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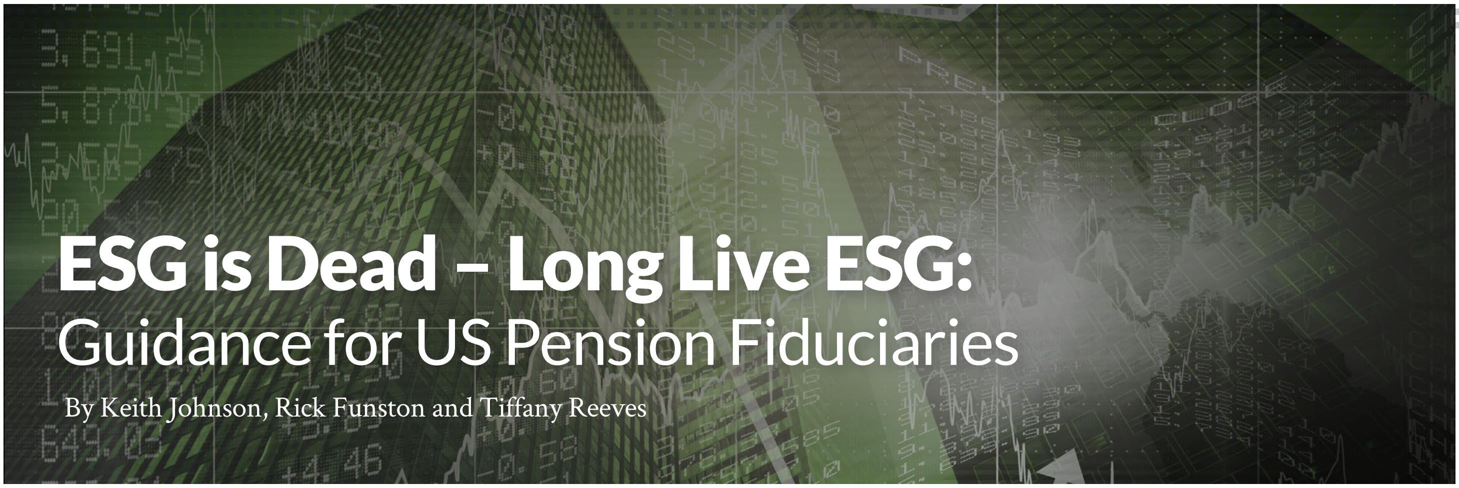

ESG is Dead – Long Live ESG:
Guidance for US Pension Fiduciaries

By Keith Johnson, Rick Funston and Tiffany Reeves

Serving as a pension investment fiduciary has become considerably more difficult in the past few months due to market gyrations, inflation and potential recession. More surprising has been discovering that pension funds and their investment managers are now a piñata in the "culture wars" with whacks coming from all sides.

We explore what this means for pension fiduciaries and offer six suggestions for managing trust fund assets through these challenges. This is a time that requires working closely with fiduciary counsel and investment advisers to ensure pension plans can fulfill the full range of their pension fiduciary obligations. Pension fiduciaries should develop a fact-based understanding of the situation, clarify their investment beliefs and policies, update stakeholder communication plans and explicitly focus on balancing investment strategies to impartially deliver promised benefits both now and in the future.

Fiduciaries Are Caught Between a Rock and a Hard Place

Pension fiduciaries are finding themselves in a Catch 22 situation, as they have recently been pulled into the broader national debate regarding environmental, social and governance ("ESG") investing. Assuming, for the sake of this discussion that the term "ESG investing" is even a defined thing (some would argue that it is not), ESG investing has, in any event, become a ubiquitous concept used by investment professionals as a shorthand reference. Nevertheless, it remains an ambiguous concept that encompasses several different investment and analytical strategies that are evolving at a rapid pace. ESG investing means different things to different people. This ambiguity has generated heated debate about the application of fiduciary duties to ESG, often without differentiation between vastly different ESG approaches.

