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ERISA Developments

Speaker:

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TOPICS

- Socially responsible/ESG investing
- Securities litigation recovery
- Lifetime income
- Litigation involving investment firms

Socially Responsible/ESG Investing

WHAT IS SOCIALLY RESPONSIBLE INVESTING?

- Various names and definitions:
  - Environmental, social, and governance (“ESG”);
  - Responsible investing; and
  - Sustainable investing.
- Has evolved from negative exclusion to positive inclusion (i.e., the mindset has transformed from eliminating “sin” stocks, such as tobacco companies, to including companies that benefit the greater social good).
- Academic studies have shown that there is a strong correlation between ESG scoring models and financial performance.[1]

[1] Gordon L. Clark, Andreas Feiner & Michael Viehs, *From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance* (2015).

Daily News

Recent Headlines

“Blackrock, projecting sales explosion, makes ESG products core”

“Investors warming, like earth, to ESG Funds”

“TD Ameritrade, E*Trade add ESG options for Advisors”

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EXAMPLES OF ESG FACTORS

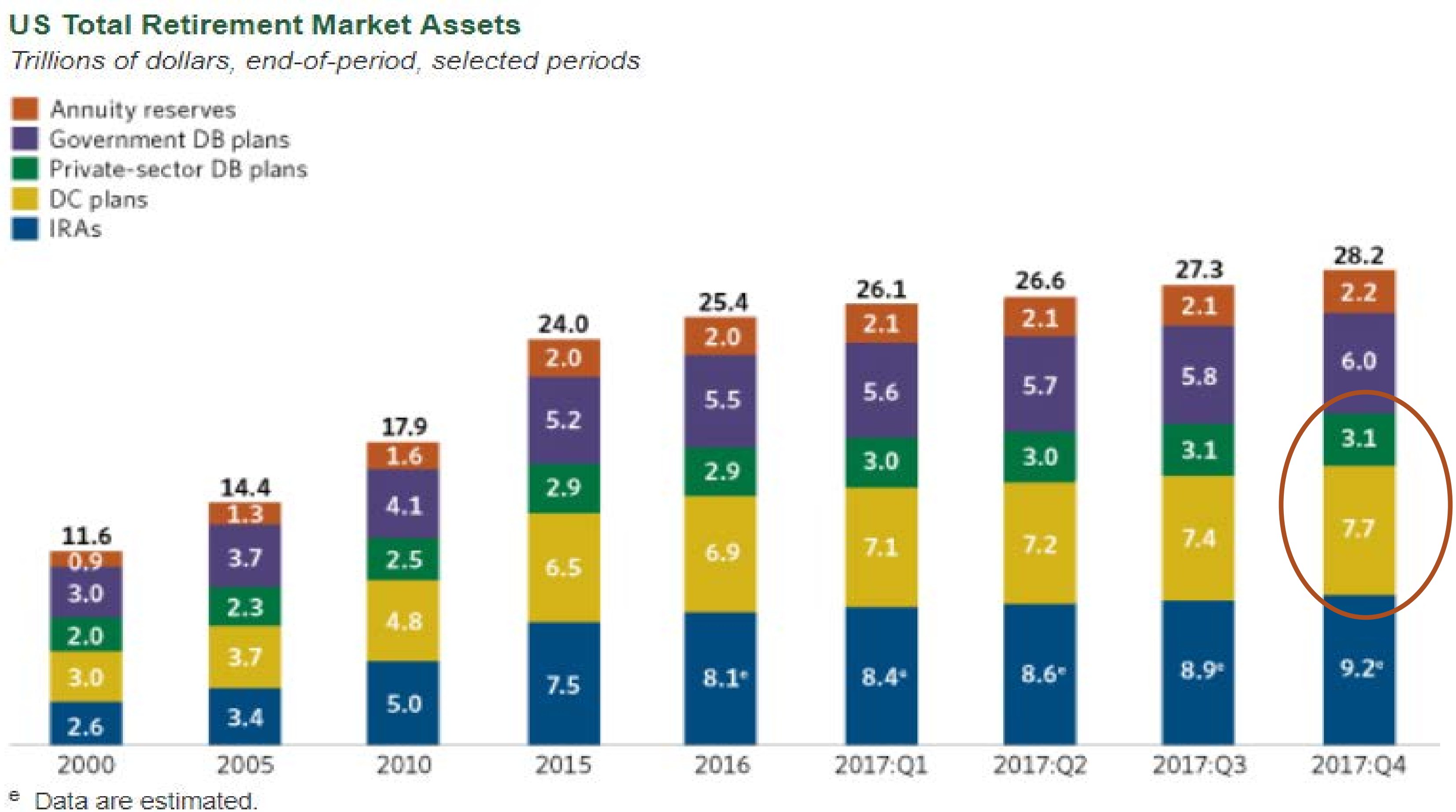
Environmental	Social	Governance
Climate change impacts, greenhouse gas emissions	Labor standards	Board composition
Energy efficiency	Human rights	Executive compensation
Renewable energy	Employee engagement	Audit committee structure
Air, water, or resource depletion or pollution	Customer satisfaction	Bribery and corruption
Waste management	Community relations	Whistleblower programs
Biodiversity impacts	Data protection and privacy	Lobbying
	Gender and diversity	Accident and safety management

