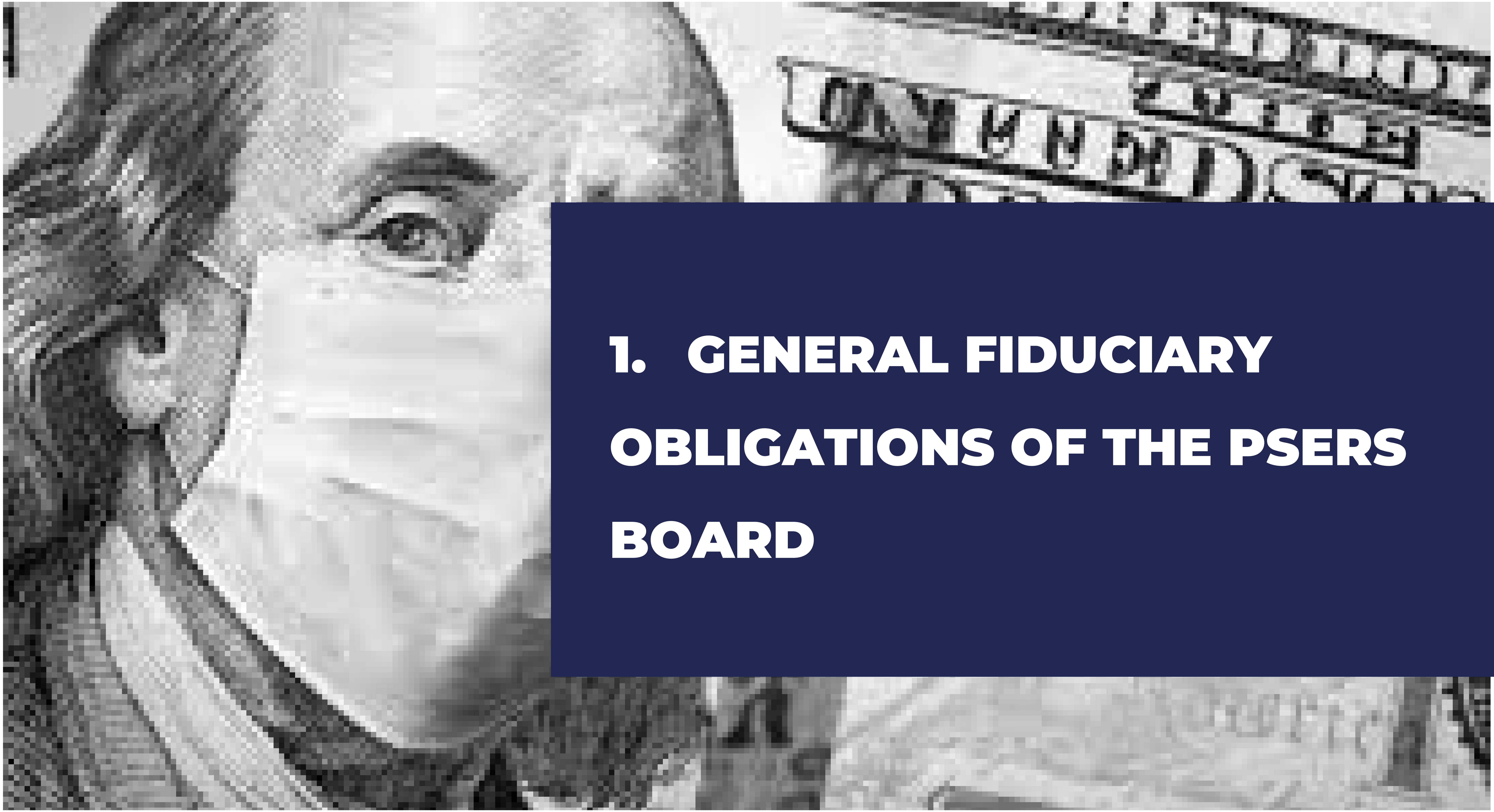
Dilworth Paxson LLP

PENNSYLVANIA PUBLIC SCHOOL EMPLOYEE RETIREMENT SYSTEM

FIDUCIARY DUTIES OF PSERS BOARD OF TRUSTEES



1. GENERAL FIDUCIARY OBLIGATIONS OF THE PSERS BOARD

The Public School Employees' Retirement Code (the "Retirement Code") provides that the PSERS board shall have exclusive control and management of the PSERS fund and full power to invest the same "subject, however, to the exercise of that degree of judgment, skill and care under the circumstances then prevailing which persons of prudence, discretion and intelligence who are familiar with such matters exercise in the management of their own affairs not in regard to speculation, but in regard to the permanent disposition of the fund, considering the probable income to be derived therefrom as well as the probable safety of their capital."

