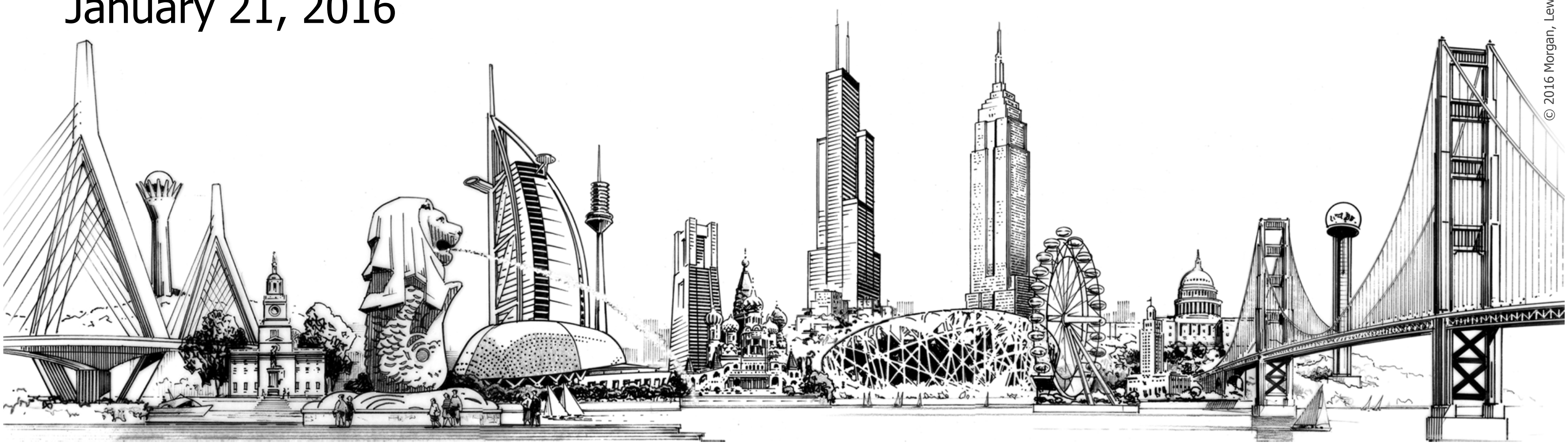
Morgan Lewis

SOCIAL INVESTING BY INSTITUTIONAL INVESTORS

Presenters: Craig Bitman, Paul McCoy, and Celia Roady

January 21, 2016



Agenda

- Introduction
- Employee Benefit Plans
  - General fiduciary rules applicable to these types of investors
  - US Department of Labor (DOL) and case law guidance
    - Social investments (economically targeted investments)
    - ESG (environmental, social, and governance) investments
    - Process to follow to engage in these types of investments
- Exempt Organizations
  - General fiduciary rules applicable to these types of investors
  - Program-related investments
  - Expenditure responsibility
- Impact on Investment Managers

SECTION 01

EMPLOYEE BENEFIT PLANS

Employee Benefit Plans – Basic Rules and Governing Law

- Privately Sponsored Plans
  - Defined benefit plans and defined contribution plans
  - Investment authority typically rests with trustees or committees of the plan sponsor
  - Investment authority often delegated to investment managers or funds
  - Subject to ERISA
    - Duty of prudence
    - Duty to diversify plan assets
    - Duty of loyalty/prohibited transactions
    - Exclusive benefit rule
  - Enforcement through US DOL and private causes of action

Employee Benefit Plans – Basic Rules and Governing Law

- Governmental Plans
  - Not subject to ERISA, but subject to IRC prohibited transaction rules
  - Typically governed by state or local statute that is similar in nature to ERISA or one of the model investment acts
    - Duty of prudence
    - Duty of loyalty
    - Exclusive benefit rule
  - Often no private cause of action – however, union grievances process may create causes of action
  - Oversight often by Attorney General, Insurance Commissioner, or some other state body
  - Because of lack of guidance, many states look to US DOL guidance as persuasive authority

ETIs

- What is an Economically Targeted Investment?
- General Rules
  - Investments must benefit "participants as participants"
  - The exclusive benefit rule requires that first and foremost an investment must be made for the benefit of the System
  - All other things being equal, can select an investment that serves a social goal
  - Must comply with prohibited transaction rules to maintain qualification of the System
  - **PROCESS IS KEY**

Social Investing and ETIs

- *Withers* (SDNY 1978): Pension Fund Trustees' investment in bonds found not to violate prudent investor rule where the alternative to purchasing the bonds would be bankruptcy of the Fund itself
- *University of Oregon* (Circuit Court, Oregon 1986): Resolution adopted by the State Board of Higher Education instructing the trustee of the Oregon Higher Education endowment funds to divest such funds of all common stock of corporations doing business in South Africa and Namibia violated standards of prudence

