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Sub. S.B. 6 of the 135th General Assembly

Sen. Schuring

May 11, 2023

Staff Recommendation

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Summary of Sub. S.B. 6

Sub. S.B. 6 prohibits the boards of the five state retirement systems[1] from making an investment decision with the primary purpose of influencing any social or environmental policy or attempting to influence the governance of any corporation. The bill also requires the boards to make investment decisions with the "sole purpose of maximizing return on its investments."

The provisions of Sub. S.B. 6 also apply to the Bureau of Workers' Compensation and State Institutions of Higher Learning. This analysis and recommendation will only address the proposed changes to the law governing the state retirement systems.

An uncodified section of the bill, Section 3, encourages the state retirement systems that are offering a defined contribution plan to offer multiple investment choices to the members participating in those plans.[2]

Background

Environmental, Social, and Governance (ESG) Investing

There is no definitive consensus defining ESG investing. Instead, the U.S. Securities and Exchange Commission's (SEC) comments and advisements on ESG are made in the broadest sense and include a range of investment strategies that incorporate environmental, social, or governance factors.[3] The CFA Institute gives a sense of the core of the concept but also the broad range that can be included under ESG:[4]

1) "Environmental" can be defined as conservation of the natural word, including climate consideration, energy efficiency, or biodiversity;
2) "Social" can be defined as consideration of people and relationships, including customer satisfaction, diversity, and data protection;
3) "Governance" can be defined as the standards for running a company, including board composition and audit considerations.

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[1] The five state retirement systems are the Public Employees Retirement System (PERS), State Teachers Retirement System (STRS), Ohio Police and Fire Pension Fund (OP&F), School Employees Retirement System (SERS), and Highway Patrol Retirement System (HPRS).

[2] Currently, PERS and STRS offer a defined contribution plan and SERS is authorized to provide a defined contribution plan. Under a defined contribution plan, participants receive a retirement benefit based on employee and employer contributions, and any investments on those contributions. Under a defined benefit plan, participants receive a benefit based on a formula including final salary and years of service.

[3] U.S. Securities and Exchange Commission, *Environmental, Social and Governance (ESG) Funds – Investor Bulletin* (February 26, 2021), https://www.sec.gov/oiea/investor-alerts-and-bulletins/environmental-social-and-governance-esg-funds-investor-bulletin.

[4] https://www.cfainstitute.org/en/research/esg-investing.

How any particular firm approaches ESG investing using the above factors also varies. The SEC provided a Risk Alert in 2021 advising investors on the various and inconsistent strategies used by firms in applying ESG factors.[5] As discussed above, the SEC itself does not provide a specific definition of ESG investing. While the SEC includes "impact investing," socially responsible investing, or "ESG" within its description of ESG, they may mean very different things in investment applications. This matters as many ESG factors may and often do include pecuniary considerations while impact investing typically does not.

Prudent Person Rule/Divestment History

The General Assembly has provided full investment authority to the retirement boards since 1997, subject to the "prudent person rule." The prudent person rule was first set out in *Harvard College v. Amory* in 1830. The Court held that a trustee "is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested."[6] This standard has remained unchanged and is bolstered by the Employee Retirement Income Security Act of 1974 (ERISA). ERISA provides that a fiduciary must discharge its duty "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in alike capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."[7] In short, the prudent person rule requires that a trustee make decisions in such a way that a reasonable person would with the same information available.

This standard governs most American private pension plans and provides for prudence in asset allocation and selection of investment vehicles. The objective is to protect investors from risky or questionable investments by requiring that assets be invested in a manner that seeks to achieve reasonable income and the preservation of capital.[8]

The ORSC and General Assembly have traditionally recommended against actions that would interfere in this authority, most recently expressed in its approach to various divestment bills. The ORSC has expressed two primary concerns with mandated legislative divestment.[9] Requiring retirement boards to divest from certain asset classes could have significant ramifications on investment earnings, which account for 70-80% of the funds necessary to provide benefits. Restrictions on the types of investments available to retirement boards potentially limits their ability to achieve

[5] SEC, Division of Examinations, Risk Alert, "The Division of Examinations' Review of ESG Investing," (April 9, 2021), https://www.sec.gov/files/esg-risk-alert.pdf.

[6] *Harvard College v. Amory*, 26 Mass (9 Pick) 446, 461 (1830).

[7] 29 U.S.C. § 1104(a)(1)(B).

[8] ORSC Recommendation, "H.J.R. 6 of the 131st General Assembly" (June 9, 2016).

[9] Staff Recommendation, "Am. Sub. H.B. 151 of the 127th General Assembly" (June 13, 2007), ORSC Recommendation, "H.J.R. 6 of the 131st General Assembly" (June 9, 2016).

necessary earnings. The second concern is that retirement systems are trusts, meaning monies must be used in the sole interest of participants and beneficiaries. Requiring divestment from an asset class would inhibit a retirement board's ability to do so.