- Trustees' standard of care under the Retirement Code is higher than the duty of care for directors of a Pennsylvania business corporation.

    - PA BCL: a director must act "in a manner he reasonably believes to be in the best interests of the corporation and with such care, including reasonable inquiry, skill and diligence, ***as a person of ordinary prudence*** would use under similar circumstances."

    - Retirement Code: uses a person "of prudence, discretion and intelligence ***who are familiar with such matters***," ***meaning the management and investment of an investment fund***, as the measuring stick.

The PSERS board members are subject to the general fiduciary duties of trustees under the Pennsylvania Uniform Trust Act, including:

- **Duty to administer the fund in good faith**, in accordance with its provisions and purposes and the interest of the beneficiaries and in accordance with the PA UTA

- **Duty of prudent administration**: the trustees must administer the fund as a prudent person would, by considering the purposes, provisions, distributional requirements and other circumstances of the trust and by exercising reasonable care, skill and caution

The PSERS board members are subject to the general fiduciary duties of trustees under the Pennsylvania Uniform Trust Act, including:

- **Duty of loyalty:** the trustees must administer the fund solely in the interests of the beneficiaries
  - The trustees' duty of loyalty under the Retirement Code and the Uniform Trust Act appears higher than the duty of loyalty under the PA BCL.
  - As noted above, the PA BCL requires a director of a business corporation to act in a manner that "he reasonably believes" to be in the best interests of the corporation. The Retirement Code does not give the trustees the benefit of this more subjective standard.

Right to delegate duties to investment advisers and other experts

- The Retirement Code permits the retention of investment advisers and other consultants.

§ 8502. Administrative duties of board.

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(b) Professional personnel.—

(1) The board shall contract for the services of a chief medical examiner, an actuary, investment advisors, counselors, an investment coordinator, and such other professional personnel as it deems advisable.

The right to delegate is subject to prudent selection and monitoring of the investment advisers and other experts

- **Delegation :** the trustees may delegate duties and powers that a prudent trustee of comparable skills might delegate under the circumstances . The trustees retain the duty to exercise reasonable care, skill and caution in:
  - Selecting the agent ;
  - Establishing the scope and specific terms of delegation ; and
  - Periodically reviewing the agent's actions to monitor performance and compliance

- **Safe harbor** : A trustee who complies with these duties is not liable to the beneficiaries or to the trust for an action of the agent to whom the function was delegated .

Practical Application of the Fiduciary Duty of Care

The fiduciary duty of care comes into play when:

- Affirmative act or decision made by the Board
  - E.g., a Board decision to retain and delegate responsibilities to an investment consulting firm or investment advisory firm
- Board's decision must measure up to what a prudent expert would do in like circumstances
- Takes into account: amount of due diligence, adequate time to deliberate; financial condition of the Trust; reputation of the delegated firm; size and change of assets and personnel of the firm; and financial aspects of the transaction.

Practical Application of the Fiduciary Duty of Care

The fiduciary duty of care also comes into play when the Board fails in its duty of oversight.

- For example, having retained and delegated responsibilities to the firm, the Board fails to monitor its activities. (See previous slide on delegation rights and duties under the UTA).
- Well-established Pennsylvania (*In re Lemington Home for Aged*, (3d Cir. 2011)) and Delaware law (*In re Caremark*, (Del. Ch. 1996); *Marchand v. Barnhill*, (Del. 2019); *In re Clovis Oncology, Inc. Derivative Litigation*, (Del. Ch. 2019)) will give guidance on how the duty of oversight will be interpreted.
- There are two prongs to satisfy:
  - (i) whether the Board has failed to implement any reporting or information systems or controls;
  - (ii) the Board having implemented an oversight system, subsequently fails to monitor it and to ignore red flags
- The Board must be informed of compliance issues "intrinsically critical" to the Trust's fundamental business operations.

