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Holding Auditors Accountable for Complicity in Corporate Fraud

The health of the U.S. financial markets and investors is dependent on auditors fulfilling their critical gatekeeping function. While the Sarbanes-Oxley Act led to great improvement in financial reporting, it didn't go far enough to ensure auditor independence.

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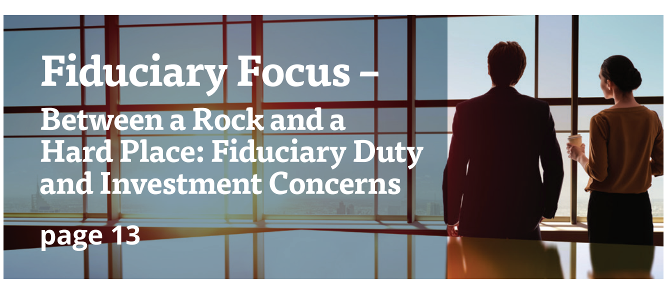

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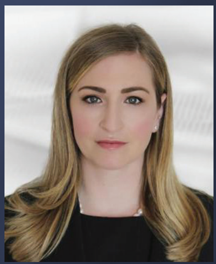

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WHILE SARBANES-OXLEY LED TO GREAT IMPROVEMENT IN FINANCIAL REPORTING, IT DIDN'T GO FAR ENOUGH TO ENSURE AUDITOR INDEPENDENCE.

Holding Auditors Accountable for Complicity in Corporate Fraud

The health of the U.S. financial markets and investors is dependent on auditors fulfilling their critical gatekeeping function. While the Sarbanes-Oxley Act led to great improvement in financial reporting, it didn't go far enough to ensure auditor independence, says Laura H. Posner, a Partner in Cohen Milstein.

In July, the Sarbanes-Oxley Act turned 20 years old. Sarbanes-Oxley, a landmark piece of legislation that transformed auditing and financial reporting in the wake of the Enron and Arthur Andersen scandal, has proven to be one of the most effective pieces of financial legislation passed since the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934.

Among other things, Sarbanes-Oxley led corporations to adopt and implement significantly more robust financial controls, leading to fewer and smaller restatements. But since it was enacted, both the financial markets and the Big Four accounting firms have transformed dramatically. Audit firms have expansive consulting arms, and financial products are significantly more complex. Legal developments have also made it increasingly difficult to hold fraudsters accountable when they run afoul of auditing rules and the securities laws. Perhaps most alarming is the dangerous pattern of auditors lacking independence from their clients, creating conflicts of interest that we must not ignore.

While Sarbanes-Oxley led to great improvement in financial reporting, it didn't go far enough to ensure auditor independence. Hopefully, the necessary changes will be made before the next auditing scandal rocks the markets and harms investors.

"Independent" Auditors

Sarbanes-Oxley attempted to ensure auditor independence, requiring engagement partners to rotate off clients every five years and audit firms to bar certain consulting work for audit clients. But the concept of the independent auditor in the U.S. has blurred as accounting firms have become increasingly ensconced in their clients, leading to erosion of investor confidence and opening the door to corporate misstatements, breaches of fiduciary duties, or worse—fraud.

An illustration of this is the recent report that Ernst & Young devised elaborate—and what federal authorities now claim were sham—tax shelters that allowed Perrigo, a leading maker of nonprescription drugs, to avoid more than $100 million in federal taxes. When Perrigo's outside auditor, BDO, questioned the legality of the tax shelters, Perrigo replaced BDO with Ernst & Young, which then blessed the transactions its consulting arm helped create. This is a prime example of why there must be a bright line defining what it means to be an independent auditor and proscribing what activities are permitted and which run afoul of auditor independence rules.

While the Securities and Exchange Commission has released some guidance on what kinds of relationships accounting firms and their auditing divisions can and cannot have with clients, it is not surprising that this activity still takes place. The client, after all, is the one who pays the bills.

Role of Litigation

Auditor independence issues often play an important role in private litigation, too. For example, investors recently settled securities litigation against Mattel Inc. and its auditor, PwC, for $98 million. According to Mattel's own audit committee, PwC's lead audit partner for the engagement violated auditor independence rules by providing recommendations on candidates for Mattel's senior finance positions. A Mattel whistleblower referenced in the complaint also alleged that PwC then helped cover up Mattel's valuation allowance misstatement that ultimately led to the need for a restatement. Mattel had improperly understated its net loss by approximately $109 million, effectively overstating earnings by $0.32 per share.

THE CONCEPT OF THE INDEPENDENT AUDITOR IN THE U.S. HAS BLURRED AS ACCOUNTING FIRMS HAVE BECOME INCREASINGLY ENSCONCED IN THEIR CLIENTS, LEADING TO EROSION OF INVESTOR CONFIDENCE AND OPENING THE DOOR TO CORPORATE MISSTATEMENTS, BREACHES OF FIDUCIARY DUTIES, OR WORSE—FRAUD.

While Sarbanes-Oxley attempted to prevent such compromises of independence, the Mattel/PwC case demonstrates that the legislation did not go far enough and that further regulatory action and civil litigation is necessary to protect investors.

