June 30, 2021

Navigating State Regulation of ESG Investments by Investment Managers: A Rapidly Evolving and Contradictory Landscape

Attorneys
Joshua A. Lichtenstein
Michael R. Littenberg
Jonathan M. Reinstein
Adwoa Hinson

ESG integration by retirement plans has become front and center for regulators and political leaders across the world and in the U.S. over the last 12 months. As we await further developments from the U.S. Department of Labor (DOL) on ESG issues for private sector retirement plans, a number of states have taken steps to implement ESG regulatory frameworks for their pension systems. In particular, lines in the sand have been drawn for the fossil fuel, firearms and ammunition sectors. Some states seek to restrict their pension funds from investing in these sectors, while other states seek to penalize managers that exclude investments in or discriminate against these sectors. The landscape is rapidly evolving, with legislation adopted in the last few weeks in Maine and Texas. Bills are in various stages of progress in several other states.

Complicating things for asset managers, some of the laws take opposite stances. In addition, like state laws in many subject areas, the legislation in this area is loosely drafted, raising a host of questions and interpretive issues for both managers and state officials. These laws therefore create challenges for managers to navigate in their ESG policies, marketing, funds and managed accounts.

In this Alert, we describe the state laws adopted to date, as well as various pending state initiatives. We also discuss the current state of play of the DOL's ESG guidance.

State Efforts to Control ESG Investing by Public Pensions

At the state level, political leaders are taking varying approaches to overseeing investment decisions made by their retirement systems and companies. These approaches are discussed below and summarized in greater detail in the Appendix.

Legislation and Policies Calling For Integration of ESG Considerations in Investment Decisions

In 2019, Illinois passed legislation that required public investment leaders to incorporate ESG into their investment decisions, which was the most direct sustainable investing policy from a state up to that point. According to the Illinois state treasurer's office, sustainability factors provide a more complete view of an investment, its past performance, and its future potential. Sustainability factors have a material impact on business performance and long-term shareholder value, and as such, investors have an interest in integrating these factors into investment decision-making processes. This requirement to incorporate ESG considerations took effect on January 1, 2020.

In September 2020, the Oregon Investment Council (OIC) approved a policy formalizing the importance of ESG factors in investment decisions, which will be considered in its $107 billion investment portfolio. The OIC oversees allocations for the state trust funds, including the Oregon Public Employees Retirement Fund, the Common School Fund, and the State Accident Insurance Fund.

Legislation, Bills and Policies Promoting Divestment from the Fossil Fuel Industry

A variation on this theme of giving sustainable business practices more consideration for investment decisions has been some states' efforts to promote divestment from the fossil fuel industry.

On June 16, 2021, Maine became the first state to pass legislation mandating divestment of public assets from fossil fuel. H.P. 65-L.D. 99 requires the state, including its $17 billion pension fund and state treasury, to divest itself of assets invested in the fossil fuel industry by January 1, 2026.

New Jersey introduced legislation in 2020 to prohibit investment of state retirement funds in any of the top 200 companies that hold the largest carbon content fossil fuel reserves.

Also in 2020, the New York State Comptroller adopted a goal of transitioning the state's $226 billion retirement fund to net zero greenhouse gas emissions by 2040.

Legislation and Bills Restricting Investment in Entities that Boycott the Fossil Fuel Industry

In contrast, governors and legislators from energy-producing states such as Texas, North Dakota, Oklahoma, and Alaska have adopted or proposed laws or policies limiting transactions with companies that have called for divestment from the fossil fuel industry.

Recently, Governor Abbott of Texas signed into law S.B. 13, which prohibits investment in companies that boycott certain energy companies. The law, which takes effect on September 1, 2021, directs state retirement systems such as the Employee Retirement System of Texas, the Teacher Retirement System of Texas, among other entities, to sell, redeem, divest or withdraw all publicly traded securities of a company if the company does not cease a boycott of energy companies.

