Seattle City Employees' Retirement System

Environmental, Social and Governance (ESG) Update
First Quarter 2017

Purpose
This update is required by the following motion adopted by the Board on February 12, 2015:

> *The Retirement Board of Administration directed that the Seattle City Employees' Retirement System (SCERS) pursue corporate engagement on climate change and other environmental issues, as presented by staff in their January 26, 2015 memorandum; and pursue, as appropriate, investments that are expected to produce investment results consistent with SCERS's fiduciary duty to its members and, if possible, also positively address climate change and other environmental issues. The Board recognizes that these types of investments (e.g. renewable energy, cleantech, and green bonds) are relatively new and limited in availability and will need to be considered prudently as SCERS pursues investments in its asset class (e.g. real assets, private equity, fixed income).* ***SCERS's staff and advisers will provide quarterly updates regarding Environmental, Social and Governance (ESG) investment issues*** *and incorporate ESG into SCERS's work plan. The Board directs SCERS's staff to engage with trade associations such as Coalition for Environmentally Responsible Economics (Ceres) and other pensions to examine an approach to ESG investments, and also to consider engaging with an independent consultant to assist in this review.*

Staff has focused on the environmental issue of climate change. At the Board's direction, other ESG matters may be considered in future updates.

Activity Directed to SCERS

- The **Seattle City Council** sent a letter to SCERS on February 13, 2017, seeking an update on Resolution 31525 that passed on June 30, 2014 urging SCERS to divest its fossil fuel holdings. SCERS responded to the Council's letter on February 17, 2017, stating that SCERS had closely examined the issue of divesting from its fossil fuel holdings, with assistance from its investment consultant and legal counsel, and determined that it was unable to do so because it would violate the Board's fiduciary duties. Specifically, the response stated that "we believe that it would be illegal under the requirements of state law for SCERS to take such actions because it would violate the duty of loyalty to its members by prioritizing an unrelated objective, and the duty of prudence by choosing to disregard the unanimous advice of its experienced investment consultant, Investment Advisory Committee, and professional investment staff." The response also described the proactive strategy that SCERS has embarked on to address climate change in a manner that is consistent with its fiduciary duties. A copy of the City Council's letter and SCERS's response is enclosed.

Seattle City Employees' Retirement System, Jeffrey S. Davis, Executive Director
720 Third Avenue, Suite 900, Seattle, Washington 98104
Tel: 206.386.1293 Toll Free: 877.865.0079 Fax: 206.386.1506
Website: www.seattle.gov/retirement Email: retirecity@seattle.gov

- **350 Seattle** sent a letter to SCERS on February 28, 2017, submitting a formal ESG investment proposal requesting that SCERS: (1) immediately stop any new investments in the top 200 fossil fuel companies; (2) drop coal, oil and gas from the investment portfolio by divesting from the top 200 fossil fuel companies by 2020; and, (3) commit to reinvesting at least 5 percent of the investment portfolio into climate solutions defined as, but not limited to, renewable energy, energy efficiency, clean technology, community adaptation funds, transit, and clean energy access. SCERS staff find that 350 Seattle's proposal fails to meet the requirements of the SCERS ESG Policy because it is "duplicative of a recently considered proposal or similar proposal." Accordingly, SCERS staff does not recommend forwarding the proposal to SCERS's investment consultant for further review. A copy of 350 Seattle's letter and SCERS staff's memo to the Board is enclosed.

<u>Industry Developments</u>

- PCA, an investment consultant, performed an analysis for the **Vermont Pension Investment Committee** (VPIC) on fossil fuel divestment. PCA recommended that VPIC not pursue divestment, stating that "divestment from fossil fuels, thermal coal or Exxon could: increase costs; add diversification and technological change risks to VPIC's portfolio; only effect potential stranded assets risk, not other material climate change risks and opportunities; leave unaffected the financial situation of companies offering alternatives to fossil fuels; conflict with VPIC's governance in its asset allocation, equity investment strategy, and proxy voting and direct corporate engagement; and, introduce a slippery slope of potential other restrictions on VPIC's investment universe whose potential benefits have not been shown to outweigh the potential harm to the VPIC portfolio." [1]
- The **Task Force on Climate-related Financial Disclosures** (TCFD), established by the global Financial Stability Board and chaired by Michael Bloomberg, released their recommendations seeking to improve the disclosure of climate-related financial risks and opportunities. Michael Bloomberg described the importance of the TCFD's work, stating that "what gets measured better gets managed better. Widespread adoption of the recommendations will help ensure that climate-related financial issues are routinely considered in business and investment decisions and encourage an effective dialogue between companies and banks, insurers and investors. That will lead to smarter, more efficient allocation of capital, and speed the transition to a low-carbon economy." [2]