Call for Regulators to Get Tough

In the U.S., accounting firms are regulated by both the SEC and the Public Company Accounting Oversight Board, a quasi-public agency created by Sarbanes-Oxley. SEC and PCAOB rules require audit firms to keep an arms-length relationship with the companies they oversee. In 2020, the SEC clarified the auditor independence rule under then-SEC Chairman Jay Clayton. Under the revised rules, companies are required to limit the number of services they provide to a single client to ensure objectivity and impartiality in their audit work.

Unfortunately, since the fall of Arthur Anderson in the wake of the Enron scandal, the SEC and PCAOB have often failed to go after auditors playing fast and loose with the rules. The death knell of Arthur Andersen—which was one of the "Big Five" auditing firms—was a massive blow to the accounting industry and gave many regulators cold feet in bringing claims against audit firms. When the Supreme Court later overturned the government's obstruction of justice case against Arthur Andersen, it further dampened enforcement efforts.

THE SEC RECENTLY ROLLED OUT A NEW ENFORCEMENT INITIATIVE AIMED AT INVESTIGATING CONFLICTS OF INTEREST IN THE NATION'S LARGEST ACCOUNTING FIRMS—A KEY STEP TO ENSURE AUDITORS ARE ACTING AS THE INDEPENDENT GATEKEEPERS.

The SEC recently rolled out a new enforcement initiative aimed at investigating conflicts of interest in the nation's largest accounting firms—a key step to ensure auditors are acting as the independent gatekeepers. One suggestion is for the SEC and PCAOB to look across the pond at the Competition and Markets Authority and Financial Reporting Council's recent hardline efforts to regulate the separation of the audit and non-audit practices of the UK's largest auditing firms—the same Big Four as in the U.S.—as a part of the UK's "Restoring Trust in Audit and Corporate Governance."

In addition to the Big Four establishing a separate regulatory audit board, FRC's April 2022 proposed revisions to the Audit Firm Governance Code stipulates a maximum tenure of nine years to guard against threats to independence and requires an independent non-executive to participate in the auditing process alongside the audit board. The INE would be entirely independent from the auditor and audited entities. It also would be meant to represent the public interest and act for the benefit of the common good, including that of the shareholder and other stakeholders.

Conclusion

The health of the U.S. financial markets and investors is dependent on auditors fulfilling their critical gatekeeping function. To do so, accounting firms must be truly independent from the companies they are auditing. ■

This Expert Commentary originally appeared in Bloomberg Tax on August 11, 2022.

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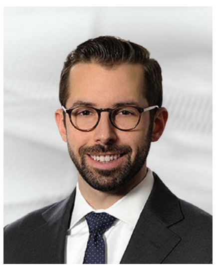
THIRD CIRCUIT REJECTS BID TO OVERTURN CLASS CERTIFICATION IN EQT LITIGATION



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***IN RE EQT* IS A PRIME EXAMPLE OF HOW FEDERAL SECURITIES DEFENDANTS NOWADAYS NEARLY ALWAYS FILE A RULE 23(F) PETITION FOLLOWING A DECISION TO CERTIFY A CLASS, NO MATTER HOW LONG THE ODDS OF SECURING A REVERSAL.**

Cohen Milstein and its co-counsel recently scored an important victory in the Third U.S. Circuit Court of Appeals, which refused to allow Defendants to appeal the District Court's class certification decision in *In re EQT Corp. Securities Litigation*, a federal securities class action relating to the 2017 merger of major natural gas producers EQT Corporation and Rice Energy. *In re EQT* is a prime example of how federal securities defendants nowadays nearly always file a Rule 23(f) petition following a decision to certify a class, no matter how long the odds of securing a reversal.

EQT is a major producer of natural gas that drills wells through hydraulic fracturing, or "fracking." In November 2017, EQT acquired rival gas producer Rice Energy for $6.7 billion. EQT's senior executives told investors at the time that the merger would create synergies worth between $2.5 billion and $7.5 billion by combining the two companies' supposedly contiguous drilling acreage, which would allow for longer and more efficient lateral wells, and by enabling EQT to capitalize on best practices and new technologies developed by Rice Energy. Plaintiffs in *In re EQT* allege that these representations were false and misleading because, among other things, the claimed synergies were based on assumptions Defendants knew or recklessly disregarded were invalid, and because EQT did not in fact intend to adopt Rice Energy's best practices or technology following the merger. After the acquisition, EQT concealed skyrocketing costs and serious problems drilling long lateral wells, instead telling shareholders it was "ahead of schedule for achieving our capital synergies." The truth was ultimately revealed through EQT's financial disclosures and a series of presentations the former Rice Energy executive team made during a proxy contest for control of the company.

On August 11, 2022, the U.S. District Court for the Western District of Pennsylvania issued a thorough 51-page opinion that

THE THIRD CIRCUIT GAVE NO QUARTER TO DEFENDANTS' ARGUMENTS, DISPATCHING WITH THEIR PETITION IN A TERSE, THREE-SENTENCE ORDER.

granted Plaintiffs' motion for class certification. Defendants then filed a motion for leave to appeal the District Court's decision to certify the class to the Third Circuit pursuant to Federal Rule of Civil Procedure 23(f).