INCREASING FOCUS

- **U.S.** – Institutional investors considered ESG factors on about $4.7T in investments in 2016, up by 14% since 2014.
- **Non-U.S.** – Use of ESG factors has also grown considerably as the amount of global assets invested using ESG factors increased from $18.3T in 2014 to $22.9T in 2016.
- **ERISA** – Institutional investors subject to ERISA (e.g., defined benefit plans; 401(k) plans) are increasingly focused on ESG factors.

Source: GAO Report 18-398 “Retirement Plans’ Use of ESG Factors.”

ERISA INVESTORS ARE LARGE ASSET OWNERS



Source: Investment Company Institute, "Retirement Assets Total $28.2 Trillion in Fourth Quarter 2017," www.ici.org/research/stats/retirement/ret_17_q4.

DEPARTMENT OF LABOR GUIDANCE

- The Department of Labor (“DOL) has a longstanding position that ERISA fiduciaries may not sacrifice investment returns or assume greater risks as a means of promoting collateral social policy goals.
- Series of DOL guidance.
- Most recent guidance issued in April (Field Assistance Bulletin 2018-01).
  - Clarification?
  - Warning bell?
  - ERISA fiduciaries must not too readily treat ESG factors as economically relevant; rather, an evaluation of an investment opportunity should be focused on financial factors that have a material effect on return and risk.

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ERISA CONSIDERATIONS

- Can ESG-themed investments be included in a 401(k) investment lineup?
- Can ESG-themed investments be a default investment option?
- Can a target date fund allocate to ESG-themed investments?
- What should an investment policy statement say about ESG factors?
- What process should a fiduciary follow in considering ESG factors?
- Does the DOL’s guidance apply to IRAs? Public plans?
- Are there any specific considerations for defined benefit plans?

OTHER CONSIDERATIONS

- **European Commission Proposals**
  - Earlier this year, the European Commission High-Level Expert Group published a report that identified incorporating ESG factors into investment decision-making as an imperative.
  - The European Commission recently issued a package of proposals that included (i) an EU-wide classification system and (ii) disclosure rules.
- **SEC**
  - Has been asked to develop comprehensive ESG disclosure rules (looking for a more standardized process).

PRODUCT MANUFACTURERS, ADVISORS, FIDUCIARIES, AND ASSET OWNERS SHOULD STAY INFORMED REGARDING THESE MATTERS.

Securities Litigation Recovery

EXAMPLE

- $2B defined benefit pension plan hires investment manager (separate account structure) for a $200M equity mandate.
- Investment manager invests $10M in shares of Volkswagen.
- Emissions cheating scandal occurs (Sept. 2015).
- Plan's shares lose $4M in value.
- Securities fraud class action brought by a shareholder (not the plan).

