POLICY PAPER

The ESG Gordian Knot: Evaluating ESG in a Fiduciary World

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Executive Summary

Environmental, social, and governance (ESG) investing has become a prominent topic in the financial industry, as many asset managers have made commitments to leverage their clients' assets to accomplish ESG goals. However, these ESG commitments raise significant concerns, including the lack of standardization and transparency in ESG ratings, the divergence of ESG performance and financial performance, and most importantly, conflicts with fiduciary duty and legal obligations. This report aims to provide a critical analysis of these issues by examining the following aspects:

- The history of ESG and the inherent conflicts with the current "Risk-Return" theory of ESG
- The current statutory, regulatory, and case-law landscape around the fiduciary duty of trustees, investment advisors, and investment managers
- The inherent conflicts between ESG commitments and fiduciary duties
- The challenges and limitations of ESG ratings methodologies and how they can be improved and enhanced
- The performance of ESG vs. non-ESG portfolios and the implications for risk and return
- The effects of ESG commitments on proxy voting and engagement activities
- The impact of the Energy Discrimination Elimination Act (EDEA) on Oklahoma pensions and the fiduciary principles involved

The primary conclusions in this report are as follows:

- ESG commitments are inconsistent with the legal and ethical framework of fiduciary duties and constitutional requirements, which require acting in the sole interest of the beneficiaries.
- ESG ratings are not reliable or comparable across different providers, as they use different methodologies, criteria, indicators, data sources, and quality controls. ESG ratings can also be inconsistent, incomplete, and inaccurate, leading to divergent and misleading results.
- ESG investing does not consistently or significantly outperform non-ESG investing, as the relationship between ESG performance and financial performance is complex and context-dependent.
- ESG commitments have substantial effects on the voting and engagement practices of asset managers, even though those actions are governed by fiduciary duties.
- The EDEA aligns with fiduciary principles. In contrast, when a public entity knowingly entrusts trust assets to asset managers who appear to be violating fiduciary duty rules, the public entity's act conflicts with its own fiduciary duties.

Introduction

Environmental, social, and governance (ESG) investing has emerged as a global phenomenon in two primary forms: (1) investors voluntarily choosing to invest their money in ESG funds, either in hopes of increased returns or increased support for ESG goals, and (2) asset managers committing trillions of dollars under management to support ESG goals, regardless of the wishes of those investors.

The amount of money committed in the first category has recently dropped. ESG investment in the United States saw a net $9 billion outflow in 2023.[1] Those outflows have continued in the first half of 2024, with over $13 billion in net outflows.[2]

However, trillions of dollars remain committed to ESG investing under the second category. This memo focuses on that category, including the commitments made by asset managers like BlackRock and State Street to use client assets to support ESG, and whether those commitments align with fiduciary duties.

This memo concludes that asset manager ESG commitments are incompatible with fiduciary duties. These ESG commitments create mixed motives, violating the fiduciary duty of loyalty. ESG commitments lead asset managers operating active funds to rely on questionable ESG data (as demonstrated by inconsistencies in ratings) and ignore evidence showing that ESG investing does not produce superior returns, violating the fiduciary duty of prudence. ESG commitments also lead asset managers operating both active and passive funds to use proxy voting and engagement powers conferred by client shares in order to advance ESG goals rather than maximizing value for clients, and these actions appear to violate fiduciary duties.

This memo also concludes that Oklahoma's EDEA upholds fiduciary duties, because the EDEA encourages public entities not to violate their own fiduciary duties by entrusting public funds to asset managers that have made ESG commitments. It finds that the OPERS Board's decision to keep billions invested with asset managers who have ESG commitments violated

1 Tucker, Brakman Reiser, Xia, 2024
2 Tucker, Brakman Reiser, Xia, 2024

the Board's fiduciary duties. Finally, based on available research, this memo concludes that the EDEA has not increased costs for municipalities, despite some claims to the contrary.

History of SRI and ESG

Origins of Socially Responsible Economics in the US

It has long been true that some U.S. investors have chosen to voluntarily use their assets to pursue social goals. The first US-based socially responsible investments (SRI) fund, Pioneer Investments, began in 1928 as a fund committed to the Christian values of its founder and remains in existence today.[3] During the 1950s and 1960s, the United States saw its first forms of financial-social activism develop when trade unions began using multi-employer pension funds to support investments benefiting their membership's interests.[4] Labor unions also began using pension fund assets as leverage in early shareholder-activism efforts in the form of proxy fights and shareholder resolutions. In the 1970s and 1980s, as a result of public outcry related to the Vietnam War and social and racial unrest during the Apartheid era in South Africa, SRI took the form of financial protest and divestment from companies contracted to the Department of Defense.[5]

Eventually, Apartheid collapsed and the SRI topic faded significantly.[6] In the late 1990s and early 2000s, the marketing and strategy of SRI proponents began to evolve. Specifically, some SRI advocates for the first time began including corporate governance (the G in ESG) into their investment strategies, with the goal of tying their social principles to improved corporate governance—effectively rebranding the movement as ESG.[7]

Collateral Benefits vs. "Risk-Return" ESG

As ESG has developed, its advocates have primarily settled into two schools of thought: Collateral Benefits and "Risk-Return," though as described below,

3 Henry W. Lane, et al., 2009
4 Gray, 1983
5 Schanzenbach & Sitkoff, 2020
6 Caplan, et al., 2013; see also Gary, 2016
7 Gary, 2016

the latter theory is fatally flawed, and merely attempts to provide cover for asset managers using their clients' assets to push Collateral Benefits ESG investing.

Collateral Benefits theory (effectively, classic SRI) implies that investors can achieve secondary benefits, such as environmental improvements or social enhancements, through investment choices. Investors subscribing to Collateral Benefits theory are willing to sacrifice financial maximization in order to advance ESG goals, such as by applying a financial penalty to companies with poor ESG practices, or providing a financial boost to companies with good ESG practices, and thus advance ESG goals.[8] It is noteworthy that the Collateral Benefits theory is often predicated upon pursuing benefits that primarily accrue to third parties either for moral or ethical reasons. However, in a market with many sophisticated investors, it is difficult even for large investors to drive up a company's cost of capital simply by divesting a company's shares.[9]

In contrast, most ESG advocates now promote Risk-Return theory, which purports to use ESG factors as an aid in maximizing financial returns while reducing risk. Risk-Return advocates expressly or impliedly represent that investors can avoid the traditional tradeoff accepted by the Collateral Benefits theory, which recognizes that investors will sacrifice some financial returns in exchange for progress towards social goals. Instead, Risk-Return advocates promise investors that they can have both, and "do well by doing good," maximizing returns while still promoting ESG goals.[10] The primary premise for this theory that the world is moving towards net-zero, so companies that are moving towards net-zero now will produce better returns than companies that are unprepared and left behind in the transition.[11]

However, the Risk-Return theory is fundamentally flawed in at least three ways.

First, Risk-Return suggests that ESG factors will help predict financial return separate from the typical fiduciary analysis. However, either ESG factors are material to financial performance, or they are not, which sets up a dilemma:

8 Schanzenbach & Sitkoff, 2020
9 Schanzenbach & Sitkoff, 2020
10 See, e.g., Mischke, Woetzel, and Birshan, 2021
11 See, e.g., BlackRock, Letter to Clients, 2020; see also BlackRock, Climate-Related Risks and the Low-Carbon Transition, 2024

A) If ESG factors <u>are</u> financially material, then they already should be included in the typical fiduciary analysis, which seeks to examine *all* financially material factors in the pursuit of maximizing returns.
B) If ESG factors <u>are not</u> financially material, then making different decisions based on those factors will by definition result in a failure to maximize returns.