On one side, some states are passing anti-ESG legislation. State treasurers have started firing investment managers for allegedly boycotting fossil fuel companies. Attorneys general from 19 states have accused investment firms of breaching both fiduciary duties and anti-trust laws by joining with other investors to allegedly impose a "woke" policy agenda. Former Vice President Pence asserted that *"ESG is a pernicious strategy, because it allows the left to accomplish what it could never hope to achieve at the ballot box or through competition in the free market."* A group of US Senators even sent a letter to 51 large US law firms, warning of coming Congressional hearings and advising that lawyers have *"a duty to* *fully inform clients of the risks they incur by participating in climate cartels and other ill-advised ESG schemes."*

On the other side, the heat on pension fiduciaries to address material ESG risks is increasing. New York City's Comptroller recently filed shareholder resolutions at Bank of America, Goldman Sachs, JPMorgan Chase and Royal Bank of Canada asking them to cap financing of carbon emissions. The Comptroller said, *"These banks say they have net zero commitments, but if they don't have absolute emissions targets, they don't really have a net zero plan."* An open letter from 14 state treasurers accused their counterparts on the anti-ESG side of the debate of imposing an *"ideological screen on an investment manager's ability to perform"* which *"increases potential risks"* and *"in the case of state and public pension funds, these losses will be borne by the taxpayers and that means all of us."*

On the Federal level, the Department of Labor recently issued new private pension fund rules which confirm that ESG factors may be financially material and can be used by plan fiduciaries in making investment selections and proxy voting decisions.

Pension investment fiduciaries are finding themselves caught between these increasingly contradictory narratives of what their roles require. As demands and threats from both sides continue to increase, fiduciaries should focus on their mandate and the practical application of their fiduciary duties.

The Fiduciary Duty Context

Uninformed observers and those with ancillary policy goals often make assertions about pension fiduciary duties based upon a limited or unnuanced understanding of the concepts involved. However, pension managers and trustees must operate with a full understanding of the legal principles which govern their conduct. Blindly applying sweeping and/or conclusionary notions of what prudence requires and what it means to manage assets solely in the interests of plan beneficiaries runs the risk of violating legal duties. We highlight several fundamental aspects of fiduciary duty that have largely been missing from the debate and are essential for a fully informed understanding of investor fiduciary obligations.

Prudence Is Process Oriented and Forward Looking

The duty of prudence is often described in a conclusory manner (i.e., "this" or "that" is prudent or imprudent). However, prudence is a process-oriented and forward-looking concept. In fact, the Oxford Languages dictionary definition of prudence is "acting with care and thought for the future." It requires investigation of relevant facts and application of logical analysis to reach well-informed conclusions. Fiduciaries cannot merely jump to conclusions without using a robust decision-making process that considers all fiduciary duty principles.

Peer practices serve as a reference point for prudent fiduciaries. However, variances in plan design, size, demographics, investment strategy, funding levels, plan sponsor financial stability, state constitutional and statutory provisions, or other characteristics can result in plan fiduciaries independently following similar prudent processes but reaching different conclusions. In other words, prudence in not a *"one size fits all"* concept – even, for example, when it comes to climate change risk exposures and related investment opportunities. Different pension plan characteristics can introduce variances that generate different conclusions. A prudent process requires analysis of relevant facts and circumstances in the context of the unique characteristics of each plan.

Prudence Is Dynamic

Prudence is often viewed as a static concept. However, while prudence has been part of trust law for centuries, its application evolves as conditions change and investment industry knowledge grows. For example, during the last half of the 20th century, application of the duty of prudence evolved away from what used to be a common practice of using “legal lists” that specified permitted investments. The lists set forth a limited number of specific investments deemed to be prudent (which typically precluded investment in the stock market). Trust law then evolved to adopt Modern Portfolio Theory principles that focus on the risk and return roles which investments play in overall construction of a portfolio. That evolution of prudence was driven by research demonstrating how diversification improved performance.

