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OECD Focus on Pensions: ESOPs Acknowledged, Social Investing Promoted

The Organisation for Economic Cooperation and Development (OECD) Working Party on Private Pensions (WPPP) met again in at the Organisation's Paris headquarters in early June, amidst multiple labor strikes and the worst flooding of the Seine in sixty years. The OECD is a group of 34 countries with advanced economies that meet to develop economic and social policies, and has been working to advance principles and best practices in the tax and pension areas for a number of years.

During this most recent meeting, the WPPP finalized its Core Principles of Private Pension Regulation, which had been the subject of many prior meetings. In the final version, the WPPP added, following comments by numerous US and European stakeholders, acknowledgement of US-style ESOPs. The Party also issued a Progress Report on Investment Governance and ESG (Environmental, Social and Governance principles), including for pension investing. In the US, ESG is more typically referred to as social investing, and the US Department of Labor has issued various guidance on the intersection of fiduciary duties under ERISA and social investing in the past.

This report will focus on the new ESOP provisions in the Core Principles, the beginning of apparent advocacy of ESG investing by pension funds, and a few of the other areas that are beginning to attract the attention of the WPPP.

<u>The Core Principles and ESOPs</u>

As noted in a prior Groom alert of August 10, 2015, available online at http://www.groom.com/media/publication/1616_OECD_Opens_Revised__Core_Principles_of_Private_Pension_Regulation_.pdf , the last draft version of Core Principles of Private Pension Regulation released for public comment in July 2015 included as part of Core Principle 4 on Investment and Risk Management language that discouraged investment in employer stock, such as with employee stock ownership plans in the U.S. (ESOPs). This elicited numerous comments from US groups advocating for ESOPs, such as The ESOP Association and the Employee-Owned S Corporations of America (ESCA), as well as a number of European stakeholders, and discussions with OECD staff. As a result, the OECD has adopted a neutral stance and, importantly, acknowledged the availability of US-style ESOPs by adding the following language:

> "In the case of pension funds specifically designed to invest in employer stock, to ensure sufficient diversification of the employee's pension assets, such funds should not be the sole type of pension plan made available to employees by the sponsor and such funds should reduce their investment in the plan sponsor's stock to a prudent level as retirement approaches."

Pension Investment and ESG

The OECD was asked by the French Presidency of the 2015 United Nations Climate Change Conference (the 21st Conference of the Parties, known as COP 21) to examine the governance of institutional investments in relation to ESG factors, particularly those associated with climate change. At the WPPP, this has resulted in a Progress Report on Investment Governance and the Integration of ESG Factors. Though describing itself as preliminary and incomplete, findings in the report include a number of points of interest to pension fund investors:

- The report indicates that there appears to be no legal conflict between fiduciary status and integrating ESG factors in investment governance, and that legal and regulatory frameworks, including ERISA, provide ample scope to incorporate ESG factors in investment beliefs.

- The report acknowledges that some institutional investors are reluctant to adapt their investment governance processes because they see a conflict between their responsibility to protect the financial interest of their beneficiaries and the consideration of ESG factors, which are typically perceived as "non-financial".

- The report also includes arguments that Modern Portfolio Theory (MPT) is inadequate in today's markets and has behavioral effects that makes investors focus on financial metrics at the expense of ESG factors. The observation is made that at least one sovereign wealth fund, the Norwegian oil fund, chose to forego $1.9B in returns on tobacco stocks in order to obtain non-financial returns such as good health and support for ethical positions.

- The report describes the "Universal Owner" approach to investing, which generally argues that, because institutional investors own a large share of global markets, they are vulnerable to the overall health of the economy and have a large influence, and thus have a duty to take long-term factors such as climate change into account and invest in such a way as to reduce ESG risks. The report acknowledges that this theory is not yet widely accepted, but cites as an example that pension investor APG (Netherlands) has an investment policy that takes into account ESG factors to not only contribute to risk-adjusted returns, but also to demonstrate social responsibility and contribute to the integrity of financial markets.

- While a report and not a proposal, the report suggests that, in the view of the OECD at least, incorporating ESG into pension investment decisions may lead to enhanced financial performance.

Although it is not presently clear what the next steps will be after this report, those investors with an interest in this area and the subject of whether non-financial factors such as ESG are appropriate for pension fiduciaries to consider, may wish to monitor the OECD's study of this topic closely, particularly for its influence in US policy on fiduciary duties for US pension investors. If you would like a copy of this Progress Report and the presentation made on it, please contact your Groom lawyer.

Other Areas of Work

Ideas frequently percolate at the WPPP for some time. Topics introduced or covered at the most recent meeting include:

- Financial advice for retirement - a hot topic in a number of countries, and Phyllis Borzi of the ESBA gave a report to the WPPP meeting on the approach being taken in the US using the new fiduciary rule. The topic was also on the agenda of the Institution for Occupational Pension Supervisors (the association for pension regulators of over 80 countries) at their meeting held in conjunction with the WPPP meeting.

- The shift from defined benefit to defined contribution - not news in the US, but not as advanced elsewhere.

- Use of annuity products in retirement plans - for example, to address longevity risk.

- The relationship between private and public pensions (e.g., US Social Security).

If you have any interests or concerns regarding any of these topics, or would like to obtain a copy of the papers presented on them, please contact your Groom lawyer.