A PARTNERSHIP OF PROFESSIONAL ASSOCIATIONS
ATTORNEYS AT LAW

# CALIFORNIA PUBLIC EMPLOYEES RETIREMENT SYSTEM

# BOARD OF ADMINISTRATION FIDUCIARY EDUCATION PROGRAM

## MONTEREY, CALIFORNIA
## JANUARY 20, 2016

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## I. CALIFORNIA'S DEFINITION OF A FIDUCIARY

### A. Article XVI, Section 17, California Constitution.

Constitution uses the Prudent Investor standard. See, Cal. Gov. Code 20151.

### B. History behind the provision.

Arose after *Claypool v. Wilson*, 6 Cal.Rptr.2d 77 (Cal. App. 3 Dist. 1992) which approved Governor selecting System actuary.

### C. Limits of the Provision.

System is not a guarantor of every promise made by an employing agency. *City of Pleasanton v. Board of Administration*, 149 Cal.Rptr.3d 729 (Cal. App. 1 Dist. 2012). There is no duty to pay greater benefits than the statutes allow. *Chaidez v. Board of Administration*, 169 Cal. Rptr.3d 100 (Cal. App. 3 Dist. 2014).

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D. Judicial Definition.

E. Where Does the Legal Duty to Act Lie?

1. Trustees have a duty to secure full payment of all contributions owed to the Fund.

2. Trustees have a duty to enforce the provisions of the legislation as written. If legislation proves to be unwise, it is a matter for the Legislature to resolve. California courts have enforced the rights of retirement plans to secure their assets and income streams from interference.

3. Trustees have a duty to adopt sound actuarial and investment policies designed to protect the interests of the members and beneficiaries of the System.

## II. WHAT DOES DE MINIMIS MEAN IN THE FIDUCIARY CONTEXT?

A. Various Divestiture Statutes Allow CalPERS to Decline to Divest If To Do So Would Interfere With Its Constitutional Duty.

1. In deciding to follow or decline a divestiture mandate, the System has looked to whether the effect on the portfolio is "de minimis."

2. How is de minimis defined?

3. Black's Law Dictionary defines de minimis as "of the least" or "trifling; minimal" and a fact or thing that is "so insignificant that a court may overlook it in deciding an issue or case."

4. In the context of an investment decision when is an effect de minimis?

5. *De minimis non curat lex* - "The law does not concern itself with trifles."

6. At least one state, New York, rejected the above maxim in the context of a fiduciary duty. In *Sorin v. Shahmoon Industries*, 220 N.Y.S.2d 760 (N.Y. App. 1961), a waste of corporate assets challenge, the court held that where a fiduciary's duty to account is at issue, it is a question of "principle," not principal. When a fiduciary is to account for funds entrusted to his or her care, it means all funds "not some, or even most." This would seem to suggest that there is no de minimis exception (at least in New York), highlighting the confused and unsettled state of the law.

7. The leading (and really the only) case in this context remains *Board of Trustees v. Mayor and City Council*, 562 A.2d 720 (Md. 1989). The trustees of the City pension fund sued to challenge ordinances requiring divestiture of holding in companies doing business with the Apartheid government of South Africa. In upholding the ordinances the Court observed that given "vast power that pension funds exert in American society, it would be unwise to bar trustees from considering the social consequences of investment decisions," where the cost was de minimis. In the Baltimore case, the trial court found that the initial cost of divestment was 1/32 percent (3 basis points) and the on-going cost was 1/20 percent (2 basis points. To date this remains the only public pension case giving some concrete definition to the term "de minimis" in the divestment context.

8. A similar case concerned an action by the Oregon Board of Higher Education passing a divestiture resolution relating to investment of endowment funds. The State Investment Council declined to adopt the resolution finding it contrary to prudent investment standards. Various student groups whose members received endowment funded scholarships sued. An Oregon trial court held that the Board of Higher Education and not the State Investment Council controlled the endowment funds but agreed that divestiture was a violation of the prudent investor standard. The decision was overturned on appeal when the student plaintiffs were found to lack standing sufficient to challenge the investment decision. The trial court decision on prudent investment standards was a contrary result to that reached in Maryland. Significantly, the Maryland divestiture was legislatively driven by the plan sponsor, while the Oregon decision was driven by Board of Higher Education policy. *Associated Students v. Oregon Investment Council,* 728 P.2d 30 (Or. App. 1986).

## B. What If Survival Is At Stake - Are The Rules Different?

1. In *Withers v. Teachers' Retirement System*, 447 F.Supp. 1248 (S.D.N.Y. 1978), the Board of Trustees agreed to buy $2.53 billion (approximately $10 billion in 2015) in New York City bonds to prevent the City from becoming insolvent. This commitment raised the amount of the portfolio in City securities to more than 37%. Members of the plan sued the trustees for breach of fiduciary duty. Ultimately, the Court ruled that trustees acted reasonably as the insolvency of the City would have led to depletion of the retirement system within less than 10 years. The court rejected the claim of breach of fiduciary duty because the motivation of the decision was the long term solvency of the System and not the long term welfare of New York City. The trustees reasonably feared that in bankruptcy, the protection of employee benefits would be secondary to claims of bondholders and the preservation of essential public services.

