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PODCAST TRANSCRIPT

TREACHEROUS SHOALS—NAVIGATING GROWING ANTI-ESG SENTIMENT
RECENT DEVELOPMENTS IMPACTING ASSET MANAGERS


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Michael Littenberg: Welcome to this Ropes & Gray podcast. I'm Michael Littenberg—I'm a partner in the New York office of Ropes & Gray, and I'm global head of our ESG, CSR and Business and Human Rights practice. Our topic for today is "navigating anti-ESG sentiment." Over the last year-plus, we've seen a growing anti-ESG movement, which has been widely covered in the press. Also, as reported, most of the focus has been on asset managers. As the leading asset management practice, Ropes & Gray has been in the trenches advising clients on these issues on a daily basis. I'm joined today by several of my partners who've been leading those engagements—all of them are recognized thought leaders in this space. Among other things, they're advising managers on navigating fiduciary duty, antitrust and consumer protection, proxy voting, state law, and ERISA considerations.

With 20/20 hindsight, last year turned out to really just be minor skirmishing. This year, more than 250 ESG and anti-ESG bills have been introduced in state legislatures, with some of those bills now passing. "Red state" attorneys general have been especially active, with the pace of activity picking up over the last two months. Among other things, red state AGs have issued open letters to asset managers, sent civil subpoenas to managers, and filed motions with federal agencies seeking to limit asset managers' ability to invest in utilities.

Staying with the states, in the last few weeks, we've also seen a new "boycott" list issued and a breach of fiduciary duty suit brought against a group of public pension funds.

At the federal level, we've seen the first in what is likely to be a series of House ESG hearings, as well as efforts to overturn the Department of Labor's ESG rule, and those efforts are still ongoing.

In today's discussion, we're going to unpack many of these and also other recent and ongoing developments. We'll also provide practical compliance tips for asset managers, and we'll share our thoughts on the direction of travel for the remainder of this year and beyond.

FIDUCIARY DUTIES

Michael Littenberg: Rob, I'd like to start with you. One of the principal areas of disagreement, it seems, between the red and the blue states is whether ESG is consistent with a manager's exercise of fiduciary duties—in other words, a question of "value versus values." So, how are the red states framing their position?

Rob Skinner: In a nutshell, the red state officials argue that an asset manager's core fiduciary duty of loyalty to its clients requires that the manager's sole purpose is to maximize financial returns for clients and that ESG investing necessarily violates that duty because ESG furthers a social or political agenda at the expense of financial returns. The red state theory simply rejects out of hand a core premise of ESG investing—that is, that ESG-related considerations (such as climate change) present both risks and opportunities that can be material to companies' financial performance. The red states apply this theory not only to second-guess securities' selection decisions but also manager activities such as engagement with portfolio companies and proxy voting on shareholder proposals and directors. Indeed, the red state officials go so far as to say that any consideration of ESG-related factors is evidence of so-called "mixed motives"—meaning not solely focused on financial returns—amounting to a breach of fiduciary duty.

Now, of course, there are ESG-focused products in the market that do affirmatively screen out certain types of investments (such as oil and gas companies) to meet investor demand for that approach. But the much larger use of ESG investing is the integration of ESG considerations into standard products pursuing the same financial returns they always have—a fact the red states simply refuse to acknowledge. In the most recent iterations of these theories, we see the red state officials focusing heavily on asset managers' membership in climate-related industry initiatives such as Climate Action 100+ and Net Zero Asset Manager (NZAM) initiative and assuming that such membership is basically per se evidence of what they call "mixed motives." In recent weeks, we have seen this theory spun out in several different forms, with a particular emphasis on the 2023 proxy voting season.

- First, we saw a March 30 letter from 21 state attorneys general to a large group of asset managers detailing these theories of supposed liability.
- Second, we saw a May 15 information request from 18 state treasurers to a group of large asset managers asking detailed questions about engagement in proxy voting practices.
- Third, there was a May U.S. House hearing on ESG where the GOP-led committee provided red state attorneys general a platform to explain their anti-ESG legal theories.
- And, fourth, we saw a series of identical CIDs being issued over the last couple of weeks by several red state attorneys general to a broad cross-section of managers demanding documents regarding their proxy voting on ESG-related shareholder proposals and membership in climate-related initiatives.

Michael Littenberg: You noted some of the climate initiatives that managers are participants in that Republican AGs have pointed to as examples of breach of fiduciary duties. For managers, is it as simple as not participating in those initiatives, and then they're out of the crosshairs?

Rob Skinner: It's not quite that simple. On the one hand, yes, we have seen at least one fund advisor that seems to have received somewhat more favorable treatment from red state investigators after withdrawing from a climate initiative. But we can't really see withdrawal as a panacea, at least at this point, since it's clear that the red state focus is on more than just membership in such initiatives. For example, the red states drill into specific proxy voting decisions on high-profile ESG-related shareholder proposals, pressing asset managers to explain how their votes are in furtherance of financial returns. These questions don't go away if the manager simply withdraws from a given initiative. Instead, managers will need to look at their full range of their practices, their disclosures about their practices, their ESG-related commitments, and carefully consider both their practices and their narrative about those practices in their totality. For example, do they clearly distinguish between ESG-focused products and their ESG integration practices in non-ESG-focused strategies? This is a key distinction that has not always been expressly defined in industry disclosures.

Michael Littenberg: Besides climate change, what are some of the other ESG factors that red state AGs are alleging are not consistent with fiduciary duties?

