SEATTLE CITY EMPLOYEES' RETIREMENT SYSTEM

Consideration of Environmental, Social, and Governance (ESG) Investment Proposals

Explanation of Proposed Policy

Attached is a proposed policy for the Seattle City Employees' Retirement System regarding consideration of environmental, social, and governance (ESG) investment proposals. The purpose of this memorandum is to explain the need and the basis for the proposed policy.

1. Introduction

The Seattle City Employees' Retirement System (Retirement System or System) periodically receives inquiries and requests regarding investment, disinvestment, divestment or other changes to the System's investment portfolio designed to further environmental, social, and/or governance objectives. Further, given the ongoing national and international discussion of Environmental and Social Investment, the Retirement Board has engaged its Governance Committee, professional investment advisory firm, staff, and legal counsel to propose revisions to its existing policy and procedures.

2. Summary of the Proposed Policy

The proposed policy reflects that ESG investment proposals will be given priority to the extent that the Retirement System's fiduciary obligations are not compromised, and specifies a procedure for considering ESG proposals.

3. Background Regarding the Proposed Policy

A. <u>Fiduciary Responsibilities</u>

The Retirement System's assets are held in trust for the exclusive benefit of the members of the system and their beneficiaries. Seattle Municipal Code (SMC) 4.36.360A provides:

> "The retirement fund shall be a trust fund for the exclusive benefit of the members of the City Employees' Retirement System and their beneficiaries. No part of the corpus or income of the retirement fund shall be used for or diverted to, purposes other than for the exclusive benefit of the members of the system or their beneficiaries and the payment of fees and expenses of maintaining and administering the system."

This structure makes the Board of Administration function as trustees over the Retirement System's assets – subject to the "duty of loyalty" as well as the duty of prudence in Retirement System investments. As summarized by the Washington Supreme Court, this duty of loyalty means that the Board "must act with undivided loyalty to the trust beneficiaries, *to the exclusion of all other interests*. . . . It may not sacrifice this goal to pursue other objectives, no matter how laudable those objectives may be." *Skamania v. State*,102 Wn.2d 127, 134 (1984) (emphasis added).

Investment and management of the Retirement System's assets is also a matter of fiduciary responsibility under state law. The Board of Administration must "act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man or woman 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; shall diversify the investments of the employees' pension system so as to minimize the risk of large losses; and shall act in accordance with the documents and instruments governing the employees' pension system, insofar as such documents and instruments are consistent with the provisions of this title." RCW 35.39.060. This is very similar to the fiduciary responsibility of the Washington State Investment Board in investing the state retirement systems' holdings. RCW 43.33A.140.

Because of these directives, it has long been understood by the state, the City of Seattle, and the Retirement System that economically-targeted investment proposals, and proposals designed to address environmental, social, and governance issues have to meet the same fiduciary standards of prudent investment as any other investments. For example, addressing proposed disinvestment from companies doing business in South Africa, in 1985 the Seattle City Attorney's office opined that "[w]hen the return to and the safety of principal from investments are equivalent, trustees may take into account in making trust investments . . . moral, ethical, and social considerations." Opinion 7695 (March 26, 1985). That opinion concluded that the Board of Administration "may not pursue a policy or practice, which reduces the financial return to the pension fund or significantly increases the risk to fund capital in order to further ethical or social considerations." This is consistent with legal opinions throughout the nation regarding public and private retirement fund investments. Exercising its authority to oversee fiduciary responsibility in private pension plans, the U.S. Department of Labor has issued a bulletin stating that "in the course of discharging their duties, fiduciaries may never subordinate the economic interests of the plan to unrelated objectives, and may not select investments on the basis of any factor outside the economic interest of the plan," except in the very limited circumstance where "two or more investment alternatives are of equal economic value to a plan." In that case, "fiduciaries can choose between the investment alternatives on the basis of a factor other than the economic interest of the plan." U.S. Dept. of Labor Interpretive Bulletin 2008-1.

The Investment Policy for the Retirement System follows these requirements. Regarding "Economically Targeted Investments," it states that an investment to "promote a socially desired goal such as rewarding nondiscrimination and promoting local industry will be given priority if the investment meets the goals of the Retirement System and if the resulting return on investment and related risk are comparable to other available investments in the same category" and that investments "will not be selected, rejected, or divested from based solely on geopolitical and social issues."