2. Is ESG related to the long term survival of the System? That is a matter conferred on the trustees in the California Constitution. To the extent that ESG is integral to the long term success and prosperity of California, and the employers' ability to make required employer contributions to sustain the System, it is comparable in sound fiduciary practice to the New York City System decision to invest in the long term economic survival of the primary plan sponsor. Development of that information as part of the ESG consideration is an appropriate means of insulating the decision making of the trustees. Can the System align its ESG policy with the marketplace?

3. The Florida Attorney General opined that a decision by the State Board of Investment (which acts as the fiduciary for the Florida Retirement System) could not adopt an administrative rule on divestiture based on ethical considerations in the absence of enabling legislation. The opinion continued, however, that instability in a region (here, South Africa) would be a legitimate consideration in making an investment decision because of the potential effect on economic considerations.

4. In a post-South Africa Attorney General opinion, Maryland considered whether Iran and Sudan divestiture was inconsistent with the State Retirement Board's fiduciary duty. The AG concluded it was not under the following conditions:

   a. Fair market value was received for the divested interests

   b. Substitute investments had comparable return and risk

   c. The timing and manner of divestment transactions were prudent.

   d. The effect was de minimis as compared to "total fund assets."

5. Viewing the de minimis nature of an event in the context of "total plan assets" would have a different effect in the context of CalPERS.

## III. RESPONSIBLE INVESTING - IS THIS AT ODDS WITH BASIC FIDUCIARY PRINCIPLES?

A. Environmental, Social and Governance (ESG) - Incorporates these issues into the investment decision making process as means to enhance returns and reduce risk. Additionally, these approaches may involve active proxy voting, company engagement, and public policy work. It may be argued that these are qualitatively difference from divestment, because they directly involve the "G" in ESG by promoting better governance through shareholder engagement on multiple fronts.

B. Mission Related Investing is a more focused type of ESG and is closely aligned with the mission of the organization. For example, one large church pension plan will not invest in stocks relating to gambling, firearms, alcohol, or private prisons. The religious doctrinal issues that have made faith based investing beyond the reach of legislation on First Amendment grounds are not a comparable measure with public pension plans which are highly regulated.

C. Sustainable investing is generally focused on investments in companies addressing issues relating conservation of natural resources, such as energy, air, and water.

D. Currently billions of dollars of public and private pension money has been placed into economically targeted investments (ETI's) which are designed to create jobs, boost local economies or create affordable housing.

E. The Labor Department began issuing responsible investing guidance for ERISA plans as early as 1998. Fund trustees were reminded loyalty to the plan, diversification, and prudence were the primary investment determinants. Responsible investing was criticized for failure to provide a solid economic return to the pension fund. Later research has been inconclusive on the economic impact to the investor. Focus has shifted from negative screening (limiting the opportunity set) to positive screening, yielding a more balanced approach of integrating the ESG principles into the over-all investment decision making process. CalPERS experience has shown that governance related efforts have improved performance. Research does not presently support a conclusion that social or environmental principles will yield a positive investment result.

F. At least one federal court has recognized the propriety of ESG principles for governmental plans.

   1. On December 8, 2015, a U.S. District Court in Colorado found that the retirement plan administered by Catholic Health Initiatives (CHI) was a "church plan" and therefor exempt from ERISA. *Medina v. Catholic Health Initiatives*, ___F.Supp.3d___, 2015 WL 8144956 (D. Colo. 12/8/2015).

   2. The focus of the case was on whether the "church plan" exemption violated the Establishment Clause of the first Amendment of the United State Constitution.

   3. The Court rejected this argument finding that the strictures of ERISA would involve far more government entanglement in religious doctrine than did the exemption. In reaching this conclusion, the Court expressly distinguished between the investment prerogatives of Church plans and public pension plans to engage in social investing and the inability of ERISA plans to employ such considerations:

*I]t has become generally accepted that ERISA-governed asset management may not be based on social investing. ERISA fiduciaries correctly understand that insofar as social investing is concerned, they do not have the same investment prerogatives as* ***fiduciaries of state and local pension plans****, church plans, and other programs not subject to ERISA....The risk-averse fiduciary will avoid activity that could be construed as symptomatic of nonfinancial motives, such as social investing. The investment decisions of risk-averse fiduciaries should be based exclusively on economic merit. (emphasis added)*

4. While not referring to the Baltimore decision, the Court reached the same conclusion as did the high court of Maryland - if there is a political decision to engage in investing with a social purpose, and that decision is made by the political branch of the government which is ultimately responsible to insure the financial integrity of the retirement program, that social purpose in not *per se* unlawful.