Defendants raised three principal arguments to support their petition. First, they argued the District Court's ruling conflicted with the Supreme Court's decision in *Goldman Sachs Group, Inc. v. Arkansas Teacher Retirement System*, 141 S. Ct. 1951 (2021), even though the District Court directly quoted and correctly applied the standard endorsed by that decision. Second, Defendants argued that the District Court had ignored "qualitative" evidence of the lack of price impact in the form of analyst reports, even though the District Court assessed the qualitative evidence of the "economic materiality" of the corrective disclosures at issue. Third, Defendants argued that Plaintiffs' out-of-pocket damages model is not susceptible of common proof on a class-wide basis and violated the requirements of *Comcast Corp. v. Behrend*, 569 U.S. 27 (2013)—ignoring that *Comcast* is generally inapplicable in securities litigation, that the out-of-pocket damages model is the accepted standard approach in securities class actions, and that the District Court thoroughly analyzed Plaintiffs' model and found it to be applicable class-wide.

On September 23, 2022, just nine days after the parties' briefing on the petition was complete, a Third Circuit panel consisting of Judges McKee, Shwartz, and Bibas denied Defendants' petition for leave to appeal. The Third Circuit gave no quarter to Defendants' arguments, dispatching with their petition in a terse, three-sentence order.

In re EQT exemplifies the current trend of defendants filing Rule 23(f) petitions following class certifications as a matter of course. Hopefully, more plaintiff victories like the one in *In re EQT* will give defendants pause and deter them from filing meritless petitions and imposing unwarranted costs on federal securities plaintiffs. ■

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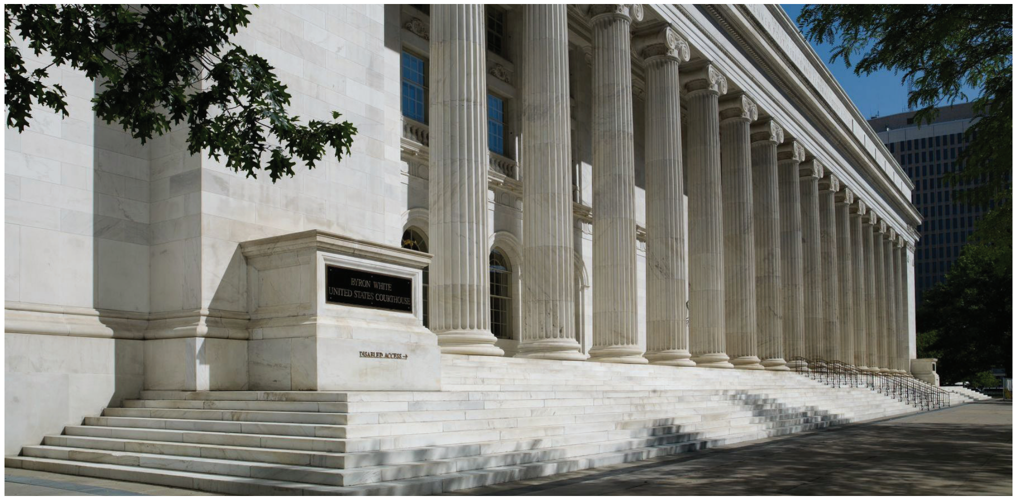
TENTH CIRCUIT REVIVES INVESTORS' FRAUD SUIT AGAINST PLURALSIGHT



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In a significant holding for plaintiffs arguing *scienter* in shareholder lawsuits, the Tenth U.S. Circuit Court of Appeals said a lower court had erred when it found that Pluralsight, Inc. Defendants' use of a predetermined trading plan automatically removed their motive to manipulate the company's stock price. In its August 23, 2022 opinion reversing the District Court's dismissal of the shareholder lawsuit[1], the Tenth Circuit held, among other things, that the existence of a 10b5-1 trading plan does "not per se rebut an inference of *scienter* where … a defendant was allegedly motivated to misrepresent or withhold material information to affect a stock price."

Pluralsight is a startup software company that offers a cloud-based technology skills platform and sells subscriptions to its products and services. At the start of the class period in January 2019, the complaint alleged that Defendants misrepresented the size of the company's salesforce—the primary driver of Pluralsight's quarter-over-quarter billings growth, which was the key business metric by which Pluralsight attracted investors. In addition, the complaint alleged that the company and its CEO and CFO knew that Pluralsight misrepresented the size of the salesforce and intentionally withheld this pertinent information from investors. The Lead Plaintiffs appealed to the Tenth Circuit after the U.S. District Court for the District of Utah dismissed the amended complaint on August 2, 2021.

The Tenth Circuit reversed the dismissal in part, holding that the two Lead Plaintiffs—the Indiana Public Retirement System and the Public School Teachers' Pension and Retirement Fund of Chicago—had plausibly alleged that Defendants made a false and misleading statement at the start of the class period. At that time, Pluralsight CFO

1 *Indiana Public Retirement System, et. al. v. Pluralsight, Inc.*, 45 F.4th 1236 (10th Cir. 2022).

James Budge had stated that the company had "about 250" quota-bearing sales representatives; however, it was later revealed that Pluralsight actually only had only "about 200" quota-bearing sales representatives at the time. The Tenth Circuit stated that this "strongly suggests Pluralsight could not have had 'about 250' quota-bearing sales representatives on January 16, 2019" and found that the information was "objectively verifiable." The misstatement marked the beginning of the class period and was a key misrepresentation, the falsity of which was revealed in the third quarter of 2019, when the Company reported a dramatically decreased billings rate of growth, shocking analysts and investors alike. The stock price dropped nearly 40 percent.