Power and Privileges of the PSERS Board

- The Retirement Code suggests that the PSERS Board shall in some respects be in the position of the board of a corporation –

§ 8501. Public School Employees' Retirement Board.

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(e) Corporate power and legal advisor -- For the purposes of this part, ***the board shall possess the power and privileges of a corporation***. The board shall be an independent agency under the act of October 15, 1980 (P.L.950, No.164), known as the Commonwealth Attorneys Act.

General Fiduciary Obligations of the PSERS Board

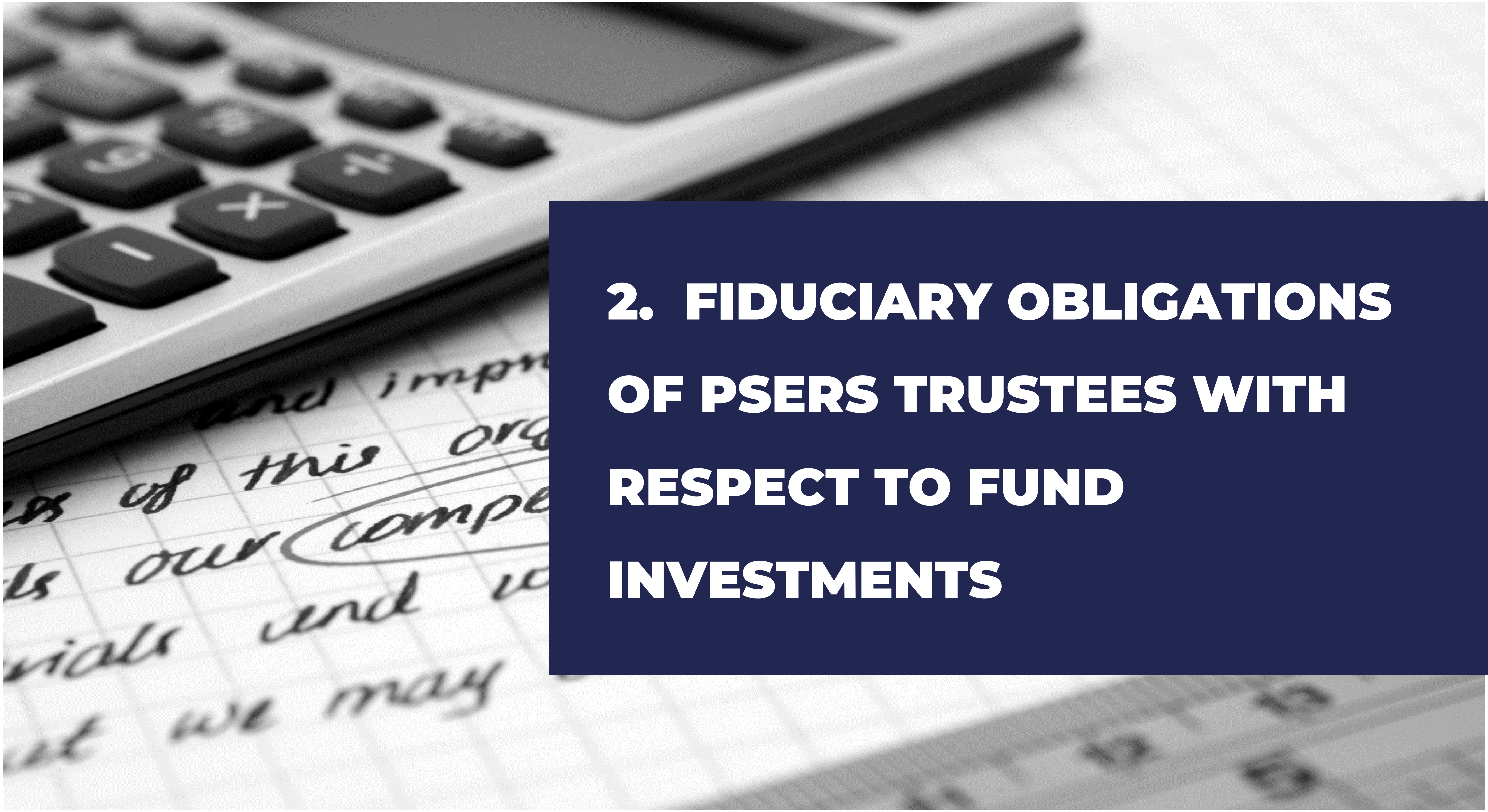
- However, as noted above, the PSERS trustees are subject to fiduciary duties under the Retirement Code and the Uniform Trust Act that are more stringent than those that apply to directors of a PA business or nonprofit corporation, including the duty of care and duty of loyalty.