Other energy-producing states like North Dakota and Oklahoma have taken a slightly different approach. In North Dakota, S.B. 2291, which was signed into law by Governor Burgum on March 23, 2021, requires the state's department of commerce to undertake a study of ESG as it pertains to a set of nonspecific, quantifiable, and nonquantifiable criteria for making decisions or investments as it pertains to government and private industry in North Dakota. The study must also include the potential implications for the state as it relates to the boycott of energy or production of agriculture commodities by companies that intend to penalize, inflict economic harm on, or limit commercial relations. In Oklahoma, H.B. 2034, which was sent to committee in March 2021, intends to prohibit state contracts with a company unless the company submits a written certification that the company is not currently engaged in a boycott of the oil and gas industry.

Bills Pertaining to Investments in Firearms and Ammunition Companies – For and Against

As with fossil fuel investments, there have been efforts by state legislatures – from both sides of the political spectrum – to oversee investments in firearms and ammunition companies.

In Massachusetts, H.43 was introduced in April 2021 to require public pension fund divestment from firearms and ammunition companies.

In contrast, in Texas, S.B. 19 was signed into law on June 14, 2021, which prohibits contracts with companies that discriminate against the firearms or ammunition industries. The law applies to contracts paid partly or wholly from public funds between government entities and companies. Under the law, which takes effect on September 1, 2021, a Texas governmental entity, such as the various public retirement systems, is not permitted to enter into a contract with a company unless the company provides written verification that it does not have a policy of discriminating against firearms companies solely because of their status as such.

ESG Investing by ERISA Retirement Plans: The DOL's Changing Guidance

The "Current" Regulation

In Fall 2020, the DOL adopted a final regulation that amended ERISA's investment duties rule articulating how a fiduciary can satisfy his or her duties of loyalty and prudence in selecting plan investments. This was the latest change in law after years of issuing sub-regulatory pronouncements going back to 1994.

The 2020 final regulation, which was best understood as an incremental expansion of the DOL's longstanding guidance in this area, explained how ERISA plan fiduciaries must make investment decisions solely based on the financial interests of plan participants, and not on collateral issues such as ESG aims (outside of rare "tie-breaker" scenarios between two otherwise equivalent investments).

The final regulation states that when selecting plan investments, ERISA fiduciaries may only consider so-called "pecuniary factors." A "pecuniary factor" is a factor that the fiduciary prudently determines is expected to have a material effect on the risk and/or return of an investment based on appropriate investment horizons consistent with the plan's investment objectives and funding policy. In addition, the fiduciary must ensure that when it assigns relative weights to these pecuniary factors it bases those weights on a prudent assessment of the impact of each factor on risk and return. The final regulation also flatly prohibits qualified default investment alternatives that use non-pecuniary factors as part of the product's investment goals and principal investment strategies.

Interestingly, the final regulation does not use the term "ESG" or define it in any way—and there is no per se prohibition on selecting investment strategies that incorporate ESG as long as they are selected based on pecuniary factors.

Prior Guidance – A Seesawing Approach

As noted above, prior to last year's final regulation, the DOL had released several pieces of guidance over the last three decades in response to the concern that a fiduciary's decision to select an ESG investment could inherently violate his or her duties under ERISA, because ERISA requires that the fiduciary act for the exclusive benefit of plan participants. In response to this concern, the DOL issued an "interpretive bulletin" in 1994, which said that a fiduciary may consider a collateral benefit (such as ESG) as a deciding factor in a tie-breaker scenario—but only if the fiduciary determines that the investment with the collateral benefits is expected to provide fundamentally the same investment return as available alternative investments with similar risk characteristics, and if the investment is otherwise appropriate for the plan in terms of diversification, the investment policy, etc. This is often referred to as the "all things being equal" standard for ESG-themed investments.

Starting in 2008, the DOL began issuing more sub-regulatory guidance on ESG investments. The DOL's view of ESG investments shifted back and forth over the next decade—first saying that a fiduciary's consideration of ESG factors should be "rare," then saying that ESG could be a valid financial factor for a fiduciary to consider even in the absence of a tie-breaker situation. ESG investments came under particular scrutiny during the Trump administration, which included a DOL enforcement initiative that asked plan sponsors for information about their ESG investments. This scrutiny culminated in a proposed regulation, which was issued in June 2020 and, following an unusually short comment period, the final regulation described above, was released last Fall.