In ruling for Lead Plaintiffs on the *scienter* element of a 10b-5 securities fraud claim, the Tenth Circuit found that Lead Plaintiffs had pled a compelling inference that Defendants knew overstating Pluralsight's number of quota-bearing sales representatives was likely to mislead investors. The Tenth Circuit performed a holistic review in reaching this conclusion, looking to multiple allegations. To begin with, the panel cited Defendants' statements to analysts and investors on July 31, 2019 and in January 2020, which supported the inference that the CFO knew of the capacity gap but failed to admit it. The appellate court's finding was bolstered by the fact that the CFO had repeatedly emphasized to analysts and investors that Pluralsight carefully monitored the data surrounding Pluralsight's billing growth and that the size of the sales force was at the core of Defendants business model.

Moreover, the Tenth Circuit held that the CEO's and CFO's suspicious trading within the Class Period, both inside and outside of their 10b5-1 trading plans, supported *scienter*. Importantly, the Tenth Circuit agreed with Lead Plaintiffs' argument, supported by an *amici curiae* brief by former SEC Commissioners Robert J. Jackson and Luis A. Aguilar, former SEC Chief Accountant Lynn Turner and Columbia Law Professor Joshua Mitts, along with other prominent academics, that the "text and history of Rule 10b5-1 shows that such plans can be manipulated easily for personal financial gain and thus cannot rebut the inference that personal financial gain was a motive for Defendants' material misrepresentations." The Tenth Circuit noted that these plans do not prevent officers from "making false statements to artificially inflate the stock price to trigger those automatic trades—and that is what Plaintiffs allege occurred here." The appellate court then found that Lead Plaintiffs' allegations raised a strong inference of *scienter* because the CEO and CFO allegedly profited from their stock sales, sold a significant portion of their holdings, and the volumes

IN ITS OPINION REVERSING THE DISTRICT COURT'S DISMISSAL OF THE SHAREHOLDER LAWSUIT, THE TENTH CIRCUIT HELD THAT THE EXISTENCE OF A 10B5-1 TRADING PLAN DOES "NOT PER SE REBUT AN INFERENCE OF *SCIENTER* WHERE ...A DEFENDANT WAS ALLEGEDLY MOTIVATED TO MISREPRESENT OR WITHHOLD MATERIAL INFORMATION TO AFFECT A STOCK PRICE."

of sales were higher than outside the class period.

The Tenth Circuit also revived Plaintiffs' claims under Section 20A of the Exchange Act, which provides a private right of action to contemporaneous purchasers against corporate insiders who purchase or sell a security while in possession of material inside information.

This case is an important holding for investors. It demonstrates that affirmatively misrepresenting facts or data that a company and it officers continuously report on and that form a "key metric" in attracting investor interest, presents a danger of misleading investors and will support a finding of *scienter*. Significantly, the Tenth Circuit's holding also shows that 10b5-1 trading plans are not an automatic shield to fraud claims, or a "get out of jail free card." Courts recognize that, regardless of when the plan is created, Defendants with a 10b5-1 plan could be motivated to make material misrepresentations affecting the stock price to their benefit before a scheduled sale or to trigger a sale at a particular price. ■

IN RULING FOR LEAD PLAINTIFFS ON THE *SCIENTER* ELEMENT OF A 10B-5 SECURITIES FRAUD CLAIM, THE TENTH CIRCUIT FOUND THAT LEAD PLAINTIFFS HAD PLED A COMPELLING INFERENCE THAT DEFENDANTS KNEW OVERSTATING PLURALSIGHT'S NUMBER OF QUOTA-BEARING SALES REPRESENTATIVES WAS LIKELY TO MISLEAD INVESTORS.

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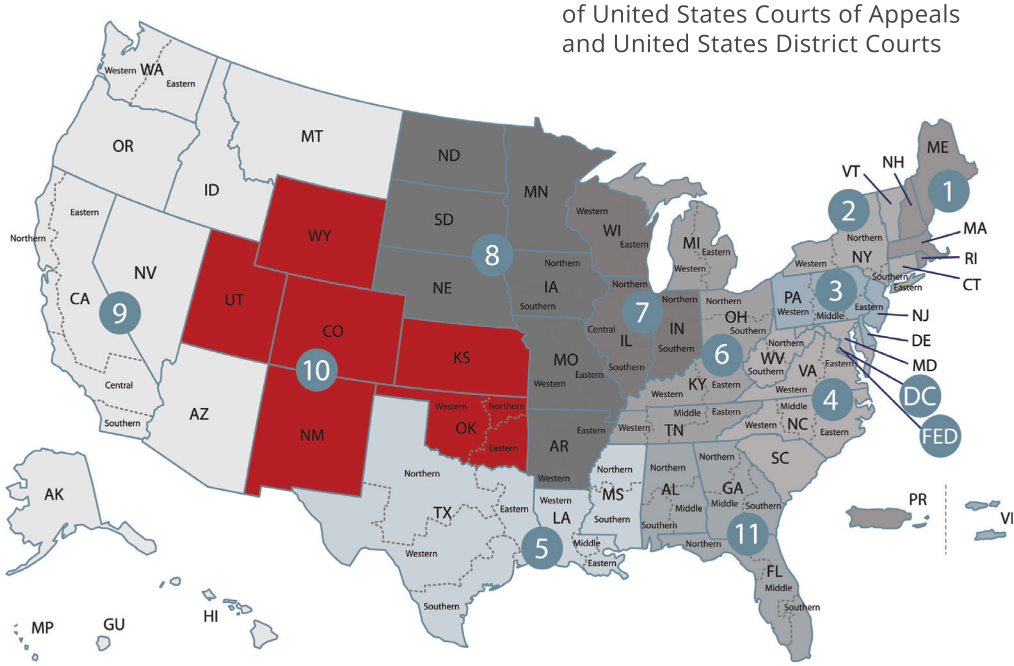

