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The challenge of investing in the face of state anti-ESG legislation

By Lance Dial, Esq., Elizabeth Goldberg, Esq., and Rachel Mann, Esq., Morgan, Lewis & Bockius LLP

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Interest in environmental, social and governance (ESG) investing has exploded in recent years and, at the same time, has garnered the attention of global regulators. Given the ambiguities in terminology around ESG, certain global regulators are concerned that investment managers may be "greenwashing" their investment products, or overemphasizing the ESG features of these products.

Several states have proposed or adopted new legislation that would prohibit or significantly limit their state governments from investing in ESG strategies or from doing business with financial institutions that adopt specific ESG policies.

In Europe, ESG investment products are subject to disclosure requirements coming from the Sustainable Finance Disclosure Regulation, and the U.S. Securities and Exchange Commission (SEC) has proposed its own rules regarding the disclosures required for U.S. mutual funds and conditions under which such funds can adopt names suggesting an ESG focus.

In recent months, this regulatory interest has broadened to include individual states that opened their own front with respect to the regulation of ESG investing. Some of these states are using their legislative power to limit ESG investing, citing concerns that ESG investing is putting policy and social objectives ahead of financial objectives, or even concerns relating to the impact ESG investing could have on their local economies. Several states have proposed or adopted new legislation that would prohibit or significantly limit their state governments from investing in ESG strategies or from doing business with financial institutions that adopt specific ESG policies (Anti-ESG Bills).

A table of Anti-ESG Bills is set forth below:

State	Bill	Status	Type (i.e., Investment Restriction Targeted)
Information Current as of August 15, 2022			
Texas	S.B. 13	Enacted 05/21	Boycott Bill – Fossil Fuel Energy
Texas	S.B. 19	Signed 6/21	Boycott Bill – Firearms
West Virginia	S.B. 262	Enacted 03/22	Boycott Bill – Fossil Fuel Energy
North Dakota	S.B. 2291	Enacted 03/21	No Social Investment Bill
Oklahoma	H.B. 2034	Enacted 05/22	Boycott Bill – Fossil Fuel Energy
Oklahoma	H.B. 3144	Passed House, Read in Senate 05/22	Boycott Bill – Firearms
Kentucky	S.B. 205	Enacted 04/22	Boycott Bill – Fossil Fuel Energy
Kentucky	H.B. 123	Introduced 01/22	Boycott Bill – Firearms
Utah	H.B. 312	House Filed 03/22	Boycott Bill – Fossil Fuel Energy
Minnesota	H.F. 4574; S.F. 4441	Introduced 03/22 and 04/22	Boycott Bill – Energy, Mining, Production Agriculture, Production Lumber
Idaho	H.B. 737	Introduced 03/22	Boycott Bill – Energy, Mining, Production Agriculture, Commercial Timber
South Carolina	H.B. 4996	Referred to Committee 02/22	Boycott Bill – Energy
Louisiana	H.B. 25	Referred to Committee 03/22	Boycott Bill – Energy
Louisiana	H.B. 978	Engrossed in House 06/22	Boycott Bill – Firearms
Wyoming	H.B. 0236	Signed 4/21	Boycott Bill – Firearms
Arizona	H.B. 2473	Engrossed in House 2/22	Boycott Bill – Firearms
Indiana	H.B. 1224 S.B. 397	Introduced 01/22	Boycott Bill – Energy
Indiana	H.B. 1409 S.B. 397	Introduced 01/22	Boycott Bill – Firearms
Missouri	S.B. 1048	Introduced 04/22	Boycott Bill – Firearms
Ohio	H.B. 297	Referred to Committee 5/21	Boycott Bill – Firearms
South Dakota	S.B. 182	Introduced 2/22	Boycott Bill – Firearms

Florida Governor Rick DeSantis announced in July 2022 that he plans to propose an anti-ESG bill in the 2023 legislative session that we would classify as a No Social Investment Bill.

Source: chart compiled by the authors.

Types of Anti-ESG bills

These Anti-ESG Bills vary considerably from state to state. Almost all the state Anti-ESG Bills require state entities to take certain anti-ESG actions, be it divesting from companies that engage in ESG investing or refusing to contract with companies that engage in ESG discrimination (the definition of which varies somewhat state-to-state). The Anti-ESG Bills differ based on their scope, the state entities they regulate, the specifics of what they require, and the types of entities they target. Despite the large variation, as a general matter there are two main categories of Anti-ESG Bills.

The challenge created by these Anti-ESG Bills involves the question of whether implementing an investment strategy that considers ESG risks rises to the level of effectively "boycotting" an industry or particular issuers or makes the strategy a "social" strategy ineligible for state investments.

One category of the legislation targets "financial institutions" that "boycott" or "discriminate against" companies in certain industries. Such bills prohibit the state from doing business with such institutions and/or from investing the state's assets (including pension plan assets) through such institutions (the Boycott Bills).

Boycott Bills most commonly attach to "discrimination against" fossil fuel-related energy companies, but some states have also targeted companies that "boycott" mining, production agriculture, or production lumber. These Boycott Bills are based on the premise that companies that refuse to do business with companies domiciled in a given state are indirectly harming the citizens of that state and therefore should not benefit from (i) the state's direct investments in such companies or (ii) contracts for business from the state.

In general, Boycott Bills require some element of the state to make a determination as to the entities that engage in "boycotts" or "discrimination" against the relevant issuers. With respect to these entities, the state may be required to divest from companies engaging in ESG-related discrimination (e.g., one of Oklahoma's Anti-ESG bill (H.B. 2034) requires that state government entities divest from all publicly traded securities of financial companies that boycott energy companies).