Under the dilemma, either the Risk-Return theory is indistinguishable from the typical fiduciary analysis, or it violates the fiduciary duty of loyalty, as further discussed below.[12]

Second, the basic premise of companies profiting by joining the world's supposed transition to net-zero ignores basic political and economic realities. Politically, only 14% of countries have net-zero commitments in law,[13] so most companies are under no legal obligation to set net-zero targets. Economically, even if one were to assume that the world generally is transitioning to net-zero policies, voluntarily making changes to align with net-zero policies now may be economically disadvantageous. For example, if most oil and gas producers reduce output in order to cut emissions in line with net-zero goals, oil and gas producers without such plans stand to gain substantially.

Third, Risk-Return theory only considers one side of the coin—whether a *pro*-ESG policy would enhance returns. After all, even if net-zero compliance is assumed to be a financial factor, then a fiduciary seeking to maximize financial return should evaluate whether non-net-zero compliant assets have been oversold.[14] But in practice, Risk-Return theory prizes "sustainability" and ignores the possibility that returns could be maximized by companies that are increasing emissions or eschewing net-zero plans. For instance, in early 2020, BlackRock announced a new policy to sell off all shares of certain thermal coal producers from its active portfolios, announcing that thermal

12 Schanzenbach & Sitkoff, 2020 ("risk-return ESG can be consistent with the duty of loyalty under ERISA, provided that the fiduciary's "sole" or "exclusive" motive is benefiting the beneficiary by improved risk-adjusted returns")
13 Net Zero Tracker
14 Schanzenbach & Sitkoff, 2020 (data-driven models of ESG factors may conclude that "firms with high ESG scores are overvalued and firms with low ESG scores are undervalued, perhaps because the market has overcorrected in reaction to [] ESG scores.").

coal had "high ESG risk" because it was "significantly carbon intensive."[15] Since BlackRock divested, the price of coal increased from around $50/ton to over $400/ton, and continues to trade at around $150/ton today.[16] BlackRock's clients have missed out on sizeable returns because BlackRock was more focused on "ESG risk" than financial risk.

Risk-Return theory thus in practice is little more than an attempt to provide cover for asset managers using their clients' assets to push Collateral Benefits ESG investing. As an example, one of the largest state pension systems in the country, CalPERS, was forced to respond to public criticism over actions that could be fairly described as Collateral Benefits ESG investing.[17] CalPERS defended its position by arguing that it was using Risk-Return ESG "as an informed investor," "not because [ESG factors] make us feel good but because there is sound economic reasoning to do so."[18] But in the next sentence, CalPERS touted that it was a "founding member of Climate Action 100+," and that the group was "urging the 100 major greenhouse gas emitters to fight climate change by cutting greenhouse gas emissions."[19] As evidenced by CalPERS' description, Climate Action 100+ (CA100+) is a Collateral Benefits effort, pushing the largest emitters to "fight climate change" for the benefit of the climate rather than pushing those companies to maximize returns for the benefit of investors.

Simply put, financial maximization and ESG goals are in tension, and fiduciaries cannot pursue both at once. The U.S. Department of Labor struggled with the complexity of this Gordian Knot in its November 22, 2022, announcement of its final rule on prudence and loyalty in selecting plan investments. The Department's rule explains specifically that fiduciaries must make decisions "based on factors that the fiduciary reasonably determines are relevant to a risk and return analysis" and that "the final rule maintains the longstanding principle that the fiduciary may not accept reduced returns or greater risks to secure collateral benefits."[20] However, the Department further described that if the fiduciary can "prudently conclude" that competing

15 BlackRock, Letter to Clients, 2020
16 Trading Economics: Coal
17 Doyle, 2017
18 CalPERS, 2017
19 CalPERS, 2017
20 Employee Benefits Security Administration, 2022

investments or investment courses of action "equally serve the financial interests" of the plan and participants over a particular time horizon, the fiduciary is not prohibited from using collateral benefits as a means of a "tiebreaker" between competing investments.[21] Going further, the final 2022 rule added language specifically authorizing risk and return factors that can be considered such as the "economic effects of climate change and other environmental, social, or governance factors."[22] In other words, even under its revised rule, the Department of Labor suggests that ESG factors can be considered as collateral benefits only when two investment opportunities are otherwise identical.

Fiduciary Duty Framework

For the purposes of this report, we adopt the definition of an "investment fiduciary" adopted by the Center for Fiduciary Studies and described in Fi360's "Prudent Practices for Investment Stewards." This definition states that "an investment fiduciary is someone who is providing investment advice or managing the assets of another person and stands in a special relationship of trust, confidence, and/or legal responsibility." An investment fiduciary may take the form of an "investment steward"—a non-professional person with a legal obligation for managing investment decision-making processes (i.e., trustees or investment committee members), an investment advisor,[23] or an investment manager.[24]

The cornerstone of the fiduciary administration of financial assets or trusts is accountability. Specifically, a beneficiary may always hold a fiduciary accountable to demonstrate that actions taken on behalf of the beneficiary were congruent with the duties of loyalty and care along with any other duties imposed, either by contract or law or both.

21 See 29 CFR 2550.404a-1(c)(2)
22 See 29 CFR 2550.404a-1(b)(4)
23 The terms "advisor" and "adviser" are used for different purposes in this report. The term "adviser" is used in reference to the Investment Advisers Act of 1940 and the 2006 Pension Protection Act. A "registered investment adviser" is a firm registered with the Securities and Exchange Commission (SEC) or state securities regulator under the rules promulgated pursuant to the Investment Advisers Act (or state variant). "Advisor" as used in this document refers to an individual professional who is providing investment advice.
24 Fi360, 2020

Several state and federal statutes create the primary legal foundation for the duties imposed on fiduciaries. These include:

- The Employee Retirement Income Security Act of 1974 (“ERISA”)[25]
- Uniform Prudent Investors Act[26]
- Uniform Prudent Management of Institutional Funds Act[27]

In this document, we evaluate a fiduciary’s duties and obligations under trust law, including widely adopted legal authorities such as the Restatement of Trusts. However, there are important, subtle distinctions and variations between general trusts, pension and retirement trusts, and charitable trust law. For the purposes of this document, the focus of the analysis will be on the fiduciary duties and obligations as observed in the world of pension and retirement trusts.

Fiduciary Principles

Duty of Loyalty

Under the common law, trustees are “under a duty to the beneficiary to administer the trust *solely in the interest of the beneficiary*.” Restatement (Second) of Trusts § 170(1) (1959) (emphasis added). This duty is “the most fundamental” rule of trust law. 2A Scott & Fratcher, The Law of Trusts § 170, at 311 (4th ed. 1987). The “core duty” of loyalty “regulates potential conflicts of interest and proscribes misappropriation.”[28] The duty of loyalty is at the heart of trust law: “all powers held in the capacity of trustee must be exercised … in accordance with the trustee’s fiduciary obligations.”[29] Under the duty of loyalty, “the trustee has a duty to the beneficiaries not to be influenced by the interest of any third person or by motives other than the

25 29 U.S.C. § 1001 et seq. ERISA generally imposes a mandatory trust structure on most private retirement benefit plans as a matter of federal law.
26 Adopted in 1992 by the American Law Institutes 3rd Restatement of Trusts and promulgated by the National Conference of Commissioners on Uniform State Laws (NCCUSL) in 1994.
27 Adopted in 2006 by NCCUSL as a replacement to its predecessor Uniform Management of Institutional Funds Act.
28 Azgad-Tromer, 2016.
29 Restatement of the Law (3rd) of Trusts, 2024 §70 cmt. a.

accomplishment of the purpose of the trust."[30] Prohibited interests include "advancing or expressing the trustee's personal views concerning social or political issues or causes." Restatement (Third) of Trusts § 90 cmt. c (2007).[31]

Importantly, the existence of mixed motives establishes "an irrebuttable presumption of wrongdoing," regardless of the level of harm from those mixed motives. *Halperin v. Richards*, 7 F.4th 534, 546 (7th Cir. 2021).[32] This rule avoids after-the-fact enforcement and instead embraces clear rules to help fiduciaries avoid any "occasions of temptation." Restatement (Third) of Trusts § 78.

