



# Board of Retirement Regular Meeting

## Sacramento County Employees' Retirement System

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### Agenda Item 15

**MEETING DATE:** October 18, 2023

**SUBJECT:** Education: Fiduciary Duties and Investment Considerations

**SUBMITTED FOR:**  Consent  **Deliberation** and Action  **Receive** and File

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### RECOMMENDATION

Staff recommends that the SCERS Board receive and file presentations regarding fiduciary duties and investment considerations, as presented by Nossaman LLP and Verus Advisory.

### PURPOSE

This item supports the 2023 Annual Investment Plan to provide investment education to Board members.

### SUMMARY

At the March 2023 Board meeting, Staff and general investment consultant Verus presented an educational session on Environmental, Social, Governance (ESG) and Value-Based investing. The objective of the presentation was to provide background on ESG, highlight approaches that institutional investors take to ESG, and review SCERS' experience related to ESG.

As a next step, Verus and Staff recently conducted a survey with Board members on the topic, including a broad range of ESG-related considerations, including Diversity, Equity, and Inclusion (DEI). The objective of the survey was to learn how the Board wanted to address ESG considerations within the SCERS portfolio, if at all. At the October meeting, general investment consultant Verus will present the results from the survey.

Prior to Verus' presentation of the survey results, Ashley Dunning, an attorney from law firm Nossaman will provide education on fiduciary considerations associated with ESG and DEI. Ms. Dunning has provided a similar presentation to several public pension plans. Her presentation will review the fiduciary standards applicable to public pension plan boards and how ESG and DEI considerations fit within these fiduciary standards. She will also focus on ways to balance ESG and DEI considerations with fiduciary duties when making investment decisions.

**ATTACHMENTS**

- Board Order
- Nossaman Presentation - Fiduciary Considerations Regarding “ESG” and “DEI”
- Verus Presentation - Trustee ESG Survey Results

Prepared by:

Reviewed by:

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Steve Davis  
Chief Investment Officer

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Eric Stern  
Chief Executive Officer



# Retirement Board Order

## Sacramento County Employees' Retirement System

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Before the Board of Retirement  
October 18, 2023

AGENDA ITEM:

### Education: Fiduciary Duties and Investment Considerations

THE BOARD OF RETIREMENT hereby approves Staff's recommendation to receive and file presentations regarding fiduciary duties and investment considerations, as presented by Nossaman LLP and Verus Advisory.

I HEREBY CERTIFY that the above order was passed and adopted on October 18, 2023 by the following vote of the Board of Retirement, to wit:

AYES:

NOES:

ABSENT:

ABSTAIN:

ALTERNATES:

(Present but not voting)

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James Diepenbrock  
Board President

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Eric Stern  
Chief Executive Officer and  
Board Secretary



**Ashley Dunning**  
Partner

## **Fiduciary Considerations Regarding “ESG” and “DEI”**

Presentation to the Board of Retirement  
Sacramento County Employees’ Retirement System

October 18, 2023

# Overview

- Discuss definition of “ESG” investing, as referenced in Staff and Verus Advisory presentation to SCERS Board on March 15, 2023.
- Address Diversity, Equity and Inclusion (“DEI”) as an “S” factor in ESG.
- Summarize fiduciary and other legal standards applicable to California public pension boards, and, in particular, as to investing trust assets.
- Review Department of Labor (DOL) guidance to plans governed by the Employee Retirement Income Security Act of 1974 (ERISA).
  - SCERS is exempt from ERISA, but governmental plans sometimes look to DOL rules for guidance.
- Consider next steps for SCERS re ESG investing.

# What is ESG Investing?

- Environmental-Social-Governance (ESG) Investing:
  - Use of factors that consider environmental footprint, social impacts and/or corporate governance.
  - Ranges from minimal (applying ESG factors to inform economic analysis) to direct (applying ESG screens or selecting only ESG-specific funds in designated investment options (i.e. economically targeted investments (“ETIs”))).





# Fiduciary Standards Applicable to Public Pension Plans Under California Law

- Duty of Care
- Duty of Loyalty

# Fiduciary Duty of Care

- **Prudent Expert Rule:** make decisions that a prudent person acting in like capacity, familiar with these matters would use.
- **Duty to Assure Competency of Retirement System Assets.**
- **Duty to Monitor** and take corrective action.
- **Duty to Consult with Experts** to make informed investment and other decisions.
  - Demonstrate an informed, reasonable, and prudent rationale for failing to follow any such expert advice.

# Fiduciary Duty of Loyalty



- **Exclusive Benefit Rule:** use trust fund only to provide retirement and related benefits as provided by the plan, and defray reasonable administrative expenses.
- **Primary Duty Rule:** duty to participants/beneficiaries takes precedence over any other duty.
- **No “dual loyalties”:** trustees aren’t “agents” for the party that appointed or elected them.
- **No collateral interests:** trustee’s personal views concerning social or political issues or causes shouldn’t be basis of decisions.

