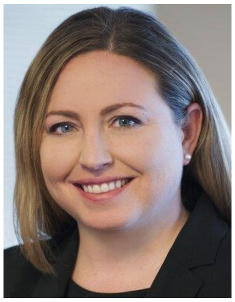
Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Anti-ESG Bills Raise Questions For Public Retirement Plans

By **Elizabeth Goldberg, Lance Dial and Rachel Mann**
(August 29, 2022, 5:37 PM EDT)



Elizabeth Goldberg

Lance Dial

Rachel Mann

At the same time that the federal government, through the U.S. Department of Labor, appears to be easing[1] retirement plan fiduciaries' paths to considering certain environmental, social or governance factors in making investment decisions, some states are passing legislation that would prohibit the states from doing business with managers who invest based on ESG criteria.

These anti-ESG state legislative efforts could complicate the use of ESG by public retirement plans and put retirement plan fiduciaries and providers of retirement plan investment products in a tricky spot, looking to bridge their fiduciary obligations with these new limitations.

These legislative activities could also create challenges for investment providers seeking to simultaneously serve both public and private retirement plans.

The DOL regulates the majority of U.S. employer-sponsored retirement plans through the Employee Retirement Income Security Act, but public retirement plans are not subject to ERISA's requirements and are instead regulated by state and local laws.

Some states use ERISA's framework as a standard for their public pension statutes, either directly or indirectly. There are currently more than 5,500 of these state and local government-sponsored pension plans,[2] with close to 21 million participants and $4 trillion in assets. These public retirement plans account for close to 20%[3] of total U.S. retirement savings assets.

Over the past year, 17 states have proposed or adopted state legislation that would limit the ability of the state government, including public retirement plans, to do business with entities that are identified as boycotting certain industries based on ESG criteria or goals, or consider ESG factors in their investment processes.

These anti-ESG bills operate in different ways. Some ban government contracting with companies identified by the state officials as discriminating against certain industries, including the firearms industry or the fossil fuels industry.

For example, Texas has enacted S.B. 19,[4] prohibiting a government entity from contracting with companies for over $100,000 unless the company verifies in writing that they will not discriminate against a firearms entity or a firearms trade association.

Other types of anti-ESG bills ban state funds, such as state retirement plans, from investing in ESG-type investment products.

For example, Kentucky has enacted S.B. 205,[5] mandating that state government entities must divest from financial companies that boycott energy companies.

Some states have only enacted or proposed one type of bill. For example, West Virginia's S.B. 262[6] and Utah's H.B. 312[7] ban certain types of government contracting with companies that discriminate against energy companies, but don't mandate state divestiture.

Meanwhile, other states have proposed or enacted both types of anti-ESG bills, like Oklahoma's H.B. 2034[8] and H.B. 3144,[9] and Louisiana's H.B. 25[10] and H.B. 978.[11]

Texas led the state push to increase scrutiny over ESG investing with the passage of both types of anti-ESG laws in May 2021. Texas' S.B. 13[12] is directed squarely at state-held retirement funds and permanent school funds and mandates divestiture from companies that boycott the fossil fuel industry.

The funds affected by this law are worth approximately $330 billion,[13] though it's unclear how much of those assets are invested in companies that would be considered to be boycotting the fossil fuel industry.

The law would also prohibit the Texas state government and municipalities from entering into any contract with a vendor valued at over $100,000 unless the vendor represents that it does not and will not for the term of the contract boycott energy companies as defined in the Texas statute.

Texas S.B. 13[14] defines "boycott" very loosely — even firms that invest in fossil fuels but also offer fossil fuel-free financial products could be caught in the ban.

As Sherri Greenberg, a former Texas lawmaker who formerly helped oversee pension fund investments, explained, "If they have any mutual funds or exchange traded funds in their portfolios that prohibit or limit investment in fossil fuels, then that is problematic."[15]

That said, the specific terms of the rule leave room for some interpretation. For example, it is not clear that a firm that avoids doing business with energy companies would instantly be considered to be boycotting energy companies. The Texas law provides an exception for companies acting with a normal business purpose, and the definition presents its own complications.

Specifically, the definition of "boycott energy companies" requires the determination to avoid doing business with the energy company to be based on two prongs:

- Because the company engages in the exploration, production, utilization, transportation, sale or manufacturing of fossil fuel-based energy; and
- The company does not commit or pledge to meet environmental standards beyond applicable federal and state law.

This two-pronged approach could leave open the possibility that a financial company could refuse to do business with an energy company without boycotting the energy company under Texas law as long as that refusal was not motivated by the failure of the company to adopt heightened environmental standards.