The "interest" of the beneficiary that a trustee must solely pursue is the client's financial interest.[33] At the federal level, ERISA created the mandatory obligation that plan fiduciaries must "discharge their duties *solely* in the interest of the participants and beneficiaries … for the *exclusive* purpose of providing benefits to participants and their beneficiaries."[34] (emphasis added). The Supreme Court clarified this rule in *Fifth Third Bancorp v. Dudenhoeffer*, holding that ERISA's term "benefits" specifically referred to "financial benefits" for a plan's beneficiaries.[35] Then in 2015, the court concluded that investment menus under ERISA's 404(c) participant-directed rules did, in fact, require a fiduciary to adhere to the duty of loyalty.[36] A further 2018 unanimous ruling

30 Restatement of the Law (3rd) of Trusts, 2024 §78 cmt. f; *see also* Bogert, Trusts & Trustees § 543 (2d ed. 1978) ("One of the most fundamental duties of the trustee is that he must display throughout the administration of the trust complete loyalty to the interests of the beneficiary, and must exclude all selfish interest and all consideration of the interests of third persons.").

31 See generally Posner & Langbein, 1980 (concluding that "social investing is contrary to trust law and its statutory counterparts")

32 See Schanzenbach & Sitkoff, 2020 ("Acting with mixed motives triggers an irrebuttable presumption of wrongdoing, full stop.")

33 See, e.g., *Dodge v. Ford Motor Co.*, 1919 ("A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes."); *see also* Dep't of Labor, *Financial Factors in Selecting Plan Investments* (amending the "investment duties" regulation under Title I of ERISA requiring plan fiduciaries to select investments and courses of action based solely on financial considerations relevant to the risk-adjusted economic value of a particular investment or course of action).

34 29 U.S.C. § 1104 (emphasis added)

35 *Fifth Third Bancorp v. Dudenhoeffer*, 2014

36 *Tibble v. Edison International*, 2015

reversing the Seventh Circuit in *Hughes v. Northwestern University* extended this reasoning to the duty of prudence to monitor and control plan fees and expenses.[37]

Therefore, in light of ERISA's sole interest and exclusive benefit standards and recent Supreme Court rulings, a plan fiduciary's duty of loyalty does not allow for the consideration of collateral-benefit factors in investment decision-making. Likewise, the fiduciary duty of loyalty does not allow a plan fiduciary to employ asset managers that the plan fiduciary knows will not honor their own fiduciary duties.[38]

Interestingly, the Department of Labor highlighted the stringent nature of the sole interest requirements under existing ERISA law. In the announcement of its 2022 change to ERISA Rule 404a-1, the department replaced the previous "economically indistinguishable" standard for using collateral-benefits factors with an "equally serve the financial interests" standard while also removing the predecessor rule's required documentation of a fiduciary's analysis and consideration of the collateral-benefits factors. The department justified these changes by concluding after the rule's public comment period that the previous requirements created "unnecessary burdens" to apply tiebreaker provisions and "erroneously suggest[ed]" to fiduciaries that they should be wary of considering ESG factors in the development of investment strategies. However, if two investment opportunities truly appear to be "identical," rather than breaking the "tie," "textbook economics" would simply call for diversifying and splitting the investment between both opportunities and further reducing risk.[39]

Duty of Prudence

Proponents of Risk-Return ESG investing rely predominantly on the argument that such an approach is directly related to a fiduciary's duty of care or prudence. Under the prudent investor rule, a fiduciary must have a reasonable basis to conclude that an ESG strategy will either provide higher return for the same level of risk as a competing non-ESG alternative or provide less risk for the same level of return as a competing non-ESG

37 *Hughes v. Northwestern University*, 2022
38 See Indiana Attorney General Opinion 2022-3.
39 Schanzenbach & Sitkoff, 2020

alternative.

According to Schanzenbach's and Sitkoff's analysis, the main purpose behind the prudent investor rule was greater fiduciary flexibility in investment decision-making than had been acceptable under the predecessor standard, the prudent man rule. Contrary to the more conservative prudent man rule, the prudent investor rule allowed for more sophisticated and broad-based investment strategies we are familiar with today. Under this standard, a fiduciary may create investment strategies based on any type of investable asset so long as the overall portfolio of investments is reasonably designed to meet the overall risk and return objectives of a trust and over the appropriate time horizon.[40]

The prudent investor rule was a natural evolution in fiduciary investment decision-making following Harry Markowitz's development of the efficient frontier in 1952 and the continued exploration in the financial academic literature of modern portfolio theory. Importantly, the mathematical analysis resulting in the efficient frontier demonstrated the risk-reduction benefits obtained by the diversification of an investment portfolio across many individual investment assets with varying characteristics and risk-return profiles.

The duty of prudence does not stop once a fiduciary creates an investment portfolio or strategy. In fact, the U.S. Supreme Court described in *Tibble v. Edison International* that "a trustee has a continuing duty to monitor trust investments and remove imprudent ones" and "[t]his continuing duty exists separate and apart from a trustee's duty to exercise prudence in selecting investments at the outset."[41]

Another core component of the duty of prudence is the requirement to create and maintain appropriate records regarding the administration of the trust, including important decisions made and the analysis and reasoning supporting the decision. A commonly cited New York Court of Appeals case puts a fine point on the consequences of failing to maintain adequate records. In the case, a bank trustee was held to have violated his duty of prudence for failing to liquidate a concentrated position in a publicly traded stock. The court highlighted the bank's process errors, including a

40 Schanzenbach & Sitkoff, 2020
41 *Tibble v. Edison International*, 2015

failure "initially to undertake a formal analysis of the estate and establish an investment plan," a failure "to conduct more than routine reviews," and lack of consideration for alternative investments for estate assets.[42]

Fundamentally, Schanzenbach and Sitkoff describe that an objective standard of care can be critically important as a check and balance against violating a fiduciary's duty of loyalty based on dubious assertions of motive. They illustrate this principle by describing an analysis by CalPERS after a decision to divest internally-managed funds from tobacco-related investments in 2000. In 2016, investment staff recommended that CalPERS end its policy, but the CalPERS board refused to do so, and in fact divested from additional tobacco-related investments.[43] A 2018 analysis of the investment decision by the investment consultants for CalPERS concluded that the decision was detrimental to the portfolio, forgoing $3.6 billion in portfolio returns while also reducing portfolio diversification.[44] The investment consultants recommended CalPERS end its tobacco divestment policy.[45] CalPERS once again did not do so, and rejected another proposal to end its boycott in 2021.[46] A 2022 analysis found that the total loss had increased to over $4.25 billion.[47] This example demonstrates the risks inherent in boycotting types of companies rather than making decisions based solely in the interests of the fund.

The process requirements of the duty of prudence will be discussed in the context of how ESG investments are identified and evaluated.