# Fiduciary Duties of Care and Loyalty as to *Investments* under California Law



- **Diversification mandate**

- Board of Retirement required to diversify the investments to minimize the risk of loss and to maximize the rate of return, *unless under the circumstances it is clearly not prudent to do so.*

- **Divestment-related rules**

- Legislature may prohibit certain investments by a retirement board where it is in the public interest to do so, *if that the prohibition satisfies the standards of fiduciary care and loyalty required of a retirement board.*

# Fiduciary Considerations In ESG Investing

- **Common thread:**

- Social interests may be advanced through investments by fiduciaries only if the interests of trust beneficiaries *are not compromised*.
  - Interest of trust beneficiaries: *risk-adjusted returns used to fund benefits provided by SCERS.*



# Background of DOL ESG Rule for Plans Governed by ERISA (not binding on SCERS)

- Guidance fluctuated over time:
  - ETIs were not “inherently incompatible” with ERISA’s fiduciary obligations, to “all things being equal” tie-breaker test, to “financial factors” rule with extra documentation requirement, to prioritization of creation of well-paying union jobs and bolstering environmental sustainability.
  - DOL uniformly cautioned, however, against reduced returns or greater risks to secure ESG goals.

# DOL Recent Final Rule re ESG Investing By ERISA fiduciaries (not binding on SCERS)

- “Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights” (effective 1/30/2023).
  - Removes “pecuniary/non-pecuniary” concepts.
  - ESG considerations can be weighed *so long as fiduciary reasonably determines they are relevant to risk and return analysis.*
  - Removes special regulatory documentation requirement.
- Pending litigation in other states challenges this rule, but it is currently in effect for plans that are subject to ERISA.
  - On September 23, 2023, Federal Court in Texas rejected Attorneys General challenge to DOL Final Rule.

# Legislative Actions Regarding ESG Factors

- State legislatures throughout the country have considered, and some cases enacted, bills either *prohibiting or requiring* the consideration of some or all such factors.
  - Implementation of such mandates typically, but not always, contains a “fiduciary savings clause” allowing trustees to consider whether complying with the governmental mandate would be consistent with their fiduciaries duties of care and loyalty.
- In California, most divestment legislation, which typically seeks to address an environmental, social or governance-related topic, has been directed at state, rather than county or city, retirement systems.

# Legislative and Court Actions Regarding DEI Factors

- In California, Prop. 209 added Section 31 to the California Constitution in 1996, thereby prohibiting the state from discriminate against or grant preferential treatment on the basis of race, sex, color, ethnicity, or national origin in the operation of public employment, public education, and public contracting. Therefore, Prop. 209 banned the use of affirmative action involving race-based or sex-based preferences in California.
- In *Hi-Voltage Wire Works v. San Jose* (2000), the California Supreme Court held that, within the context of Proposition 209, *discrimination* means “to make distinctions in treatment; show partiality (in favor of) or prejudice (against)” and *preferential* means “a giving of priority or advantage to one person ... over others.”

# Legislative and Court Actions Regarding DEI Factors

- Many California state and local agencies have developed policies and procedures to foster relationships internally and externally that strive for diversity, equity and inclusion, even in the context of Prop. 209.
- The United States Supreme Court issued *Harvard* and *UNC* decisions on June 29, 2023, determining that the admissions systems used by those universities as they pertained to race were not lawful under the Equal Protection Clause of the Fourteenth Amendment.
  - Discussion and debate continues regarding potential impacts of those decisions.

# Summary regarding ESG, including DEI

- **Key Takeaways for Fiduciaries of SCERS:**

- ESG considerations may be weighed, so long as the fiduciaries reasonably determine they are relevant to risk and return analysis of SCERS
- Discrimination against, as well as preferential treatment of, people on the basis of race, sex, color, ethnicity, or national origin are not permitted.
- DEI efforts may continue, as long as they are implemented in a manner that complies with federal and state constitutions.

# Questions to Pose for Fiduciary Compliance and Range of Approaches

Am I keeping my personal or political views separate from my decision?

What's in the best long-term interest of members in the security of their SCERS benefits?

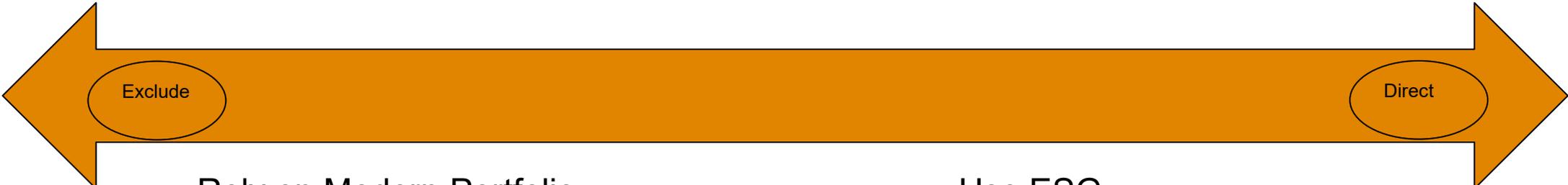
How does performance compare to other investments?

Am I keeping my decision independent from opinions of those who put me in office?

What does investment consultant recommend and why?

Will ESG factors likely affect long-term performance?

Will investment approach diversify portfolio to maximize return, minimize losses?