Rob Skinner: For one, red state officials are also very focused on DEI initiatives based on their assumed premise that diversity and inclusion—whether in the workforce or in the boardroom—has nothing to do with furthering financial performance. Therefore, shareholder proposals calling for things such as diversity and inclusion audits at companies are a point of great focus for the red states. Second, in the wake of the Supreme Court's Dobbs decision, we are seeing a lot of red state focus on shareholder proposals pressing companies to ensure reproductive health coverage and abortion access for employees, challenging whether the support of such initiatives furthers the financial returns of the companies at issue. Asset managers need to understand that their proxy voting on these hot-button topics is potentially subject to scrutiny in this heightened political environment, where the culture wars have spilled over into Wall Street in a way that we really haven't seen before.

Michael Littenberg: Amy, what about the blue states? How are they framing their position?

Amy Roy: On the other end of the spectrum, although blue state attorneys general have not yet launched their own investigations, we have started to hear more from various blue state regulatory actors stating their vehement defense of asset managers using ESG as an important tool for assessing risk and making informed investment decisions. One example is, late last year, we saw the New York Comptroller's response to certain of the red state assertions that Rob just articulated, where he suggested that asset managers have an affirmative obligation to pressure portfolio companies into moving to net-zero emissions—the idea being that having identified ESG-related considerations as being potentially material to a fund's performance or risk-adjusted returns—that it may be a breach of fiduciary duty to now retreat from investing in the that manner out of concern for anti-ESG client or regulatory backlash.

More recently, at the House Oversight Committee hearing that Rob alluded to, we heard Democratic lawmakers defending the consideration of ESG factors as providing critical data points for assessing investment risks and arguing that long-term fiduciaries should be able to consider them, especially when managing assets such as public pensions. At this hearing, Illinois's treasurer testified and explained how when investing portfolios such as public pension assets, the time horizon of the investments is long, and, as a result, an asset manager's consideration of the ESG factors (like climate risk) is frankly more relevant to a risk assessment. The treasurer argued that the anti-ESG effort by red state regulators is simply an attack on the investment profession to restrict investors' freedom to exercise their professional discretion and fiduciary duty and stated that "to ask investment professionals to ignore material risks in investment opportunities is asking them to stop doing their jobs."

Michael Littenberg: As I noted in my opening remarks, recently, in the last couple of weeks, certain New York City pension funds were sued for breach of fiduciary duty. What's been alleged there?

Amy Roy: Yes, that's right, Michael. On May 11, three New York City pension plans were sued for allegedly breaching their fiduciary duties when the trustees of retirement plans back in 2021 determined to divest roughly $4 billion in fossil fuel investments from the portfolios. The suit was filed by individual participants in the three plans as well as by a national trade organization. According to the complaint, the three retirement plans violated their obligations to plan participants when they divested from fossil fuels in order "to advance environmental goals unrelated to the financial health of the plans," alleging those investment decisions were made without regard to whether those assets would actually produce a superior return for the plans.

Michael Littenberg: That suit involves pension funds. Do we think ESG-related breach of fiduciary duty suits against other managers are coming—in other words, involving non-pension-fund assets?

Amy Roy: It's always hard to say, but given the high level of state regulatory activity we've been seeing, especially in just the past few weeks, from various state attorneys' general offices, I don't think we'd be terribly surprised to see certain of those offices ultimately pursue litigation against an asset manager (or more) ostensibly on behalf of pension plan participants. I would anticipate any such litigation to assert theories along the lines that we saw alluded to in the March letter that Rob discussed earlier, but, at the end of the day, we do think that such litigation would suffer from the same pitfalls that we think the New York Pension Plan participants face in their lawsuit. Mainly, that is, once you strip away the politics here and focus on the law governing fiduciary duties and the facts about ESG investing practices—and climate-based risks, in particular—it simply does not back up the plaintiffs' legal theories. Fiduciaries are held to high legal standards of loyalty and prudence, to be sure, but they are also granted broad discretion in making investment decisions with the law emphasizing the importance of a reasoned and transparent decision-making process consistent with plan documents. These legal theories would require any court to simply ignore the actual process that boards and professional asset managers are undertaking in making those investment decisions and instead assume that any given investment decision or proxy vote cast was made solely to have a positive impact on climate change, for example.

Michael Littenberg: In anticipation of these claims, Amy, what, if anything, should managers consider doing now?

Amy Roy: I would continue to focus on disclosures about ESG and taking any steps necessary to ensure those disclosures are appropriately measured. Specifically, to the extent that ESG factors do account for some part of your investment process—because managers do believe that such considerations can be material to the potential risks and opportunities available to funds—make sure you're being clear and express about those considerations. Try avoiding talking about ESG investing in the same context and breath as talking about "improving climate change" or "enhancing DEI efforts"—the narrative really does need to focus, when it comes to ESG investing, on the pursuit of financial returns. With respect to memberships and organizations like Climate Action 100+ or NZAM, I think it's helpful to make clear that as an investment manager, you do retain independence and discretion in making the investment decisions that you make and that you do so, at all times, in a manner consistent with fiduciary duties to enhance pecuniary returns for investors. To the extent that you have carve-outs and only specified levels of AUM intended to meet any net-zero targets, be clear about those carve-outs and targets.

ANTITRUST

Michael Littenberg: Thanks, Amy. I want to shift gears now a little bit and talk about antitrust. Fiduciary duties are just one part of the debate. Republican state AGs have also been alleging that some managers are violating the antitrust laws. Chong, what's being alleged?

Chong Park: Basically, the Republican state AGs are alleging an anti-competitive conspiracy and collusion. And that such anti-competitive activity harms fossil fuel and energy companies. Now, the claims are fairly general in nature but basically focus on concerns that these kinds of companies are being harmed and that somewhere—down the line—consumers will face higher energy costs as well.