  - The trustees on the PSERS board do not appear to get the benefit of the "business judgment rule" that offers significant protection to directors of business corporations.

  - The PSERS board is subject to a number of Pennsylvania statutes that govern the conduct of trustees, officers and other officials on state governmental bodies, including the Pennsylvania Ethics Act and Adverse Interest Act.

The PSERS Board has also adopted a number of policies, including an Ethics Policy, which impose standards of conduct on the trustees. The **Ethics Policy** contains detailed rules on avoiding and/or disclosing conflicts of interest, prohibiting self-interested transactions, duties of confidentiality and other duties that are similar to those inherent in the duty of loyalty.

Section IX of the PSERS Investment Policy sets forth a detailed plan for monitoring the performance of the PSERS fund against the investment objectives and benchmarks established by the board.



2. FIDUCIARY OBLIGATIONS OF PSERS TRUSTEES WITH RESPECT TO FUND INVESTMENTS

The Public School Employees' Retirement Code sets forth the fiduciary duties of the PSERS board with respect to the management of the PSERS fund.

§8521. Management of fund and accounts

(a) Control and management of fund.– "the trustees shall have exclusive control and management of the said fund and full power to invest the same, in accordance with the provisions of this section, subject, however, to the ***exercise of that degree of judgment, skill and care under the circumstances then prevailing which persons of prudence, discretion and intelligence who are familiar with such matters exercise in the management of their own affairs not in regard to speculation, but in regard to the permanent disposition of the fund, considering the probable income to be derived therefrom as well as the probable safety of their capital***."

§8521. Management of fund and accounts

(e) Fiduciary status of board.--The members of the board, employees of the board, and agents thereof shall stand in a fiduciary relationship to the members of the system regarding the investments and disbursements of any of the moneys of the fund and shall not profit either directly or indirectly with respect thereto. The board ***may, when possible and consistent with its fiduciary duties . . . consider whether an investment*** . . . ***enhances and promotes the general welfare of this Commonwealth and its citizens, including, but not limited to, investments that increase and enhance the employment of Commonwealth residents, encourage the construction and retention of adequate housing and stimulate further investment and economic activity in this Commonwealth.***

§ 8521. Management of fund and accounts

(h) Venture capital, private placement and alternative investments.--The board in its prudent discretion may make any venture capital investment, private placement investment or other alternative investment of any kind, structure or manner which meets the standard of prudence set forth in subsection (a).

Duty of Prudence – ERISA Standard

- Compare the PSERS board's duty of prudence under the Retirement Code to that under ERISA standard (the prudent *expert* standard)
  - ERISA's prudent expert standard requires the exercise of duties "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man *acting in a like capacity* and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims"
  - PSERS standard does not contain "acting in a like capacity" language, but the standard could be viewed as the same
  - Many statewide systems exempt from ERISA look to ERISA for guidance in establishing the contours of trustee fiduciary duties

Contrast: Duty of Prudence – Prudent Man Standard

- Compare the PSERS board's duty of prudence under the Retirement Code to that under the PA statute on Municipal Investments, 20 Pa. C.S. §§ 7301 et seq. (the prudent person standard)

  - The "prudent person" standard: "Any investment shall be an authorized investment if purchased or retained in the exercise of that degree of judgment and care, under the circumstances then prevailing, which men of prudence, discretion and intelligence exercise in the management of their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income to be derived therefrom as well as the probable safety of their capital." 20 Pa. C.S.A. § 7302.