Rely on Modern Portfolio Theory without explicit ESG directions

Use ESG factors to inform economic analysis

Require certain ESG screens

Exclude ESG factors from decisions

Develop investment beliefs regarding one or more ESG factors

Select only ESG-specific funds

# Peer Investor Approaches

- Verus identified varying approaches of peer investors, including among others:
  - Informal integration/value/risk-based approach
  - Formal ESG policy or investment beliefs

# CERL System Approaches to “ESG” Investing in their Investment Policy Statements vary

- “Modern Portfolio Theory” Approach:

“Environmental, Social, and Governance (ESG) investing strategies are active investment management strategies based on one or more ESG factors. [The retirement system] evaluates and judges an ESG investment strategy by assessing the theory and evidence that the strategy will increase Trust Fund returns, decrease Trust Fund risk, or both, using Modern Portfolio Theory best practices. [The retirement system]’s primary reference point is a capitalization-weighted market index, which contains all the ESG factors at market weights, thus reflecting the collective judgment of all market participants with regard to each ESG factor’s impact on each investment.”

# CERL System Approaches to “ESG” Investing in their Investment Policy Statements vary (cont.)

- “Stewardship” Approach:

“[The retirement system] recognizes that environmental, social, and corporate governance factors (ESG) may present financial risks and opportunities for the Fund. [The retirement system] seeks to identify, evaluate, and manage financially relevant ESG factors in its investment process—including portfolio construction, investment due diligence, and stewardship strategies—to safeguard and enhance Fund performance.”

# CERL System Approaches to “ESG” Investing in their Investment Policy Statements vary (cont.)

- “Material Risk/Opportunity” Approach:

“[The retirement system] recognizes that environmental, social, and corporate governance factors (ESG) may potentially present financial risks and opportunities for the Fund. [The retirement system] will identify, evaluate, and manage financially relevant ESG factors in its investment process to safeguard and enhance Fund performance.”

# Next Steps in Fiduciary Compliance re ESG

- SCERS Board has broad (but not absolute) discretion; avoid abuse of discretion.
  - **Process is important** – record should reflect that prudent process: minutes reflecting deliberation, written materials provided by experts.
  - **Rationale for decision-making is important** – explain reasons for actions that reflect goal of serving overall best interest of members and beneficiaries in the security of their SCERS benefits.
  - **Expert advice regarding prudence is important** – obtain independent investment oversight, including determination by experts that SCERS may reasonably anticipate equal or better returns, with same or less risk to portfolio, from investments that do, or do not, consider environmental, social and/or governance related risks.

# Questions?



# Thank you for your time



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**PERSPECTIVES  
THAT DRIVE  
ENTERPRISE  
SUCCESS**



OCTOBER 2023

Trustee ESG Survey Results

**Sacramento County Employees' Retirement System**

# Table of contents



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Executive summary **PAGE 3**

---

Survey results **PAGE 4**

---

Conclusion **PAGE 13**

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# Executive summary

- Following an ESG education session in March, we had enough feedback from Trustees that we felt a survey was an appropriate next step in learning how the Board wanted to address ESG considerations within the SCERS portfolio, if at all.
- A short questionnaire was developed by Verus and Staff to see if there was Board consensus on a range of topics related to using ESG as a consideration within SCERS' investment portfolio.
- All the Trustees participated in virtual Q&A/discussion interviews this past summer, the results of which we are presenting today.
- ***A special thanks to all the Trustees for participating in this process. While opinions will vary around the consideration of ESG within the investment due diligence process, we gathered from this survey that all of you want what is best for SCERS and its members.***