Recognizing the dynamic nature of prudence is especially important now, as we appear to be at another inflection point in the ongoing evolution of prudent investing in response to the context of 21st century global changes.

Prudent Benchmarking and Cost Management Can Be Confused With Collusion

Prudence suggests the use of peer practices as a guide, which can cause investors to adopt similar investment practices. Also, fiduciaries are required to manage costs, and that encourages them to collaborate or share specialized service providers when investor interests are aligned, to reduce plan expenses. However, to an uninformed observer, the combination of these fiduciary duty practices may be confused with anti-competitive collusion.

Loyalty Includes a Duty of Impartiality

Most people appreciate that fiduciaries have a duty of loyalty to act only in the interests of plan beneficiaries and for the sole purpose of providing promised investment benefits. However, many people are not aware that the duty of loyalty includes a duty of impartiality. Among other things, impartiality requires that investment fiduciaries who manage inter-generational liabilities act in good faith to balance the short- and long-term investment time horizons and risk tolerance levels of both older and younger fund members. Uncompensated inter-generational transfers of risks or return opportunities can raise fiduciary duty compliance concerns. Impartiality has the practical effect of precluding fiduciaries from considering only short-term investment results or ignoring practices associated with creation of sustainable, risk-adjusted long-term portfolio returns.

Loyalty Is Owed to Plan Participants Rather Than Third Parties

The duty of loyalty is widely understood to preclude fiduciaries from using their powers to misappropriate trust fund assets or to pursue their own personal or political goals (regardless of where such person’s personal or pollical values align). Fiduciary conflicts of interest are strictly regulated, and personal biases should not influence fiduciary decision-making. Establishing good governance practices with prudent and consistent processes helps fiduciaries mitigate the impact of any inherent bias in the decision-making process.

Most importantly, the duty of loyalty is owed to plan beneficiaries rather than the managers of portfolio companies or other third parties who may have conflicting or misaligned interests. The duty of loyalty leads plan fiduciaries to focus on both portfolio construction and future viability of investee company business plans, as well as expected company performance over both the short- and long-term.

An important related corporate governance concept is the design of company governance under state law as a three-legged stool, where shareholders, management, and directors each play distinctly different roles. Unfortunately, there is substantial confusion about how the fiduciary duties of loyalty and impartiality interact with corporate governance structure. This confusion seems to underly much of the current debate about portfolio construction and the exercise of shareholder rights as a plan asset. Despite the differing opinions on the merits of exercising shareholder rights, the law is clear: fiduciaries are simply not allowed to purchase, sell, or manage plan assets to meet third party demands when not in the best interests of plan participants over the relevant time periods.

Implications for Pension Fiduciaries

What are investor fiduciaries to do in the current environment? We offer the following as suggested guideposts to help fiduciaries navigate these turbulent times.

1. **Confer With Qualified Fiduciary Counsel and Investment Advisers**
   It is essential that fiduciaries work with qualified expert fiduciary counsel and investment advisers. Consultation with prudently selected legal counsel and other advisers not only provides practical guidance but also offers a degree of liability protection. However, the duty of prudence requires that advisors be carefully selected and have current expertise on ESG issues and investor practices as well as on all aspects of investor fiduciary duties.