Michael Littenberg: The debate over ESG and antitrust has gone well beyond writing open letters. Over the last year, red state AGs have issued numerous antitrust-focused civil subpoenas, also known as Civil Investigative Demands (or CIDs). Significantly, we've seen the pace of CIDs accelerating. What's transpired just over the last month or so?

Chong Park: Basically, more CIDs. As Rob mentioned early in the podcast, we've seen a real uptick in activity. It appears that the state AGs from the Republican states are handing out subpoenas and CIDs like Halloween candy now. And the CIDs are coming from different state AG offices. We're seeing states like Louisiana, Montana, Alabama, and Tennessee joining the fray. There also appears to be clear coordination. Our understanding is that the requests for documents and information set forth in these various CIDs and subpoenas are identical.

Michael Littenberg: Samer, you and Chong, along with Rob and Amy, have been advising numerous leading managers on their CID responses. Other than calling Ropes & Gray, what are we advising managers to do when one of these CIDs arrives?

Samer Musallam: Yes, it's crucial for managers to approach any CID with the utmost seriousness and prepare a thoughtful response. Ignoring a CID can have severe consequences, including civil penalties, reputational harm, and even the risk of being blacklisted by the state. So, what are we advising?

- The first step is to get out a document preservation notice and temporarily suspend routine document retention policies for information that could be deemed responsive. This ensures compliance with preservation obligations.
- Second, besides identifying custodians and sources for responsive information, it's important to assess the managers' connections and assets in the state from which the CID is issued. This helps identify the scope of relevant information, and, interestingly, an absence of context might even provide grounds to challenge the CID based on lack of personal jurisdiction.

- The third step is thinking through the strategy. Each manager's situation is unique and objectives different, so it's crucial to understand the individual facts and circumstances—and, by doing so, we can develop a tailored response strategy. But regardless of the legal theories or motivations behind the CID, it's wise to cooperate with the state AG's office and avoid becoming the manager they want to make an example of.

Early engagement with the state AG's office is key. This allows for clarifying and potentially narrowing the scope of the request, understanding the AG's level of commitment to the CID, and establishing a positive rapport with the staff from the start.

Michael Littenberg: We've been talking about the states. How do the Feds think about ESG in the antitrust context? Is that also a risk for managers?

Chong Park: Like any competitor or potential competitor collaboration, any ESG engagement may be an antitrust risk. But, as a practical matter, I think it's less of a risk at the federal level right now than at the state level. Last year, at a Senate hearing, the heads of both antitrust agencies, Jonathan Kanter at the DOJ and Lina Khan at the FTC, testified that ESG is not a magic wand that grants antitrust immunity; and they basically reaffirmed that traditional antitrust principles will apply. So, unlike the Republican state AGs' efforts, right now, there is no considered effort by the federal antitrust agencies to scrutinize or focus on ESG activities.

Michael Littenberg: As we've talked about, managers are receiving a lot of CIDs now—and I don't want to downplay that—but is the red state AG focus on antitrust also having any impact on market practice?

Samer Musallam: Absolutely. We're witnessing a tangible impact on market practices because of the red state AGs' emphasis on antitrust matters. One notable example is the effect on the UN's Net-Zero Insurance Alliance (NZIA), which has seen several global insurers withdraw due to concerns over antitrust issues and the resulting backlash from the state attorneys generals. For instance, we've witnessed significant departures, including AXA, whose group chief risk officer was chairing the alliance. Of the eight original signatories to the NZIA, only three remain. This trend showcases how the increased scrutiny and pressure from red state AGs has compelled insurers to reassess their participation in many of these initiatives.

Michael Littenberg: Chong and Samer, to mitigate the antitrust risks we've been discussing, are there any preventive measures managers should consider? Samer, we'll start with you on this question.

Samer Musallam: Definitely. There are several preventive measures that managers should take. Given that the primary antitrust risk is whether there are "agreements" among competitors to coordinate activity and share sensitive information, establishing a robust antitrust compliance policy is crucial. This policy should clearly outline rules and guidance for participation in climate-related organizations, including (i) ensuring that the manager's decision to entertain any ESG initiative is made unilaterally, without regard to competitors' or peers' actions, (ii) that the policy has clear guidance for communications with peer managers and (iii) clear guardrails for the handling of competitively sensitive information. Equally important is ensuring that managers are well-trained on these policies and best practices. So, by providing comprehensive training, managers can effectively navigate potential antitrust pitfalls and proactively mitigate against antitrust risk.

Chong Park: While it might sound self-serving, this is an area where it is really critical to have appropriate antitrust counsel—whether it's in-house counsel or outside counsel—and have that guidance to appropriately manage the risk. Whether it's training, review of relevant business documents, or prior consideration of engagement and collaboration activities, obtaining good guidance is really important and will help managers avoid pitfalls.

PROXY ADVISORS

Michael Littenberg: The red states also have been increasingly vocal in criticizing proxy advisors and their use by managers. Here, the red states have been asserting both fiduciary duty and antitrust concerns. Turning first to the fiduciary duties, Rob, what's being alleged?

Rob Skinner: The theory here is really an extension of the argument leveled against the asset managers. As articulated by the Republican attorneys general, just as asset managers cannot exercise their proxy votes with so-called “mixed motives” that elevate social and political concerns over financial returns, they equally cannot delegate those decisions to proxy advisors with the same supposed agenda. Now, just as the theory is the same, so, too, is the underlying flawed premise the same—that is, that consideration of ESG factors is necessarily divorced from long-term financial performance. The red states may say it loudly and repeatedly, but that just doesn’t make it so, no matter the setting.