More recently, Florida Gov. Rick DeSantis announced[16] in July his plan to propose a Florida state bill that would prohibit the Florida State Board of Administration from engaging investment managers who consider ESG criteria when managing state assets, including state-sponsored pension funds.

The proposed legislation would amend Florida's state statute on deceptive and unfair trade practices to prohibit discriminatory practices by large financial institutions based on ESG social credit score metrics, and would require State Board of Administration fund managers to only consider maximizing the return on investment on behalf of Florida's retirees.

On the federal level, ERISA has long required that retirement plan fiduciaries make decisions solely in the best interests of the plan participants and beneficiaries and for the exclusive purpose of providing benefits to participants and their beneficiaries.[17] Whether and how ESG factors can be considered has been a game of regulatory pingpong, changing with successive presidential administrations.

The recently proposed version[18] of the DOL's ESG investing guidance reiterated ERISA's focus on participants' financial interests, requiring that a fiduciary "may not sacrifice investment return or take on additional investment risk to promote benefits of goals unrelated to the interest of the participants and beneficiaries in their retirement income or financial benefits under the plan."[19]

The proposed rule also states[20] that "[a] fiduciary's evaluation of an investment or investment course of action must be based on risk and return factors that the fiduciary prudently determines are material to investment value."

The DOL appears to be trying to clarify that ESG factors can be considered where they are material to an investment. This DOL approach is in contrast to the recent anti-ESG state bills that seem to be aimed at discouraging the use of ESG investing.

These anti-ESG state legislative efforts could complicate the use of ESG by public retirement plans and create challenges for retirement plan fiduciaries. The distinction could also create headaches for investment providers seeking to serve both public retirement plans and ERISA-governed plans.

Elizabeth Goldberg and Lance Dial are partners, and Rachel Mann is an associate, at Morgan Lewis & Bockius LLP.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] https://www.morganlewis.com/pubs/2021/10/erisa-fiduciaries-dol-proposed-rule-signals-more-ease-for-esg-investing.

[2] https://www.urban.org/policy-centers/cross-center-initiatives/state-and-local-finance-

initiative/projects/state-and-local-backgrounders/state-and-local-government-pensions.

[3] https://www.urban.org/policy-centers/cross-center-initiatives/state-and-local-finance-initiative/projects/state-and-local-backgrounders/state-and-local-government-pensions.

[4] https://capitol.texas.gov/tlodocs/87R/billtext/pdf/SB00019F.pdf.

[5] https://apps.legislature.ky.gov/recorddocuments/bill/22RS/sb205/bill.pdf.

[6] https://www.wvlegislature.gov/Bill_Status/bills_text.cfm?billdoc=SB262%20SUB2%20ENR.htm&yr=2022&sesstype=RS&billtype=B&houseorig=S&i=262.

[7] https://le.utah.gov/~2022/bills/static/HB0312.html.

[8] http://webserver1.lsb.state.ok.us/cf_pdf/2021-22%20ENR/hB/HB2034%20ENR.PDF.

[9] http://webserver1.lsb.state.ok.us/cf_pdf/2021-22%20COMMITTEE%20SUBS/HCCS/HB3144%20CCS.PDF.

[10] https://trackbill.com/bill/louisiana-house-bill-25-retirement-systems-prohibits-retirement-systems-from-investing-in-companies-that-boycott-energy-companies-or-see-actuarial-note-fc-sg-ex/2209892/.

[11] http://www.legis.la.gov/Legis/ViewDocument.aspx?d=1277773.

[12] https://capitol.texas.gov/tlodocs/87R/billtext/pdf/SB00013I.pdf.

[13] https://www.npr.org/2022/04/29/1095137650/texas-stumbles-in-its-effort-to-punish-green-financial-firms.

[14] https://capitol.texas.gov/tlodocs/87R/billtext/pdf/SB00013I.pdf.

[15] https://www.npr.org/2022/04/29/1095137650/texas-stumbles-in-its-effort-to-punish-green-financial-firms.

[16] https://flgov.com/2022/07/27/governor-ron-desantis-announces-initiatives-to-protect-floridians-from-esg-financial-fraud/.

[17] See 29 CFR 2550.404a-1(a).

[18] https://www.govinfo.gov/content/pkg/FR-2021-10-14/pdf/2021-22263.pdf.

[19] See 86 Fed. Reg. 57302, 57303 (Oct. 14, 2021).

[20] https://www.govinfo.gov/content/pkg/FR-2021-10-14/pdf/2021-22263.pdf.