# II. Survey results

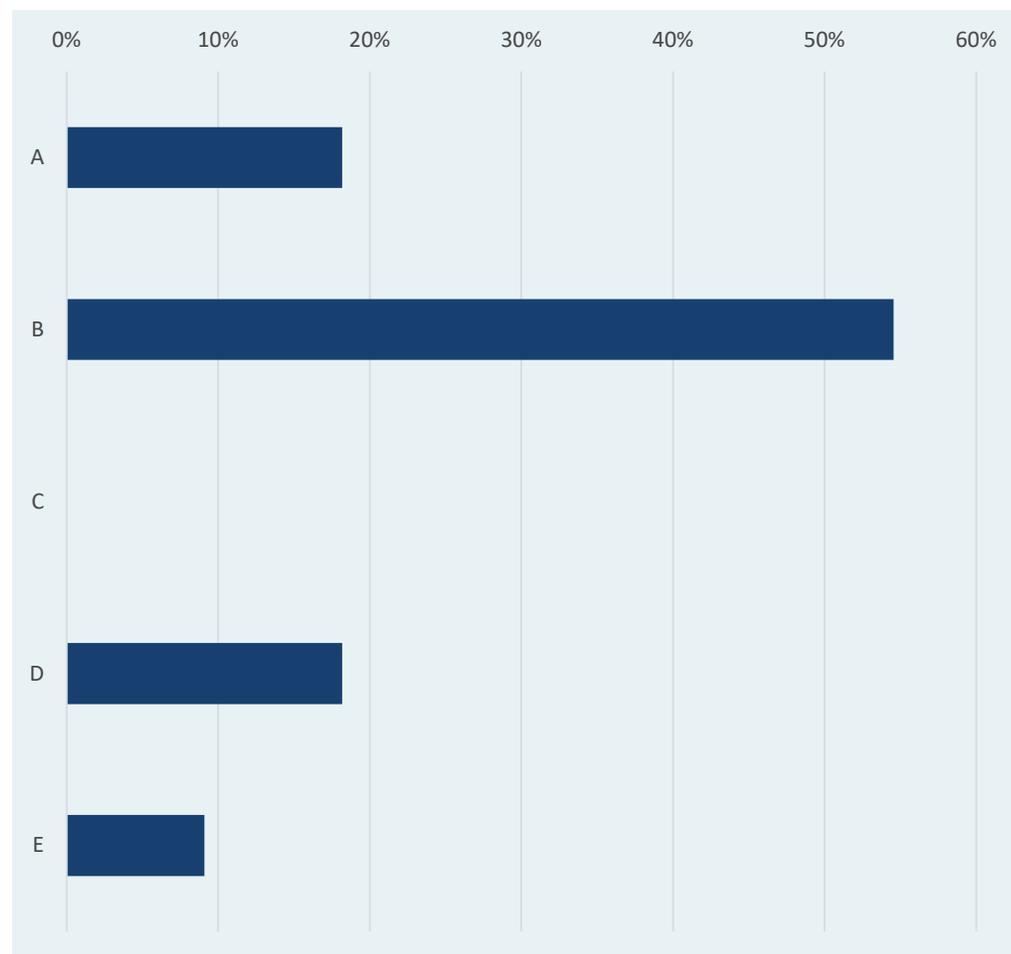
# ESG survey results

1) Do you believe your fiduciary duty extends beyond strict financial benefits for stakeholders?

- a. Strongly agree
- b. Agree
- c. No opinion
- d. Disagree
- e. Strongly disagree

**Results: 73% said they agree with that statement**

FIDUCIARY DUTY EXTEND BEYOND FINANCIAL BENEFITS

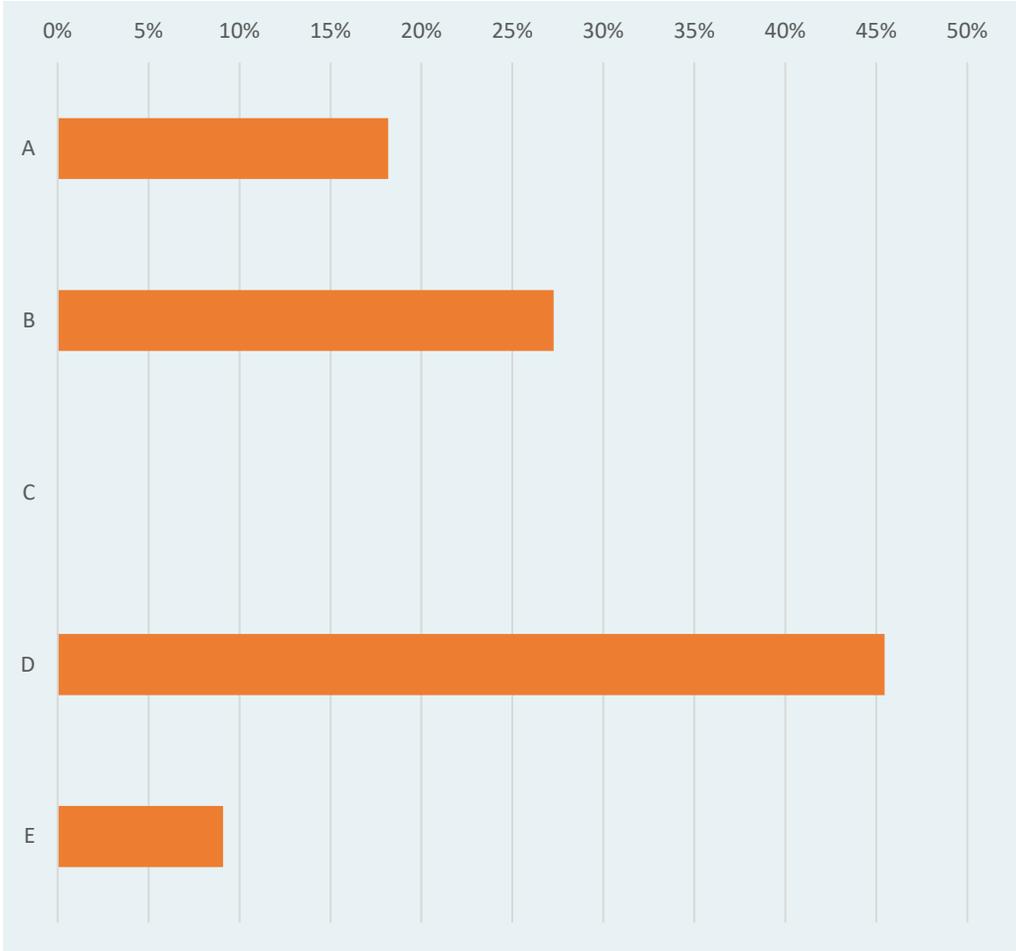


# ESG survey results

- 2) Do you view ESG as a material factor in investment decisions (i.e., risk and/or opportunity)?
- a. Strongly agree
  - b. Agree
  - c. No opinion
  - d. Disagree
  - e. Strongly disagree