A New Administration, a New Position

The final regulation took effect in January 2021. However, following the change in presidential administration, the Biden-led DOL issued a non-enforcement policy less than two months later saying it would not enforce the final regulation or pursue actions against a fiduciary on the basis that they failed to comply with it. Then in May 2021, President Biden issued an executive order on climate-related financial risk, which asked the Secretary of Labor to "consider publishing, by September 2021…a proposed rule to suspend, revise, or rescind" the final regulation. Consequently, ESG investing by ERISA plans remains in a state of flux at the Federal level.

Until the DOL issued its non-enforcement policy in March, the final regulation was expected to require asset managers to reassess how they market their ESG capabilities and philosophies, and if necessary, to make changes in how the investment decision-making process would be documented. The rule posed particular challenges to managers who are also subject to the EU's rules (including the Sustainable Finance Disclosure Regulation or SFDR), and navigating the intersection of these rules would require care and special consideration. But now with this non-enforcement policy and President Biden's executive order in May, it is clear that the legal framework governing ESG investments by ERISA plans will continue to evolve. Asset managers will need to watch the DOL's activity closely over the coming months to see how this story unfolds.

Conclusion

It is critical that investment advisers, registered investment companies, and private funds that currently offer or intend to offer ESG products and services to governmental pension plans and/or ERISA retirement plans assess the impact of the recent and developing state laws and the DOL's activities discussed in this Alert. They also must remain vigilant in continuing to monitor developments in this area of law.

About Our Practice

Ropes & Gray has a leading ESG, CSR, and business and human rights compliance practice. We offer clients a comprehensive approach in these subject areas through a global team with members in the United States, Europe and Asia. In addition, senior members of the practice have advised on these matters for more than 30 years, enabling us to provide a long-term perspective that few firms can match.

For further information on our practice, click here.

June 30, 2021

Appendix

State Initiatives to Incorporate ESG Factors in Investment Decisions

State	Bill No.	Status	Summary
Illinois	PA 101-473 (The Illinois Sustainable Investing Act)	Signed by Governor Pritzker in 2019; Took Effect on January 1, 2020	• The Illinois Sustainable Investing Act provides that all state and local government entities that hold and manage public funds should integrate material, relevant, and useful sustainability factors into their policies, processes, and decision-making. • The law defines sustainability factors to include data and indicators related to (i) corporate governance and leadership, (ii) environmental, (iii) social capital, (iv) human capital (including responsible contractor and responsible bidder policies), and (v) business model and innovation. Collectively, these are also commonly referred to as ESG factors. • For those agencies making investment decisions on the security or company level, sustainability factors should be incorporated into the overall decision-making process, providing an additional layer of factors to consider when assessing the risk/value proposition of investment decisions.

Oregon	Oregon Investment Council Formalizes Importance of ESG to Treasury's Investment Decisions	Announced 9/14/2020	• Effective September 2020, leaders at the Oregon Investment Council (OIC) have integrated ESG factors into their $107 billion state investment portfolio. The new language reads as follows:
			THE INTEGRATION OF ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) FACTORS, SIMILAR TO OTHER INVESTMENT FACTORS, MAY HAVE A BENEFICIAL IMPACT ON THE ECONOMIC OUTCOME OF AN INVESTMENT AND AID IN THE ASSESSMENT OF RISKS ASSOCIATED WITH THAT INVESTMENT.
			A. The consideration of ESG factors within the investment decision-making framework is important in understanding the near-term and long-term impacts of investment decisions.
			  • The OIC believes that understanding how social and environmental factors impact investments is an important step towards building a more sustainable portfolio.
			B. Over time, there has been an evolution of multi-factor, or more holistic approaches, to identify opportunities and remediate risks, in a large globally-diversified investment portfolio.
			  • ESG data collection aligns our ability to prudently measure and monitor risks and returns. Once identified, ESG risk mitigation strategies can be implemented and proactive ESG transition strategies pursued, subject to statutory fiduciary obligations.

