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2019 SEATTLE INVESTMENT MANAGEMENT CONFERENCE

ERISA Developments

Speakers:

Robert L. Sichel, Partner, K&L Gates LLP

Ruth E. Delaney, Partner, K&L Gates LLP

TOPICS

- Socially responsible/ESG investing
- Distribution through consulting/OCIO 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

"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

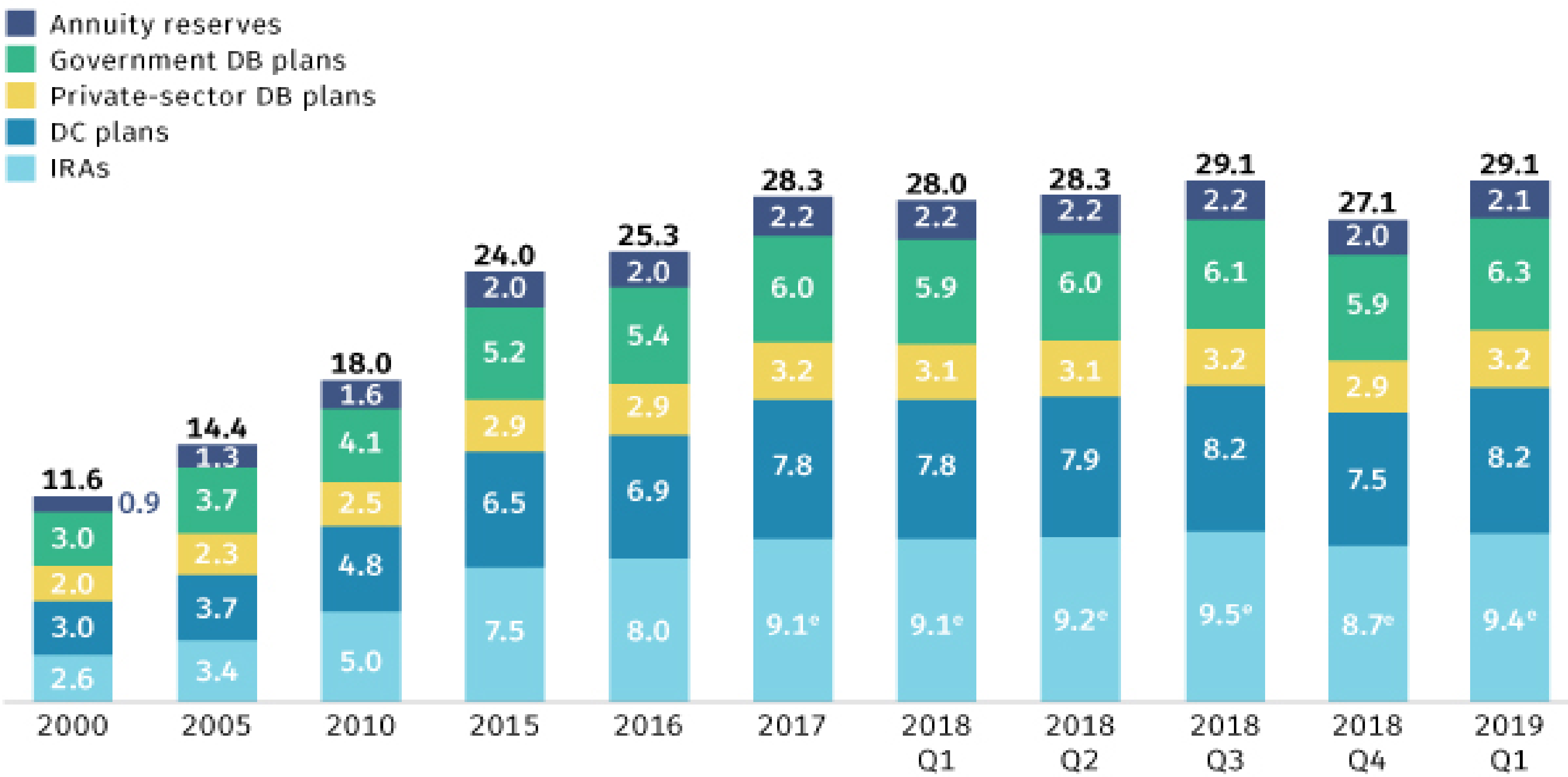
Environmental	Social	Governance
Climate change impacts, greenhouse gas emissions	Labor standards	Board composition
Energy efficiency	Human rights	Executive compensation
Renewable energy	Employee engagement	Audit committee structure
Air, water, or resource depletion or pollution	Customer satisfaction	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 $29.1 Trillion in First Quarter 2019".
https://www.ici.org/research/stats/retirement/ret_19_q1

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.

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?

Distribution Through Consulting/OCIO Firms

BACKGROUND

“Outsourced chief investment officers” or “OCIOs” are advisory firms that help institutional investors, such as endowments, foundations, and pension plans, select investment managers and make other investment-related decisions, such as asset allocation and rebalancing decisions

DIFFERENT SERVICE OFFERINGS

Advisory (non-fiduciary)

- Consultant advises the plan
- Plan's internal fiduciary (e.g., retirement committee) considers the advice when making decisions
- Contract provides that consultant is not a fiduciary

Advisory (fiduciary)

- Consultant advises the plan and serves as a co-fiduciary with the plan's internal fiduciary
- Most common arrangement
- Sometimes referred to as "3(21) services"

Discretionary (fiduciary)

- Consultant makes all decisions for the plan and may sign documents on the plan's behalf
- Sometimes referred to as "3(38) services"
- "True" OCIO

ERISA INVESTORS

- OCIO firms are an important distribution channel to access larger ERISA investors
- Investment managers should consider the legal and regulatory implications of marketing through this channel
- Considerations include:
  - Potential ERISA "prohibited transactions"
  - Potential implications for the investment manager's duty of prudence

LEGAL & COMPLIANCE CONSIDERATIONS

Prohibited Transactions

To avoid engaging in prohibited transactions, an investment manager hired by an OCIO firm may be precluded from using the OCIO firm and its affiliates in connection with providing services to the plan. For example, an investment manager may not be able to execute trades with a broker that is affiliated with the OCIO firm or clear swaps through a clearing member that is affiliated with the OCIO firm.

The OCIO firm may ask the investment manager to contractually agree to avoid engaging in these transactions.

Regardless of whether an investment manager agrees to contractual restrictions, the manager may need to avoid certain service providers to ensure it complies with a prohibited transaction exemption.

LEGAL & COMPLIANCE CONSIDERATIONS (CONT.)

Duty of Prudence

An investment manager may be precluded from using the OCIO firm and its affiliates in connection with providing services to the plan. Also, an investment manager may be precluded from causing the plan to purchase securities issued by the OCIO firm and its affiliates.

The manager should consider whether such restrictions impact its ability to meet its duty of prudence to the ERISA client. For example, (a) Can the manager comply with its best execution policy, if it is precluded from using a major broker-dealer? and (b) Can the manager prudently manage the strategy if it is precluded from purchasing certain bonds?

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