Michael Littenberg: Samer, and the antitrust allegations?

Samer Musallam: The focus here has been primarily on the two largest players in the field: ISS and Glass Lewis. The red state AGs assert that these two companies basically operate as a duopoly, hold significant “market power,” and exert influence over investment funds’ voting decisions. The investigations initiated by the red state AGs aim to examine whether ISS and Glass Lewis are coordinating with climate and sustainability organizations and their members to advocate for and align actions with climate change goals. So, while the antitrust allegations against proxy advisors are not as explicit as those made against banks and asset managers, the focus remains on investigating potential coordination and market influence that may impact investment decisions and the broader market.

STATE LEGISLATION

Michael Littenberg: We’re going to switch gears a bit again. Thus far in today’s conversation, we’ve been focused on enforcement and litigation. For many managers, though, I think, the more immediate focus is just navigating the staggering amount of state anti-ESG legislation that’s been proposed in 2023. I want to bring our colleague Josh Lichtenstein into the conversation—he’s been chomping at the bit for a while now. In addition to spending a tremendous amount of time advising on state-level ESG-related legislation, Josh is also the architect of our award-winning interactive online state ESG legislation tracker. Josh, so what does the current crop of state anti-ESG bills provide for?

Josh Lichtenstein: Yes, I think that “staggering” is exactly the right word, Michael. We’ve been seeing an enormous amount of legislation introduced this year, and we’ve seen it both from states that haven’t already passed any laws restricting the ability to use ESG in investing, and we’ve also seen it coming from states that already have laws in place or other rules in place and that are moving on to their second or even third iterations of the anti-ESG rulemaking process. Broadly speaking, there are two categories of laws that we’re seeing. The first are what I like to call the “anti-boycotter boycotting laws,” where we have a state that is designating certain industries as basically protected industries, like the fossil fuels industry or the firearms industry. We see the state go through a pretty involved process where they do outreach to asset managers and request information, they review publicly available data of various different types, and then, through a combination of the information that they gather from the managers and the information that they’re able to access, they make determinations about which asset managers or financial institutions they believe to be boycotting those protected industries, and then, they publish a list of those banned asset managers and financial institutions. Then, once you’re on that list, the institution will be restricted from contracting with the state, and it will also be restricted from being able to manage retirement assets. The state plans will generally be required to divest of any holdings that they have of public securities of those asset managers or funds. Now, I’ve seen two different types of “boycott” lists. Most of the “boycott” lists we’ve seen are of specific financial institutions, but we’ve also seen states have lists that include—separate and apart from the institutions that are deemed to be boycotting these industries—funds that are also specifically targeted for divestment or for restriction from investment by the state plans, and, in some cases, those lists of funds can actually be very broad and can extend more broadly than just the universe of managers that get put on the “boycotting” list.

The second category of laws are really focused more on the use of ESG or other collateral considerations as part of the investment process. There’s a lot less process that goes into these rules because instead of the state coming out with a list of specific practices they don’t want to see or a list of specific investments that they don’t want to see made, what they’re really doing is just putting a broad framework in place—an idea that the state’s pension assets can’t be invested considering or in furtherance of ESG goals or imposing specific requirements that the assets only be invested based on pecuniary factors, which means “material financial considerations.” Managers are really left to read between the lines to figure out exactly what the states mean both by "ESG" and by "pecuniary factors" because there just isn't a lot of specificity, either in the definitions or otherwise. While there's a sense in which the second category of laws might seem less troubling—because for the boycotting laws, if you're put on the list, you're just on the list, and you know you can't do any business with the state anymore—the second category isn't restricting asset managers wholesale from doing any type of business. The real challenge is that, given the murkiness of these definitions, basically almost everything or anything could potentially fall within the scope. I mention the term "pecuniary factors"—it's a term that we're seeing utilized in a lot of these laws, and I'll talk about that a little bit more in a bit—but the term "pecuniary factors" is itself a loaded term that was introduced into the lexicon by the Trump Administration's Department of Labor. At that time, they were regulating private pension plans and 401(k) plans, not the state-run plans. This term "pecuniary factors," although it might seem somewhat innocuous on its face, it's been interpreted within the industry as being very restrictive and skeptical of the idea that ESG factors can really often be material economic factors.

Now, I would also note that both categories of legislation are covered by some model legislation, including from the Heritage Foundation. Some of the proposed laws that we've seen have virtually copied the models word for word—others have been different variations on the themes that are presented by the models. I mention the models more than anything because I think that it helps to highlight that, as has been described by others already, there really is a lot of concerted action among the red states in this area. And so, the same way that we're seeing state attorneys general acting in concert or state treasurers acting in concert, we are also seeing state legislatures basically acting in concert and adopting very similar versions of the same types of rules.

Michael Littenberg: Thanks, Josh. Sticking specifically with some of the 2023 bills, some of those have already passed or passage is imminent. With respect to the 2023 bills, which states should managers be especially focused on of the 40-plus states that have introduced legislation this term?

