, 1985). That opinion concluded that the Board of Administration "may not pursue a policy or practice, which reduces the financial return to the pension fund or significantly increases the risk to fund capital in order to further ethical or social considerations." This is consistent with legal opinions throughout the nation regarding public and private retirement fund investments. Exercising its authority to oversee fiduciary responsibility in private pension plans, the U.S. Department of Labor has likewise stated that "in the course of discharging their duties, fiduciaries may never subordinate the economic interests of the plan to unrelated objectives, and may not select investments on the basis of any factor outside the economic interest of the plan," except in the limited circumstance where two or more "investment alternatives . . . are otherwise equal with respect to return and risk over the appropriate time horizon." See U.S. Dept. of Labor Interpretive Bulletins 2008-1 & 2015-1. SCERS's policy for consideration of ESG investment proposals follows these requirements. Of course, where an ESG consideration has a direct relationship to the economic value of an investment, that factor has always been and remains a proper component of fiduciary analysis of the economic merit of the decision.

The Washington State Investment Board's policy regarding Economically Targeted Investments (ETIs) takes the same approach, stating that the WSIB "will consider for investment only those ETIs that are commensurate on a risk-adjusted financial basis to alternatively available investments" and that a "decision to invest in an ETI in consideration of its collateral benefits shall be made only after the opportunity is deemed acceptable exclusively on its economic investment merits."

Fiduciary duty has also long been understood to require that appropriate experts be employed to provide the Board members with the information that they need in order to meet their fiduciary responsibilities. Board members must either become knowledgeable themselves on sophisticated investment issues, or use experts to augment their own expertise in order to make investments consistent with the work of a sophisticated, professional investment team. As one federal appeals court put it: "A pure heart and an empty head are not enough." *Donovan v. Cunningham*, 716 F.2d 1455, 1467 (5th Cir. 1983).

B. Consideration of Changes to the Legal Standards for Permissible ESG Investments

Over the years, the accepted legal standards for consideration of ESG investments have sometimes been questioned or challenged, particularly by proponents of broader acceptability of ESG proposals. These efforts have not produced any changes in Washington law or in the law nationally, and instead the only substantial developments have been to reaffirm the legal principles described above.

1. Continuation of “Tie-Breaker” Legal Standard for ESG Actions

The Washington State Supreme Court’s *Skamania v. State* decision remains in full effect in all state courts and continues to require that the Board of Administration “*act with undivided loyalty to the trust beneficiaries, to the exclusion of all other interests*” and “*may not sacrifice this goal to pursue other objectives, no matter how laudable those objectives may be.*” The court decisions from around the nation analyzing fiduciary responsibility have uniformly required that an ESG action be taken only where it is equivalent to other available investment options. *Associated Students of the University of Oregon v. Oregon Investment Council*, No. 78-7502 (Cir. Ct. Lane Co. Or. Jan. 21, 1985), *rev’d* 728 P.2d 30 (Or. App. 1986), *pet. den.* 734 P.2d 354 (Or. 1987); *Sgaglione v. Levitt*, 337 N.E.2d 592 (N.Y. 1975); *Board of Trustees of Employees’ Retirement System of City of Baltimore v. Mayor & City Council of Baltimore*, 562 A.2d 720 (Md. App. 1989). To our knowledge after exhaustive research, no contrary court decisions have been issued in the 33 years since *Skamania* was decided, or in the wake of any of the other ESG decisions.

Meanwhile the U.S. Department of Labor has repeatedly reaffirmed the ESG “tie-breaker” framework, in which collateral benefits of an ESG proposal may only be considered if the ESG and non-ESG investment options are economically equivalent. The most recent of these reaffirmations came in 2015, in U.S. Dept. of Labor Interpretive Bulletin 2015-1.

In addition, as noted above, law firms other than MMPL have conducted independent analyses of the fiduciary responsibilities applicable to ESG proposals to plans like SCERS, and concluded that the ESG standard is consistent with SCERS’s existing policy.

There are thus no court decisions or other authorities to suggest any likelihood of changes to the law of ESG investment consideration.

2. Continuing Need to Rely on Experts and Well-Accepted Economic Principles

Particularly in the wake of financial services scandals and the economic crisis of 2008-2009, some advocates of broader ESG investment have argued that ordinary methods of valuation of stocks and other securities are missing the mark and should be supplemented – simply for the benefit of the retirement fund and the beneficiaries, to protect them from overvaluations. In particular, advocates of divestment from fossil-fuel companies have suggested that the financial markets are overvaluing them, and that alternative analyses of the alleged weaknesses of these companies require consideration of fossil fuel divestment.

However, in the last few years the U.S. Supreme Court has reaffirmed that it is generally “implausible” for a fiduciary to believe that a retirement plan committee can predict the value of a publicly-traded company better than the financial markets have. *Fifth Third Bancorp v. Dudenhoeffer*, 134 S. Ct. 2459, 2471 (2014). The Supreme Court has endorsed rulings in other court cases that: “[a] trustee is not imprudent to assume that a major stock market . . . provides the best estimate of the value of the stocks traded on it” and “[f]iduciaries are not expected to predict the future of the company stock’s performance.” *Id.* (internal quotation marks and citations omitted).