**Results: 55% said they disagree with that statement**

ESG AS A MATERIAL FACTOR IN INVESTMENT DECISIONS

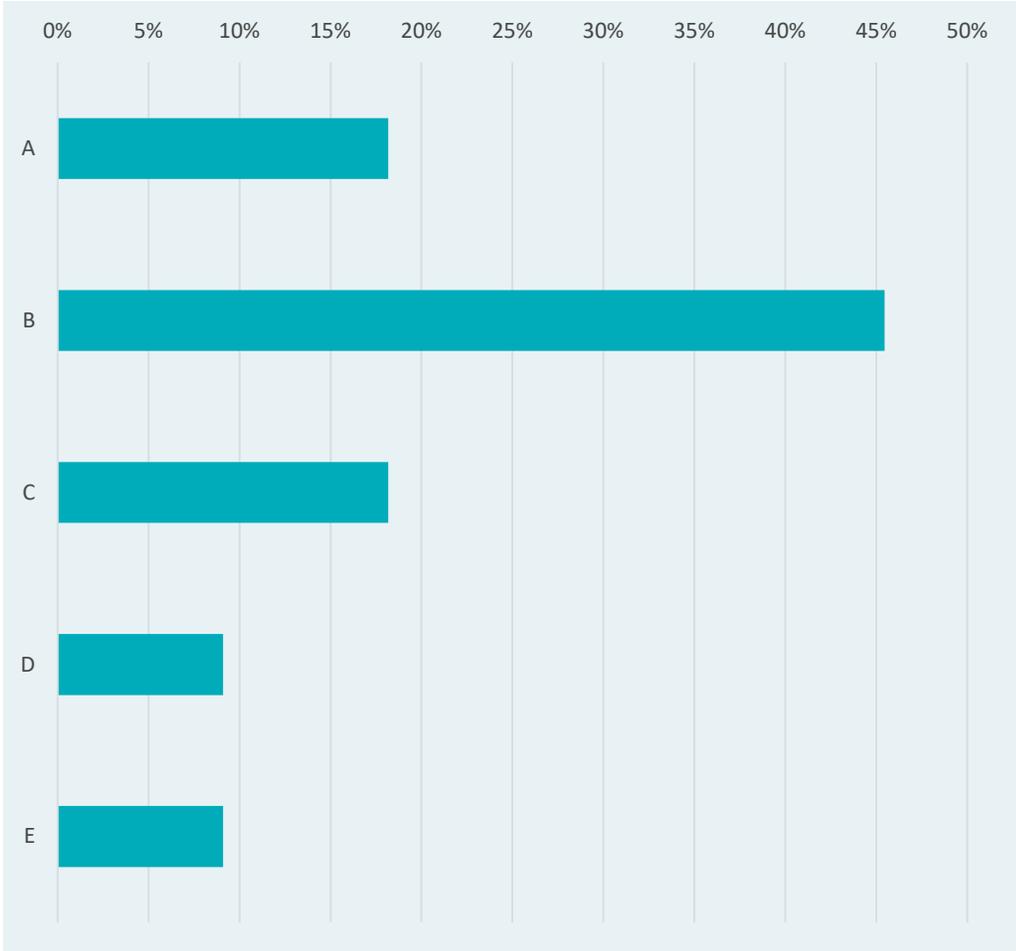


# ESG survey results

- 3) To what extent do you agree or disagree that it is appropriate for SCERS to take ESG factors into account when making investment decisions?
- a. Strongly agree
  - b. Agree
  - c. No opinion
  - d. Disagree
  - e. Strongly disagree