State Initiatives to Encourage Divestment from Fossil Fuel, Firearms and Ammunition Companies

State	Bill No.	Status	Summary
Connecticut	State Treasurer's "Responsible Gun Policy"	Announced 12/3/2019	• The State Treasurer's Responsible Gun Policy is a framework for guiding sound financial decisions and responsible corporate behavior on guns. In addition to encouraging companies to adopt safe gun practices, the Responsible Gun Policy informs and guides the State Treasurer's work related to investments, borrowing and banking transactions. The policy includes three core components: ◦ Divestment – Prohibits the investment of the state's pension funds in public securities of "civilian firearms manufacturing companies" with flexibility to invest in gun safe technologies. ◦ Disclosure – Requests banks and financial institutions that wish to work with the Office of the Treasurer to disclose their policies on guns. ◦ Decision-making – Weighs a financial institution's gun policy as one factor, among many, when the Office of the Treasurer contracts banking and financial services. This state policy prohibits investment of the state's pension funds in public securities of civilian firearms manufacturing companies.
Maine	H.P. 65 - L.D. 99	Signed by Governor 6/16/2021	• The State Treasurer and the Board of Trustees of the Maine Public Employees Retirement System may not invest the assets of any state pension or annuity fund in any stocks or other securities of any corporation or company within the fossil fuel industry or any subsidiary, affiliate or parent of any corporation or company among the 200 largest publicly traded fossil fuel companies, as established by carbon in the companies' proven oil, gas and coal reserves. • Moreover, the State Treasurer and the Board of Trustees of the Maine Public Employees Retirement System shall, in accordance with sound investment criteria and consistent with the board's fiduciary obligations, divest any such stocks or other securities whether they are owned directly or held through separate accounts or any commingled funds. Such divestment must be complete by January 1, 2026.
Massachusetts	H.43	Introduced 4/13/2021; Referred to the Committee on Public Service	• The bill requires public pension fund divestment from ammunition and firearms companies. The bill would stop the public fund, and the board of the public fund, from investing in any ammunition, firearm or firearm accessory manufacturing or retailing companies. • The public fund shall sell, redeem, divest or withdraw all applicable publicly-traded securities within 12 months of enactment. This requirement shall not apply to indirect holdings in actively managed investment funds; provided, however, that the public fund shall submit letters to the managers of any such investment funds that contain relevant companies, requesting that they remove such companies from the investment fund or create a similar actively managed fund with indirect holdings devoid of such companies.

State	Bill No.	Status	Summary
New Jersey	A.2196	Introduced on 1/14/2020, Referred to Assembly State and Local Government Committees	• The bill prohibits the Director of Investment from investing any assets of the State retirement funds in any of the top 200 companies that hold the largest carbon content fossil fuel reserves. • Under the bill, divestment from coal companies must be completed within two years, and from all other fossil fuel companies by January 1, 2022. The director may cease divestment or reinvest in previously divested companies if the director demonstrates that, as a direct result of the divestment, the funds have or will become equal to or less than 99.5% of the hypothetical value of all assets under the director’s management, assuming no divestment from any company occurred.
New York	New York State Pension Fund Sets 2040 Net Zero Carbon Emissions Target	Announced 12/9/2020	• On December 9, 2020, the New York State Comptroller announced that the New York State Common Retirement Fund adopted a goal to transition its portfolio to net zero greenhouse gas emissions by 2040. This process will include completion within four years of a review of investments in energy sector companies, using minimum standards to assess transition readiness and climate-related investment risk, with, where consistent with fiduciary duty (suggestion: will result in), divestment of companies that fail to meet minimum standards.

State Initiatives to Discourage Divestment from Fossil Fuel, Firearms and Ammunition Companies