Social Investing and ETIs

- *City of Baltimore* (Md. 1989): Baltimore City Council ordinances that generally provided that no funds of the City's retirement systems could be invested in banks or financial institutions that made loans to South Africa or Namibia or in companies doing business in or with these countries were upheld
  - Additionally, the court reasoned that if the cost of investing in accordance with social considerations is *de minimis*, the duty of prudence is not violated
- *Scaglione* (NY 1975): Court found legislation that would have mandated that the Comptroller purchase a specified amount of bonds issued by the Municipal Assistance Corporation was unconstitutional

Social Investing and ETIs

- DOL Interpretive Bulletin 2008-1
  - Fiduciary standards for ETIs are no different from standards applicable to plan investments generally
  - Need to follow standard ERISA duties of prudence and loyalty
  - **All** other things being equal
  - Contemporaneous writing
- DOL Interpretive Bulletin 2015-01
  - Removes contemporaneous writing requirement
  - Makes it clearer that can take into account ESG factors in making investment decisions
  - Issues that go to investment return are not subject to all other things equal standard
  - Acceptable to consider these factors when reviewing managers

ESG

- What is ESG and potential investment impact?
  - Environmental Issues
    - Resource management and pollution control
    - Reduced emissions
    - Reporting/disclosure
  - Potential Economic Impact
    - Avoid or minimize environmental liabilities
    - Lower costs/increase profitability through efficiencies
    - Reduce regulatory, litigation, and reputational risks
    - Indicator of well-governed company

ESG

- Social Issues
  - Workplace
  - Product integrity
  - Community impact
- Potential Economic Impact
  - Improved productivity, morale, absenteeism, openness to new ideas, reduced employment litigation risk
  - Create brand loyalty, reduce product replacements, reduce reputational and product liability litigation risk
  - Retain license to operate

ESG

- Governance
  - Executive compensation
  - Board accountability
  - Reporting and disclosure
  - Shareholder rights
- Potential Economic Impact
  - Align interests of shareowners and management
  - Avoid negative financial surprises
  - Reduce reputational risk

ESG Process

- IB 2015-01 clarifies that ESG considerations are undertaken for expected financial impact only – avoids need for “all other things being equal” analysis
  - Document general Board findings on these matters
  - Instruct the Executive Director and investment staff to consider these issues in connection with investments
  - Like all other investment attributes, ESG factors to be considered and weighed – but, like other factors that influence risk and return, they should not necessarily be dispositive in decisionmaking
  - PROPER DOCUMENTATION OF ACTIONS

SECTION 02

EXEMPT ORGANIZATIONS

Private Foundation Tax Rules for Social Investments

- Section 4944 governs private foundation investments
- Investments must either meet "prudent investment" rules or constitute "program-related investments"
- Investments that fail to meet one of these requirements will subject the foundation to excise tax
- Foundation managers who approve the investments may also be subject to tax

Jeopardy Investments

- These are essentially defined as investments that do not meet the "prudent investment" rules under state law
- The Uniform Prudent Management of Institutional Funds Act (UPMIFA), which has been adopted in all but one state, provides that an institution is allowed to consider any special relationship between the investment and the organization's mission as one of the factors to be considered in determining whether an investment is prudent
- In IRS Notice 2015-62, the Treasury and the IRS explicitly referenced this provision of UPMIFA as relevant to private foundations considering mission-related investments
- Investments meeting this standard are often referred to as "mission-related investments" or "MRIs"

Program-Related Investments

- Program-related investments (PRIs) are investments made to serve charitable purposes
- PRIs must meet three requirements:
  - The primary purpose must be to accomplish charitable purposes
  - No significant purpose can be the production of income or appreciation of assets
  - No part of the investment can be for lobbying or campaign intervention

Types of PRIs

- PRIs can be made to charitable or non-charitable organizations
- PRIs can take many forms
  - Low-interest loans
  - Equity investments
  - Guarantees
- PRIs can be made to domestic or international organizations
- Common denominator is that the purpose must be charitable

Expenditure Responsibility

- Foundations must exercise "expenditure responsibility" on PRIs made to non-charitable organizations
- Under Section 4945, expenditure responsibility involves several steps:
  - Conducting a pre-grant inquiry to determine that the PRI can be expected to carry out the charitable activity for which the PRI will be made
  - Entering into a written PRI agreement containing certain requirements
  - Obtaining reports on the use of the PRI funds
  - Making reports to the IRS on Form 990-PF
- There is no "expenditure responsibility" requirement for MRIs

SECTION 03

IMPACT ON INVESTMENT MANAGERS

Key Considerations for Asset Managers

- Increased investor demand
- Implementing solutions for investors
  - Existing products
  - New products
- Passive approach – e.g., investment screens
- Active approach – e.g., seeking affirmative impact other than solely financial returns
- Fiduciary duties run to all investors
- Reporting considerations

Morgan Lewis

QUESTIONS?

