EBEC EXPO2024

Proskauer's Perspective on Employee Benefits, Executive Compensation and ERISA Litigation

Proskauer

EBEC
EXPO2024

The ESG Flip Flop: Developments in Pension Investing and Executive Compensation

Andrea S. Rattner
Seth J. Safra

May 2, 2024

Proskauer

Meet Your Presenters

Andrea S. Rattner

Partner
New York
+1.212.969.3812
arattner@proskauer.com

Seth J. Safra

Partner
Washington, DC
+1.202.416.5840
ssafra@proskauer.com

Introduction

- ESG – a hot topic with broad application and interest!
- E is for Environment – What kind of impact does a company have on the environment? How does a company address external environmental issues?
- S is for Social – What is a company's social impact, both within the company and the broader community?
- G is for Governance – How does a company's board and management drive positive change?
- Two Dimensions – Our Agenda
  - Investment of Retirement Plan Assets
  - Executive Compensation

Investment of Retirement Plan Assets

Proskauer

Basic Fiduciary Responsibilities

- ***Prudence***: prudent expert conducting a similar enterprise
- ***Loyalty***: act solely in the interest of participants and beneficiaries
- ***Exclusive purpose*** of providing benefits, defraying plan expenses

Contrast responsibility of corporate/organizational officers

- Owe loyalty to various stakeholders, not constrained by ERISA
  = may have more flexibility for collateral considerations
- ERISA: "solely in the interest" and "exclusive purpose" are rigid

Defined Benefit vs. Defined Contribution

Defined Benefit	Defined Contribution
Responsible for selecting, monitoring ***investments***	If participant-directed: • Responsible for selecting, monitoring investment ***menu*** • Participants are responsible for specific fund selection
Managers are responsible for day-to-day investment decisions within their funds/accounts	Managers are responsible for day-to-day investment decisions within their funds/accounts
Investment performance ***affects funding but typically not benefit amount*** (unless sponsor becomes unable to make contributions)	Investment performance ***directly affects benefit amount***

Proskauer

DOL Regulation

- Risk-return analysis ***may*** include ***economic effects*** of:
  - Climate change, other environmental factors,
  - Other Environmental, Social, Governance factors

  on the particular investment
- ESG can be a tiebreaker
- Duty of ***loyalty*** does not prohibit accounting for participant preferences
- ***But . . .***

Proskauer

ESG Regulation (Cont.)

- No material change to overarching responsibility (prudence . . .)
- Must consider all relevant factors that are material to risk/return
- Exclusive purpose of providing benefits to participants, defraying expenses
- **May not subordinate** interests in financial benefits to other objectives
- **May not sacrifice** investment return or **take additional risk** to promote other goals
- Evaluation still must be based on **risk and return** factors that are material to investment value

Proskauer

2022 ESG Regulation: What's Not Included

- No obligation to offer ESG fund
- No safe harbor
- No permission to offer ESG fund as a separate asset class

Hindsight is 20/20

Examples: Impact on Risk/Return

- Economic impact of climate change
  - Regulation, new technologies threaten business of companies relying on fossil fuels
  - EV mandates, subsidies will help companies producing EVs and their suppliers
- Choosing manager
  - Diverse range of views (colored by diversity of background, experience) might affect quality of investment decisions
  - Investment strategy might take into account economic impact of ESG factors

Examples: Impact on Risk/Return

- Choosing an index fund: compare Standard index to Exclusionary index
- *E.g.*, VGD ESG U.S. Stock ETF excludes—
  - Companies related to adult entertainment, alcohol, tobacco, cannabis, gambling, chemical and biological weapons, cluster munitions, anti-personnel landmines, nuclear weapons, civilian firearms, nuclear power, coal/oil/gas
  - Companies that do not meet certain labor, human rights, environmental, and anti-corruption standards
  - Companies that do not meet certain diversity criteria
- Do these characteristics tie back to an investment thesis related to risk/return?

Proskauer

Documenting Decision

- Document prudent process

Not Acceptable	Potentially Acceptable?
Fund A has higher projected return and less risk than Fund B, but we gave the business to Fund B because B's manager is diverse	Diversity of Fund B's management team will lead to better decisions—which we expect to boost performance by 10%-20% relative to Fund A
Add investment option that values social responsibility over returns, for participants who are willing to sacrifice returns for good conscience	Reduce weighting in companies that depend on fossil fuels because modeled long-term returns are lower than companies using cleaner energy sources

Proskauer

Regulation on Proxy Voting

- Cost-benefit analysis for proxy voting (consider costs involved vs. impact of vote)
- Focus on economic interest of the plan, participants and beneficiaries (comparable to investment selection)
- Can't subordinate participant interests, risk/return for other objectives
- Good to have proxy voting policy, but:
  - No safe harbor rubric for decisions
  - May not blindly follow proxy advisory firm
  - Fund manager has to reconcile competing policies
- Selecting and monitoring proxy service: general prudence principles

Spence v. Am. Airlines (pending, N.D. Tex.)

