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Overview of ESG Legislation

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Environmental, Social, and Governance (***"ESG"***) investing refers to the practice of utilizing a set of social rather than pecuniary factors to vet potential investments. Typically, ESG investors eschew investment in companies doing business in industries they believe impair the climate, increase violence, or fail to prioritize social and ideological interests—such as fossil fuel companies, arms manufacturers, or businesses lacking diversity. ESG investors comprise a significant portion of the industry; in 2021 alone, $500 billion was invested in ESG-oriented investment funds.

Trustees of pension plans owe an unwavering duty of loyalty to the members and beneficiaries of their plans, and several state attorneys general have opined that a plan trustee's duty of loyalty outright prohibits investment decisions based on any factor other than promoting the economic interests of the plan. Many states are using this interpretation of existing fiduciary duties to justify divestment of assets from certain investment managers based on ESG views.

As such, a complex legal landscape is forming. In some states, ESG principles are prerequisite investment criteria, while in others there are outright prohibitions against the state entering into financial contracts with companies that "boycott" certain industries that are generally thought to be contrary to the furtherance of ESG policies, such as fossil fuels.

The divide between the two approaches continues to grow as more states weigh in on the merits of ESG investing, with many states enacting measures to combat ESG driven investing. The dichotomous legislation does not end at the state level, and many investment managers are waiting on a ruling from the White House after the U.S. Department of Labor sent a final rule for review on October 7, 2021 that would, if accepted, allow retirement plan fiduciaries to consider ESG principles in their investment decisions. The final rule is expected to be released late December of this year.

The following summarizes the status of laws enacted to date.

I. Anti-ESG Legislation

A number of states have enacted, or are considering enacting, laws prohibiting government agencies from ESG-driven investment, as follows:

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a. Anti-Firearms Measures

A number of states have passed or introduced legislation prohibiting investments that discriminate against firearms manufacturers or suppliers. The states which have passed such legislation include Texas, South Dakota, and Wyoming. Arizona, Indiana, Kentucky, Louisiana, West Virginia, and Missouri are considering such legislation.

b. Anti-Fossil Fuels or other Energy Measures

Other states have passed or introduced legislation prohibiting investments that discriminate against fossil fuel developers or energy companies. The states which have passed such legislation include Utah, Kentucky, Ohio, Oklahoma, Texas, Tennessee, and West Virginia. The states considering passage of such legislation include Alaska, Idaho, Indiana, Louisiana, Minnesota, South Carolina, and Utah.

On October 19, 2022, attorneys general from 14 states sent civil investigative demands to the country's six largest banks, requesting information about the banks' involvement in climate-based initiatives. The demands allege that such strategies are an attempt to prevent fossil fuel companies from accessing financial services and that the banks' ESG policies are damaging to the energy industry.

c. Anti-Social Motivation Measures

To date, 13 states have adopted anti-ESG regulations in the form of state laws, investment resolutions, attorney general opinions, and state Treasurer opinions: Arizona, Idaho, Indiana, Florida, Kentucky, Louisiana, North Dakota, Oklahoma, Texas, Pennsylvania, South Carolina, Utah, and West Virginia. It would come as no surprise to see similar laws enacted by more states, particularly Republican- governed states, in short order.

Such legislation and executive decrees typically require that investments made by government agencies be based on pecuniary factors and not motivated by societal goals.

As a recent example, in August 2022 the Florida Board of Administration issued a directive that all investment decisions of the Florida Retirement System must be based on pecuniary factors rather than in furtherance of social, political or ideological interests.

Also, in a letter issued in August of 2022, 19 state attorneys general accused an investment advisor focusing on ESG principles of "us[ing] the hard-earned money of our states' citizens to circumvent the best possible return on investment."

d. Ordinary Business Purpose Limitation

The foregoing anti-ESG laws and policies create a complex legal minefield for companies pursuing ESG investment strategies. However, it should be noted that many of these laws include a so-called "ordinary business purpose limitation." For example, the Texas divesture law applies to companies that "boycott energy companies"—defining boycott as actions done "without an ordinary business purpose." The divestiture statutes enacted in Kentucky, Oklahoma, West Virginia, and proposed in Indiana, Idaho and South Carolina all contain a similar limitation. Therefore, we presume that arguments will arise, and indeed are currently arising, that "ordinary business purpose" includes taking a forward-looking position with respect to climate risks and future energy transitions, which, in the long term, may generate better financial outcomes.

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II. Pro-ESG Legislation

While the majority of states that have addressed ESG considerations legislatively have enacted laws or issued executive orders ***combatting*** socially motivated investing, a number of states have ***embraced*** socially motivated investing, or are considering implementation of such legislation, as follows:

a. Laws Allowing Consideration of ESG Implications

Multiple states, including Oregon, Connecticut, Illinois, Maryland, and Maine, have enacted legislation allowing consideration of ESG factors in the investment decision-making process. These states also promote implementation of sustainable investment policies, and Maine's law is designed to divest from industries like fossil fuels.

State pension funds in California, New Jersey, New York, and Oregon follow similar policies. For example, New Jersey's policy requires that fund managers engage in an ESG analysis of factors that present material business risks and opportunities, including carbon gas emissions, climate change, work force diversity, human rights, fair wages, etc.

Massachusetts, Nevada, New Jersey, New York, Pennsylvania, Rhode Island and Vermont are considering implementing legislation with ESG-favored investment guidelines, many related to gun control and firearm measures.

While no other states have enacted similar legislation, the Treasurers of Maine, Nevada, Delaware, New Mexico, Illinois, Wisconsin, Massachusetts, California, Rhode Island, Vermont, Washington, Oregon, Colorado, as well as the New York City Comptroller, have criticized anti-ESG legislation, arguing that consideration of ESG factors will result in better long-term growth.

III. Conclusion

There is a widening division between states regarding ESG investing. Some states vehemently oppose it, citing the need to consider only what monetary gain may come out of the investment, while others see ESG-driven investment as an opportunity to promote societal and environmental goals in tandem with future financial considerations.

The jury is still out who will win the argument.

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