ESG Ratings in Investment Analysis

Asset managers like BlackRock and State Street have committed to "ratcheting up the proportion of AUM [assets under management] covered" by net-zero goals "until 100% of assets are included."[48] In furtherance of this goal, both asset managers have pushed investors towards their actively-managed ESG funds, including BlackRock pushing billions of dollars from a

42 *In re Estate of Janes*, 1997
43 Diamond, 2018
44 Diamond, 2018
45 Diamond, 2018
46 Diamond, 2021
47 Wilshire, 2022
48 Net Zero Asset Managers Initiative, Net Zero Asset Managers Commitment

standard S&P index fund to an ESG-specific fund.[49] These ESG funds not only help fulfill net-zero commitments, they also pay asset managers much higher fees.[50]

Although some investors would be willing to pay higher fees for perceived societal benefits as part of a Collateral Benefits theory, the Risk-Return theory promises return-minded investors that an increased focus on ESG also will result in increased profits. However, state enforcers in three different states have alleged that BlackRock's fund representations about connections between ESG and profitability are misleading investors.[51]

Actively-managed ESG theories depend on ratings or systems to determine which companies can be included in an ESG fund. It stands to reason that if an asset manager tells investors that an ESG fund includes only companies that are more environmentally and socially desirable and have better governance, an investor must have tools and methods to measure these particular data points. Just as critically, those tools and methods must actually measure what they purport to measure. For example, if an investor chose to analyze and compare the amount of pollution produced by various cars, the investor could choose to conduct the analysis by comparing how far each vehicle could drive on one tank of gas. This analysis, however, fails to take into consideration that some vehicles have much larger tanks than others. Such a method would not actually measure what the investor intends to measure, and the results would be useless for the intended purpose.

Similar flaws exist with financial data providers and their development of ESG ratings and scores. Prominent data providers with ESG ratings and scores include Morningstar (previously Sustainalytics), Bloomberg, MSCI, Refinitiv, Moody's, FTSE, and S&P. Each firm develops its own proprietary methodologies for calculating its various ESG scores and ratings, taking into account data that each firm believes most appropriately measures aspects of ESG performance.

In a paper entitled "ESG Ratings: A Compass Without Direction," Larcker and his colleagues examined the ESG ratings frameworks from a number of

49 Simpson, 2021; Thrasher, 2023
50 BlackRock, iShares ESG Aware MSCI USA ETF; BlackRock, iShares Core S&P 500 ETF
51 Mississippi Secretary of State, 2024; Indiana Secretary of State, 2024; *Tennessee v. BlackRock*, 2023

companies. The ESG ratings of these firms relied on data from public, quasi-public, and non-public sources. Quasi-public information includes data from government, regulatory, and NGO datasets. Non-public information might be information shared directly from a company in response to a questionnaire but not published for public consumption. A common theme emerged across the paper's analysis: the combination of these types of information sources creates a ratings framework that can lack completeness, standardization, and/or consistency.[52]

When a data model includes hundreds of data points, many of which are non-public or quasi-public, a ratings firm must decide how to manage missing data points. Three primary choices exist to address missing data points: omit the data from the analysis, make assumptions about the data, or estimate the data using statistical modeling techniques. For example, Larcker notes that when data is not available for a particular data point, MSCI appears to assume the company's performance on that data point is the industry average. However, FTSE assumes that the company's performance is the worst.[53] Measurement standardization becomes a further challenge when different firms collect different data points for similar objectives or report the information on scales that are not easily comparable. Lastly, multiple studies have found that ratings firms rewrite historical ESG scores when they publish updated ratings methodologies. As an example, in 2020 Refinitiv updated their methodology and, as a result, made changes to both current and historical ESG ratings. By doing so, their new ratings looked more predictive (higher ESG scores outperformed) than the previous scoring methodology. As a result, transparent analysis of the change in ratings predictability over time became more difficult.[54]

When taken collectively, these challenges lead to significantly inconsistent results. In a 2022 study by Raghunandun and Rajgopal, it was found that companies with high Sustainalytics (now Morningstar) ESG scores had worse records on compliance with labor and environmental laws than companies in non-ESG portfolios.[55] Furthermore, companies added to ESG portfolios did not show evidence of improvement on environmental

52 Larcker, Pomorski, Tayan, & Watts, 2022
53 Mackintosh, 2018
54 Berg, Kolbel, & Rigobon, 2022
55 Raghunandan & Rajgopal, 2022

regulations. Yet another 2022 study showed that US firms that adopt the Principles for Responsible Investment (PRI) actually earn worse ESG ratings than US firms that do not make the PRI commitment.[56] Finally, a Dobrick et al. (2023) study confirmed a persistent company size bias initially reported in Drempetic et al. (2020) in the Asset4 ESG database (now Refinitiv) and Berg et al. (2022) confirmed an ESG rater bias or "halo effect" where companies receiving a high ESG score in one category are statistically more likely to receive a high ESG score in other categories.

Accordingly, we conclude that it would not be prudent as a fiduciary to rely upon ESG ratings and scoring methodologies as a means to consistently predict the ESG objectives or outcomes which those methodologies purport to predict.

Performance of ESG vs. Non-ESG

Ratings and scoring are important factors for investment selection in ESG active-portfolio investment strategies, but they are not the only factors. Many institutional managers self-identify strategies as ESG-focused—many of these are tied to a scoring methodology and many are not. Therefore, it is important to also understand relative performance of investment strategies that are described in name or description as being ESG-focused. This issue also is important when considering the question of whether purportedly passive funds should push companies to embrace ESG values.

One of the largest studies of performance of ESG vs. non-ESG portfolios was published in the *Journal of Sustainable Finance* in 2022 with academic contributions from the NYU Stern Center for Sustainable Business, the Johns Hopkins School of Advanced International Studies, and the University of Pennsylvania Wharton School of Business Management Department. The study reviewed 1,141 primary peer-reviewed papers as well as an additional 27 meta-reviews (based on approximately 1,400 underlying studies) between 2015 and 2020. This study concluded that, on average, ESG investing had investment results that were indistinguishable from conventional investing

56 Gibson, Glossner, Krueger, Matos, & Steffen, 2022

strategies.[57] Interestingly, in a related publication, Whelan et al. (2021) demonstrated with much the same data that the positive relationship related to ESG and financial performance at the corporate level (58% of studies) all but vanished at the portfolio level, where approximately 68% of studies showed a neutral, mixed, or negative relationship.[58]

In a slightly different view of ESG investing, a pair of studies evaluated the correlation of ESG and investing in "sin stock" industries, which was defined to include: tobacco, gambling, alcohol, adult entertainment, firearm, military, nuclear power, bioengineering, and oil and gas. In Sterns (2023), it was determined that ESG was negatively correlated with the stock prices of companies in the "sin stock" industries and that the constructed "low ESG portfolio" outperformed the "high ESG portfolio" in the study.[59] This reinforced the results of a corresponding 2009 study by Harrison Hong of Princeton University and Marcin Kacperczyk of New York University that found "sin stocks" are less held by what the study calls "norm-constrained" institutions such as pension funds compared to mutual funds and hedge funds. Those sin stocks had higher expected returns than otherwise comparable stocks—29 basis points per month (3.48% annually) and when controlling for tobacco, 21 basis points per month (2.52% annually).[60] Finally, a 2021 study published by the European Corporate Governance Institute found that S&P 500 stock returns are positively correlated with ESG ratings disagreement, suggesting a risk premium for companies with higher dispersion of ESG ratings between ratings firms.[61]

These findings have implications not only for active portfolios seeking to pick ESG-friendly stocks, but also for passive portfolios run by asset managers with ESG commitments. If companies that already are ESG-oriented do not produce superior returns to companies that are not ESG-oriented, it stands to reason that forcing a company to incur substantial expenses to transition from the latter group to the former group will diminish returns from that company.