  - PSERS duty of prudence is higher – not just men, but men "who are familiar with such matters"

ERISA: Duty of Prudence

- Includes the duty to thoroughly investigate contemplated investments – must give "appropriate consideration" to all facts and circumstances the fiduciary knows or should know are relevant

- Department of Labor Interpretive guidance – fiduciaries should select investment classes in accordance with generally accepted investment theories, such as modern portfolio theory (DOL Interpretive Bulletin 96-1)

- Recent Supreme Court case *Hughes v. Northwestern University*
  - Expands on *Tibble v. Edison International*, 575 U.S. 523 (2015)
  - Fiduciary has continuing duty to regularly review and monitor investments
  - Must remove imprudent investments, not simply offer prudent investments alongside imprudent ones (for a 403(b) plan administrator)

ERISA: Duty of Prudence

- DOL issued final rules in 2020 discouraging the use of ESG ("non-pecuniary factors") in investment decisions based on the duty of prudence under ERISA

- Current administration has announced that they will not enforce those rules and have proposed new rules that acknowledge consideration of ESG factors may be permitted (or required) under the duty of prudence

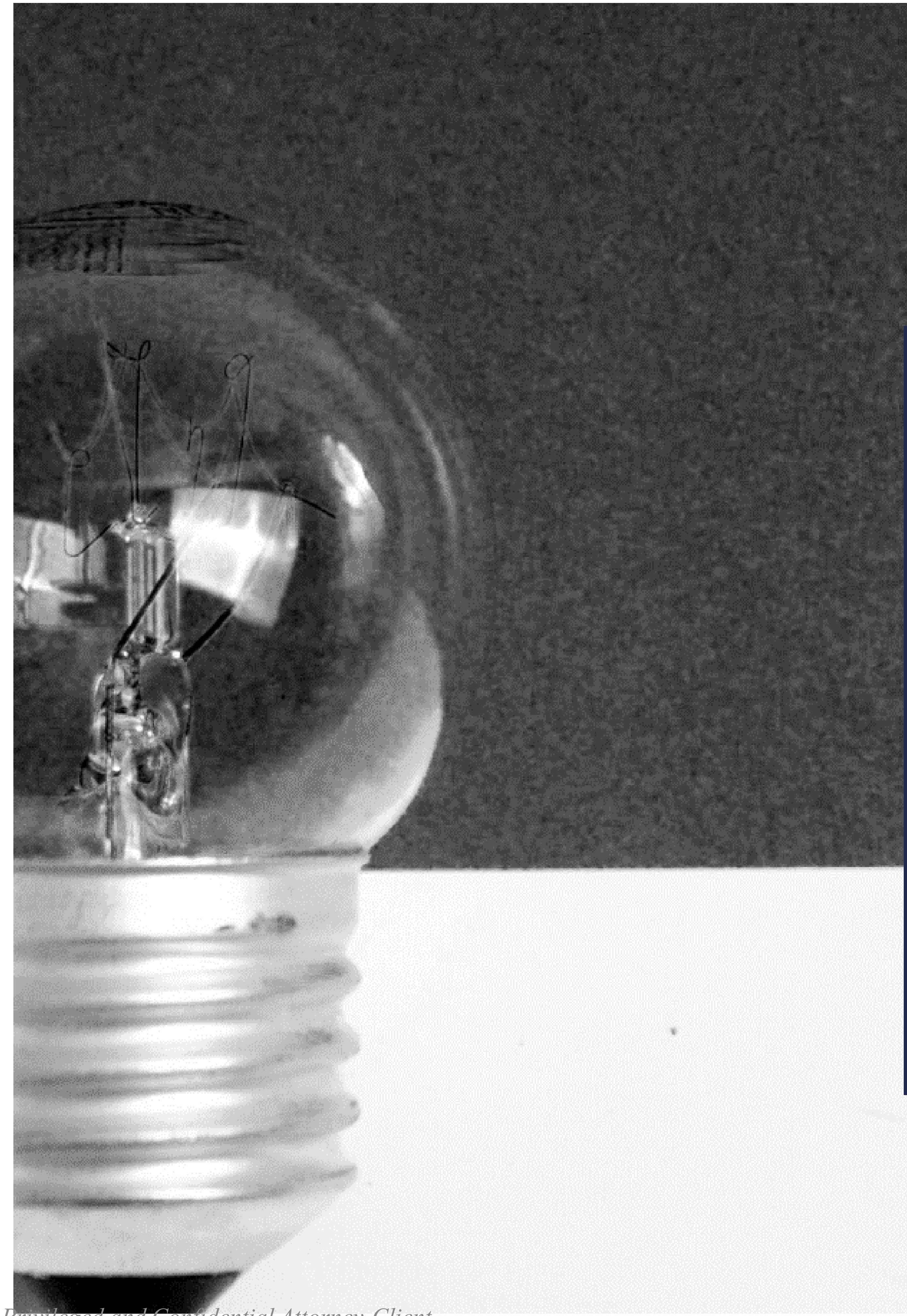
- Consistent standard: fiduciaries must take into consideration the risk of loss and opportunity for gain associated with the investment compared to the opportunity for gain associated with reasonably available alternatives with similar risks.