Presenters

Craig Bitman

Partner, Employee Benefits

New York

+1.212.309.7190

cbitman@morganlewis.com

Celia Roady

Partner, Tax

Washington, DC

+1.202.739.5279

croady@morganlewis.com

Paul McCoy

Partner, Investment Management

San Francisco

+1.415.442.1385

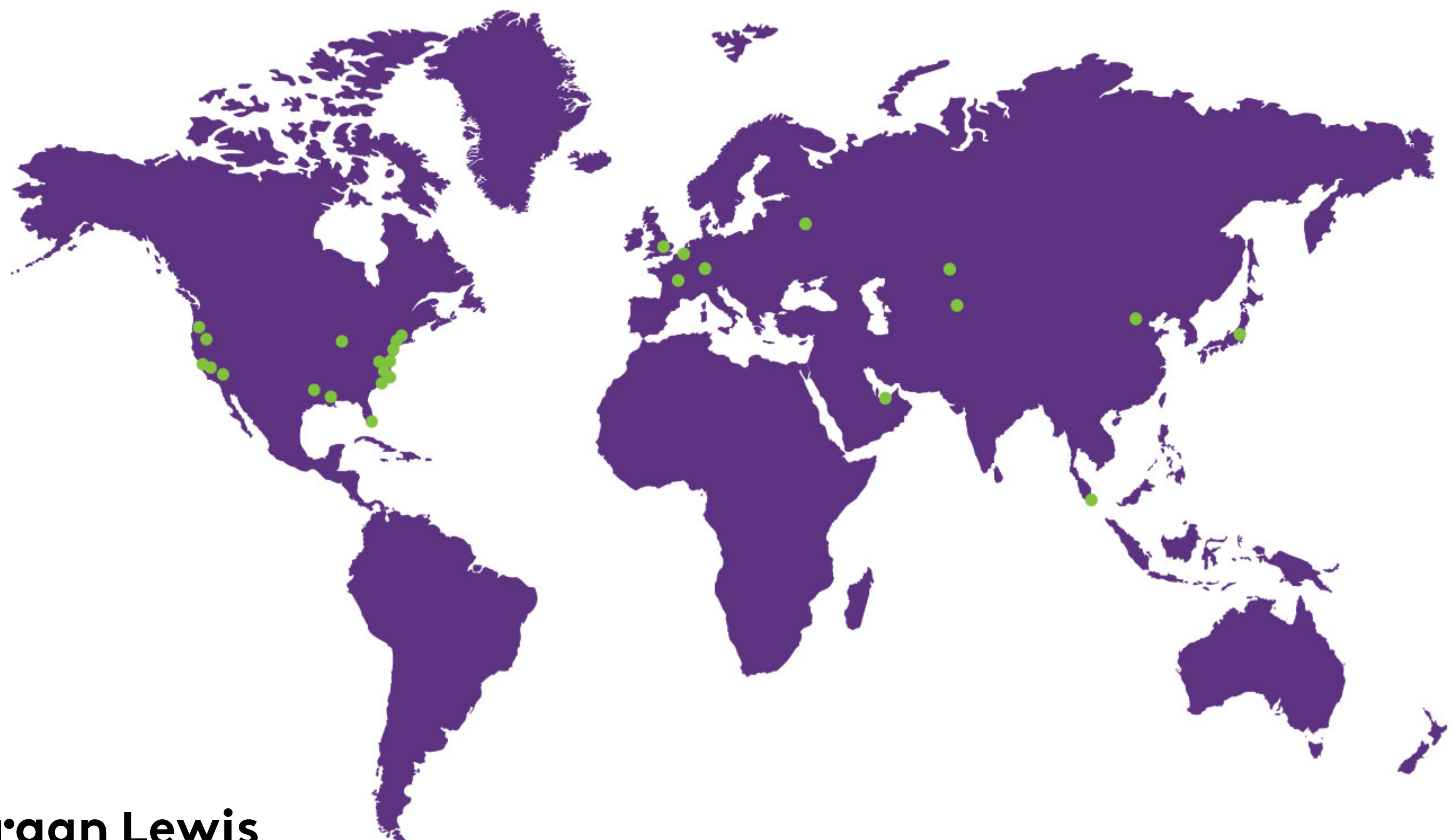
pmccoy@morganlewis.com

Our Global Reach

Africa
Asia Pacific
Europe
Latin America
Middle East
North America

Our Locations

Almaty
Astana
Beijing
Boston
Brussels
Chicago
Dallas
Dubai
Frankfurt
Hartford
Houston
London
Los Angeles
Miami
Moscow
New York
Orange County
Paris
Philadelphia
Pittsburgh
Princeton
San Francisco
Santa Monica
Silicon Valley
Singapore
Tokyo
Washington, DC
Wilmington



Morgan Lewis

THANK YOU