Josh Lichtenstein: It's a great question, Michael. I think it's going to differ from manager to manager. I think that even though some of the laws have grabbed more attention and more headlines, it's really going to be most important for an individual asset manager to consider exactly where their investors are and to make sure that they're looking at individual state rules and trends. One thing that I always like to flag is that even if you're investing the assets of a state that may seem like it's flying under the radar a little bit more on this topic—maybe they haven't introduced as much legislation or maybe they haven't passed legislation—you could still see that state plan coming to you for additional information requests or representations about the use of ESG. So, I think it's important not just to be tracking legislation but to also be looking at those state AG actions and other group actions that were being discussed earlier. I'd like to point to Oklahoma and Florida at this current moment in time. I point to Oklahoma largely because it's the most recent example of a state having issued a banned list, and it was a broader banned list than we've seen in other places in a number of ways. And I mention Florida because Florida is on now what I would call its "third iteration of anti-ESG rules"—the first one that's legislative, but they've been restricting for over a year now in different ways. Florida obviously has a very vocal governor who talks a lot about these topics, and there are some unique requirements around shareholder engagement which can be a bit challenging. But I really think it's important to keep a broad perspective and really be looking at what states your current investors or prospective investors are in and keeping close watch on exactly what's developing there.

Michael Littenberg: Josh, you noted the Florida legislation, colloquially referred to as "HB-3," which we previously wrote about in a client alert. How does HB-3 compare to some of the other legislation that's been proposed or adopted? It's not based on the model statute, right?

Josh Lichtenstein: Yes, that's right. I would put it in the second category I was describing before of anti-ESG investment, but it's a very broad anti-ESG-investment considerations law. Like I said before, this isn't the first time that we're seeing Florida taking this anti-ESG investment approach, but through this legislation, they've extended it to all of their state pension plans. Previously, they had covered the largest of their plans and they'd also covered certain supplemental plans, but now, the new development with the new law is that all of the state pension plans are subject to these restrictions. We're also seeing Florida actively seeking compliance representations from its managers either in side letters or otherwise—and we're seeing this from other states as well, but we're seeing it more from Florida than we are from any other state. You don't really have a lot of ability to push back when they request this language, because in their view, they need certifications or assurances that you're not going to invest their assets in violation of their law. The challenge is this is basically amounting to risk-shifting from the state pension board to the managers. Put another way, the state pension board wants to invest the way they want to invest, and we have not seen, thus far, changes in the way that they're actually allocating their assets. But they want to have cover, I think, to be able to show that they've determined that the funds they're investing with are not going to be investing their assets for the purposes of advancing any non-pecuniary goals. And so, this really amounts to, if you want to manage the Florida money, you have to take on extra risk that if the Florida State AG or someone else ever believes that you are managing the assets in a manner that shifts too far in supporting ESG-type goals, the liability will be shifted really from the state board that selected your fund to you as the manager.

Now, the bill also requires investment managers that are investing public funds on behalf of any Florida state or local government entity to follow the new stickering requirement which requires that in any written communication they have with an issuer that the investment manager has invested the Florida State assets in, they need to include this express disclaimer that says, "The views and opinions expressed in this communication are those of the sender, and do not necessarily reflect the view and opinions of the people of the State of Florida." You have to include that on any written communication with an issuer that's discussing (i) social, political, or ideological interests; (ii) if you are subordinating the interests of the company's shareholders to the interests of another entity; or (iii) if you're advocating for an entity other than the company's shareholders. Now, those second two categories are probably null sets because I don't think that asset managers are generally going to say that they are suggesting that a company they've invested in should "subordinate the interests of the shareholders" to others or should be "advocating for the interests" of people other than the shareholders, but that first category of "discussing social, political, and ideological interests" is extremely broad. Given the lack of any sort of clear guidance on what Florida means by that, there might be a knee-jerk reaction to think, "You should just put the stickering on every communication you have, just in case the communication is deemed to discuss social, political, or ideological interests."

The challenge there, I think, is that if you are representing to the state that you are managing its assets not based on advancing ESG-type goals but just based on pecuniary factors and advancing the financial interests of the plan, but then the record shows that every time you engage with any of the companies you've invested in, you're ostensibly talking about "social, political, or ideological interests," I think that it undercuts the argument that you really are investing the assets just based on what's in the economic interests of the plan participants. So, I think it's important to be really nuanced and careful about when the stickering is applied. These Florida investors will actually have the unilateral right to terminate their contract with you if you fail to include the required disclaimers, so it's really challenging. You need to include the disclaimers—if you don't, then you're basically giving the plans a rescission right. But if you overuse the disclaimers, then I think there's a real risk that you create the appearance that you have violated representations about investing the assets just in the interests of the plan.

Michael Littenberg: We'll move away from Florida. We'll move halfway across the country—you mentioned Oklahoma before. In the last few weeks, Oklahoma issued a "boycott" list joining three other states that had previously issued "boycott" lists. What's the basis for these lists, and how are the states deciding which managers and funds to put on those lists?

Josh Lichtenstein: Yes, that's right, Michael. Oklahoma went through a boycott process—like some other states, including Texas and Kentucky—and, like I was saying before, the process is pretty robust. We know the most about the Texas process because there have been some helpful FAQs that have been issued in Texas, and there have been a few iterations of those FAQs. Basically, we understand that the process is a combination of looking at different memberships in different organizations that managers sign up to, net-zero commitments managers make and certain comparative data on the way that they're investing, but also, a lot of it comes down to specifically requesting information from the managers (the managers have to fill out questionnaires). In some cases, they may be indicating that certain of the questions aren't applicable to them due to the status of their company. In other cases, they'll have to include substantive responses. Then, the states are taking all of that data from a very large number of asset managers, and, in each case, they've come back with a pretty small list of managers which have been put on the "boycott" list. No one knows exactly what's happening behind closed doors to get to those lists, but there is definitely a sense that the lists skew non-U.S.-heavy and that, in many cases, the lists also tend to skew towards managers that the states may have some level of relationship with but, generally, with the exception of one or two high-profile names, probably not some of the biggest relationships that they have. The biggest surprise for Oklahoma was the number of banned managers that aren't public companies, and that's a stark difference from others. These rules are really written in a way that you expect publicly traded managers to wind up on the "boycott" list, and, in fact, the common response to these questions by managers is that, "You're not publicly traded so you are not in scope." And so, that was really surprising.