**Results: 64% said they agree with that statement**

APPROPRIATE FOR SCERS TO TAKE ESG FACTORS INTO ACCOUNT

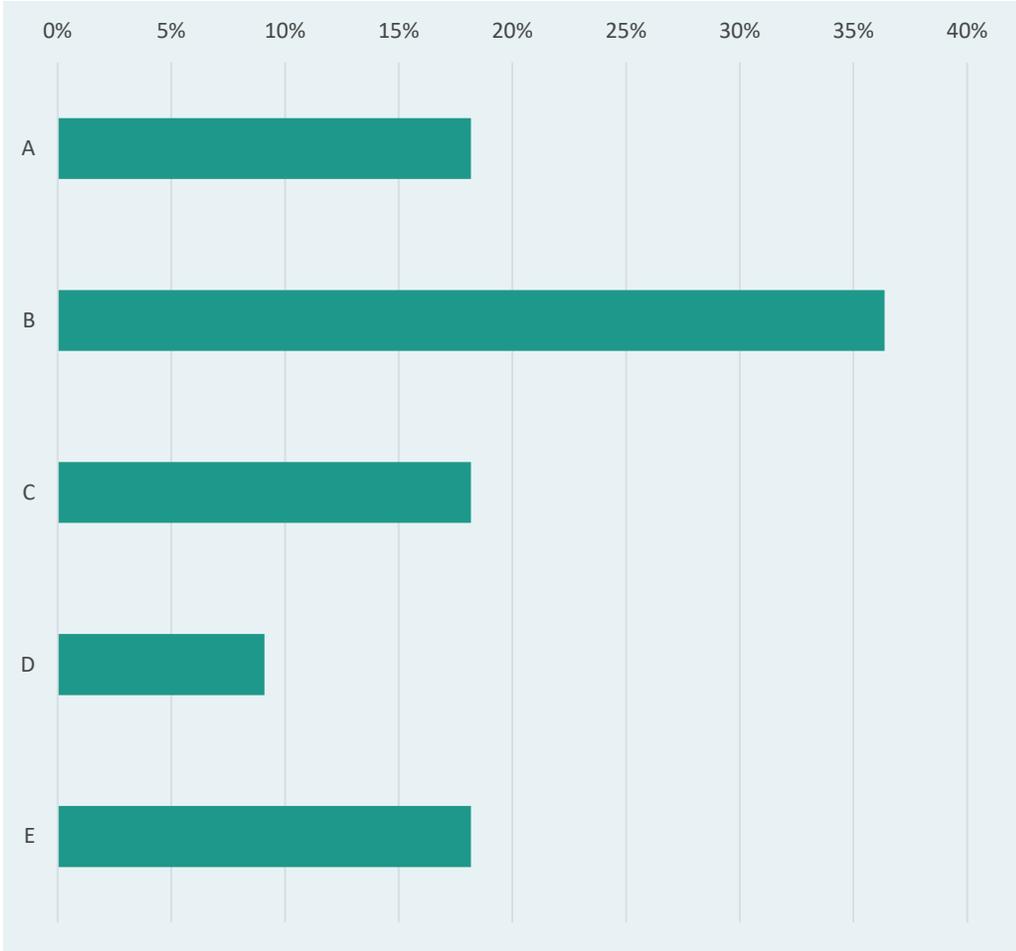


# ESG survey results

- 4) Should SCERS actively engage with consultants and asset managers on their ESG approach?
  - a. Strongly agree
  - b. Agree
  - c. No opinion
  - d. Disagree
  - e. Strongly disagree

**Results: 55% said they agree with that statement**

SHOULD SCERS ACTIVELY ENGAGE WITH PARTNERS ON ESG

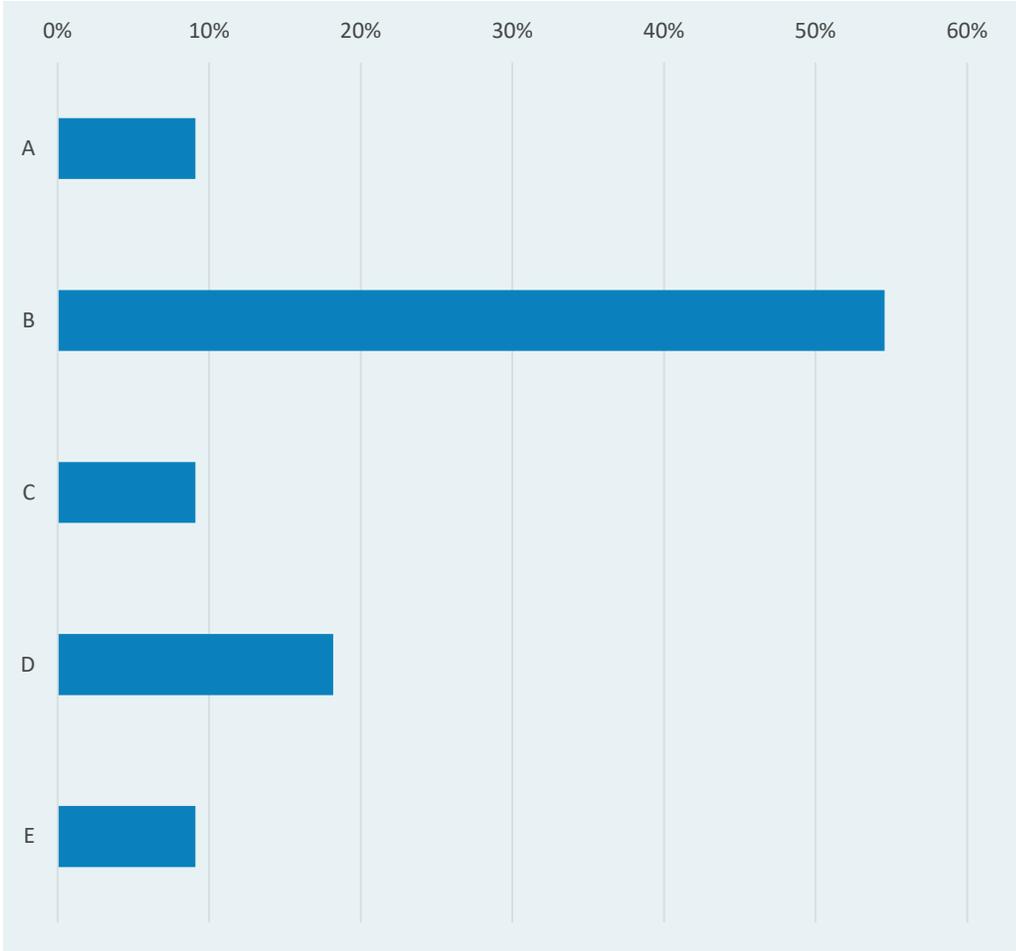


# ESG survey results

- 5) To the extent it complies with California laws, do you agree or disagree that it is appropriate for SCERS to take Diversity, Equity and Inclusion (DEI) factors into account when making investment decisions?
- a. Strongly agree
  - b. Agree
  - c. No opinion
  - d. Disagree
  - e. Strongly disagree