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57 Atz, Van Holt, Liu, & Bruno, 2022; Raghunandan & Rajgopal, 2022 ("ESG funds appear to underperform financially relative to other funds within the same asset manager and year, and to charge higher fees.")
58 Whelan, Atz, Van Holt, & Clark, 2021
59 Stearns, 2023
60 Hong & Kacperczyk, 2009
61 Gibson, Krueger, & Schmidt, 2021

Based on these results, we conclude that it would not be prudent as a fiduciary to (1) rely upon actively-managed investment portfolios described as having a focus on ESG objectives to produce consistently positive financial results that are distinguishable from similar non-ESG portfolios, or (2) rely upon passively-managed investment portfolios operated by asset managers who have committed to align their portfolio companies with ESG objectives.

ESG Commitments and Related Actions

Proxy Voting and Engagement

Asset managers that have made ESG commitments go well beyond using ESG as a "tiebreaker" in situation where investments are otherwise identical. Instead, they have committed to use *all* client assets to support an ESG agenda, including when engaging and voting proxies for securities under its management on behalf of its clients.

Asset managers have a fiduciary duty to manage their clients' investments in the sole interest of those clients, including the exercise of informal engagement rights and formal voting rights attached to those investments.[62] Asset managers should conduct engagements and cast proxy votes based on maximizing value for their client shareholders.

When asset managers accumulate more investment dollars in portfolio securities, their percentage of shares available to vote on behalf of their clients as a percentage of outstanding securities increases. As a result, those asset managers' opinions become increasingly important to company directors, who do not want to be voted out at shareholder meetings. In particular, the "Big Three" (BlackRock, State Street, and Vanguard) typically cast about ***25%*** of the vote at public company meetings.[63] As a result, the management of other companies view the opinions of the Big Three as "very important"[64]—and as discussed later, two out of the Big Three (BlackRock and State Street) are on the Oklahoma Treasurer's EDEA Restriction List.[65]

62 See, e.g., 29 C.F.R. § 2550.404a-1(d); 17 C.F.R. § 275.206(4)-6.
63 Bebchuk, L., 2022
64 Bebchuk, L., 2022
65 Oklahoma State Treasurer Todd Russ.

However, both BlackRock and State Street have openly committed to engaging and voting based on net-zero goals rather than maximizing client value. Both organizations have joined the Net Zero Asset Managers initiative (NZAM), which aims to "accelerate the transition towards global net zero emissions and for asset managers to play our part to help deliver the goals of the Paris Agreement." The NZAM commitment includes the following under the heading "In order to fulfil these commitments my organisation **will ... across all assets under management**":[66]

> 7. Implement a stewardship and engagement strategy, **with a clear escalation and voting policy**, that is consistent with our ambition for all assets under management to achieve net zero emissions by 2050 or sooner.

This is an unmistakable commitment to use the power of *all* client assets in engagement and voting not to promote financial maximization, but instead to force companies to fall in line with net-zero goals.

The execution of this commitment is most visible in proxy voting. BlackRock and State Street both have frequently carried out their NZAM commitment by casting votes that promote a net-zero agenda but conflict with maximizing value for shareholders. To take just one recent example, in March 2024, BlackRock and State Street voted for a shareholder proposal urging Jack in the Box to "determine and disclose … short-, medium-, and long-term goals for reducing its emissions" and citing McDonald's Scope 1, 2, and 3 emissions targets as a model.[67] Neither asset manager explained how setting such targets would be beneficial for a hamburger chain, when net zero emissions-reduction goals call for America's beef consumption to be cut in half.[68] Other prominent examples include BlackRock and State Street successfully voting out several of Exxon's directors in 2021, to be replaced with directors who would prioritize reducing emissions rather than maximizing shareholder returns,[69] and BlackRock voting for a proposal pushing British Petroleum to set "short-, medium-, and long-term emissions

66 Net Zero Asset Managers Initiative (emphasis added)
67 BlackRock, *Proxy Voting Search*; Jack in the Box, 2024
68 *See* Waite et al., 2024
69 See Phillips, M., 2021

reduction targets" in line with the Paris Climate Agreement.[70]

These votes do not just affect behavior at the targeted companies—they send a message to other companies to fall in line or risk similar votes. BlackRock and State Street also have expressly sent such messages in public communications. BlackRock's CEO Larry Fink stated in 2022 that BlackRock is "asking companies to set short-, medium-, and long-term targets for greenhouse gas reductions."[71] And State Street continues to openly threaten that it "may take voting action against directors serving at companies" in certain indexes if those directors fail to set "climate-related targets, in accordance with the TCFD framework."[72]

But though proxy voting is more public, private engagement is even more powerful and important. When joining CA100+ in 2020, BlackRock publicly stated that it was "accelerating [its] engagement with companies" on the issue of "climate risk."[73] Since then, BlackRock has engaged in *thousands* of climate-related engagements behind closed doors.[74] Pursuant to its NZAM commitment, BlackRock uses those engagements to push companies to adopt net-zero goals.

For example, in 2020, BlackRock boasted that its "engagement intensified to encourage [oil and gas company Total] to pursue more ambitious greenhouse gas (GHG) emissions reduction targets."[75] This engagement eventually resulted in Total announcing "new net zero emissions ambitions" and "more aggressive 2050 targets."[76] BlackRock voted against a subsequent shareholder resolution at Total calling for emissions reduction targets, but only because the company "had already substantively met the request made in the proposal."[77] Therefore, even in a situation where BlackRock *appeared* to have voted in line with financial maximization, it did so only because it had already accomplished its goals behind the scenes through engagement using the power of its clients' assets.

Similarly, State Street has stated that it conducted engagement efforts

70 BP, 2021
71 BlackRock, Larry Fink's 2022 Letter to CEOs: The Power of Capitalism, 2022
72 State Street Global Advisors, 2024
73 BlackRock, Climate Action 100+ Signon Statement, Jan. 6, 2020
74 BlackRock, *2024 Global Voting Spotlight*, 2024; BlackRock, *2023 Global Voting Spotlight*, 2023
75 BlackRock, *Our Approach to Sustainability*, 2020
76 BlackRock, *Our Approach to Sustainability*, 2020
77 BlackRock, *Our Approach to Sustainability*, 2020

to push British bank HSBC to "align its financing activities with the Paris agreement," and that HSBC agreed to "phase out financing of coal-fired power and thermal coal mining"[78] in order to avoid a "shareholder revolt."[79] Although no shareholder vote was cast, State Street used the power of client assets to accomplish its net-zero objective.

A fiduciary should document their review and understanding not only of the proxy voting policies, procedures, commitments, and history of the asset managers they select, but also the engagement policies, procedures, commitments, and history. Such a process would determine if, in fact, the voting of those proxies and the engagements with companies are in the best interests of the fund and its beneficiaries.

Given the power of company engagement and the commitments made by BlackRock and State Street to use all assets under management in such engagement, the issues with both firms would not be addressed by public entities taking advantage of programs allowing investors to vote more of their shares directly.[80] The only way to ensure that BlackRock and State Street are not using public assets to promote an ESG agenda in engagements is for public entities to not to entrust assets to either manager.

We conclude that an important responsibility of a prudent fiduciary is to analyze whether a current or proposed asset manager's proxy voting and engagement commitments align with fiduciary duties. This analysis should include an asset manager's voting guidelines, voting history, and commitments for both proxy voting and engagement. If an asset manager has committed to using client assets to promote engagement and/or voting according to goals other than maximizing financial returns, prudent fiduciaries should choose an alternative asset manager without such commitments.