Duty of Loyalty

- Board “shall not profit either directly or indirectly” with respect to the investment of the PSERS fund and has the obligation to invest and manage the fund for the exclusive benefit of the members of the system.

- As noted above, the PSERS board is also subject to the Pennsylvania Ethics Act and Adverse Interest Act and other Pennsylvania statutes that govern the conduct of agency directors and officials.

- The Ethics Policy adopted by the PSERS board imposes detailed obligations on the trustees that are similar to the duty of loyalty.



3. CONSIDERATION OF ENVIRONMENTAL, SOCIAL AND GOVERNANCE FACTORS

Section 8521(e) of the Retirement Code, quoted above, states that the PSERS board may consider whether an investment "enhances and promotes the general welfare of this Commonwealth and its citizens", but further provides that such investment must be consistent with the board's fiduciary duties imposed by the Retirement Code and other law.

ESG – Environmental, Social, and Governance

- Funds have factored in social and environmental investment objectives since the 1970s
- Investor demand has increased: first "socially responsible" indexes in the 1990s
- One study found that assets in ESG strategies were over $1.6 trillion with advisors globally reporting that 16% of assets are invested in ESG
- Over 70% of institutional investors implement an ESG strategy
- Governmental pension funds such as PSERS have investment objectives and standards of care that differ from those applicable to the private sector

ESG Definition

- Beyond "environmental, social, and governance" there are many subjective distinctions
  - Environmental : climate, resource depletion, pollution and many others
  - Social : employee relations, labor standards, diversity, human rights issues
  - Governance : shareholder rights, corruption and bribery, board composition, executive pay
- Many indexes have proprietary formulas for weighting the factors relating to a company's ESG score
- Investment funds espousing ESG strategies coming under scrutiny by the SEC

ESG Strategies

- Three main methods of considering ESG factors

  - ESG Integration – consider ESG alongside non-ESG factors in investment decisions
  - ESG-Focused – focus on one or more ESG factors to choose investments (targeted portion of the fund)
  - ESG Impact – invest with a stated goal of impacting specific ESG benefits

Other ESG Approaches

- How are other statewide pension systems approaching ESG?
  - Approach varies state by state, though all seem to have considered the issue and incorporated some aspect of ESG analysis (e.g., good governance standards) into their approach
  - Many have rejected aggressive tactics based on ESG (e.g., complete divestment from certain industries or policy-driven decision making on investments) as incompatible with trustees' fiduciary duties absent a statutory mandate

Five Largest Statewide Pension Funds: CalPERS/ CalSTRS

1. **CalPERS**: (a) incorporates ESG analysis in investment decisions through written investment policies tailored to each asset class and (b) takes into account ESG in its approach to voting as a shareholder. Also engages in other advocacy for sustainable investment and financial markets topics.

2. **CalSTRS**: CalSTRS "incorporates ESG considerations into its analysis of the riskiness of its investment decisions and its ownership policies and practices, to the extent that ESG factors are material to the long-term success of an investment."

Both: emphasize short-term gains at the expense of long-term gains are not in the best interest of the fund; see ESG as integral to long-term benefits and evaluation of companies' long-term sustainability to be required by fiduciary responsibilities.

Five Largest Statewide Pension Funds, cont.

3. New York State Common Retirement Fund:

- Incorporates ESG factors into investment process pursuant to investment philosophy because of the influence on return and risks.

- Lengthy list of ESG factors evaluated (Social, for example, includes: human capital management, labor relations, human rights, health and safety, supply chain labor standards, privacy and data security, product safety and quality, and community impact)

Five Largest Statewide Pension Funds, cont.

4. **Florida State Board of Administration** :

- Doesn't formally factor in any ESG analysis in investment decisions

- Written policy as shareholders is to support improved handling of risks and disclosure of a company's environmental practices and contingency plans in order "to protect and enhance our long-term portfolio values"

- Includes areas like: environment and sustainability, greenhouse gas emission, energy efficiency, water supply and conservation, political contributions and expenditure, operations in protected or sensitive areas, community impact assessments (such as controversies, fines, and litigation), supply chain risks, corporate diversity and human rights risks (companies operating in regions that are politically unstable).