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SECURITIES LITIGATION 101:

PORTFOLIO MONITORING BEST PRACTICES

Securities fraud costs investors billions of dollars a year and shareholder lawsuits are the best available tool to recover fraud-related losses. The top 100 securities class action settlements alone have returned more than $68.6 billion to defrauded investors since 2001; approximately $10 billion in settlement proceeds awaited distribution as of September 30, 2022, according to ISS Securities Class Action Services.

Potential securities litigation claims are considered assets of the trust fund, giving trustees and staff a fiduciary duty to manage them effectively. For that reason, many pension funds have established portfolio monitoring programs to calculate their losses when new shareholder lawsuits are filed and keep track of settlements in which they are entitled to share. This article reviews the elements of a successful monitoring program.

Adopting and Maintaining a Securities Litigation Policy

A successful monitoring program begins with a comprehensive and up-to-date securities litigation policy. The Board should approve a policy that reflects its thinking about the factors that could tip the balance between remaining an "absent" class member, which is suitable for most shareholder lawsuits, or actively pursuing litigation as a lead or individual plaintiff. Spending time in this area bears dividends because a well-considered policy makes sure that staff will only spend their time on cases that the policy defines as worth the effort.

Tracking Settled Cases

For securities acquired in the United States, trustees should at least take steps to ensure their fund's custodial bank is filing all class-action settlement claims to which the fund is entitled. Because U.S. class actions function on an "opt in" basis, settlement claims administrators will attempt to contact all class members via their custodian once a settlement receives final approval. At that time, any fund owed a recovery can decide whether to collect its share, opt out of the class to pursue individual litigation, or object to the settlement.

Monitoring New Cases

When a securities class action is filed in U.S. federal court, impacted shareholders have 60 days to ask the judge to appoint them lead plaintiff. For that reason, trustees arguably have a fiduciary duty to monitor newly filed lawsuits to decide if active involvement can boost a fund's recovery or is otherwise beneficial to fund members. Since custodian banks only concern themselves with settlement claims, investors often select law firms or other third-party providers to track all new cases, calculate a fund's initial losses, and evaluate the merits of active involvement (something discussed in greater detail below).

A securities litigation policy should list factors the fund wants evaluators to consider before recommending it consider pursuing active litigation. Policies sometimes include a minimum dollar loss threshold to trigger a full case evaluation. They may specify other factors to weigh: the strength of the legal claims at issue; the probability of a meaningful financial recovery; the opportunity for corporate governance improvements; the amount of staff time necessary to oversee counsel; and the egregiousness of the fraud, for example.

SINCE CUSTODIAN BANKS ONLY CONCERN THEMSELVES WITH SETTLEMENT CLAIMS, INVESTORS OFTEN SELECT LAW FIRMS OR OTHER THIRD-PARTY PROVIDERS TO TRACK ALL NEW CASES.

Non-U.S. Litigation

Since many non-U.S. cases are litigated in "opt out" jurisdictions, where a fund must register earlier to collect in an eventual settlement and where a "loser pays" regime may expose plaintiffs to financial risk, policies may establish different criteria for U.S. and non-U.S. litigation.

The National Association of Public Pension Attorneys and other organizations have model policies to use as templates.

Selecting Monitoring Firms

If the policy calls for retaining monitoring law firms, staff should manage the process. The quality, selectivity, and number of law firms selected —together with the policy guidelines—will affect the number of cases flagged for consideration. Some funds issue open or targeted RFPs to select firms; others invite a group of reputable firms to submit proposals and select some to make "final" presentations to the board. While there is no magic number of monitoring firms to select, using more than one firm is a best practice; doing so offers checks and balances at no extra cost (since law firms do not charge a fee for monitoring), ensures a single firm won't be excluded from considering a case due to conflicts of interest, and allows for a mix of law firms with different approaches, strengths, and experiences. You'll want to consider reducing the number of monitoring firms if your staff feels overwhelmed by too many recommendations.

With a properly designed program, staff involvement will be limited largely to reviewing periodic reports from monitoring law firms and, on occasion, screening case recommendations. Monitoring firms should identify all new cases that impact the fund; investigate and evaluate their merits; properly assess initial losses and complications in collecting damages; and recommend the best course of legal action, focusing on the fund's policy goals. Most newly filed U.S. securities class actions will not require action before the settlement stage.