Case Study: BlackRock Appears To Be Violating Fiduciary Duties and Should Be Excluded as an Asset Manager

78 State Street Global Advisors, 2021
79 Ennis, D., 2021
80 See BlackRock, BlackRock Expands Voting Choice to Additional Clients 2022

As stated previously, BlackRock manages billions of dollars of Oklahoma's public pension funds—including more than half of all OPERS assets. This section further details multiple ways in which BlackRock's management of those assets appears inconsistent with Oklahoma's fiduciary standards.

First, BlackRock has committed to managing assets for the purpose of advancing environmental and ideological goals rather than for the exclusive purpose of providing system benefits to beneficiaries. For example, as a member of the Net Zero Asset Managers initiative ("NZAM"), BlackRock has committed to "play [its] part to help deliver the goals of the Paris Agreement" by "accelerat[ing] the transition towards global net zero emissions" and by phasing out fossil fuels.[81] Further, BlackRock has specifically committed to "[i]mplement a stewardship and engagement strategy, with a *clear escalation and voting policy*, that is consistent with [the] ambition for *all assets under management* to achieve net zero emissions by 2050 or sooner."[82] That commitment is non-waivable; NZAM emphasizes that "stewardship and policy advocacy" will be "comprehensively implemented" to ensure that there is "real action [and] not just empty statements."[83] By committing to use assets for the purpose of promoting net zero, BlackRock appears to have violated its fiduciary duty to manage state retirement assets "*solely* in the interest" of system beneficiaries and "for the *exclusive purpose*" of providing system benefits to those beneficiaries.

Second, in line with its climate commitments, BlackRock has repeatedly used proxy votes for the impermissible purpose of advancing an environmental agenda. Before BlackRock joined NZAM, an internal email from the climate-activist group Ceres indicated that BlackRock's "large asset owner[]" clients were exerting coordinated pressure to force BlackRock to "step up [its] climate ambition."[84] Another email from Ceres warned that BlackRock could suffer "billions of dollars in lost revenue" if it did not "*dramatically change*" its proxy voting by increasing its support for climate proposals.[85]

81 Net Zero Asset Managers Initiative, Signatory Disclosure; Net Zero Asset Managers Initiative, Net Zero Asset Managers Commitment; Net Zero Asset Managers Initiative, 2021
82 See Net Zero Asset Managers Initiative, Net Zero Asset Managers Commitment (emphasis added)
83 Net Zero Asset Managers Initiative, FAQ
84 Ceres Senior Associate, 2020
85 Ziv-Kreger, D., 2020

After joining CA100+ in 2020, BlackRock appears to have provided private assurances that it would change its proxy voting policies, because the CA100+ Global Steering Committee's internal meeting minutes from early 2020 record that "BlackRock understands that by joining CA100+, *it is expected to shift its voting to support climate resolutions*."[86] After committing to climate initiatives like CA100+ and NZAM, BlackRock did indeed "dramatically change" its voting patterns by shifting its support toward supporting net zero resolutions.[87] To illustrate: In the 2019-20 proxy season, BlackRock voted for only about 6% of environmental proposals, and it voted against only 55 directors on climate-related issues.[88] But in the 2020-21 proxy season—after joining climate initiatives like CA100+ and NZAM—BlackRock voted for ***64%*** of environmental proposals (over 10x more than the previous year), and it voted against ***255*** directors on climate-related issues (nearly 5x more than the previous year).[89]

BlackRock's sudden shift included voting for proposals it had expressly labeled as "not in shareholders' best interests" just a year prior:

- BlackRock voted for a 2021 proposal urging Norwegian oil refining company Equinor to adopt "short-, medium-, and long-term emissions reduction targets" that align with the Paris Agreement.[90] But BlackRock voted against a substantially identical proposal at Equinor in the prior proxy season, stating that the "Proposal [was] not in shareholders' best interests."[91]
- BlackRock voted for a 2021 proposal urging FedEx to disclose lobbying information and whether it is a member of "any tax-exempt organization that writes and endorses model legislation," with the proposal expressly mentioning the right-leaning American Legislative Exchange Council.[92] But BlackRock voted against a nearly identical proposal at FedEx in the prior proxy season, stating that the proposal was "not in

86 Climate Action 100+, 2020
87 Posner, C. 2021
88 BlackRock, Investment Stewardship Annual Report, 2020
89 BlackRock, 2021
90 Equinor, 2021; Follow This 2021; BlackRock, Proxy Voting Search
91 Equinor, 2020; BlackRock, Proxy Voting Search
92 FedEx Corporation, 2021; BlackRock, Proxy Voting Search

shareholders' best interests."[93]

Together with its proxy votes, BlackRock's shareholder engagements also shifted heavily toward advancing environmental goals following BlackRock's climate commitments to NZAM. In fact, BlackRock's climate engagements nearly doubled between the 201920 and the 2020-21 proxy seasons; they went from being BlackRock's third-most-common engagement topic to its most-common engagement topic.[94] And from July 1, 2022, through June 30, 2024, BlackRock held over ***2,900*** engagements behind closed doors with companies on the issue of "climate and natural capital."[95] BlackRock's use of votes and engagements for the purpose of advancing its ESG commitments is inconsistent with the duty to manage funds "*solely* in the interest" of system beneficiaries and "for the *exclusive purpose*" of providing related system benefits.[96]

Despite these actions and its sweeping commitments for "all assets," BlackRock represented to investors in prospectuses that many of its funds did "not seek to follow a sustainable, impact, or ESG investment strategy." Three different state enforcers have brought legal actions alleging that representations like these misled investors about BlackRock's net-zero commitments.[97]

BlackRock often defends its ESG actions by noting that it is a large investor in energy companies.[98] Of course, BlackRock is a large investor in virtually *every* public company due to the size of its index funds. But BlackRock uses those shares to restrict production—as noted above, BlackRock voted for dissident directors at Exxon and has used its engagement and voting power to push oil and gas companies to adopt net-zero targets. In addition, BlackRock co-led a paper about how to use ownership stakes to force the early retirement of energy assets.[99]

93 FedEx Corporation, 2020; BlackRock, Proxy Voting Search
94 BlackRock, Investment Stewardship Annual Report, 2020 (1,260 engagements on "environmental risks and opportunities"); BlackRock, Pursuing Long-Term Value for Our Clients, 2021 (2,330 engagements on "climate and natural capital")
95 BlackRock, 2024 Global Voting Spotlight, 2024; BlackRock, 2023 Global Voting Spotlight, 2023
96 Okla. Const. art. 23, § 12; Okla. Stat. Ann. tit. 74, § 909.1; Okla. Stat. Ann. tit. 70, § 17-106.1; see *Fifth Third Bancorp v. Dudenhoeffer*
97 Mississippi Secretary of State, 2024; Indiana Secretary of State, 2024; *Tennessee v. BlackRock*, 2023
98 See, e.g., BlackRock, Re: Attorneys General Letter, Dated August 4, 2022, 2022
99 GFANZ, 2022

We conclude that BlackRock's commitments and actions appear to have violated fiduciary duty laws.