Sub. S.B. 6, however, is not a divestment bill with prior ORSC guidance. Instead, Sub. S.B. 6 provides increased clarity on the prudent person rule and how existing provisions in the Ohio Revised Code addressing ESG-type factors can be considered. Existing law provides for retirement board considerations of investments that enhance the general welfare of the state and require equal consideration to be given to women and minority owned firms.[10] Sub. S.B. 6 serves to clarify the fiduciary duty that is required to allow for these types of considerations to take place; that is, only in a prudent person framework. This clarity is desirable in light of ambiguities resulting from a lack of clear SEC definitions of ESG and oscillations in Department of Labor ESG guidance, to be discussed below.

Department of Labor Changes to ESG Guidance

Since 1994, the Department of Labor has regularly made changes to its guidance on ESG investing.[11]

- IB 1994-01: Established the "everything being equal test" for collateral benefits. This provided that collateral benefits (such as ESG factors) could be considered as long as the investment was prudent.
- IB 2008-01: Issued to replace IB 1994-01 and requires that collateral benefit investments be "truly equal [to alternative options], taking into account a quantitative and qualitative analysis of the economic impact on the plan.
- IB 2015-01: Replaced IB 2008-01 and established that ETI factors can be a "tie breaker" but cautions against converting collateral benefits into relevant investment return economic factors. ESG factors used as more than tie breakers must "present material business risk or opportunities that company officers and directors need to manage as part of a business plan and that qualified investment professionals would treat as economic consideration under generally accepted investment theories."
- Effective January 30, 2023: DOL issued a final rule on November 22, 2022 modifying the documentation related to "tie breaker" provisions of IB 2015-01 and permitted fiduciaries to include any factors (including ESG) that were

[10] Ohio Revised Code §§145.11(B), 742.11(B), 3307.15(B), 3309.15(B), 5505.06(B), "In exercising its fiduciary responsibility with respect to the investment of the funds, it shall be the intent of the board to give consideration to investments that enhance the general welfare of the state and its citizens where the investments offer quality, return, and safety comparable to other investments currently available to the board. In fulfilling this intent, equal consideration shall also be given to investments otherwise qualifying under this section that involve minority owned and controlled firms and firms owned and controlled by women, either alone or in joint venture with other firms."
[11] Groom Law Group Benefits Brief, "DOL and ESG Investing: Evolving Guidance," (April 27, 2018), https://www.groom.com/resources/dol-and-esg-investing-evolving-guidance/.

material to an investment's risk or return[12] (The U.S. House of Representatives voted to invalidate this rule change February 28, 2023, followed by the U.S. Senate on March 1, 2023. President Biden vetoed the rule invalidation on March 20, 2023). [13]

While there have been DOL oscillations for the past 30 years on how or if ESG factors can be applied in trusts, a continuing requirement for fiduciaries is that ESG factors cannot be the *sole purpose* of an investment. Prudent person requirements continue to provide that the trust is for the exclusive purpose of providing benefits to participants and their beneficiaries[14] and fiduciaries must still engage in a prudent process to analyze the risk and return characteristics of an investment.

Staff Comments

Sub. S.B. 6 removes any remaining ambiguity that a retirement system may make an investment decision where the *primary purpose* is to influence an environmental, social, or governance policy. Clarity is favorable in light of oscillating DOL guidance and the SEC's lack of a firm definition of ESG. This requirement aligns with the prudent person rule adopted by the General Assembly for the past 26 years and its requirement that assets be invested in a manner that achieves reasonable income and preservation of capital.

The ORSC has shown concerns with legislatively mandated divestment in the past; however, this bill does not require divestment from funds that include ESG risk-related factors or alter the investment authority of the retirement systems. Instead, it further clarifies the requirements of the prudent person rule and allows investments with the consideration of ESG factors so long as the prudent person rule is followed. It is, therefore, consistent with both prior ORSC guidance and the policy of the General Assembly.

Staff Recommendation

Because the ESG related provisions of Sub. S.B. 6 comply with the prudent person policy of the General Assembly and ORSC guidance, and that greater clarity on this issue is desirable in light of federal action, ORSC staff recommend that the ORSC approve Sub. S.B. 6.

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[12] U.S. Department of Labor, "US Department of Labor Announces Final Rule to Remove Barriers to Considering Environmental, Social, Governance Factors in Plan Investments," (November 22,2022), https://www.dol.gov/newsroom/releases/ebsa/ebsa20221122.

[13] Katharine Jackson et al. "Biden uses first veto to defend rule on ESG investing," *Reuters*, (March 20, 2023), https://www.reuters.com/business/sustainable-business/biden-vetoes-resolution-block-labor-dept-rule-esg-investing-2023-03-20/.

[14] U.S.C. §1104(a)(1).