Thus, we continue to believe that the legal hazards would be great if a fiduciary were to consider taking an ESG action based (in whole or in part) on a rejection of ordinary economic principles as explained by investment professionals. As stated above, U.S. Supreme Court expressly considers a fiduciary’s acceptance well-established economic principles like the “efficient markets” view of publicly-traded companies to be prudent. More generally, the decisions by the U.S. Supreme Court (and other federal courts throughout the country) on these issues demonstrate the legal safety of basing investment decisions on analysis by established professionals with unquestionable expertise, and following established and accepted modes of analysis as well as the great hazard of failing to do so.

3. Rejection of General-Community-Benefit ESG Standard

It has sometimes been suggested that an ESG investment decision may be justified by not merely considering the economic value of the investment, but also considering the overall benefit to the community (particularly including non-economic advantages provided to beneficiaries of the plan). This reasoning has not been accepted by any courts or decision makers in the U.S., nor to our knowledge in any other countries. It also appears to be inconsistent with *Skamania* and the court decisions and agency rules discussed above.

While it might appear that some reputable treatises and reports have endorsed this type of expansive approach to ESG investments, no significant authorities have actually done so. For example, the 1988 edition of the legal treatise *Scott on Trusts* indicated that it might be permissible to consider the general benefit to the community as an element of fiduciary review of a corporate investment (even where that benefit does not translate into economic value of the company), stating that “the investor, through a trustee of funds for others, is entitled to consider the welfare of the community, and refrain from allowing the use of funds in a manner detrimental to society.” Austin W. Scott, *The Law of Trusts* (“*Scott on Trusts*”), § 227.14 (4th ed. 1988). But the subsequent edition of that treatise clarified that in accordance with the Uniform Prudent Investor Act and the *Third Restatement of Trusts*:

[T]he trustee should seek to secure for the beneficiaries the maximum overall return that is consistent with the level of risk that is appropriate under the circumstances. . . . No form of so-called “social investing” is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of trust beneficiaries – for example, by accepting below-market returns – in favor of the

interests of the persons supposedly benefitted by pursuing the particular social cause.

Scott on Trusts, § 19.1.13 (5th ed. 2007) (quoting Uniform Prudent Investor Act; internal quotation marks omitted).

Likewise, reports by influential international bodies are sometimes characterized as promoting a more permissive view of ESG investments, when they actually have not done so. For example, the 2005 legal analysis by the Freshfields Bruckhaus Deringer law firm for the United Nations Environmental Programmes' Finance Initiative (commonly known as the "Freshfields Report") broadly states that "a decision-maker may integrate ESG considerations into an investment decision to give effect to the views of the beneficiaries in relation to matters beyond financial return," but in the same section that Report ultimately states as follows:

[In] cases where a decision-maker has exhausted the analysis of financial criteria, including value-related ESG considerations [i.e. those related to the economic value of the investment] . . . and is still left with a number of alternatives, of equal attractiveness from the point of view of the overall investment strategy the decision-maker would be entitled to select on alternative on the basis of its non-value-related ESG characteristics, without thereby being in breach of his or her fiduciary duties or civil law obligations.

UNEP Finance Initiative, *A Legal Framework for the Integration of Environmental, Social and Governance Issues Into Institutional Investment*, p. 12 (October 2005) (emphasis added) (emphasis added).

Thus the "Freshfields Report," like many other reports promoting ESG investment, may be referenced in ways that suggest that the field of legally-permissible ESG investments should be (or even has already been) expanded, when in fact the legal analysis in that report is in line with the ordinary rule that only where there are a "number of alternatives, of equal attractiveness" from an economic perspective can a fiduciary choose an ESG option on the basis of non-economic factors.

4. Impossibility of Obtaining Universal Beneficiary Consent to ESG Investments

Under Washington law and a wide variety of national legal authorities, including the *Restatement of Trusts*, it is widely accepted that there is no breach of fiduciary duty if a well-informed beneficiary consents to an investment – even if that investment underperforms economically.

On the basis of this, some have suggested that it may be permissible to make an ESG investment decision on the basis of a broad but not universal "consensus" of the beneficiaries of the trust – particularly in light of language of the Freshfields Report that fiduciary can make an investment decision by "point[ing] to a consensus amongst the beneficiaries in support of" the decision. *See Freshfields Report*, p. 12. But that types of statement in the Freshfields Report (and elsewhere) cannot be read to provide a legal basis for an ESG decision based on the consent of only *some* of

the beneficiaries affected by it. Under the well-established law, “the power of one beneficiary to ratify [an investment decision] cannot be used to impair the rights of the other beneficiaries.” See, e.g., John H. Langbein and Richard A. Posner, *Social Investing and the Law of Trusts*, 79 Mich. L. Rev. 72, 105 (1980).

In a pension plan with thousands of active members and retirees, it would be impossible to obtain universal consent to any proposed ESG decision, and the notion of a general “consensus” to a proposed ESG action would be of essentially no use in preventing claims of fiduciary breach. This would be true even if a mechanism could somehow be developed and implemented to “poll” members of SCERS and obtain express statements of support for an ESG action from a wide group (or even a large majority) of members of the system. In the end, even having done such laborious work to demonstrate “support” for an ESG action, there would still be a great risk that claims of fiduciary breach could be brought (at a minimum) by each and every person who had not given such “consent” or otherwise expressed support.