ESG AND PENSION PLAN FIDUCIARY RESPONSIBILITY EUROPE VERSUS US

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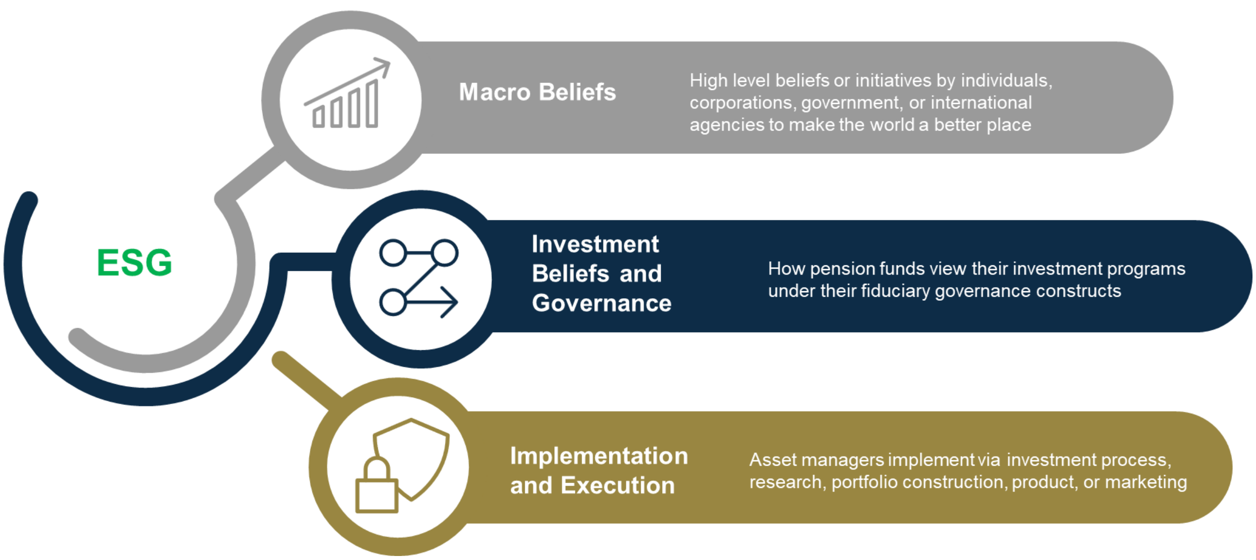
Institutional, private, and public capital globally have largely contributed to the surge in ESG (Environmental, Social, and Governance) related investments, which are currently estimated to be approximately $35 trillion and growing. This phenomenon has led to increased interest and scrutiny of ESG initiatives and corresponding ESG investments. In Europe, current (and evolving) regulations seek to harmonize important climate initiatives and enforce responsible investment disclosures. The result, however, is a widening gap between Europe and the United States - the US has not kept pace with the European implementation of ESG-related investments, laws, and regulations. The primary driver of the chasm is fiduciary duty – does the implementation of ESG-related investments meet an institutional plan sponsor's fiduciary responsibility? While the EU is making collaborative efforts to harmonize ESG regulations, the US regulators have not proceeded in that direction.

This note aims to provide a brief overview, comparing the regulatory regimes and the general state of ESG investing between American and European pension plans. Both Europe and the US have similar fiduciary duty guiding principles based on the Prudent Person Rule. In general, US and Europe have arrived at different conclusions on the suitability of incorporating ESG in Plan management. These divergent paths can be analyzed through the three following components:



Multinational corporations and global pensions must answer to multiple, and at times competing, regulatory jurisdictions, local constituents and stakeholder interests creating a growing dilemma of how one might address inconsistencies and divergent views.

EU and UK Regulatory Regime

The UK and the EU maintain a strong conviction to their ESG macro beliefs. Their ESG regulatory requirements and reporting are well established, and typically legally mandated. There are a minimum set of standards, transparency requirements and most ESG considerations are integrated within their fiduciary responsibilities. For pensions, the IORP II (Institute for Occupational Retirement Provision) has established the overarching ESG requirements for member country retirement plans and refer to ESG as an important component to investment policy and risk management systems. Regulations, such as the SFDR (Sustainable Finance Disclosure Regulation), set mandatory disclosure rules for corporations and investment products, ESG-related investment risks, and seeks to identify adverse sustainability impacts. The European Green Deal (2019) sets a net- zero emissions target, and the 2017 Shareholder Rights Directive requires asset managers and institutional investors to monitor ESG impacts and consider ESG as part of investor due diligence.[1] The full extent of EU regulations are much more comprehensive, and the laws passed by member countries in many cases exceed the requirements set forth by the EU.

