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OAG 22-05

Subject:	Whether "stakeholder capitalism" and "environmental, social, and governance" investment practices in connection with the investment of public pensions funds are consistent with Kentucky law governing fiduciary duties.
Requested by:	Treasurer Allison Ball State Treasurer of the Commonwealth of Kentucky[1]
Written by:	Carmine G. Iaccarino, General Counsel Zachary Richards, Assistant Attorney General
Syllabus:	"Stakeholder capitalism" and "environmental, social, and governance" investment practices, which introduce mixed motivations to investment decisions, are inconsistent with Kentucky law governing fiduciary duties owed by investment management firms to Kentucky's public pension plans.

Opinion of the Attorney General

There is an increasing trend among some investment management firms to use money in public and state employee pension plans—that is, other people's money—to

1 Although the Treasurer asks for the Attorney General's opinion in her capacity as State Treasurer, she also serves as chair of the State Investment Commission, KRS 42.500(1)(a), and as a trustee of the Teachers' Retirement System of the State of Kentucky, KRS 161.250(1)(b)2.

push their own political agendas and force social change.[2] State Treasurer Allison Ball asks whether those asset management practices are consistent with Kentucky law. For the reasons below, it is the opinion of this Office that they are not.

Background

To encourage public service, Kentucky offers public employees certain pension benefits. *See*, *e.g.*, KRS 61.510 to KRS 61.705. For years, however, the Commonwealth's public pension plans have hovered at severely underfunded levels. According to the Kentucky Public Pension Authority's most recent annual report, the public pension plan for most state employees is roughly 17% funded.[3] Kentucky's other public pension plans have not fared much better: the public pension fund covering Kentucky State Police is roughly 30% funded and the County plans are 46% to 52% funded.[4] And while the public pension plans administered by the Kentucky Public Pension Authority have shown year-over-year improvement in funding,[5] there is a concern that this trajectory may be threatened by extreme approaches to investment management—particularly those that put ancillary interests before investment returns for the benefit of public pensioners and state employees.

One such approach is "stakeholder capitalism." According to its advocates, "[s]takeholder capitalism is an expansion of corporate management fealty beyond shareholders to include the workforce, supply chain, customers, communities, societies, and the environment."[6] What this means in reality is that investment

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[2] The social change they seek has often been rejected outright by the people's elected representatives. *See*, *e.g.*, *Will ESG Disclosures be Mandated by Law? A Legislative Analysis*, KING & SPALDING (Sept. 22, 2021), https://perma.cc/F4FZ-9JA7 (discussing environmental, social, and governance ("ESG") legislation from the 117th Congress and finding a "low likelihood" that the legislation becomes law); *see also* Stuart Loren, *ESG and the Road to Serfdom*, LINKEDIN (Oct. 22, 2021), https://perma.cc/3UVC-ETZ7 ("Even if well-intentioned and sensible, . . . do we really want a handful of senior management at BlackRock and the world's largest asset allocators pushing for policy-related changes? Isn't this the role of government?").

[3] *Annual Comprehensive Financial Report for the Fiscal Year Ended June 30, 2021*, KENTUCKY PUBLIC PENSION AUTHORITY (Dec. 8, 2021), at 6, https://perma.cc/AN5N-9YXA (hereinafter "KPPA 2021 Report").

[4] *Id.* Kentucky is not alone in its public pension experience. Pew, *Legal Protection for State Pension and Retiree Health Benefits, Findings from a 50-state survey of retirement plans* (May 30, 2019), https://perma.cc/CNR7-QK89. ("Since 2000, when public retirement systems were almost fully funded, states have seen aggregate unfunded pension liabilities grow to more than $1 trillion, with an additional $700 billion in unfunded retiree health benefit costs.").

[5] KPPA 2021 Report, *supra* note 3, at 14.