PUTTING A PORTFOLIO MONITORING PROGRAM IN PLACE TO ACCOUNT FOR SECURITIES LITIGATION ASSETS IS A BEST FIDUCIARY PRACTICE AND ENACTING A SECURITIES LITIGATION POLICY IS THE BEST WAY TO PROVIDE A FUND WITH CLEAR, CONSISTENT GUIDELINES ABOUT PROTECTING ITS INTERESTS IN SHAREHOLDER LAWSUITS.

Pursuing an Active Role in Litigation

There are cases, however, where a fund may want to become a lead plaintiff. Doing so may boost its recovery and will ensure proper management of a case in which it has a significant financial interest. Typically, the lead plaintiff signs off on major strategic decisions, reviews important filings, and is involved in any settlement discussions. It may be able to pursue corporate governance remedies. It selects lead counsel, negotiates attorneys' fees, and oversees class counsel. Some lead plaintiffs choose to do more. While there are no out-of-pocket costs—lead counsel reimburses the costs of travel and other expenses—the lead plaintiff should expect to dedicate some hours of staff time to the litigation. If the case is successful, lead counsel may petition the court to authorize compensating staff for time spent carrying out lead plaintiff duties.

Conclusion

Putting a portfolio monitoring program in place to account for securities litigation assets is a best fiduciary practice and enacting a securities litigation policy is the best way to provide a fund with clear, consistent guidelines about protecting its interests in shareholder lawsuits. Just as an investment policy is regularly reviewed to ensure consistency with the fund's evolving circumstances, a securities litigation policy should be regularly reviewed to ensure it accurately reflects the fund's evolving attitude toward involvement in securities litigation. ■

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FIDUCIARY FOCUS

BETWEEN A ROCK AND A HARD PLACE: FIDUCIARY DUTY AND INVESTMENT CONCERNS

It seems as though Environmental, Social and Governance investing is on the forefront of everyone's mind these days. News stories on the topic abound, with politicians of every stripe propounding their positions. A recent opinion piece in one national newspaper pronounced that trustees who engaged in Environmental, Social and Governance investing were clearly violating their fiduciary duty, while an op-ed in a competing news outlet claimed that those who ignored Environmental, Social and Governance investing were most certainly in violation of *their* fiduciary duty. What is a prudent fiduciary supposed to do in these polarized times?

Language Matters—Define the Terms

Critical to the analysis of fiduciary duty and Environmental, Social and Governance investing is an understanding of exactly what Environmental, Social and Governance investing actually means. One of the greatest difficulties in this area is a lack of clarity over Environmental, Social and Governance investing terminology, as Environmental, Social and Governance investing is not clearly defined and can mean different things to different investors. As set forth by State Street Global Advisors, different Environmental, Social and Governance investing strategies include: "exclusionary screening" (excluding certain companies, sectors or countries from the universe of possible investments); "positive screening" (affirmatively tilting the portfolio toward certain companies based on Environmental, Social and Governance investing metrics—note that the appropriateness of the metrics themselves has been hotly debated); "impact investing" (targeting a measurable positive social or governance impact, usually project specific); "active ownership" (engaging with companies on a variety of issues to initiate changes in company policies, practices and behaviors), and "ESG integration" (consideration of factors in order to achieve higher returns and/or mitigate risk). As these strategies differ widely, analyzing the application of fiduciary duty in each of these strategies may likewise be different.

Back to Basics

The fundamental starting point for any prudent pension system fiduciary facing a difficult situation is to return to the fundamental elements that underlie fiduciary duty. Fiduciary duties have been called "the highest known to the law." Key to beginning an analysis is **the exclusive benefit rule,** which provides that investments shall be for the exclusive benefit of the participants and beneficiaries of the system and therefore fiduciaries must act solely in the interests of the members and beneficiaries of the system. This common law rule is codified in the enabling legislation that governs most public pension plans. Moreover, the Internal Revenue Code

(“IRC”) provides that no part of the corpus or income of the pension trust may be used for or diverted to purposes other than for the exclusive benefit of the employees or their beneficiaries. This is critically important since public pension plans must remain “qualified plans” in order to entitle their members and beneficiaries to tax exemptions.

Closely related to the exclusive benefit rule and central to every statement of fiduciary duty is the **fiduciary duty of loyalty,** which provides that trustees must act solely in the interest of members and beneficiaries without regard to the interest of any other person. The trustee owes a duty to the beneficiary to administer the trust solely in the interest of the beneficiary and may not be guided by the interests of any other parties or person. The duty of loyalty is strictly construed in law and the U.S. Supreme Court has stated that the duty to trust beneficiaries must overcome any loyalty to the interests of the party that appointed the trustee. This is sometimes called the “one hat rule,” requiring that while trustees may also have a “day job”—as an elected official, an employee of an employer who pays into the system, or an officer of a union whose members belong to the system, for example—when making decisions as a trustee of the retirement system they may only wear their fiduciary trustee “hat.” This means that trustees of public retirement systems are **not** fiduciaries for appointing authorities, employers who pay into the systems, employees, unions, constituents, taxpayers, the public—or anyone other than the members and beneficiaries.