Five Largest Statewide Pension Funds, cont.

5. **Teacher Retirement System of Texas**:

- Takes into consideration ESG factors when material to long-term returns and levels of risk.
- The materiality of specific ESG factors varies across strategies, companies, sectors, geographies and asset classes
- Governed by the "prudent person" standard and an investment policy that states "All investments must be made prudently and in accordance with fiduciary and ethical standards, without promoting interests unrelated to the portfolio's stated objectives of controlling risk and achieving a long-term rate of return."

ESG Considerations in Proxy Voting

PSERS has generally adopted Glass Lewis' proxy voting guidelines, include an evaluation of whether a company's directors have adequately considered ESG factors in managing risk:

> "Glass Lewis believes that one of the most crucial factors in analyzing the risks presented to companies in the form of environmental and social issues is the level and quality of oversight over such issues. When management and the board have displayed disregard for environmental risks, have engaged in egregious or illegal conduct, or have failed to adequately respond to current or imminent environmental risks that threaten shareholder value, we believe shareholders should consider holding directors accountable. When companies have not provided for explicit, board-level oversight of environmental and social matters and/or when a substantial environmental or social risk has been ignored or inadequately addressed, we may recommend voting against members of the board."

ESG Considerations in Proxy Voting

- PSERS voting policy provides for several modifications and enhancements to the Glass Lewis guidelines :
  - PSERS policy requires that, in voting proxies, special attention be given to companies that are headquartered, incorporated, or have significant contact Pennsylvania to ensure that the best interests of the Commonwealth and PSERS' beneficiaries are promoted
  - PSERS' proxy voting policy also supports increasing diversity in the boardroom (including diversity in experience, gender, race and age) on the grounds that this will enhance shareholder value Therefore, the PSERS' policy is generally to vote for qualified diverse nominees unless such a vote would violate another provision of its policy
  - Regarding shareholder proposals on various matters, including environmental matters, PSERS' policy is to abstain from voting for or against such proposals unless they will positively or negatively affect the best economic interests of PSERS' beneficiaries

ESG Factors

- As noted above, the PSERS board has a duty to invest and manage the fund for the exclusive benefit of the members of the system, rather than for the benefit of the general public or the community at large (although PSERS *may* consider these factors).

  - Therefore, the PSERS board may not be able to consider ESG factors in making investment decisions unless there is a reasonable basis for concluding that such consideration will enhance the performance of the fund in the long run.

  - However, arguably the board could take ESG considerations into account in declining an investment opportunity where the ESG factors support the conclusion that the investment could have a detrimental effect on the general welfare of the Commonwealth.

ESG Factors

- The PSERS Investment Policy does not mention ESG considerations
  - However, the PSERS Investment Policy sets forth an investment philosophy that focuses on the performance of the fund over the long run, and does not require investments to be made strictly on the basis of maximizing returns or preservation of principal .
  - If the PSERS board wants to consider ESG factors as part of its investment philosophy – either as a basis of making investments or turning down investment opportunities – it should amend the Investment Policy to permit (and possibly require) such consideration and provide guidance with respect to the proper role of ESG factors in investment decisions .

ESG Factors

- The fact that so many private and public investors, including public pension funds, consider ESG factors suggests that the PSERS board should at least consider whether to adopt any type of ESG investment policy.

- The prevalence of investor attention to ESG factors in the markets may in itself be influential on investment results, even if those factors do not ultimately have the same impacts on individualized economic outcomes such as profitability.

- The PSERS trustees could be subject to criticism if they fail to take ESG risk factors into consideration in making investment decisions given that they have generally subscribed to Glass Lewis' consideration of ESG related risks in evaluating whether directors are properly performing their duties

ESG Factors

- Guidance based on standards used by other pension funds
- Guidance based on proposed US DOL Regulations
  - Comparison to regulation proposed by DOL under the current administration with the regulations promulgated by the previous administration .
  - Despite the more hospitable treatment of ESG considerations under the proposed federal regulations, ESC factors cannot be used to make investments that are inconsistent with a board's duty of prudence .

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