Oklahoma's Energy Discrimination Elimination Act

The principles of a fiduciary's duties of loyalty and prudence came into particular focus during the controversy surrounding the 2022 passage of the Energy Discrimination Elimination Act ("EDEA") by the Oklahoma Legislature.[100] The law was designed to prevent state public funds, including pension assets, from being entrusted to financial firms who had committed to "penalize, inflict economic harm on, or limit commercial relations with" energy companies without an ordinary business purpose.[101] The EDEA required the Treasurer of the State of Oklahoma to keep and maintain a list of financial firms that met these criteria. Pursuant to the law, Treasurer Todd Russ finalized a list of seven financial companies that met the EDEA's criteria, including asset managers BlackRock and State Street.[102]

The text of the EDEA aligns with the fiduciary duty principles explained above—if asset managers have committed to use client assets to penalize energy companies without an ordinary business purpose, those asset managers are embracing collateral benefits, contrary to the duty of loyalty, and are not making decisions based on business purposes, contrary to the duty of prudence. State pension plans should not entrust assets to asset managers that are openly violating their fiduciary duties.

We conclude that the EDEA aligns with fiduciary duty principles, as it helps fiduciaries avoid entrusting public funds to asset managers that have made commitments to manage all assets under management to pursue goals other than maximizing financial returns.

Challenges to the EDEA

However, as one might expect, a statute challenging the practices of asset

100 74 O.S. § 12001, et seq.
101 74 O.S. § 12001, et seq.
102 Oklahoma State Treasurer Todd Russ, 2024

managers that manage trillions of dollars has not gone unchallenged. The EDEA is currently subject to a three-pronged assault from the courts, pension board members, and academics.

Court Challenge

A lawsuit filed in Oklahoma County District Court in 2023 challenged the constitutionality of the EDEA and claimed a purported cost to various state pension funds of approximately $10 million “with the potential for even greater losses.”[103]

The plaintiff cited a section from the Oklahoma Constitution regarding public retirement system assets, highlighting that those assets shall be “held, invested, or disbursed … in trust for the exclusive purpose of providing benefits, refunds, investment management, and administrative expenses of the individual public retirement system, and shall not be encumbered for or diverted to any other purposes.”[104] The plaintiff argued this section was being violated by using funds for “political warfare,” and the Oklahoma district court judge appeared to side with that view in granting a temporary restraining order.[105]

The fiduciary analysis outlined above, however, directly contradicts the petitioner’s claims and the court’s tentative conclusion. BlackRock and State Street have committed to using all client assets in voting and engagement activities to promote net-zero goals. These are commitments to use assets for purposes other than the “exclusive purpose of providing benefits, refunds, investment management, and administrative expenses” of Oklahoma’s public retirement system. If a public entity made these commitments, it would plainly violate Oklahoma’s constitution. By the same token, a public entity cannot knowingly entrust assets to either asset manager, given those commitments. The EDEA thus *upholds* the Oklahoma constitution’s fiduciary duty standards and avoids the use of Oklahoma funds for “political warfare.”

In addition, State Street manages active funds for OPERS but has made net-zero commitments, introducing mixed motives into its stock selections. This situation is reminiscent of CalPERS’ decision to divest from tobacco-

103 *Keenan v. Russ*, 2023
104 Oklahoma Constitution Art. 23, § 12
105 *Keenan v. Russ*, Order as to Plaintiff’s Motion for Temporary Injunction, 2024

related investments, resulting in CalPERS missing out on $3 billion in returns. As noted above, an investment consultant analyzing CalPERS's decision demonstrated after approximately 18 years of investment history that such divestment was objectively and measurably detrimental to the portfolio both from an absolute return and diversification perspective. The EDEA seeks to avoid entrusting pension funds to asset managers that are determined to make similar mistakes.

In addition, even assuming for the sake of argument that the EDEA did somehow threaten fiduciary duties, the EDEA contains express language clarifying that nothing in the act overrules any fiduciary duty laws,[106] making it unclear at best how the law could violate the constitution's fiduciary duty clause.

We conclude that the plaintiff's claims that the EDEA violates the Oklahoma Constitution are meritless, as the EDEA upholds fiduciary duties and contains a specific exception to ensure those duties are upheld.

OPERS Board's Refusal to Switch Any Funds

In another notable challenge to the EDEA, the Board of the Oklahoma Public Employees Retirement System (OPERS) voted to keep entrusting over $6 billion to BlackRock and State Street, even though both firms were listed by the Treasurer under the EDEA.

As of the 2023 Annual Comprehensive Financial Report for OPERS, the system managed $11.4B in investments and, with cash holdings, reported a total fund balance of $11.7B in total assets. Interestingly, at $6.4B in managed system assets, BlackRock managed approximately 57% of total system investment assets and 54% of total system fund assets.[107] For managing these assets, OPERS paid BlackRock $1.98M in asset management fees, which is 17% of total investment-related expenses of $11.47M for 2023.

OPERS' extraordinarily high concentration in BlackRock funds raises fiduciary concerns. Although risk is diversified within the index funds used, which prudently invest in many different companies, OPERS seems to be

106 74 O.S. § 12002(D)(3)
107 Oklahoma Public Employees Retirement System, 2024

ignoring its lack of diversification in *asset manager* risk. If BlackRock were to collapse (as Lehman Brothers famously did in 2008), OPERS could suffer substantial losses, given that it has billions invested in BlackRock's funds.

After the EDEA was passed and the Treasurer created his list of restricted firms, the Board decided to keep *every penny* of public pension funds with BlackRock and State Street. The Board's primary contention at the time was that switching away from both managers would cost state pensions over $10 million. However, Oklahoma Treasurer Todd Russ, acting in his role as Chairman of the State Pension Oversight Commission, pointed out "the Board could have switched at least five of the eight funds at issue," because those five funds "had zero or near-zero switching costs and bidders who had similar or superior fees and performance to BlackRock and State Street."[108]

In response to Treasurer Russ's criticism, OPERS claimed that it "did not have the legal ability to partially divest," because contracts with asset managers "must be terminated under the EDEA unless an exemption is taken."[109] This position is inconsistent with the exception cited by OPERS, which states that an exception to a requirement may be made if "such requirement would be inconsistent with [OPERS'] fiduciary responsibility."[110] Rather than simply applying the exception *to the extent* it deemed the EDEA to be inconsistent with fiduciary responsibility (for example, to the three funds that would have involved substantial switching costs), OPERS stretched the exception to justify its decision not to switch five funds with "zero or near-zero switching costs and bidders who had similar or superior fees and performance."[111] Under OPERS' reasoning, as long as it could invoke the EDEA's exception for *any* of its investments with an asset manager, it could keep *all* of its other investments with that asset manager. This clearly contradicts both the letter and spirit of the EDEA.

The Board also tried to justify its decision not to switch from the five funds based on fees, but the fee differences involved in switching the passive index funds (four of the five funds with no transition costs) were miniscule—switching those funds would have resulted in a change of fees of *less than one basis point* for each of those funds. After Treasurer Russ criticized

108 Oklahoma State Pension Commission, 2023
109 Oklahoma Public Employees Retirement System, 2023
110 Oklahoma Public Employees Retirement System, 2023 (citing 74 O.S. § 12002(D)(3))
111 Oklahoma State Pension Commission, 2023

OPERS' decision, the Board revealed that BlackRock promised OPERS a 15% discount if OPERS kept *all* of its index funds with BlackRock. But the total "discount" afforded to OPERS was less than $100,000 a year, less than a sixth of a basis point of the $6 billion OPERS has entrusted to BlackRock.[112]

OPERS' rationale for not switching its large-cap actively-managed fund from State Street is even more suspect. After stressing that its fiduciary duty could not allow OPERS to pay about $100,000 to switch from BlackRock, OPERS brushed off the fact that it would save, on average, *over a million dollars a year* by switching its large cap funds to T Rowe Price. OPERS stated that it was basing its decision not to switch on T Rowe Price's higher fees, yet OPERS' own document clearly demonstrated that T Rowe Price consistently outperformed State Street *net of fees* over the last one, three, five, and ten years:[113]

Excess	1 Year	3 Years	5 Years	10 Years
Fidelity	-9.3	1.2	-3.2	-2.5
Parametric	4.3	-	-	-
PGIM	-1.7	-0.6	-2.2	-0.8
T Rowe Price	1.9	0.9	0.6	0.6
SSgA (current manager)				

Note: Performance is Net of Fees. Informaiton provided by the manager in their RFP response.