In addition, entities that contract with the state could be required to include verifications/representations in their contracts (generally subject to a minimum contract value of $100,000) that they do not and will not discriminate against the specific entities protected by Boycott Bills. Some states have Anti-ESG Bills mandating just one of the above actions, and other states have bills mandating both.

The second category of Anti-ESG Bills would prohibit the use of state funds for the purpose of "social investment." Under this type of Anti-ESG Bill, the state would be specifically prohibited from investing in strategies that consider "social" factors for any purpose other than maximized investment returns.

Scope of Anti-ESG bills

The scope of Anti-ESG Bills can vary as well, depending on the type of bill. For example, the recently adopted legislation in Texas applies to five specific public retirement funds and the permanent school fund with respect to the requirement to divest holdings of financial institutions that boycott energy companies, but the contractual requirements apply to any Texas state agency or political subdivision of Texas.

Importantly, all of these Anti-ESG Bills are limited in their application to the activities of state entities; they do not impact the ability of private investors, in their own accounts, to select ESG-related investment strategies or to invest in a particular entity, even those deemed to be subject to an applicable state limitation.

In addition, Anti-ESG Bills vary as to their impact. While almost all the state Anti-ESG Bills require state entities to take certain anti-ESG actions, one state bill (West Virginia's S.B. 262), is permissive rather than proscriptive: it *allows* the state entity to refuse to contract while not *requiring* that it refuse to contract.

Implications for investment managers

Both types of Anti-ESG Bills pose discrete problems for ESG investment managers. For example, an ESG investment manager seeking to provide an investment product appealing to investors that desire a more environmentally or socially conscious investment product may offer an investment strategy that avoids investment in fossil fuel producers, firearms companies, or companies that do not implement sustainable forestry practices.

These Anti-ESG Bills could result in states being prohibited from investing in such a product and, potentially (depending on how the law is interpreted), from engaging that ESG investment manager to manage any of the state's assets, even in non-ESG-related investment products.

In addition, investment managers who do not necessarily view themselves as ESG managers may nonetheless be impacted by these Anti-ESG Bills. Many investment managers are recognizing that ESG criteria, including the environmental impact of an issuer, can be relevant factors for investment decision-making.

In fact, this recognition underpinned the recent SEC proposal that would require public issuers in the United States to provide more information regarding the impact of climate-related risks to their operations. The challenge created by these Anti-ESG Bills centers on the question of whether implementing an investment strategy that considers ESG risks rises to the level of effectively "boycotting" an industry or particular issuers or makes the strategy a "social" strategy ineligible for state investments.

Investment managers navigating these complex waters should understand that these Anti-ESG Bills are new and, as such, pose new interpretive questions. For example, an assessment of whether an investment manager "boycotts" the energy industry should be focused on the activities and policies of the company and not its investment products. If an investment manager offered an ESG-style fund while making it clear that as a company it does not itself discriminate against the entire fossil-fuel industry (e.g., does not completely ban all investment in the fossil-fuel industry, does not refuse to underwrite deals for the fossil-fuel industry), the investment manager itself should not be deemed to be "boycotting" energy companies, although its product may be.

In addition, and as noted above, there is considerable variation from state to state. Some states restrict only one "type" of ESG-related activity. For example, on the one hand, states such as Utah (H.B. 312), Minnesota (H.F. 4574), South Carolina (H.B. 4996), and Idaho (H.B. 737) have proposed Anti-ESG Bills limiting state contracting with companies that refuse to finance energy companies, but have no legislation related to the firearms industry.

On the other hand, states such as Wyoming (H.B. 0236), Arizona (H.B. 2473), Missouri (S.B. 1048), South Dakota (S.B. 182), and Ohio (H.B. 297) have proposed Anti-ESG Bills targeting companies that supposedly discriminate against the firearms industry, but no legislation related to the energy industry.

Conclusion

The regulatory environment for ESG investing was already complicated, given the involvement of several global regulators and an ever-increasing menu of ESG standard-setters. With the advent of Anti-ESG Bills from several U.S. states, the regulatory implications of ESG investing are now even more complex, especially where certain ESG activities could result in the inability to do business with individual state governments. Unfortunately, this seems to be a trend that could accelerate — and increase complexity in this area — before it slows down.

Elizabeth Goldberg is a regular contributing columnist on ESG and governance issues for Reuters Legal News and Westlaw Today.

About the authors



Lance Dial (L) is a partner at **Morgan, Lewis & Bockius LLP**, and focuses his practice on mutual fund law and operation, and on regulations applicable to investment managers. He advises clients on the creation of investment products and environmental, social and governance (ESG) and sustainability matters. He is resident in the firm's Boston office and can be reached at lance.dial@morganlewis.com. **Elizabeth Goldberg** (C) a partner at the firm, advises employee benefit plan sponsors and service providers to those plans (including financial service firms) on ERISA U.S. Department of Labor (DOL) enforcement investigations, DOL ERISA regulatory matters, and ERISA fiduciary counseling and compliance. She is resident in the firm's Pittsburgh office and can be reached at elizabeth.goldberg@morganlewis.com. **Rachel Mann** (R), an associate at the firm and part of its ESG Working Group, counsels publicly and privately held companies on executive compensation and employee benefits issues. She handles complex matters involving equity and incentive compensation, employment, retention and severance arrangements, Employee Retirement Income Security Act (ERISA) compliance, and qualified retirement, pension, and health and welfare plans. She is resident in the Philadelphia office and can be reached at rachel.mann@morganlewis.com.

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