Most ESG legislation and requirements in Europe are primarily aimed at corporations and investment managers, but not specifically for pension plans. The legislation fosters ESG macro beliefs, transparency and seeks to avoid potential "greenwashing" of investment products, but not specifically designed for pension funds. Pension funds are often bound by these laws even though the plans were not principally targeted. Altogether, this makes compliance in a substantive manner somewhat of a struggle at times.

US Regulatory Regime

Currently, the US lacks formal federal-level laws and regulations that specifically mandates or fosters ESG macro beliefs and sustainable investing. The US does not have any reporting requirements nor formal integration of ESG for pension plans. In general, ESG investing or related activity has been a result of voluntary demand from either corporate and financial owners or indirect influence from the EU and global ESG/sustainable investing initiatives. In the US, ESG is subject to interpretation without consistent guidance from current laws and regulations. The primary governance regime for corporate and private pensions in the U.S. is the US Department of Labor's (DOL) ERISA (Employee Retirement Income Security Act, 1974). ERISA is the federal law that sets forth the minimum standards for most voluntarily established retirement and health plans in private industry.[2] It stipulates requirements including plan features and funding, minimum standards for participation, vesting, benefits, fiduciary responsibilities and grievance and appeals processes. The DOL's interpretation of ESG has tended to sway under different presidential administrations. The most recent "DOL Final Rule" released on November 22, 2022 clarifies ERISA's principles of fiduciary duties of prudence and loyalty in selecting investments and retains this core principle.[3] This latest release takes a principles-based approach focusing on DC (defined contribution) pensions where ESG is not prohibited in QDIA (qualified default investment alternatives), but principles of prudence and loyalty should be the focus when selecting QDIA; as this continues to be the case for DB (defined benefit) plans.

Public pension plans established or overseen by state government entities however are not covered by ERISA. In short, public retirement plans are not subject to ERISA's requirements and are instead governed by state and local laws. Each state's executive, legislative and judicial branches enforce, pass or adjudicate laws and regulations that they deem applicable. The lack of a federal ESG policy has resulted in a wide array of legal interpretations and has contributed to complexity and uncertainty to retirement plan ESG considerations. Unfortunately, ESG considerations at the state and federal levels appear to have been highly politicized in the US. On January 27, 2023, 25 states' attorneys general filed a lawsuit to overturn

[1] "COUNTRY UPDATE-France: ESG reporting". Thomson Reuters Regulatory Intelligence. Jun-14-2021
[2] Employee Retirement Income Security Act (ERISA). U.S. Department of Labor (dol.gov)
[3] U.S. Department of Labor (dol.gov). 29 CFR Part 2550. Prudence and Loyalty in Selecting Plan Investments and Exercising Share Holder Rights

the DOL Final Rule which is currently pending. As of March 1, 2023, both US House of Representatives and the Senate passed a resolution to overturn the DOL Final Rule, but President Biden has declared his intention to veto the resolution. These very recent legal challenges and Congressional actions emphasize the uncertainty surrounding the ESG landscape in the US.

Until definitive legal ruling or cohesive federal law is passed, it is imperative for fiduciaries to carefully consider, and substantiate their ESG reasoning as financially relevant to investment risk and return characteristics. Rationales for ESG considerations are typically interpretations of the prudent persons rule to act in the best interest of beneficiaries. This is the primary way in which US fiduciaries can justify ESG considerations in their investments, as being a necessary aspect of sound risk management. This allows some interpretation of what is considered prudent and, in the beneficiaries' best interests, and specifically how ESG-related factors impact risk and return.

Macro Beliefs, Governance, and Implementation

<u>*ESG Macro Beliefs*</u>

In Europe, pension schemes have been taking an active role in ESG where decision-makers have determined that pensions should play a role in ESG investing. Generally, ESG and sustainability concerns are more prevalent culturally, and more supported by European citizens. They have established strong ESG macro beliefs and resulting goals have been focusing on implementing those established ESG goals for pensions. These actions are supported by legislation, regulations, and enforcement. Initiatives in sustainability and ESG by individuals, corporations, government bodies and international/industry organizations support overall strong ESG macro beliefs - which seek to make the world a better place over the long-term. Under these conditions, ESG has formally or informally become part of the fiduciary responsibility of pension funds in the UK and Europe.