[6] Mark A. Cohen, *Stakeholder Capitalism: Challenges and Opportunities for Big Law*, FORBES (Jan. 19, 2022), https://www.forbes.com/sites/markcohen1/2022/01/19/stakeholder-capitalism-challenges-and-opportunities-for-big-law/?sh=760110a449e2 (last visited May 26, 2022).

management firms who embrace stakeholder capitalism propose prioritizing activist goals over the interests of their public and state employee clients.

To achieve this version of "capitalism," investment management firms are adopting "environmental, social, and governance"—or "ESG"—investment practices. ESG investing is an "umbrella term that refers to an investment strategy that emphasizes a firm's governance structure or the environmental or social impacts of the firm's products or practices."[7]

American economist Milton Friedman once criticized an earlier version of this trend whereby one set of stockholders sought to convince another set of stockholders that business should have a "social conscience." As he explained, "what is in effect involved is some stockholders trying to get other stockholders (or customers or employees) to contribute against their will to 'social' causes favored by activists. Insofar as they succeed, they are again imposing taxes and spending the proceeds."[8] Friedman found this problematic because "the great virtue of private competitive enterprise" is that it "forces people to be responsible for their own actions and makes it difficult for them to 'exploit' other people for either selfish or unselfish purposes. They can do good—but only at their own expense." [9]

Today, in perhaps an even more pernicious version of the trend, the debate is no longer left to stockholders. In fact, there is little-to-no debate. Investment managers in some corporate suites now use the assets they manage—that is, other people's money—to enforce their preferred partisan sensibilities and to seek their desired societal and political changes.

Investment management firms have publicly committed to coordinating joint action for ESG purposes, such as reducing climate change. For example, the Steering Committee for the Glasgow Alliance for Net Zero ("GFANZ") states: "*The systemic change needed to alter the planet's climate trajectory can only happen if the entire financial system makes ambitious commitments* and operationalises those commitments with near-term action. *That is why we formed [GFANZ],* to bring together over 450 leading financial enterprises united by a commitment to accelerate the decarbonisation of the global economy."[10] Similarly, Climate Action 100 "aims to

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7 Max M. Schanzenbach & Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by A Trustee*, 72 STAN. L. REV. 381, 388 (2020).

8 Milton Friedman, *The Social Responsibility of Business is to Increase its Profits*, THE NEW YORK TIMES MAGAZINE (Sept. 13, 1970), at 4, https://perma.cc/CTJ6-9FKV.

9 *Id*.

10 *Forward from the Principals Group* GLASGOW FINANCIAL ALLIANCE FOR NET ZERO (Nov. 2021), at 6, https://perma.cc/N3KS-KTZG (emphasis added).

ensure the world's largest corporate greenhouse gas emitters take necessary action on climate change."[11] Climate Action 100 explicitly concedes a mixed motive, stating that its investor signatories believe that taking action "is consistent with their fiduciary duty *and essential to achieve the goals of the Paris Agreement*."[12] As further suggestion of a political motive, some investment management firms have committed to both advocate for government-imposed climate change mandates,[13] *and* use their fiduciary role to prevent portfolio companies from advocating against such mandates.[14]

Whether these ancillary purposes are societally beneficial is beside the point when speaking of the duty of fiduciaries. Fiduciaries must have a single-minded purpose in the returns on their beneficiaries' investments.

And this affects Kentuckians. One investment management firm, at one time directing roughly $1.5 billion on behalf of the Kentucky Public Pension Authority,[15] has made a "firmwide commitment to integrate ESG information into [its] investment processes" to affect "all of [its] investment divisions and investments teams."[16] Other investment management firms that direct billions of dollars in Kentucky pension fund investments have publicly made similar commitments to ESG investment practices.[17] There is some suggestion that politically biased investment strategies have real costs and worsen outcomes for pensioners.[18] These harms are significant

[11] CLIMATE ACTION 100+, *About*, https://perma.cc/K64N-J69K.

[12] *Id*.

[13] *Act Now, Financial Leaders Urge More Climate Action from the G20*, GLASGOW FINANCIAL ALLIANCE FOR NET ZERO, https://perma.cc/43B2-XQ4A ("More governments need to commit to the Paris target of 1.5 degrees Celsius by 2050. They need to make immediate cuts to emissions . . . .").

