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VPIC Subcommittee Fiduciary Duty Update

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Partnering for your Success

Investment Fiduciary Duty Relationships

- Delegation of discretion & control over assets given to an expert agent for the benefit of third parties
  - Governs proper use of entrusted power
- Investor duties stricter than corporate standards
- Prudence
  - Not a 'lemming standard'
  - Diversification to minimize risk exposures
- Loyalty to fund purpose & interests of beneficiaries
  - Impartiality between groups, current & future obligations
  - No self-dealing
- Focused on process; does not dictate result

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VPIC Fiduciary Duties

Vermont Prudent Investor Act and trust law

- Observe exclusive fund purpose; sole benefit of participants
- Exercise care, skill and caution of prudent investor
- Investments evaluated in portfolio context; not individually
- Incur only reasonable expenses
- Fiduciary considerations “shall” include (among other things)
  - General economic conditions
  - Possible effects of inflation or deflation
  - An asset’s special value to trust fund purposes
  - Reasonable verification of relevant facts

Title 14A, Chapter 9, Section 902, Vermont Statutes

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Fiduciary Practices are Evolving

- Economic, environmental & social circumstances change
  - Climate change; population growth; investor short-termism; pollution; Paris climate agreements; Great Recession; etc.
- Investment knowledge & theories evolve
  - Purchase of stock was once considered imprudent
- Financial crises highlighted effects of systemic integrity & long-term risk on investment success

"Trust investment law should reflect and accommodate current knowledge and concepts. It should avoid repeating the mistake of freezing its rules against future learning and development." [Restatement of Trusts 3rd §227, Intro]

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Department of Labor (2008): Outdated ERISA Interpretation

”Fiduciary consideration of non-economic factors should be rare and, when considered should be documented in a manner that demonstrates compliance with ERISA’s rigorous fiduciary standards."

Fiduciaries who consider non-economic factors “will rarely be able to demonstrate compliance with ERISA absent a written record . . . showing that the investment alternatives [economic and non-economic investments] were of equal value.”

[Dep't of Labor *ERISA Interpretive Bulletin 2008-01]*

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Department of Labor (2015): ESG Part of Primary Investment Analysis

"Environmental, social, and governance issues may have a direct relationship to the economic value of the plan's investment. In these instances, **such issues are not merely collateral considerations or tie-breakers, but rather are proper components of the fiduciary's primary analysis** of the economic merits of competing investment choices. . . **Fiduciaries need not treat commercially reasonable investments as inherently suspect or in need of special scrutiny merely because they take into consideration environmental, social, or other such factors**."

[Dep't of Labor *ERISA Interpretive Bulletin 2015-01; October 26, 2015]*

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Economically Targeted Investments: 'All Things being Equal' Test Affirmed

"Fiduciaries may invest in ETIs based, in part, on their collateral benefits **so long as the investment is economically equivalent, with respect to return and risk to beneficiaries in the appropriate time horizon**, to investments without such collateral benefits."

"The Department does **not construe consideration of ETIs or ESG criteria as presumptively requiring additional documentation or evaluation** beyond that required by fiduciary standards applicable to plan investments generally."

[Dep't of Labor ERISA Interpretive Bulletin 2015-01; October 26, 2015]

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Advice from Other Law Firms

"The current approach . . . **utilizing ESG factors, focuses on the long-term impact** of these factors, such as climate change and executive compensation, on investment performance. As such, it generally avoids the issues and concerns raised by the previous guidance . . . as recently affirmed by DOL, **ESG factors can be appropriate investment considerations** for ERISA plan fiduciaries."

[Morgan, Lewis & Bockius LLP, February 2016]

*"**It would not be imprudent to divest** the investment if the fiduciary's investment analysis [including transaction costs] identifies **other potential available investments that . . . offer reasonably similar risk and return characteristics.**"*

[Groom Law Group, February 2016]