Shifting away from Oklahoma for a minute, I also think that it's worth highlighting what happened in Kentucky. Kentucky published a banned list, but—and this has been unique to them so far—the pension board for the state actually refused to divest from the managers put on the banned list because they expressed concerns over the ability to actually adequately discharge their fiduciary duties if they just divested from all those managers. This is striking in that we have one state instrumentality publicly rejecting a new requirement of an enacted state law, but it's actually less surprising than you might think because the fiduciaries to these plans go through a very extensive process to select and vet the asset managers that they're going to hire in order to construct a properly diversified portfolio. These are very large pension plans—they do a lot of work to select and also to monitor those asset managers on an ongoing basis. And so, it isn't so easy to just move these large amounts of money away from managers without having a very long lead time to be able to go through that same attentive process in selecting who's appropriate to manage the assets following a divestment.

I'd also like to flag that Texas—which was the first state with a banned list—has indicated to at least one pension board that it actually expects the state plans to attempt to divest not just from open-ended funds that are easy to sell out of, but also from closed-ended funds (like private equity funds) where they're sponsored by one of the managers on the banned list. That was a surprising result to me—I would have thought, at first blush, that the states would grant exceptions to the banned lists in circumstances where it's really difficult for the state plan to change course on a particular fund or where they might have to actually really lose money or sell at a discount in order to get out of it. But, at least in Texas, in at least one case, that wasn't the answer—they urged the pension board for that particular plan to really consider whatever options it has to move away from the banned manager.

Michael Littenberg: One final topic that I want to briefly explore with you is some of the blue state bills. There's been a lot of discussion in the media on all the red state bills, and, I think, frankly, those are probably more fun to talk and read about. We've noted there are 250-plus bills that have been introduced in state houses this year, in 40-plus states. Obviously, a lot of the states are not red states. Some are blue states. For the audience, could you provide a little bit of an overview of some of the types of blue state bills that we've seen this term?

Josh Lichtenstein: Yes, like you said, the blue states have been a lot less active this year, and that mirrors trends from past years. I think that part of that is because, like Amy was discussing earlier, it's kind of harder for the blue states because what they generally are pushing is for a reasonable middle ground of wanting freedom to invest for their state pension plans—generally, they're not pushing for "pro-ESG" investing. Now, that said, we have seen states consider or, in some cases, adopt divestment requirements requiring their state pension plans over a certain time horizon to divest from their holdings of fossil fuel companies or to divest from their holdings of firearms companies—that's mostly what we've seen, but there has been some actual pro-ESG activity, as well.

A good example of a very current development is in Illinois. Illinois currently has in place a preference for hiring ESG managers, all things being equal, for their state pension plans. It's expected that they'll imminently sign a law that will require reporting on ESG considerations from all managers that are managing the state pension plans' money. So, Illinois stands out as a bit of a leader in this space, but the broad trend, I would say, is that while the red states are demanding a pullback or a rejection of the consideration of ESG factors as part of their investment processes or are trying to use their pension plans in a way that they're trying to ensure protects the fossil fuels industries by continued investment in them, blue states are mostly just trying to maintain the status quo of the world before all of this started and just leave their investment professionals with the freedom to invest as they see fit.

GREENWASHING AND CONSUMER PROTECTION CLAIMS

Michael Littenberg: Thanks, Josh. Another area of concern for managers that's part of the current debate over ESG is greenwashing and consumer protection claims. Amy, what are the likely greenwashing claims and which direction do we think those are going to be coming from?

Amy Roy: It's no secret that the SEC, in particular, has been laser-focused on whether advisers are engaged in so-called "greenwashing" in the way they're talking about their ESG capabilities. Unlike the red states or blue states, the SEC isn't focused on whether ESG is being pursued or not, but what the SEC cares about is ensuring that asset managers aren't overstating the degree to which ESG factors may or may not be incorporated into the investment process of any given fund in a way that's misleading or potentially misleading to prospective or current investors. Specifically, last year, we saw two enforcement actions by the SEC against asset managers in May and November of last year alleging violations of the Investment Advisors Act relating to ESG disclosures in the first instance, and then policies and procedures in the second action. The first action that we saw, in May, resulting in a settlement order, was the first ESG fund disclosure enforcement action that we'd seen in over a decade. That case involved alleged materially misleading statements and, notably, in a non-ESG-focused fund's prospectus, about the extent to which ESG ratings were applied to holdings in the fund, while the second SEC settlement order—which came with a $4 million penalty as compared to the lower $1 million penalty in the first action—involved allegations of policy and procedure failures rather than allegations of materially misleading statements. Specifically, there, the SEC alleged that after converting certain funds to ESG funds, which a number of managers are doing today, the adviser failed to have adequate procedures in place to ensure compliance with certain ESG claims and representations that had been made to investors and the fund board in that case. The SEC claimed that even once those procedures were adopted, the adviser failed to consistently follow them. So, we've seen those two actions; we know there are others in the background, other investigations being pursued, using a similar framework and roadmap. Finally, I'd note, although we haven't seen anything yet, where the SEC shows focus and attention, the civil plaintiffs bar is often not too far behind.

Michael Littenberg: Chong, what about the consumer protection claims?