OPERS brushed off these consistent returns by pointing out that T Rowe Price's fund was not "guaranteed to continue to outperform the index in the future."[114] Obviously, no returns are "guaranteed," but OPERS' decision to ignore a decade of returns flies in the face of the fiduciary duties that OPERS claims to be upholding.

112 Oklahoma Public Employees Retirement System, 2023
113 Verus, 2023 (highlighting added)
114 Oklahoma Public Employees Retirement System, 2023

More importantly, though, fiduciary duty involves, and the EDEA and state laws demand, far more than a simple pick-the-lowest-fee calculation. Trustees must "manage trust assets as a prudent investor would, by *considering the purposes*, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, "the trustee shall exercise reasonable care, skill, and caution."[115] Trustees have "a duty to administer the trust, diligently and in good faith, in accordance with the terms of the trust and applicable law."[116]

Here, the core conflict was between the Board's fiduciary duties and the fact that OPERS had entrusted billions to BlackRock and State Street, who appear to be violating those fiduciary duties. As Treasurer Russ pointed out in his letter, the Board's actions "may have conflicted with its fiduciary duties, given that it knowingly entrusted assets to firms identified on the restricted company list, who have pledged to use those assets in a manner that does not align with the Board's fiduciary duties under OPERS."[117] The Board's response completely ignores that issue, and instead pretends that all of the options are the same, either by (1) ignoring BlackRock and State Street's commitments and asserting that any increase in fees means the Board needs to "invoke its fiduciary duty" and continue using EDEA-listed managers or (2) pointing out that some of the other bidders have climate commitments as well, even though those bidders are not on the EDEA's list.[118] Again, the Board misses the point—BlackRock and State Street's activities are inconsistent with the fiduciary duties regarding Oklahoma public assets. The Board's decision to knowingly entrust those assets anyway, based on a miniscule difference in fees, conflicts with the Board's fiduciary responsibilities.[119]

As discussed above, BlackRock's and State Street's commitments and actions conflict with fiduciary duties as well as constitutional requirements imposed by the Oklahoma Constitution. Thus, the OPERS Board could not have entrusted public assets to BlackRock and State Street without violating its own constitutional requirements to ensure that Oklahoma's assets are

115 Okla. Stat. Ann. tit. 60, § 175.62.
116 Restatement (Third) of Trusts Vol. 3, § 76 (2007); see Okla. Stat. Ann. tit. 60, § 175.67.
117 Oklahoma State Pension Commission, 2023
118 Oklahoma Public Employees Retirement System, 2023
119 See Indiana Attorney General Opinion 2022-3, 2022 (reaching a similar conclusion)

managed solely for the benefit of Oklahoma's retirees. Yet, the OPERS Board chose to keep over half of OPERS' funds with BlackRock and State Street, totaling over $6 billion.

We conclude that the OPERS Board's decision to ignore BlackRock and State Street's commitments to ESG policies conflicted with the OPERS Board's fiduciary duties and constitutional requirements under the law. We also conclude that the OPERS Board incorrectly reasoned that the application of an EDEA exception to an asset manager operating *any* fund meant that the OPERS Board could keep that asset manager for *every* fund.

Study Claiming that EDEA Affected Municipal Bond Prices

Another front in the assault against the EDEA came from a recent study funded by the Oklahoma Rural Association ("ORA study"), claiming that the EDEA increased municipal bond costs.[120] That study concluded that the EDEA has increased Oklahoma's borrowing costs after comparing Oklahoma's bond coupon rates to rates in five neighboring states. Recent research has refuted the study's findings and criticized the study for cherry-picking data, including national and state bond indexes and underwriting activity, and confusing correlation with causation.[121] The ORA study ignores actual market data, which shows that Oklahoma's borrowing costs have not increased since the EDEA was passed. Since the EDEA went into effect, there has been no significant trend difference in the S&P Municipal Bond Oklahoma Index and the broader S&P Municipal Bond Index.[122] In fact, the two rates have moved in tandem over much of the last decade, including after Oklahoma passed the EDEA.[123]

The ORA study cherry-picks states and dates to exclude contrary data. *First*, the study does not explain why it selects five neighboring states, rather than comparable states to Oklahoma.[124] In selecting neighboring states to Oklahoma as a control group, the study inexplicably excludes New Mexico,

120 Oklahoma Rural Association, 2024
121 Ginn, V., 2024; Bowyer Research, 2024; Tice, P., 2024
122 Ginn, V., 2024 (Figure 1 on p. 7); Bowyer Research, 2024
123 Ginn, V., 2024
124 Bowyer Research, 2024

an adjoining state with a robust oil and gas industry similar to Oklahoma's.[125] Presumably, the study excluded New Mexico because New Mexico's high borrowing costs would have raised the control group's borrowing costs and thus refuted the desired conclusion.[126] *Second*, the study ignores states' varying credit ratings when selecting its control group, arguably the "most important factor driving borrowing costs."[127] *Third*, the study cherry-picks dates by choosing a date range that conveniently captures only 10 months of post-EDEA data and ignores an additional year of available post-EDEA data.[128]

Finally, the ORA study conflates correlation with causation by ignoring factors, other than the EDEA, that explain changes in Oklahoma's borrowing rates.[129] For example, since Oklahoma passed the EDEA, the Federal Reserve has increased its federal funds interest rate 11 times.[130] Other more plausible explanations of increasing borrowing rate include: increasing economic uncertainty in oil-producing states during the Biden Administration; expectations of inflation; Oklahoma's tax cuts in January 2022.[131] Opponents of the EDEA also have argued that borrowing costs have increased because of decreasing underwriters.[132] However, a majority of the ten largest underwriters and several energy-focused regional bank players are still eligible to provide bonds.[133] And while some underwriters are on Oklahoma's restricted company list and no longer eligible to provide bonds, several academics have found that underwriters have left because of dramatically declining profits, not anti-ESG legislation.[134]

Other studies also have purported to show that statutes designed to uphold fiduciary duties somehow increase costs, but those studies have been shown to be flawed as well. For example, one often-cited paper concluded that Texas legislation similar to the EDEA decreased municipal bond yields in the state.[135] But a more recent analysis disproved that

125 Ginn, V., 2024; Bowyer Research, 2024
126 Bowyer Research, 2024
127 Tice, P., 2024; Bowyer Research, 2024
128 Tice, P., 2024
129 Tice, P., 2024
130 Tice, P., 2024
131 Tice, P., 2024; Bowyer Research, 2024
132 Tice, P., 2024
133 Tice, P., 2024; Bowyer Research, 2024
134 Hund et al. 2024
135 Garrett et al. 2024

conclusion by examining data showing that other states without similar legislation nevertheless experienced similar changes.[136] The new paper found that "the exit of banned underwriters does not significantly and adversely affect Texas bond yields, indicating an otherwise competitive market for underwriting services."[137] The paper also concluded that exits by underwriters were not specific to Texas, and were primarily driven by "declines in the profitability of underwriting municipal debts."[138]

We conclude that there is no evidence that the enactment of the EDEA increased Oklahoma municipal bond costs.

136 Hund et al. 2024
137 Hund et al. 2024
138 Hund et al. 2024

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