ONE OF THE GREATEST DIFFICULTIES FOR FIDUCIARIES ADDRESSING ESG INVESTING IS A LACK OF CLEAR TERMINOLOGY. BECAUSE ENVIRONMENTAL, SOCIAL AND GOVERNANCE INVESTING IS NOT CLEARLY DEFINED, IT CAN MEAN DIFFERENT THINGS TO DIFFERENT INVESTORS.

One Size Does Not Fit All—And May Not Fit Forever

Public pension plans come in a variety of sizes and shapes and each plan is different. Funding levels, for example, may vary dramatically, as may pension obligations. When setting the strategic asset allocation for the pension plan, which is often referred to as one of the most important functions of a trustee, trustees consider the plan’s funding levels and pension obligations and the plan’s risk tolerance and diversification of the investment portfolio. When making investment decisions, **the fiduciary duties of prudence and care** require consideration of the prevailing circumstances—meaning that investment action that is prudent for one investor may not be prudent for another.

Moreover, since fiduciaries must consider the prevailing circumstances, what is prudent at one time may not be prudent at a later time. This means that fiduciary duty is dynamic—i.e., while the fundamental fiduciary duties are based on legal principles that do not change, the *application* of those principles cannot be static, since fiduciaries must take into consideration current circumstances.

Conclusion

Applying this analysis, we see that not every type of Environmental, Social and Governance investing may be appropriate in every case. Prudent fiduciaries must keep the interest of the plan participants and beneficiaries paramount, and may not permit the use of the corpus or income of the pension trust in violation of the exclusive benefit rule, thereby risking disqualification under the IRC. They may not sacrifice investment returns and take on additional risk to promote interests unrelated to the portfolio's objectives.

PRUDENT FIDUCIARIES MAY NOT SACRIFICE INVESTMENT RETURNS AND TAKE ON ADDITIONAL RISK TO PROMOTE INTERESTS UNRELATED TO THE PORTFOLIO'S OBJECTIVES. AT THE SAME TIME, THEY CANNOT IGNORE ENVIRONMENTAL, SOCIAL AND GOVERNANCE INVESTING FACTORS THAT INFLUENCE THE PERFORMANCE OF INVESTMENTS AND ARE MATERIAL TO LONG-TERM RETURNS AND LEVELS OF RISK.

But prudent fiduciaries cannot ignore Environmental, Social and Governance investing factors that influence the performance of investments and are material to long-term returns and levels of risk. It cannot be impermissible for trustees to consider the state of the world in applying fundamental fiduciary principles to fulfill their obligations to members and beneficiaries, since they are seeking to preserve the assets for future generations of members and beneficiaries. Indeed, that is what trustees do when exercising their fiduciary responsibilities: they gather facts about prevailing circumstances and potential investment vehicles to make well informed decisions. Decisions made in 2022 are not the same as those that might have been made in 1972. The world has changed, and circumstances are different. Factors affecting the long-term considerations that public pension trustees must weigh are different. If responsible, informed decision making were static, there would be little need for trustees or the rules guiding their decision making. Fiduciaries must gather facts, analyze and assess those facts, and make decisions based on all relevant facts. It is impossible to invest prudently, loyally, and carefully without considering the impact of factors—including environmental, social, governance, cultural, economic, and political factors—that influence the performance of investments and are material to long-term risk and return. It's a classic approach that has served pension funds and their beneficiaries well for a very long time—and should serve them for a very long time to come. ■

Suzanne Dugan is Special Counsel at Cohen Milstein and leads the firm's Ethics & Fiduciary Counseling practice.

RECENT HIGHLIGHTS

COHENMILSTEIN IN THE NEWS

- "Wells Fargo Shareholders Move for Class Certification in Consent Order Compliance Lawsuit," *Law Street* – October 5, 2022
- "Scientology Leader Evades Legal Service in Australian Trafficking Case," *The Sydney Morning Herald* – September 19, 2022
- "Poultry Workers' $85 Mln Antitrust Deal Ready for Judge's Approval," *Reuters* – September 12, 2022
- "W&M Alumnus, Board Member Appointed as Representative to the UN," *W&M News* – September 6, 2022
- "Boeing's $6.25M Settlement Over 737 Max Gets Initial OK," *Law360* – August 30, 2022
- "Pluralsight Stockholder Lawsuit Gets New Life from Tenth Circuit," *Bloomberg Law* – August 25, 2022
- "Centene Strikes $33M Deal to End Wash. Medicaid Fraud Suit," *Law360* – August 25, 2022
- "FirstEnergy's $180 Million Derivative Settlement Wins Approval," *Bloomberg Law* – August 24, 2022
- "Workers Seek OK For ERISA Class Over $244M Stock Buy," *Law360* – August 15, 2022
- "Lawyer Limelight: Christina D. Saler," *Lawdragon* – August 1, 2022
- "PCAOB Plans Tougher Audit Regulation on 20th Anniversary of SOX," *Accounting Today* – July 28, 2022
- "KPMG's $35 Million Deal to End Miller Energy Suit Gets Final Nod," *Bloomberg Law* – July 14, 2022
- "Brooklyn U.S. Attorney Intervenes in False Claims Act Suit Against Dialysis Company," *New York Law Journal* – July 13, 2022
- "Md. Judge OKs $7M T. Rowe Price ERISA Settlement," *Law360* – July 7, 2022