ERISA CONSIDERATIONS

- Hot topic for large plan sponsors.
- Pursuant to ERISA's broad fiduciary duties, plan fiduciaries have a duty to pursue valuable claims a plan has against other persons.
- Failure to preserve a plan's claims or releasing the claims without investigating their value or viability may constitute a breach of fiduciary duty.
- A plan's trustee is the party that is legally able to file a claim as the legal owner of the security (responsibility?).
- For U.S. securities class actions, the trustee may participate when it receives relevant class action and settlement notices from courts as part of resolution.
- For foreign securities actions, notice is generally not provided by courts, and participation in the lawsuit is generally required from the outset of the matter in order to preserve claims.

POTENTIAL ISSUES

- Who is the responsible fiduciary?
  - Internal fiduciary at the plan (e.g., the investment committee)
  - Investment manager
  - Plan trustee
  - Consultant
  - “Dead trustee”/“Dead investment manager”
- How to gather the relevant facts?
  - If the responsible fiduciary does not have the necessary experience or skill to research and identify potential settlement claims, it should rely on one that has the requisite abilities (more complicated for non-U.S. litigation, e.g., dealing with litigation funders; procedure to join foreign lawsuits varies country to country; fiduciary may need to show reliance on public statements as part of investment strategy; loser may need to pay opposing party’s legal fees and costs).
  - Engage outside law firm to monitor potential claims, analyze applicable contracts to join actions, and negotiate with funders.
  - Third-party vendor.

Lifetime Income

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BACKGROUND

- When participants in a DB plan retire, they typically receive a fixed level of monthly income based upon a formula specified in the plan.
- On the other hand, when participants in a DC plan retire, they often receive their entire account balance – a lump-sum payment – or roll their account balance into an IRA.

BACKGROUND (CONT.)

- DC plan participants face several risks as they enter retirement:
  - Poor investment returns (**investment risk**)
  - Inflation eroding the value of savings (**inflation risk**)
  - Outliving savings (**longevity risk**)
  - Cognitive decline that affects the ability to manage savings (**cognitive risk**)
- Increasing focus on providing DC plan lifetime income solutions.

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POTENTIAL BARRIERS

- Selecting an annuity provider is a fiduciary act that can subject the plan sponsor to legal liability (DOL safe harbor).
- Better pricing for certain plan participants may be available outside of the plan (annuities offered in-plan must be offered on gender-neutral prices, while annuities offered outside of the plan may reflect gender-distinct pricing).
- Service providers (e.g., administrator and recordkeeper) may not support.

REGULATORY ACTION

The DOL and U.S. Treasury have taken a number of steps to promote lifetime income:

- **2008** – DOL safe harbor for selecting annuity providers
- **2010** – DOL and IRS request for information on expanding lifetime income options in DC plans
- **2013** – DOL notice regarding including an illustration of plan balance as a stream of lifetime income payments on benefit statements
- **2014** – IRS rule allowing deferred annuities in target date funds
- **2015** – DOL clarification of annuity provider safe harbor

Litigation Involving Investment Firms

WAVES OF 401(K) LITIGATION

1st Wave	• Targeted plans that offer employer stock as an investment option
2nd Wave	• Targeted plans for paying “excessive fees”
3rd Wave	• Targeted hospitals and universities
4th Wave	• Targeted financial institutions, especially those that offer proprietary product as investment options

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DOL PROHIBITED TRANSACTION EXEMPTION 77-3

- Authority that enables a plan sponsor to include proprietary funds in a retirement plan without violating ERISA’s conflict of interest rules.
- Does <u>not</u> absolve fiduciaries from ERISA’s prudence requirement.
- False comfort to some.

STAKES ARE HIGH

Material Costs of Litigation

- Reputational
- Legal fees
- Settlement payments
- Insurance premiums
- Management focus

ACTION ITEMS TO MITIGATE RISK

- Review governance (e.g., committee structure, charters, and meeting minutes)
- Undertake fiduciary training
- Review (or draft) investment policy statement
- Refine written process
  - Timing for running RFPs and RFIs on service providers
  - Oversight and benchmarking
- Consider plan design changes

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