2. **Get Educated**
   If fiduciaries do not already possess current expertise on ESG practices and the full range of fiduciary duties, then they should first seek further education. Fiduciary duties require that investment decisions be informed by an investigation of the relevant facts and circumstances. For example, this might include education on topics like:
   - The evolution and definitions of various ESG practices, as well as their use by different investors across portfolio asset classes and resulting risk-adjusted performance over both short- and long-term horizons;
   - How integration of ESG factors into investment analysis relates to forward-looking risk management and identification of investment opportunities;
   - Global developments in adoption of ESG practices by companies, regulators and investors, including the expected impact of those developments on future investment risks and return opportunities;
   - How intangible capital, the business innovation cycle and market expectations for a company's future value creation and ESG due diligence practices relate to investment value creation over the long term;
   - Fiduciary duties in the investor's jurisdiction, including application of each of the duties outlined above and any unique constitutional or statutory provisions (for example, a duty to consider taxpayer and employer financial impacts);
   - The relationship between public policy and impact of prudent investment decisions and;
   - Effects of the current debate and related legislative or regulatory actions on ability of the fiduciary to meet obligations to plan members as market circumstances change.

3. **Show Your Work**
   The investment industry has adopted use of the term "ESG" as shorthand for several different (sometimes inconsistent) practices. Investment professionals generally understand which version of ESG is being referenced (e.g., integration of material financial factors vs. negative screening on moral values) based on the context in which the term is used. Unfortunately, in the current debates, different players often use the term "ESG" to refer to completely different practices without realizing they are not talking about the same thing. To achieve better communications and improve stakeholder understanding, pension and investment fiduciaries should consider whether continued use of the ambiguous term "ESG" remains useful in communicating about investment practices to stakeholders and the public.

   Instead, fiduciaries might want to "show their work" by describing what they are doing, *why* it is being done and *how* it is expected to impact beneficiaries and stakeholders. Linking investment practices to fiduciary duties (and especially to generation of risk-adjusted returns on an intergenerationally impartial basis) could improve the effectiveness of stakeholder communications.

4. **Review Investment Beliefs, Holdings, Policies, and Contracts**
   In response to the current pressures, fiduciaries should review their investment beliefs, fund holdings, investment policies and contract provisions. For example, if an investor does not allow consideration of public policy options in making investment decisions, it might be helpful to explicitly say that in policies and contracts. References to ESG might be replaced with more precise belief or policy descriptions that include supporting information. Improved consistency and accuracy across beliefs, policies, investment management agreements, and portfolio holdings could enhance the effectiveness of public and stakeholder communications.

5. **Refresh Stakeholder Communications Plans**
   The stakeholder communication practices of many pension funds are often reactive rather than proactive. Public pension funds should proactively inform stakeholders and the public about what they are doing, why they are doing it (i.e., tied to fiduciary duties), and how their chosen strategy will be implemented. Public pension funds should also endeavor to educate stakeholders and the public regarding the nuances and legal constraints of fiduciary obligations. Communications should be clear and address the misconceptions, fears, and expectations associated with the conflicting ESG-related narratives in the broader national debate.

   Proactive two-way communication with stakeholders and oversight bodies could help to improve trust and build a better understanding of a pension fund's actual policies and practices. It may also reduce the potential for imposition of legislative, enforcement, or litigation outcomes that could negatively impact risk-adjusted returns or impede fiduciaries in their ability to fully exercise their discretion and fulfill their obligations to plan beneficiaries.

6. **Consider a Court Petition for Fiduciary Instruction as a Last Resort**
   In jurisdictions where legislative or regulatory action has been taken that involves questions of constitutionality or undue interference with the ability of fiduciaries to fulfill their obligations to plan beneficiaries, fiduciaries might confer with fiduciary counsel about the potential to seek court intervention. Many states allow pension fiduciaries to petition courts for instruction when they appear to have conflicting or unclear obligations. Unlike lawsuits where parties are named as defendants, a petition for fiduciary instruction could offer a mechanism for fiduciaries to bring issues to a court for declaratory relief in a manner that is less adversarial.

Conclusion

These are unusual and challenging times that will test the ability of pension fiduciaries to meet their legal obligations to act in the best interests of millions of plan participants and beneficiaries. We hope that these suggestions will help pension fiduciaries and investment managers tune out the noise of conflicting public narratives and focus on finding a prudent pathway to achieving sustainable risk-adjusted returns.

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