- Alleged breach of fiduciary duty (prudence, loyalty) by investing in funds whose managers pursue ESG policy goals through proxy voting and shareholder activism
  - Cited Blackrock
- Initially challenged ESG funds in plan lineup ***and brokerage window***
  - Complaint listed 25 funds
- Pivoted to focus on manager activity (not specific to particular funds)
- Survived motion to dismiss
  - Court applied liberal pleading standard
  - Deferred issues like comparative benchmark, loss causation to another day

Executive Compensation Considerations

Executive Compensation and ESG

- No legal requirement to incorporate ESG metrics into any type of executive compensation program
  - Currently, no legal requirement to discuss ESG in the executive compensation portions of the proxy (*e.g.*, CD&A)
  - However, if ESG is used as a performance metric in any executive compensation program or if it otherwise relates to compensation, the use of the ESG metric and the level of achievement must be disclosed in the CD&A (the "how and the why" of using ESG metrics)
  - Note: ESG reporting exists in other contexts (*e.g.*, SEC human capital disclosures, sustainability reports, Nasdaq diversity disclosures, SEC climate disclosures)

**Source: The Conference Board, CEO and Executive Compensation Practices in the Russell 3000 and S&P 500: Live Dashboard, in collaboration with FW Cook (January 2024) ("TCB Report")*

Executive Compensation and ESG (Cont.)

- Use of ESG metrics in executive compensation programs continues to evolve and gain momentum
  - 75.8% of the S&P 500 include an ESG metric in either the annual incentive plan or long-term incentive plan*
  - Type of programs used
    - Short-term/annual incentive programs (most common)
    - Long-term incentive programs (significantly less common)
    - The share of S&P 500 companies that use ESG metrics in both annual and long-term incentive programs grew from 7% in 2021 to 12% in 2023*
  - Strong correlation between company size and use of ESG metrics in incentive plans*
    - 23.8% of companies with annual revenue under $100M reported using ESG metrics
    - 83.6% of companies with annual revenue of $50B and over reported using ESG metrics

**Source: TCB Report*

Proskauer

Executive Compensation and ESG (Cont.)

- But, some “flip flopping” and growing ESG backlash
  - Some continued skepticism of certain institutional investors of use of ESG metrics
  - Some concerns about the potential impact of SCOTUS’ Harvard/UNC decisions striking down race-conscious admissions programs on DEI metrics used in incentive compensation programs

Executive Compensation and ESG (Cont.)

- Significant variation based on industry
  - Significant prevalence among energy and utility companies (especially with climate-related metrics)
  - Some prevalence to strong prevalence in financial, health care, consumer staples and industrial companies (less with climate-related metrics)
  - Lower prevalence in information technology, consumer discretionary and real estate companies
- Significant variation in how ESG metrics are used
  - Weighed (specific weighting with specific metrics)
  - Scorecard (broad assessment as part of metrics)
  - Modifier (adjustment up or down by a specified percentile amount)
  - Individual performance assessment
  - Discretionary

Executive Compensation and ESG (Cont.)

- Significant variation in ESG metrics used
  - Human capital, culture and DEI
    - Most common (75% of the S&P 500 use DEI metrics, up > 20% in 2 years; for the Russell 3000, the percentage rose from 29% to 49%)*
    - If used, scorecard approach is most common, and then individual approach next most common
    - Rarely used as an independent, weighted metric
    - Enhanced scrutiny and review of potential impact of Harvard and UNC decisions
      - Applicability of higher ed cases to corporate/private DEI programs and DEI metrics used in incentive compensation plans?
      - Shift to qualitative (rather than quantitative) metrics?

**Source: TCB Report*

Executive Compensation and ESG (Cont.)

- Health and safety; environment and sustainability
  - Used, but not as prevalent as human capital
  - Depends on industry
  - But climate related metrics are surging*:
    - For the S&P 500, rose from 25% in 2021 to 54% in 2023
    - For the Russell 3000, rose from 16% in 2021 to 32% in 2023
  - Sometimes used as independent metric (but scorecard and individual approaches most common)

**Source: TCB Report*

Executive Compensation and ESG – Sample Metrics

Human Capital, Culture and Diversity & Inclusion	Environmental and Sustainability
− DEI information: move away from statistics on gender representation and racial minority representation (and a move to diverse slates, and qualitative measures over quantitative)	− Reduction in carbon emissions/carbon footprint
− Recruitment and retention	− Water use
− Training and talent development	− Waste reduction
− Succession planning (straddles governance)	− Environmental impact
− Employee engagement	− Chemical containment
	− Energy efficiency

Proskauer

Executive Compensation and ESG – Sample Metrics (Cont.)

Health and Safety	Governance
– Accident reduction and prevention	– Managing internal conflicts and compliance
– Fatalities	– Risk management
– Overall safety of product/service	– Best practices
– Minimizing unproductive/lost workdays	– Investor relations

Other	
– Product quality	
– CSR and other initiatives	
– Cybersecurity and data protection	
– Customer satisfaction	

Proskauer

Executive Compensation and ESG – The Considerations/ Challenges

- Linking metrics to the business strategy, culture and the behaviors that a company wishes to encourage
- Determining what percentage of overall performance goals should be dedicated to ESG
- Determining whether ESG should be included in annual incentive program and/or long-term incentive program
- Identifying the “right” ESG performance metrics
- Defining the ESG performance metric
- Identifying the relevant time period and weighing short-term and long-term interests
- Evaluating the potential impact of the Harvard/UNC decisions (for DEI-focused metrics)
- Designing the ESG approach
  - Individual assessment or group/business/scorecard
  - Discretionary, qualitative or hard-wired/quantative
  - Separate goal or a modifier

Proskauer

Executive Compensation and ESG – The Considerations/ Challenges (Cont.)

- Setting the ESG targets/goals
- Measuring “success” and the achievement of ESG performance goals
- Interrelation between financial achievement and ESG
- Employee communications
- Disclosure and transparency
- Potential investor criticism
- Potential litigation risk
- Public and employee scrutiny

EBEC EXPO2024

Proskauer's Perspective on Employee Benefits, Executive Compensation and ERISA Litigation

Proskauer