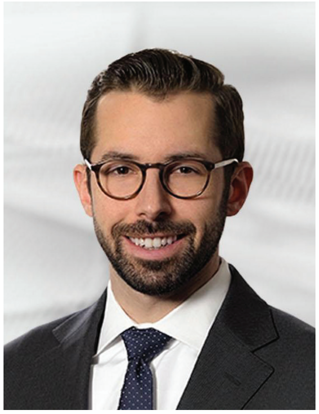
AWARDS & ACCOLADES

- Benchmark Litigation Names Julie Goldsmith Reiser a 2023 Litigation Star – October 13, 2022
- Benchmark Litigation Names Michael B. Eisenkraft, Laura H. Posner and Sharon K. Robertson 2023 Future Stars – October 6, 2022
- Benchmark Litigation Names Steven J. Toll a 2023 Litigation Star – October 5, 2022
- Corporate Counsel Names Julie G. Reiser of 2022 Women, Influence & Power in Law Awards – September 19, 2022
- Carol Gilden Named a Crain's Chicago Business Notable Women in Law of 2022 – September 6, 2022
- Cohen Milstein Recognized as Leading Firm for Women in Law360's 2022 Glass Ceiling Report: Women in Law – September 1, 2022
- Benchmark Litigation Names Julie G. Reiser to its 2022 "Top 250 Women in Litigation" List – August 18, 2022
- Benchmark Litigation's 2022 "40 & Under" List Recognizes Sharon Robertson – August 5, 2022
- American Lawyer Recognizes Cohen Milstein's Michael Eisenkraft in "Litigator of the Week Runners-Up and Shout Outs" – July 15, 2022
- Twenty-Two Cohen Milstein Attorneys Named to the 2022 Lawdragon 500 Leading Plaintiff Financial Lawyers List – July 8, 2022

UPCOMING EVENTS

- **October 23-26** | International Foundation of Employee Benefit Plans (IFEBP) 68th Annual Employee Benefits Conference, Mandalay Bay, Las Vegas, NV – Arthur Coia and Christopher Lometti
- **October 25-28** | National Conference on Public Employee Retirement Systems (NCPERS Public Safety Pension Trustee Conference, Sheraton Grand Nashville Downtown, Nashville, TN – Richard Lorant and Christina Saler
- **November 8-11** | State Association of County Retirement Systems (SACRS) Fall Conference, Hyatt Regency, Long Beach, CA – Richard Lorant and Julie Reiser
- **November 20-22** | County Commissioners Association of Pennsylvania (CCAP) Fall Conference, The Hotel Hershey, Dauphin County, PA – David Maser

ATTORNEY PROFILE



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Benjamin F. Jackson is an associate in the Securities Litigation & Investor Protection practice group. In his nine years of practice, Ben has gained invaluable experience. He clerked for the U.S. Court of Appeals for the Second Circuit and the U.S. District Court of the Southern District of New York. Before and after his clerkships, Ben worked with a highly regarded national defense firm focusing on securities, antitrust, white collar investigations, and intellectual property. Ben joined the firm in 2021 to focus exclusively on securities litigation. For this issue of the **Shareholder Advocate*****, Ben spoke with Editor Christina Saler.***

I grew up on … the South Shore of Long Island, New York. College pulled me to St. Louis, post-college work as a management consultant took me to Chicago (and all over America, really), and law school drew me to Boston, but I've always made my way back to New York. My wife, daughter (a sixth-generation New Yorker) and I live in the Bronx, and we are lucky to have family all over the New York metro area.

I knew I wanted to become a lawyer … very early on in college. As I got involved with the Democratic Party and gravitated toward other students who were politically minded and enjoyed healthy debates, I began to understand the power of advocacy. But I also didn't want to go straight to law school, so after college I spent two years as a management consultant, advising major corporations on business strategy. To this day, I regularly use the quantitative skills I developed as a consultant and the insights I gained into the corporate world. At a high level, I got an inside look at how companies make decisions, develop strategies, and incentivize their senior management. That experience enabled me to be more critical of and better understand the facts we gather when prosecuting a securities case.

A professional highlight … was when I took on a *pro bono* civil rights case for a homeless man and brought it to trial in federal court. As one of the two lead trial attorneys, I had to make all of the final decisions about how to try this challenging he-said-she-said type of case. Although the cards were stacked against us, the jury hung, and we were ultimately able to obtain a favorable settlement for our client. But for him, it wasn't about the money, it was about getting his day in court, and the thing I'm proudest of is that he felt justice was served.

Road cycling, trail running, and hiking … are my favorite ways to relax. In New York, along the Hudson River, there are some spectacular cycling routes and trails. Before my daughter was born, I would typically spend my Saturday mornings cycling 60 to 100 miles which, depending on my route, could take me from the skyscrapers of Manhattan, to the dramatic cliffs of the New Jersey Palisades, to the bucolic Hudson Valley and back. Now that I have a two-year-old, I've dialed it back a bit, but I've got a bike trailer that gives my daughter the perfect place for either experiencing nature or a long nap, depending on her mood. And my wife (also a lawyer) gets to enjoy a quiet house and get some work done. ■

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