[14] *2020 Progress Report,* CLIMATE ACTION 100+ (2020), at 18 and 78, https://perma.cc/B5XW-XW2X (scoring companies on whether the companies and their trade associations' lobbying efforts are "Paris-agreement aligned" and noting industry associations who "engage in problematic lobbying on climate" are "holding back Paris-aligned climate policy").

[15] KPPA 2021 Report, *supra* note 3, at 137. Of course, this figure fluctuates and, as of the date of this opinion, stood at roughly $1.1 billion according to the Kentucky Public Pension Authority.

[16] 2020 Sustainability Disclosure, BlackRock, at 6, https://perma.cc/4HE5-6DXH. *Compare* Larry Fink's 2022 Letter to CEOs: A Fundamental Reshaping of Finance, https://perma.cc/H59D-R4BA, *with* Larry Fink's 2022 Letter to CEOs: The Power of Capitalism, https://perma.cc/MMF7-LESJ.

[17] *See*, *e.g.*, *Responsible Investment: Policies and Principles*, FRANKLIN TEMPLETON (2020), https://perma.cc/679E-6DQ3; Lord Abbett, *ESG Investing*, https://perma.cc/S8RS-U7M6; Putnam Investments, *Philosophy – ESG integration in our investment group*, https://perma.cc/F3LT-SYJE; *see also* KPPA 2021 Report, *supra* note 3, at 136-37.

[18] *See*, *e.g.*, Christopher Bancroft Burnham, *BlackRock's ESG Strategy Plays Politics with Public Pensions*, BARRON'S (May 28, 2020), https://perma.cc/FRU5-CX93 ("Research has consistently indicated that conventional index portfolios perform better than ESG portfolios, partly because ESG portfolios charge higher fees. . . . Fink is pursuing a course which, while possibly more profitable for

because companies employing ESG investment strategies are entrusted as fiduciaries to manage the funds in the best interests of pension beneficiaries like teachers, firefighters, and many other public servants who have ordered their lives around promises made and who depend on public pensions to finance their retirements.[19]

Law

State and federal law have long recognized fiduciary duties for those who manage other people's money. The Employee Retirement Income Security Act ("ERISA"), for example, demands that a fiduciary "discharge that person's duties with respect to the plan solely in the interests of the participants and beneficiaries, for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan, and with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." 29 CFR § 2550.404a-1(a).

Kentucky law provides similarly demanding duties for fiduciaries. KRS 61.650 provides that a "trustee, officer, employee, employee of the Kentucky Public Pensions Authority, or other fiduciary shall discharge duties with respect to the retirement system . . . *[s]olely* in the interest of the members and beneficiaries [and for] the *exclusive* purpose of providing benefits to members and beneficiaries and paying reasonable expenses of administering the system[.]" KRS 61.650(1) (setting forth the duties governing the fiduciaries of the Kentucky Employees Retirement System or State Police Retirement System) (emphasis added); *see also* KRS 78.790 (setting forth similar duties governing the fiduciaries of the County Employees Retirement System); KRS 161.430(2) (setting forth similar duties governing the fiduciaries of the Teachers' Retirement System of the State of Kentucky). This language draws from traditional trust principles requiring a single-minded purpose by fiduciaries that has been summarized as follows: "[a]cting with mixed motives triggers an irrebuttable presumption of wrongdoing, full stop."[20]

BlackRock, puts public pension funds and other client portfolio performance in jeopardy by opening the door to politics as part of pension portfolio management.").

[19] This Office notes a related move in this trend: the S&P Global Ratings' (S&P) recent decision to include ESG credit indicators in state credit ratings. Energy producing states, like Kentucky, may suffer under these ratings because the Commonwealth's investment in signature industries like coal, oil, and natural gas would likely result in lower ESG scores. Yet state law requires pension trustees to "give priority to the investment of funds in obligations calculated to improve the industrial development and enhance the economic welfare of the Commonwealth." *See, e.g.*, KRS 161.430(1)(c); KRS 78.790(3) (same); KRS 61.650(3) (same). A state's credit worthiness should be determined by the health of its economy—not activist ESG considerations.