**Results: 64% said they agree with that statement**

AGREE OR DISAGREE TO CONSIDER DEI FACTORS

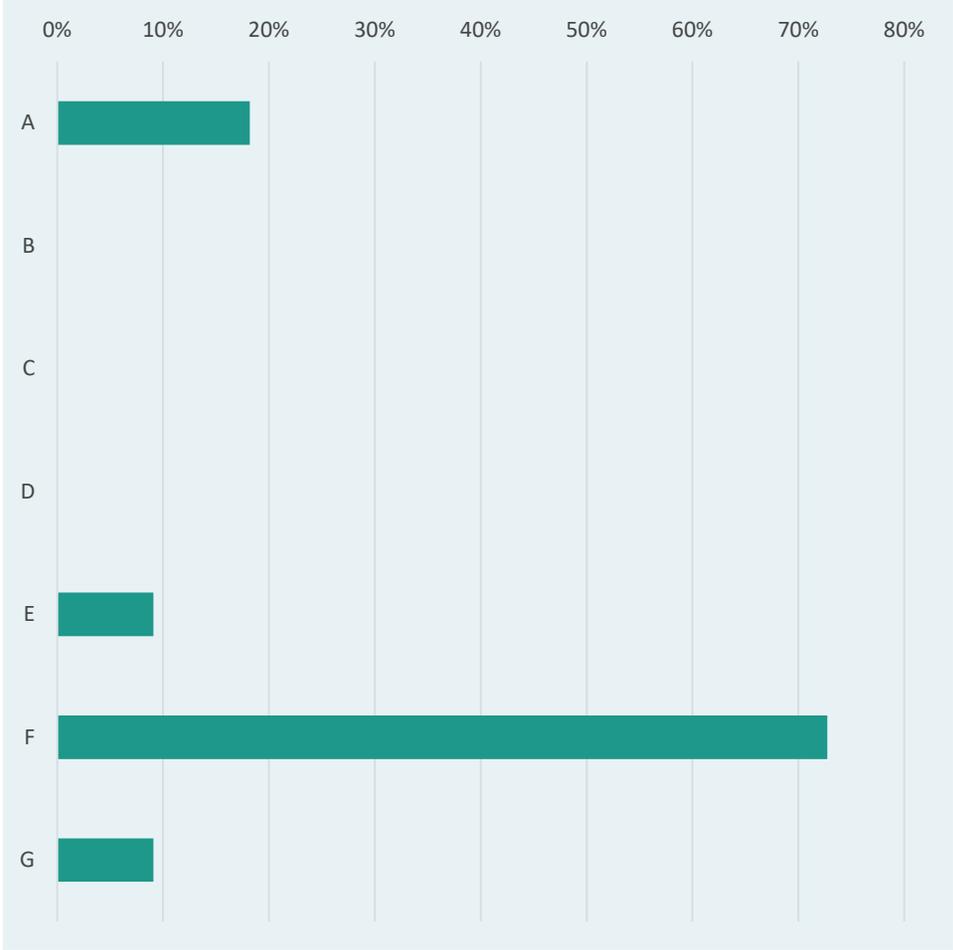


# ESG survey results

- 6) Do you believe any of these statements should be a mission statement or investment policy objective for SCERS?
- a. Investing in investment firms/strategies that fund improvements in energy efficiency, clean energy or generally reduce carbon emissions.
  - b. Investing in investment firms/strategies that provide products/services/activities which address urgent needs low-income people are facing in their communities
  - c. Investing in investment firms/strategies that promote activities/products/services to address housing insecurity
  - d. Investing in investment firms/strategies that advance wellness in communities of color or low-income people
  - e. Hire managers/consultants that demonstrate diversity among its staff
  - f. None of the above
  - g. All of the above