Chong Park: Michael, there's definitely more activity on the consumer protection front—and likely more to come—and that's because, as a general rule, consumer protection statutes in whatever state you're in are quite broad and elastic. They generally prohibit "unfair, deceptive, or misleading representations." The recent open letter to asset managers in the Spring from the 21 Republican attorneys general have now placed some emphasis on potential consumer protection theories. Specifically, they focused on whether or not the asset management firms were adequately disclosing the fact that investors were potentially funding "ESG activism." Also, the letter suggested that, potentially, managers were not adequately disclosing or explaining the downside of ESG funds, which, they claimed, were performing poorer. Interestingly, several of the recent Republican state AG CIDs and subpoenas appear to originate from their respective consumer protection bureaus. But the activity may not just come from the so-called red states, as there are potential claims and scrutiny, that may be coming from the blue states. Consistent with what Amy had just described with respect to greenwashing and scrutiny from the SEC—that same scrutiny, in parallel, may come from the blue states that may examine whether or not asset managers are actually doing what they say with respect to consideration of ESG factors. In addition, the blue states may be taking a look at whether or not, given the current climate, asset managers are walking back from their promises and not doing what they said they would be doing with respect to ESG. And so, this situation, with respect to consumer protection claims—and in fact the ESG debate in general—reminds me of the Greek myth of Odysseus trying to navigate between the two sea monsters, Scylla and Charybdis—but here, you have the red monster on one side and the blue monster on the other. And so, I think it's clear that folks have to be very careful in terms of making sure that the representations and disclosures they make are both accurate and fulsome.

Michael Littenberg: Thanks, Chong. I always like to have Chong on these panels, not only because he has such great things to say, but he also brings mythology and other symbolism in, so he makes it fun for everybody. With the anticipated increase in disclosure-based claims at the state and federal level, Amy and Samer, what tips do you both have for managers to mitigate these risks? Amy, let's start with you.

Amy Roy: Sure. At a high level, I guess one thing we're helping a number of clients with is reviewing their ESG policies and procedures that they have in place and their related internal and external disclosures and cross-checking with the legal, compliance, investment management professionals, marketing teams, and the ESG teams to make sure that everyone knows what the other is doing and saying, to make sure that those disclosures are supportable and accurate. It's fair to say everybody wants their disclosures to be accurate, but the pitfall comes when there's not adequate collaboration across a given firm, and so, we've been helping our clients take an inventory of what those disclosures and activities look like. For example, it's important to ensure that disclosures and marketing materials reflect the reality of co-existing ESG product types—from ESG-focused funds, impact funds, and regular funds that are just ESG-integrated—and making sure that there are adequate procedures and policies in place.

Samer Musallam: I'll emphasize and follow up on both Chong's and Amy's points, although maybe without reference to Greek mythology. Be clear in your disclosures—if and how ESG factors weigh into your decision-making processes and how this ultimately impacts financial returns. So, in other words, while overrepresenting the influence of ESG factors in investment decisions may result in greenwashing claims, underrepresenting the influence of ESG factors in investment disclosures may be considered misleading or deceptive under consumer protection law.

DEPARTMENT OF LABOR (DOL) RULE

Michael Littenberg: Josh, I want to come back to you for one additional topic. There have been efforts to overturn the Department of Labor's ERISA ESG rule. That's in the category of things we'd be remiss in not talking about today. To start with and to set the stage briefly, what does the current rule provide for?

Josh Lichtenstein: Yes, I agree we need to talk about the DOL while we're talking about the states because I think there's a very real sense in which there's a national fight on this topic, and the DOL is the more vocal proponent of freedom to invest, with the red states seeking limits, like we were discussing before. That said, the current DOL rule is really defined by its neutrality, not by a preference for or against any category of investment considerations, including ESG. Under the current rule, fiduciaries are free to consider any factors they believe are appropriate for investment purposes as long as they aren't subordinating the interests of the plan participants to any other interests. This is probably, really, the clearest statement of the DOL's long-held policy, going back decades, with the exception of the blip in this guidance that we saw under the Trump Administration. Although the Department of Labor has changed guidance in this topic a lot over the years, it's never really changed it that much—it's really been more refinements trying to get towards the correct statement of neutrality, and I think with this, they finally found it.

Michael Littenberg: You mentioned a "blip"—and I'm using air quotes here—during the Trump Administration. How was the rule different, or the interpretation of the rule different, during the Trump Administration?

Josh Lichtenstein: It's interesting—there's one argument that the rule under the Trump Administration wasn't that different in many ways, based on just the pure text of the rule, but the emphasis and intent of the rule under the Trump Administration was perceived as being very negative on ESG considerations and extremely skeptical of the idea that ESG considerations can ever actually be pecuniary factors (those material financial considerations that I mentioned before). The Trump rule had also imposed some radical restrictions on the ability for plans to vote proxies which would have resulted in plans often not voting ordinary-course proxies and probably devoting an inordinate amount of time and resources into determining when to vote proxies, which, I think, really would have hurt plan sponsors and plan participants. It also restricted the ability for ESG products to be incorporated into the default investment options for 401(k) plans. These restrictions were so broad that they were having a very big impact on the perceived ability for plan sponsors to adopt even mainstream non-ESG-targeted funds because there might be a reference to "ESG" on page 98 of the offering documents. Taken together, all of these changes the Trump Administration had made had a major chilling effect on the asset management industry and on plan sponsors. It led to concerns that, if there was a mention of "ESG" at all in offering materials, ADVs, on a website, or in marketing decks, that it could result in a lawsuit alleging a breach of fiduciary duty. So, it was a very big problem, and, if that rule had been allowed to play out longer before the Biden Administration paused it, I think that it would have probably pretty radically shifted what most 401(k) menus looked like, definitely, I think, to the worse for plan participants.