[20] Schanzenbach, *supra* note 7, at 400–401.

Like ERISA, state law also demands that such fiduciaries discharge their duties "[w]ith the care, skill, and caution under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with those matters would use in the conduct of an activity of like character and purpose." KRS 61.650(1)(c)(3); KRS 161.430(2)(b) (same for the Teachers' Retirement System of the State of Kentucky); KRS 78.790(1)(c) (same for County Employees Retirement System). The duty of prudence requires more than assuming sweeping government mandates that coincide with an investment manager's policy preferences.[21] Under Kentucky law, fiduciary duty is not merely gift wrapping that a fiduciary may use to conceal a package of personal motivations.

Along with these fiduciary duties, the trustees of the Kentucky Public Pension Authority, for example, have adopted an investment policy that expressly provides that, in "instances where the Investment Committee has determined it is desirable to employ the services of an external Investment Manager," those "Investment Managers . . . agree to serve as a fiduciary to the Systems."[22] Moreover, the trustees have expressly stated that, "[c]onsistent with carrying out their fiduciary responsibilities, the Trustees will not systematically exclude any investments in companies, industries, countries, or geographic areas unless required to do so by statute."[23, 24]

Conclusion. Whether an investment management firm has breached a fiduciary duty is a fact intensive inquiry. That determination rests on a number of considerations and careful review of a fiduciary's actions, statements, and commitments. While *asset owners* may pursue a social purpose or "sacrifice some performance on their investments to achieve an ESG goal,"[25] *investment managers* entrusted to make financial investments for Kentucky's public pension systems must be single-minded in their motivation and actions and their decisions must be "[s]olely

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21 *See Jarvis v. Nat'l City*, 410 S.W.3d 148, 158 n.28 (Ky. 2013) ("Trustees must often 'conduct considerable research and analysis in each potential investment and in devising an overall investment strategy.'" (quoting *Estate of Fridenberg v. Appeal of Commonwealth of Pa.*, 33 A.3d 581, 590 (Pa. 2011)).

22 Kentucky Retirement System, *Investment Policy Statement* (adopted Nov. 16, 2021), at Section II.D.i., https://perma.cc/4LLR-KNC6.

23 *Id*. at Section I.B.

24 Although beyond the scope of this request, there are some free speech concerns when considering this scheme in light of the U.S. Supreme Court's decision in *Janus v. AFSCME*, 138 S. Ct. 2448, 2464 (2018) ("Forcing free and independent individuals to endorse ideas they find objectionable is always demeaning . . . ."). Allowing investment management firms to speak on behalf of pensioners or the pension systems without notice or approval may give rise to First Amendment concerns.

25 *Domini Poll: ESG Investing is Gaining Traction,* KIPLINGER (Oct. 12, 2021), https://perma.cc/4LSV-X4DE.

in the interest of the members and beneficiaries [and for] the exclusive purpose of providing benefits[26] to members and beneficiaries," KRS 61.650(1); *see also* KRS 78.790(1)(c); KRS 161.430(2)(a). To do otherwise risks breaching clearly established statutory and contractual fiduciary duties and threatens the stability of already fragile pension systems. In sum, politics has no place in Kentucky's public pensions. Therefore, it is the opinion of this Office that "stakeholder capitalism" and "environmental, social, and governance" investment practices that introduce mixed motivations to investment decisions are inconsistent with Kentucky law governing fiduciary duties owed by investment management firms to Kentucky's public pension plans.

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[26] These "benefits" are clearly financial benefits, not an investment manager's conception of societal benefits. *See Fifth Third Bancorp v. Dudenhoeffer*, 573 U.S. 409, 420–21 (2014) (noting that the "benefits" to be pursued by ERISA fiduciaries as their "exclusive purpose" does not include "nonpecuniary benefits").