<u>*ESG Investment Beliefs and Governance*</u>

ESG investment beliefs and governance addresses how pensions should consider their investment programs under their fiduciary governance constructs. This requires evaluation of fact-based investment beliefs as well as a strong governance process. Understanding who the stakeholders are, their responsibilities to beneficiaries, fiduciaries and others investment professionals and advisors are also important. It is key to understand how ESG investment beliefs impact the risk and return profile of a pension and continues to reflect the plan's investment goals and objectives.

In the absence of national level ESG policy in the US, US asset owners and investors put greater focus on how pension funds should view their investment programs under their fiduciary governance. Given the wide range of investment beliefs and objectives across plans, fiduciaries have greater variation in interpreting the prudent person rule and determining what is in the best interests of the plan, and the role of ESG. For the US, a lack of conviction in ESG macro beliefs lead to a greater emphasis on fiduciary duty. Thus, questions surround whether pension fiduciary duty principles would allow for ESG investing:

- Should sustainable and ESG goals be the responsibility of pensions and pursued by pensions plans at the risk of not providing the promised retirement benefits for beneficiaries?
- Is there conclusive support/evidence that ESG investing can improve returns, lower risk, or solve social problems?
- Would pension beneficiaries object to trustees investing in ESG-related strategies at the risk of potential underperformance which could result in decreased benefits?

The responsibility of decision-makers (trustees, board members, legislators etc.) to stakeholders (beneficiaries) and their differences in ESG goals, varying interests and priorities are of note. A pensioner may accept lower returns for carbon-free world, another may not believe in ESG as a pension's responsibility, while still others may not accept risk of lower returns.

Implementation and Execution
Implementation and execution component is the realm of asset managers and investment advisors. They provide ESG investment solutions, processes, research, portfolio construction or products and marketing within an ESG framework. The growth in ESG is wide scale and consistent among European and UK investors including government, corporate, NGO (non-governmental organisations) and most institutional plans. Unfortunately, the demand has been met with a proliferation of ESG products where most asset managers are "jumping on the bandwagon" to feverishly develop and market ESG funds of less than desirable quality. This has resulted in many new and untested ESG products and some alleged "greenwashing". As a result, these product-hungry asset managers have become the flag waving advocate of ESG investing and arguably the fiduciary. ESG funds have grown 300% since 2016 and Europe has ~83% market share in global sustainable investment products.[4] European regulators are attuned to the situation with additional regulations and enforcement actions as evidenced by German law enforcement officials raiding Deutsche Bank's DWS unit for fraudulent advertising of sustainable/ESG funds in May 2022.

How To (Potentially) Address This Dilemma

There is divergence between Europe and the US on their governance landscapes, and comprehensive and consistent ESG pension investing standards have not yet been established globally. While Europe is going the way of recognizing ESG as part of fiduciary responsibility, many US state regulated pensions and corporate investors believe that ESG should not be a part of fiduciary responsibility. The primary objective for plan fiduciaries is the plan's financial soundness and achieving an optimal portfolio risk-return target. Though country-specific legislation differs, the guiding principle is that the board of trustees has the fiduciary duty to invest in the best interest of a pension fund's beneficiaries (the participants and the retirees).

SECOR believes that staying close to the core of fiduciary duty is the best option in the current environment. We believe investors and managers should keep their focus on an optimal risk/return profile. From a pension investment perspective:

4 Financial News, "ESG funds face huge potential shake in bear market." July 7, 2022. Kelly Anne Smith, "Greenwashing and ESG: What you need to know." Aug 25,2022.

We believe that this focus will mitigate the risks during an evolving and shifting ESG environment and allow plans to be adaptable to future regulations and changes that may arise.

As fiduciaries and investors, we believe risk and return considerations are the paramount objective, but ESG considerations are an indispensable complement for optimal investment decisions. The US lacking a cohesive ESG macro belief should improve upon these efforts and Europe should focus more on ESG investment beliefs and governance. And these two components as determined by asset owners should lead the development and evolution of appropriate implementation solutions and products by the investment management industry not the other way around.

investment strategy, or product made reference to directly or indirectly in this document, will be profitable, equal any corresponding indicated performance level(s), or be suitable for your portfolio.