State	Bill No.	Status	Summary
Alaska	N/A	Legislation to be Introduced	• On December 14, 2020, Governor Mike Dunleavy announced that his administration will introduce legislation that requires state departments and agencies to end existing relationships and partnerships with financial institutions that have chosen to stop financing oil and gas exploration and development in the Arctic.
North Dakota	S.B. 2291	Signed by Governor Burgum on 3/23/2021, and filed with the Secretary of State on 3/24/2021	• Except as otherwise provided in a state investment policy relating to the investment of the legacy fund and unless the state investment board can demonstrate a social investment would provide an equivalent or superior rate of return compared to a similar investment that is not a social investment and has a similar time horizon and risk, the state investment board may not invest state funds for the purpose of social investment. ◦ "Social investment" means the consideration of socially responsible criteria in the investment or commitment of public funds for the purpose of obtaining an effect other than a maximized return to the state. • Separately, the department of commerce shall study ESG as it pertains to a set of nonspecific, quantifiable, and nonquantifiable criteria with attributing factors used for making determinations, decisions, or investments as it pertains to government and private industry in North Dakota. The study must include an evaluation of investment policy as it relates to ESG and the level of involvement the state has with companies that use ESG in their ranking when making business or investment decisions. The study must also include the potential implications for the state as it relates to the boycott of energy or production agriculture commodities by companies that intend to penalize, inflict economic harm on, or limit commercial relations. All aspects of boycotts, including the transport, sale, utilization, production, or manufacturing of natural gas, oil, coal, petrochemicals, or production of agricultural commodities must be evaluated. The department of commerce shall report its findings and recommendations to the legislature by June 1, 2022.
Oklahoma	H.B. 2034	Engrossed on 3/10/2021; Referred to the General Government Committee and then to Appropriations Committee on 3/17/2021	• The bill declares that the oil and gas industry is a vital part of the Oklahoma economy, and those companies that do business by and through the state, in the interest of the state's economic policy, should not boycott the oil and gas industry. Accordingly, the bill prohibits state contracts with a company unless the company submits a written certification that it is not currently engaged in a boycott, in any manner, of the oil and gas industry that constitutes an integral part of business conducted or sought to be conducted with the state.
Texas	S.B. 13	Signed by Governor Abbott on 6/14/2021;	• S.B. 13 prohibits Texas state governmental entities from investing in financial companies that boycott energy companies. Specifically, it requires the Texas Comptroller to prepare and maintain a list of all financial companies that refuse to deal with, terminate business

State	Bill No.	Status	Summary
		Effective 9/1/2021	activities with, or otherwise take any action that is, solely or primarily, intended to penalize, inflict economic harm on, or limit commercial relations with a company because it engages in the exploration, production, utilization, transportation, sale, or manufacturing of fossil fuel-based energy and does not commit or pledge to meet environmental standards beyond applicable federal and state law. • This list is then to be provided to the state governmental entities that invest funds, who in turn send a letter to the listed companies informing them that they are to be subject to divestment if they do not stop boycotting energy companies within 90 days. If the company does not stop boycotting energy companies, the state governmental entity is required to sell, redeem, divest, or withdraw all publicly traded securities of the company unless the holdings are indirect holdings managed by investment funds or private equity funds. • A state governmental entity can cease divesting from one or more listed companies only if clear and convincing evidence shows that: (1) it has suffered or will suffer a loss in the hypothetical value of all assets under management by the state governmental entity as a result of having to divest from listed companies; or (2) an individual portfolio that uses a benchmark-aware strategy would be subject to an aggregate expected deviation from its benchmark as a result of having to divest from listed companies. • S.B. 13 further provides that a state governmental entity may not enter into a contract with a company for goods or services unless the contract contains written verification from the company that it does not boycott energy companies and will not boycott energy companies during the term of the contract. This provision only applies to a company with 10 or more full-time employees and that has a contract value of $100,000 or more. • "State governmental entity" means the Employees Retirement System of Texas, including a retirement system administered by that system; the Teacher Retirement System of Texas; the Texas Municipal Retirement System; the Texas County and District Retirement System; the Texas Emergency Services Retirement System; and the permanent school fund.
Texas	S.B. 19	Signed by Governor Abbott on 6/14/2021; Effective 9/1/2021	• With certain limited exemptions, S.B. 19 amends the Government Code to prohibit a state agency or political subdivision from entering into a contract paid partly or wholly from public funds with a company for the purchase of goods or services unless the contract contains a written verification from the company that: (i) it does not have a practice, policy, guidance, or directive that discriminates against a firearm entity or firearm trade association based solely on the entity's or association's status as such; and (ii) it will not engage in any such discrimination during the contract term. That prohibition applies only to a contract between a state agency or

State	Bill No.	Status	Summary
			political subdivision and a company with at least 10 full-time employees that has a value of at least $100,000. • S.B. 19 defines, among other terms, "discriminate against a firearm entity or firearm trade association" as any of the following actions with respect to the entity or association based solely on its status as a firearm entity or firearm trade association: (i) refusing to engage in the trade of any goods or services; (ii) refraining from continuing an existing business relationship; (iii) terminating an existing business relationship.