Michael Littenberg: There were efforts earlier this year by the new Congress to overturn the current rule under the Congressional Review Act. Those efforts were not expected to be successful, and they weren't successful—although, perhaps what was interesting from that attempt was that the votes were not strictly along party lines. But there still is a court case pending which was brought by Republican state AGs seeking to overturn the current rule. What's being alleged there, and what's the status today of that challenge?

Josh Lichtenstein: There are actually two cases pending. The main one is the Texas case that you mentioned and that was brought by 26 state attorneys general in the Northern District of Texas. The allegations are, basically, that the Biden Administration's rule has undermined key protections for retirement savers that they allege the Trump rule had put into place, that the Department of Labor has overstepped its authority under ERISA, and that the Department of Labor acted in a manner that was arbitrary and capricious in changing the final rule adopted by the Trump Administration. Some of the allegations include:

- They claim that the Department of Labor has now formally incorporated "ill-defined and subjective ESG concepts into the regulations."
- That it's "loosened the statutory and regulatory restraints on fiduciaries to consider ESG factors," which will "allow fiduciaries and investment managers to potentially substitute their own ESG policy preferences under the guise of making a risk-return determination."
- And, also, that they've removed certain documentation requirements under the Trump rule, which "exacerbates the risk of plan fiduciaries unlawfully pursuing their own preferences and ESG considerations."

I think you can take from all of that that the thrust is basically a belief that the Trump Administration rule was substantively protective of plan participants and that the Biden rule weakens those protections in order to favor ESG. I don't think that's a good-faith reading of the rule, to be honest, but that's where they are. The Department of Labor tried to get the suit moved out of the Northern District of Texas because that's viewed as a very unfriendly jurisdiction to federal regulators, but they've been unsuccessful in doing that.

Just quickly, the second lawsuit that I mentioned was brought in Wisconsin. It's private plaintiffs and claims that the Biden rule violates ERISA and exceeds the authority granted to the Secretary of Labor because it injects consideration of ESG factors but without requiring that fiduciaries quantify the benefits of any such factors or document the reasoning the behind their consideration. I similarly think that the arguments are pretty meritless there, but you never know how things will play out in court.

PREDICTIONS FOR THE FUTURE

Michael Littenberg: Thanks, Josh. Unfortunately for managers, I don't see the debate over ESG subsiding anytime soon. I think it's fair to say we all expect to see it intensify and become even more difficult to navigate. As we close out today's session, I want to ask each of you to please share one of your predictions for the future. Rob, let's start with you.

Rob Skinner: If the AGs or the private plaintiffs bar are going to get serious about bringing lawsuits on fiduciary duty claims, they're going to have to come up with something to support them that is more tangible than simply asking courts to assume that consideration of ESG factors is at the expense of company financial performance and fund returns. So far, those assumptions are really all they've suggested. That means coming up with actual evidence that ESG investing has a negative effect on long-term returns. I believe we'll see public and private lawyers along with their financial experts (and likely academics) devoting a lot of energy to developing more evidence about the real-world impact of ESG investing, and then, maybe the litigation floodgates open.

Michael Littenberg: Amy, what about you?

Amy Roy: I think along those same lines, this past year-and-a-half has been focused on the proposals and enactment of ESG standards, policies, and rules. I think that as those legislations and SEC rules become formally adopted, we're going to see more activity on how the enforcement of those policies and rules plays out across various regulatory fronts as well as likely in some courts.

Michael Littenberg: Chong, what's your prediction?

Chong Park: I'm going to make a bold prediction: Given that 2024 is an election year and given the fact that ESG efforts and scrutiny in large part, in my view, are a political agenda looking for a legal forum, I'm going to raise Rob and say not only are there going to be increased efforts to find evidence, but in 2024, somewhere, somehow, someone is going to bring a legal claim in the courts against an asset manager or group of asset managers.

Michael Littenberg: Samer, what about you—what's your bold prediction?

Samer Musallam: I don't know if it's "bold," but I certainly agree that the debate over ESG won't be subsiding anytime soon. I foresee the challenges surrounding ESG expanding even further. Republican lawmakers have hinted at the possibility, for example, of scrutinizing the Federal Energy Regulatory Commission (FERC) and its role in regulating asset managers' ownership of utility companies and their influence over their operations. In addition, I think other industries, like banking and insurance, might also come under the spotlight—Republicans have argued that ESG practices actually limit access to insurance and loans for critical sectors, such as agriculture.

Michael Littenberg: And, last but not least, Josh?

Josh Lichtenstein: I think it's probably just going to go away . . . just kidding. I agree with everybody else—I think we're going to see increased acceleration of statutory and regulatory restrictions from red states in, the way I see it, their actions to protect the fossil fuels industry and their actions to try and turn the tide of progressive gains in culture wars. I don't see either sets of interest groups backing down, but I do think that this is ultimately going to be a slowing of the U.S. adherence to the global pro-ESG advances, not an ultimate change in the outcome. For now, I think the key is just to make sure that, as an asset manager, you keep threading needles and being clear and precise about exactly how ESG factors are being used as part of your investment process and trying to avoid over- or understating the way that ESG is actually utilized.

Michael Littenberg: That concludes our discussion for today. I'd like to thank my colleagues for sharing their thoughts on this rapidly evolving topic. They're very active counselors in this area—I encourage you to reach out to them with any questions or if they can be of assistance. Finally, I'd like to thank you, our listeners, for joining us. We look forward to continuing to bring you updates in this dynamic area and also working with many of you. You can also subscribe and listen to this series wherever you regularly listen to podcasts, including on Apple, Google, and Spotify. Thank you again for listening.