**Results: 73% said None of the above**

**SHOULD THESE STATEMENTS BE A MISSION STATEMENT OR OBJECTIVE**



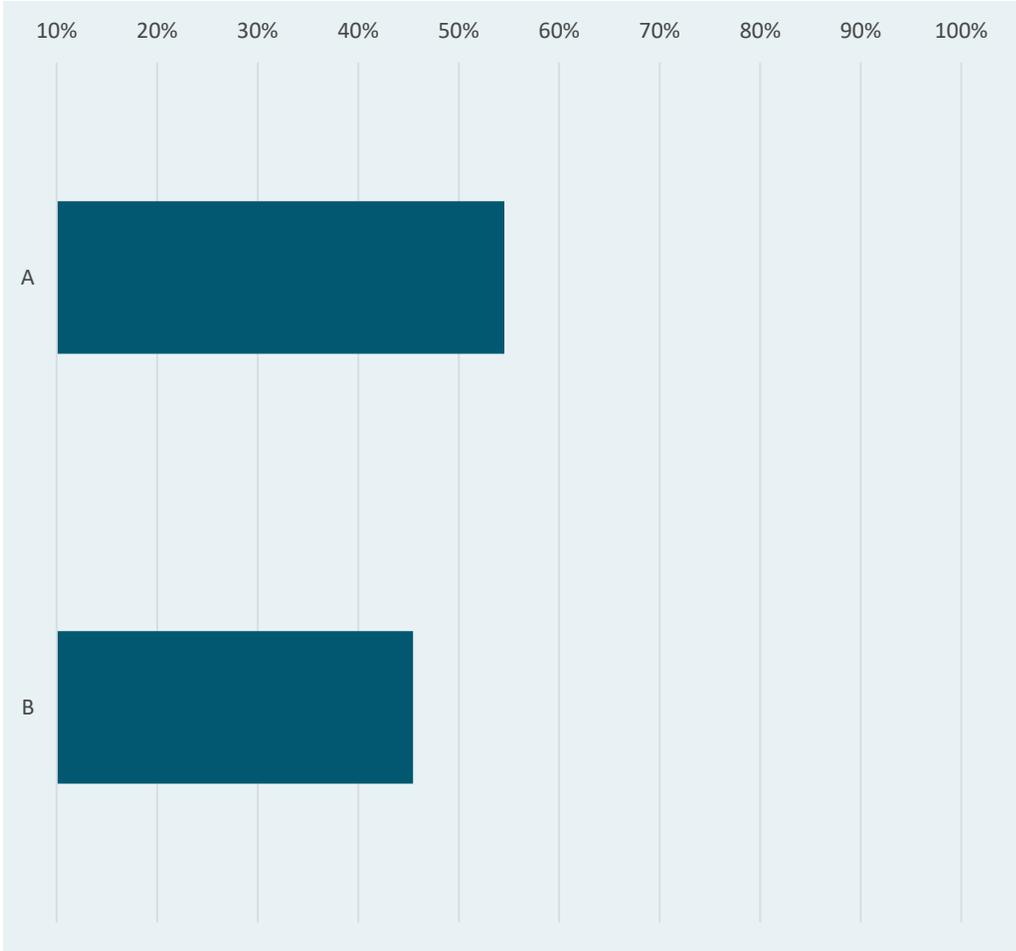
# ESG survey results

- 7) Do you believe that SCERS should incorporate ESG into policy?
  - a. If yes, do you prefer a standalone policy or incorporating into an existing policy (i.e., Master IPS)
  - b. If no, do you believe that SCERS' current policy statement is sufficient

**Results: 55% said they prefer a policy on ESG**

Most were in favor of incorporating ESG into an existing policy. There was little support for a standalone policy on ESG.

SHOULD SCERS INCORPORATE ESG INTO POLICY STATEMENT



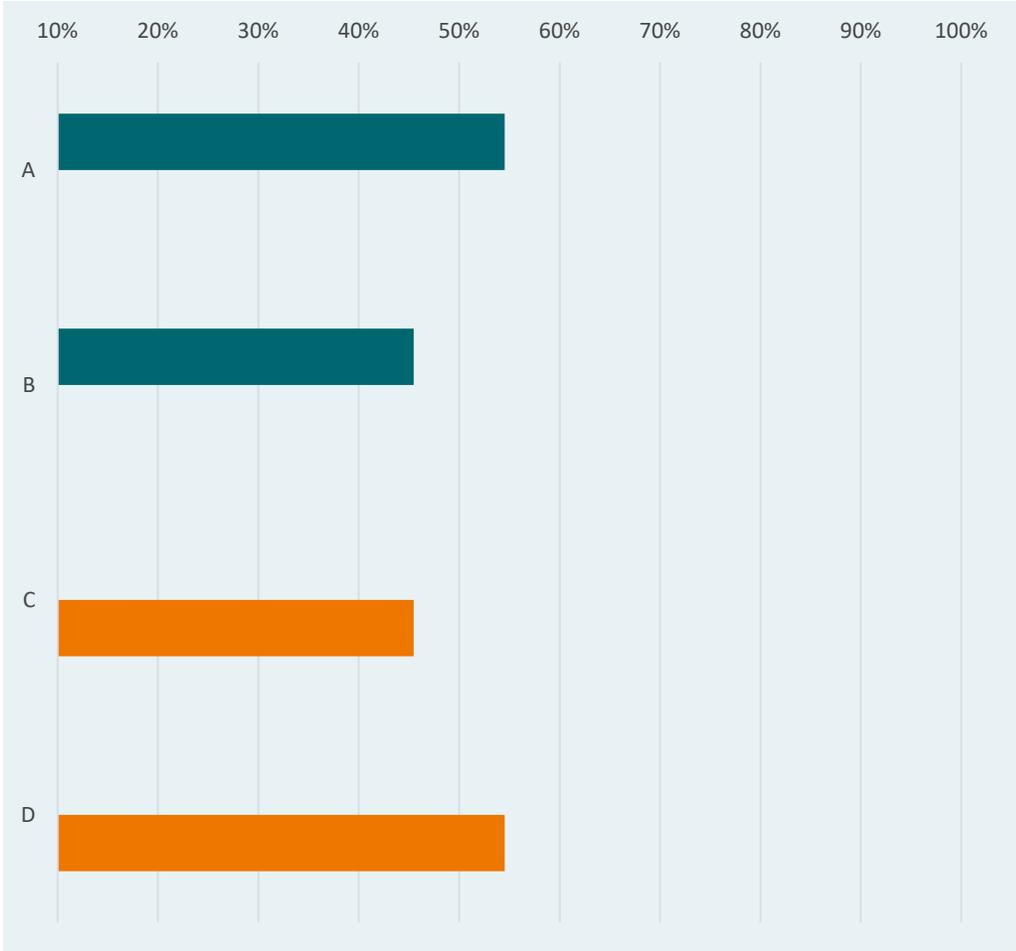
# ESG survey results

- 8) Should SCERS gather and report on ESG/DEI metrics for the managers and consultants that it hires?
- a. Yes (ESG)
  - b. No (ESG)
  - c. Yes (DEI)
  - d. No (DEI)

**Results:** 55% said Yes on ESG; 55% said No on DEI

Results were closely split on both ESG and DEI. A slim majority was in favor of gathering some information on ESG.

SHOULD SCERS GATHER AND REPORT ON ESG/DEI



# Conclusion

Next steps – Direction from Board. Staff could include sample language at a future Board meeting to amend SCERS' existing Master IPS