<u>Membership Organization Activity</u>

- Jill Johnson attended the **Responsible Investor** Americas conference in New York City from December 6-7, 2016. Key takeaways were that: (1) there was greater regulatory uncertainty on whether the SEC would continue to enforce climate risk disclosure; (2) ESG ratings of investment strategies are at an early stage of development and need to improve significantly to have greater relevance to investors; and, (3) there are increasing opportunities to invest in the water sector.
- Jason Malinowski attended the **Council of Institutional Investors** conference in Washington, DC from February 27-March 1, 2017. The conference included panels hosted by Ceres, CalPERS and the New York City pension funds on climate-related topics. Key takeaways were that: (1) Trump's election may lead to the United States withdrawing from the 2015 Paris Agreement on global climate change reduction and makes further global multi-lateral agreements on climate change unlikely; (2) there is increasing divergence between the major oil & gas companies on their strategies to cope with the shift to a low-carbon economy with Total and Shell being seen as leaders and Exxon and Chevron as laggards; (3) shareholders are actively working to close the gap in climate risk disclosure between the stronger standards in

Europe and the weaker standards in the United States, primarily through shareholder resolutions; and, (4) reduced regulation is likely in the US energy industry.

- Jill Johnson participated in **Ceres**' monthly conference calls and frequent list serve activity for the INCR Carbon Asset Risk Working Group, INCR Policy Working Group, Shareholder Initiative on Climate and Sustainability (SICS) and Low Carbon, Clean Energy Working Group.

<u>SCERS Proactive Strategy</u>

Corporate Engagement

- SCERS responded to Institutional Shareholder Services' annual survey to help shape their proxy vote recommendations for the upcoming season.
- Parametric began to offer ISS proxy voting policies after repeated requests by SCERS, allowing SCERS to vote proxies per the Public Fund Policy for all directly held stocks.

Integrating Climate Change into the Investment Process

- SCERS placed BlackRock on watch status due to ESG concerns regarding its proxy voting and other investment stewardship activities in its role as manager of the BlackRock MSCI World ex-US Fund where SCERS has a $350 million investment. Specifically, SCERS is concerned with BlackRock's: (1) reticence to oppose management; (2) limited focus on environmental and social issues; (3) inconsistency between their proxy voting record and internal policies and public pronouncements; and, (4) limited transparency on investment stewardship activities. Several institutional investors have contacted SCERS to learn more about the rationale and SCERS has begun reaching out to other institutional investors as well.
- SCERS participated in a PCA survey of institutional investors to understand best practices of US public pensions regarding climate change.

Sustainability Investments

Motion: "…*The Board recognizes that these types of investments (e.g. renewable energy, cleantech, and green bonds) are relatively new and limited in availability and will need to be considered prudently as SCERS pursues investments in its asset class (e.g. real assets, private equity, fixed income)…*"

- Brookfield entered exclusive talks with Sun Edison to acquire TerraForm, which owns 3,000 megawatts of wind and solar renewable power assets. Brookfield is unable to discuss the talks since TerraForm is publicly traded. SCERS is invested in Brookfield Infrastructure III. [3]

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[1] http://www.vermonttreasurer.gov/sites/treasurer/files/VPIC/PDF/2017/PCA_Climate_Divestment_Report_for_VPIC.pdf
[2] https://www.fsb-tcfd.org/publications/recommendations-report/
[3] https://www.bloomberg.com/news/articles/2017-01-23/brookfield-in-exclusive-talks-to-buy-terraform-power-and-global

Appendix

SCERS Public Equity Allocation to Fossil Fuel Companies

As of December 31, 2016

SCERS Ownership	Account Type	Allocation ($ million)	% of SCERS Total Portfolio
Direct	Separate Account	$34.0	1.4%
Indirect	Commingled Fund	$58.2	2.3%
Total		$92.2	3.7%

Source: Bloomberg, Fossil Free Indexes, SCERS calculation; excludes overlay program, transition holdings

Note: Fossil Fuel companies as defined by the Carbon Underground 200, a list generated by Fossil Free Indices of the top 100 public coal companies globally and the top 100 public oil and gas companies globally ranked by the potential carbon emissions content of their proven reserves; Carbon Underground 200 constituents as of July 2016