5. Some caution should be exercised in applying the dicta in the *Medina* decision. Dicta is court commentary which does not contain the actual holding of the court. The focus of the Medina court was whether the plan at issue was a "church plan." The reference to the investment prerogatives of state and local plans likely relates to the fact that public plans are regulated by their sponsoring governments rather than the dictates of Congress for private sector ERISA plans. Surprisingly, the *Medina* court's conclusions about ERISA plan consideration of ESG principles seems at odds with the recent Department of Labor guidance on the subject.

6. At the same time state and local ESG initiatives can use governance to implement avoidance of environmental disasters such as the Deep Water Horizon well explosion; the Exxon Valdez spill and in California the Plains All American Pipeline Company oil spill in Santa Barbara. The Santa Barbara spill is currently the subject of securities litigation being brought by retirement systems whose investments were adversely affected by the spill.

G. Divestiture of Fossil Fuels.

1. Generally shunned by pension plans and large endowments as destructive of the mission of achieving the highest and best return at a reasonable risk.

2. Divestiture has most recently been criticized for loss of an investor voice in a critical industry that directly impacts virtually every economic sector in which pension plans are invested.

3. The goals of ESG, particularly in the area of sustainability, are directly compromised by loss of the presence at the corporate table, thereby making divestment of fossil fuels a "futile act," according to Professor Edward Zelinsky of the Cardozo School of Law.

4. On June 4, 2015 Georgetown University announced it would make no further investments in thermal coal. See discussion at Hottinger, "In Support of Fossil Fuel Divestiture," *Georgetown International Environmental Law Review on Line (6/13/2015).*

5. Government Code 7513.75 - The Legislature made express findings that divestiture from thermal coal was in the long term economic benefit to California, although not expressly in relation to the System. Is this a comparable justification to that recognized in Baltimore City?

H. Does Recent Department of Labor Guidance Make a Difference?

1. In 1994 the Department of Labor, which regulates ERISA plans issued Interpretive Bulletin 94-1. The bulletin concluded that the fiduciary standards applicable to economically targeted investments (ETIs) were no different than the standards applicable to plan investments generally. Therefore, if the general principles relating to fiduciary decision making under ERISA were met, the selection of an ETI, or the engaging in an investment course of action intended to result in the selection of ETIs, will not violate ERISA.

2. On October 26, 2015, the DOL addressed the concern that interim guidance given in 2008 had unduly discouraged ERISA fiduciaries from considering the social impact of an investment decision. The DOL recognized in its 2015 guidance that ESG issues "..may have a direct relationship to the economic value of the plan's investment."

3. The DOL guidance is in no way binding on a state or local government plan due to the ERISA exemption for governmental plans, but it is instructive in the shifting view that the ESG component of an investment may well have a measurable economic impact on the System.

## IV. WHAT IS THE LIABILITY ARISING FROM ESG DECISION MAKING?

### A. The Restatement Of Trusts

1. The general body of American trust law is collected in the Restatement of Trusts. The current version relating to institutional investment decision-making is the Restatement 3d of Trusts.

2. Investments are to be viewed on a case by case basis and based on the information known at the time the investment decision is made rather than in hindsight.

### B. Comment C of Section 227 Of The Restatement

1. The Restatement discusses socially conscious investing in the commentary to the "black letter" rule.

2. Consideration of ESG decision making addressed with regard to the concept of the fiduciaries' "undivided loyalty" to the best interests of the participants, referencing Article XVI, Section 17 of the California Constitution.

3. The comments conclude that while the duty of loyalty does not permit a trustee to ignore legal prohibitions, it also "..does not require the trustee to disregard ethical principles generally applicable to investment managers." In other words, the Restatement offers seemingly self-contradictory guidance.

### C. Who Has Standing To Sue Over ESG Decision Making?

1. Standing of members and retirees.

2. Standing by the plan sponsors and whether there may be competing interests among?

3. Taxpayer suits.

## V. DISCUSSION QUESTIONS

A. The System's financial advisors propose to the Board that despite an earlier decision to divest, that a return to ownership of firearms manufacturers, even those manufacturing assault weapons. Financial analysis shows that the System will lose a material sum of investment opportunity in the manufacturing sector of its equity portfolio by not exercising this opportunity. How does the Board approach this issue? What factors should be considered? What alternatives should be

considered? What information does the Board need to make an informed decision? Is there a quantitative methodology to evaluate comparable investment alternatives? What is the predictive value of such data? How can the investment staff help the Board convert data to useful information?

B. The System has made a series of divestments based on various statutory mandates. Taken in isolation, each individual decision to divest has been deemed to have a de minimis effect and that other investment options are available to replace the divested companies. At what point does the Board determine that the sum of the individual decisions is no longer de minimis. What policy making considerations should the Board undertake to maintain faithful compliance with the constitutional fiduciary mandate? Is there a qualitative difference between materiality for auditing purposes and materiality (a non de minimis effect) for investment purposes? Does it make a difference if the decision is legislatively driven versus Board driven? Is there a "right" answer?