The Washington State Investment Board's policy regarding Economically Targeted Investments (ETIs) takes the same approach, stating that the WSIB "will consider for investment only those ETIs that are commensurate on a risk-adjusted financial basis to alternatively available investments" and that a "decision to invest in an ETI in consideration of its collateral benefits shall be made only after the opportunity is deemed acceptable exclusively on its economic investment merits."

B. Approach to Meeting Fiduciary Responsibilities

The proposed policy continues to meet the fiduciary requirements of state law and the Seattle Municipal Code by establishing a systematic method for review of social, geopolitical, governance, or economically-targeted investment proposals.

In considering adoption of this policy, the Retirement System received extensive information regarding permissible investment structures and approaches from the Retirement System's professional investment advisory firm, investment staff, and legal advisors. Options and structures sometimes used by private and public retirement funds, such as the Principles for Responsible Investing, were also analyzed and considered. The proposed policy is the result of careful examination of each such option and the determination of an approach that fits the Retirement System's specific legal responsibilities, structures, policies, and needs.

In establishing its procedures, the Retirement System concluded that it needs specific and detailed proposals so that it can meet its fiduciary responsibilities. Therefore, ESG proposals must be in writing and provide specific, detailed analysis to support a conclusion that the proposed action is comparable in risk and return to the alternative investments in the same category, and consistent with the System's policies. Those proposals which the System's Investment Committee feels may support such a conclusion will be referred to the Retirement System's professional investment consultants for their evaluation. When a proposed action meets these tests, it can then be considered for adoption by the Retirement System.

POLICY AND PROCEDURE FOR CONSIDERATION OF ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) INVESTING PROPOSALS

BOARD ADOPTION: __________ EFFECTIVE DATE: ____________

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POLICY

The Board of Administration (Board) adopts this policy regarding consideration of environmental, social and governance (ESG) issues for Retirement System investments. The Board's fiduciary obligations to the members of the System are its top priority. Investment actions which promote an ESG goal such as rewarding nondiscrimination or promoting local industry will be considered if the proposed action does not adversely affect investment risk and/or return for the System and if the resulting expected return on investment and related risk for the proposed action are comparable to other available investments in the same category. While the Board will give serious consideration to environmental, social and governance issues, investments will not be selected, rejected, or divested from based solely on those considerations.

PROCEDURE FOR CONSIDERATION OF ENVIRONMENTAL, SOCIAL AND GOVERNANCE INVESTING PROPOSALS

A proposal for consideration of an ESG investment action may take the form of a proposal to make a particular investment, to refrain from doing so, or to take any other action related to the handling of the System's assets or the rights associated with those assets. Any and all such proposals are to be considered in the manner outlined in this policy.

A. To receive consideration, an ESG investment proposed action must meet the following requirements:

1. It must be specific and presented in writing to the Executive Director of the Retirement System, or at a meeting of the Board or of the Investment Committee;
2. It must include objective, reasoned analysis indicating how the proposal meets the fiduciary obligations of the Retirement System, and that the return on investment to the System and related risk of the proposal are comparable to other available investments in the same category;
3. It must appear to be reasonably feasible for the Retirement System to accommodate within SCERS' portfolio of investments or in a reasonable modification of them; and
4. It must not, in the discretion of the Board or Investment Committee, be considered duplicative of a recently-considered proposal.

This determination shall be made by the Investment Committee unless the Board elects to address the matter.

B. If an ESG investment proposal meets all of the requirements of Section A as determined by the Board or the Investment Committee, it shall be forwarded to the Investment Consultant for review and written analysis of whether the proposal would be expected to provide a return on investment and related risk comparable to other available investments in the same category and meet all other requirements of the System's investment policies. The written analysis shall provide: 1) identification of the potentially available ESG investment options, if any, that meet the requirements of the System's investment policies; 2) a survey of comparable investment funds' approaches to this type of proposal, or similar proposals; and 3) assessment of the projected impact of the proposal on the returns and risks of the System's investment portfolio compared to other available investments in the same category.

C. If the Investment Consultant reports that the ESG proposal meets the requirements of the System's investment policy outlined above, the Board shall consider the proposal, after receiving such additional information as it may deem necessary or appropriate from the Investment, Consultant, Investment Committee and any other professionals.

D. The Investment Consultant will be requested to provide an annual overview of the ESG issues and industry responses to the Board or Investment Committee. The purpose of this work is to inform future policy and practices with respect to ESG proposals.

POLICY REVIEW

The Board shall review this policy at least once every three (3) years to ensure that it remains relevant and appropriate.