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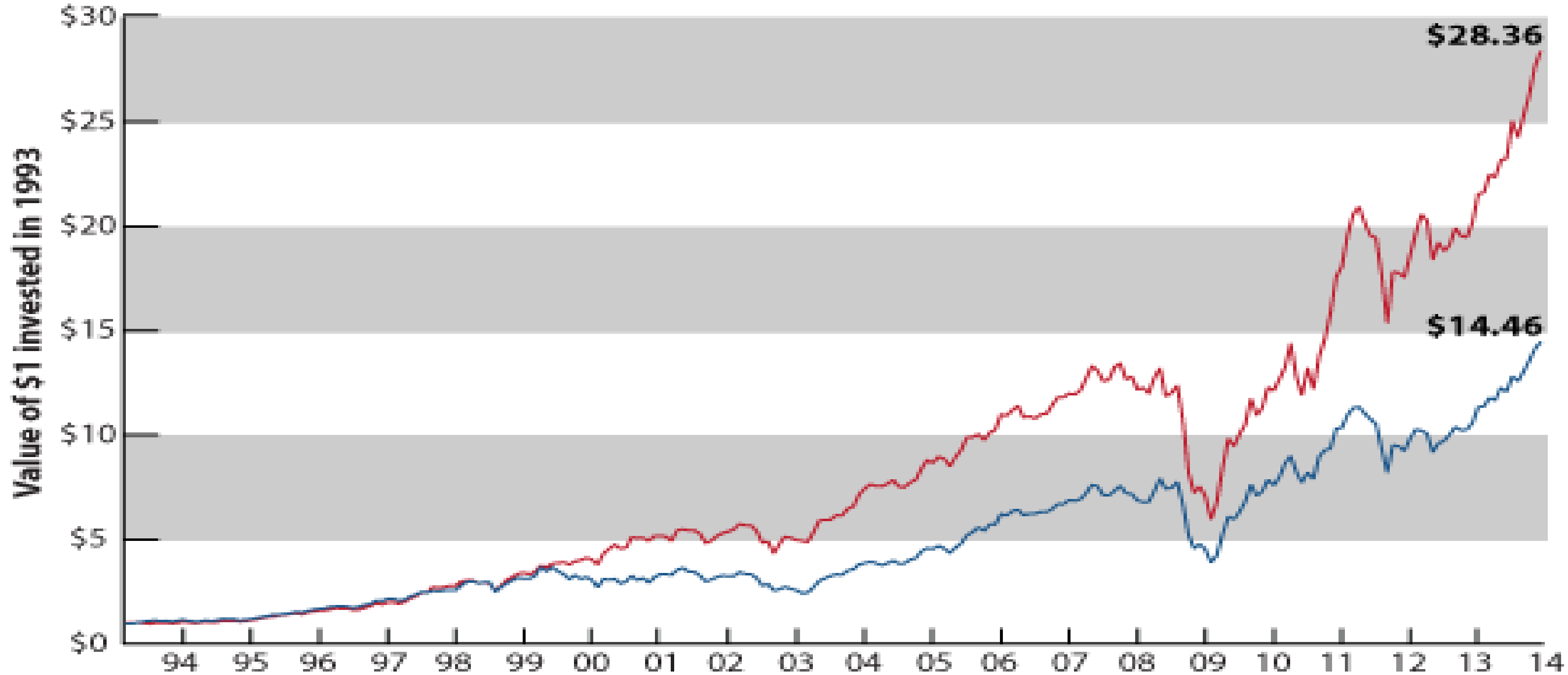
Harvard: Sustainable Investment Pays

--- High Sustainability Companies --- Low Sustainability Companies

Figure VI: Investment Performance



The figure shows the evolution of $1 invested in a portfolio of firms with high performance on the material sustainability issues versus competitor firms with low performance on material sustainability issues. Materiality of sustainability issues is industry-specific and it is defined by the Sustainability Accounting Standards Board. Source: Mo Khan, George Serafeim and Aaron Yoon. Corporate Sustainability: First Evidence on Materiality. HBS working paper, 2014.

Investment Advisor Perspectives

"We believe that **integrating ESG criteria into the investment process is a sound strategy** as a growing body of research highlights the material impact that ESG factors have on a company's long-term performance."

[NEPC, Completing the Analysis: ESG Integrations, November 2015]

"Key Findings . . . **1,051 US equity funds ($825 net asset value) were virtually 'fossil fuel free'**, even though very few of these funds – if any – were marketed as such. "

[MSCI, Fund Transparency: Exploring the ESG Quality of Fund Holdings, 3/2016]

When reviewing18 global institutional investors, Mercer found some could face over $100 billion in cumulative portfolio losses over 35 years from effects of transformative climate change.

[Mercer, Investing in a Time of Climate Change, 2015]

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Effect on Investment Practices

"As a long-term investor, CalPERS must consider risk factors, for example climate change and natural resource availability, that emerge slowly over long time periods, but could have a material impact on company or portfolio returns."
[CalPERS' Investment Beliefs, 2015]

"In her fiduciary role, the Treasurer must . . . consider the social, economic and environmental implications of investment of trust funds in particular securities or types of securities."
[Investment Policy Statement for the State of Connecticut Retirement Plan and Trust Funds, July 2 2013]

"Almost three-quarters of investment professionals worldwide (73 percent) take environmental, social, and corporate governance (ESG) issues into consideration in the investment process . . . practice and methodology are evolving."
[CFA Institute ESG Survey Press Release, August 17, 2015]

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Duty of Impartiality

"The common **law of trusts** [made applicable to ERISA §§404, 409] **recognizes the need to preserve assets to satisfy future, as well as present, claims** and requires a trustee to take impartial account of the interest of all beneficiaries."
[Varity v. Howe, US Supreme Court, 1996]

*"Over the next two decades, the physical and policy **implications of a changing climate will increasingly affect the future performance of American businesses**, and will likely steer investment decisions in areas such as energy, agriculture, coastal property and infrastructure. These effects of climate change will likely affect corporate profitability and government budgets on a global scale, **creating long-term ripple effects in the markets.**"*

[Morgan Stanley Wealth Management, Is the Climate Changing for Fossil Fuel Investments?, February 12, 2016]

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Questions?

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