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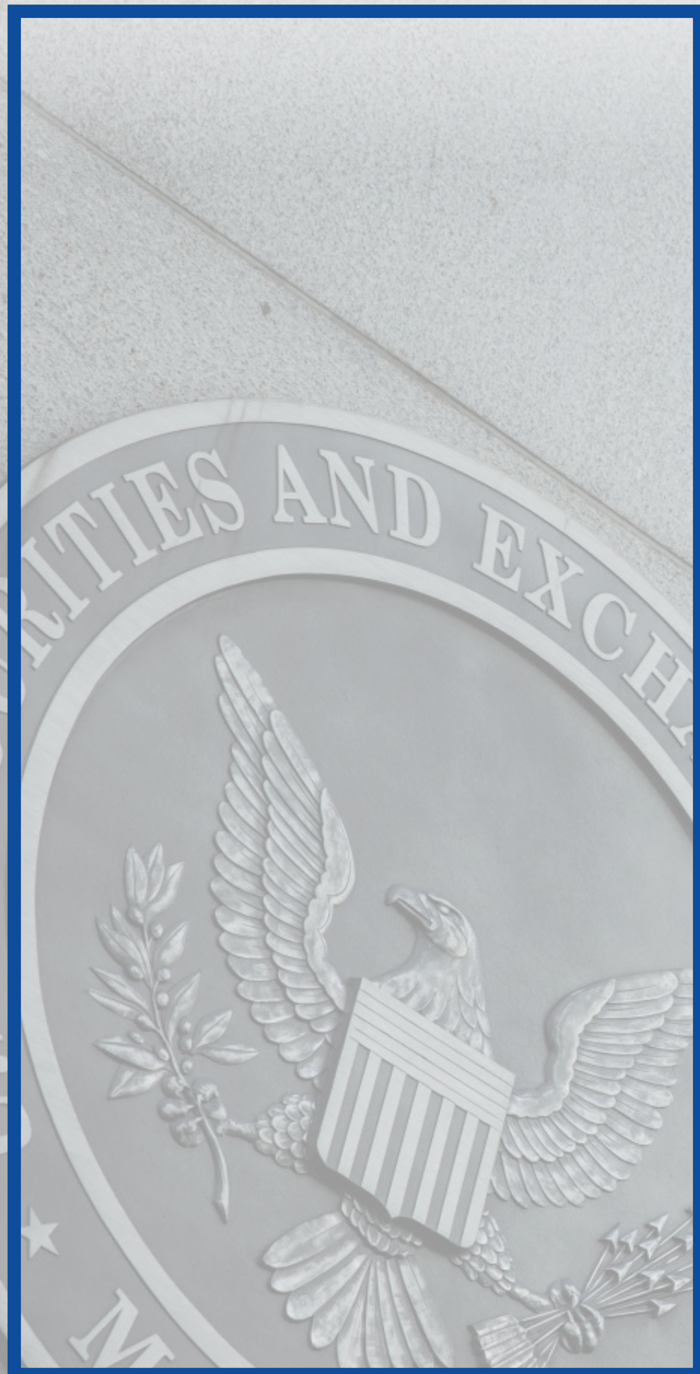

ESG: Politics over Policy and Unintended Consequences

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ESG: Politics Over Policy and the Consequences

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EXECUTIVE SUMMARY

In recent years policy proposals have been introduced at the state and federal level to restrict or mandate the consideration of environmental, social, and governance ("ESG") factors in government investments and other decisions made by public and private-sector financial institutions. Given that the control of the federal government is currently politically divided, coupled with an inability to find bipartisan solutions, the political response has been a state-level proliferation of both "anti-ESG" and "pro-ESG" laws. The focus of this paper is on two of the most common types of "anti-ESG" bills, as well as their relationship to federal regulations regarding fiduciary duty, and the potential and actual consequences of the subsequent legislation. The first type restricts state government entities from using non-pecuniary or non-financially relevant ESG factors. The second type involves blacklisting certain companies, including asset managers and banks, that are said to be boycotting other companies and industries based on ESG-related issues. The implementation of these types of laws involves divestment, prohibitions from government contracting, and even operating in a given state. These types of ESG-based legislation typically include exceptions that arguably mitigate some, but not all, of the unintended consequences, though how the laws are enforced and ultimately interpreted will be the true test of their long-term economic impact.

1. Non-Pecuniary/Financial Restrictions and the Role of Fiduciary Duty

In 2023, 19 Republican led states came together to form an "Alliance," agreeing in a joint statement to protect taxpayers from the improper use of ESG in investment decisions, and to protect citizens from the financial sector's improper use of ESG factors in their provided services. The Alliance was created in response to what was believed to be a federal overreach from the Biden Administration. Specifically, it was the Department of Labor's ("DOL") proposed amendments to a rule regarding how ESG could be used under the Employee Retirement Income Security Act of 1974 ("ERISA"). Under ERISA, the DOL regulates employer-sponsored retirement plans such as 401(k) accounts and pensions, which today covers roughly $12 trillion in retirement savings for over 150 million Americans. ERISA indicates that investment decisions are afforded a fiduciary duty that is paramount to understanding and analyzing both investment and business decisions and involves the highest level of care. ERISA requires that investment decisions must be made solely in the interests of and for the exclusive purpose of benefiting participants or beneficiaries in an investment plan.

However, the Clinton Administration attempted to address how interests other than those covered under ERISA should or could be used in making investment decisions. This led to a ping-pong effect with each successive administration changing how these so-called "collateral benefits" could be used in making investment decisions. When the Biden Administration *proposed* that ESG should "often" be considered in making investment decisions, the Alliance responded by introducing a flurry of state-level "anti-ESG" bills in their respective legislatures. However, with all the political rhetoric surrounding the issue, it is often overlooked that ESG-related factors are not always "collateral benefits" and in fact may be pecuniary or financially relevant to value creation.

The Alliance agreed that restricting the use of ESG to pecuniary or financial factors would protect its citizens from diminished returns if an investing strategy was otherwise based on a political or ideological agenda that emphasized something other than value creation or maximizing returns for a retirement portfolio. While a few states addressed this particular ESG-related issue before 2023, it was the Alliance members that led to the proliferation of this type of legislation.

2. Prohibiting Boycotts and Debanking Through Divestment

The Alliance also agreed to respond to allegations of boycotts or debanking of certain industries based on ESG analyses. The concern over either boycotting or debanking certain industries and companies has its foundation in an Obama Administration era program referred to as Operation Choke Point. The intent of the program was to put pressure on financial regulators to restrain financing of certain disfavored industries. While the program was eventually dissolved after it became public, the concern was that the Biden Administration's whole-of-government approach to climate change, thought to be a leading risk factor under the "E" in ESG, could reconstitute a similar program. There was also concern that the intent of the program could manifest itself through pressure from nontraditional activist shareholders and other third-party groups with a similar agenda.

The intent of the anti-boycotting and debanking laws was to have state officials evaluate asset managers and banks doing business in their state and determine if they were boycotting, debanking, or otherwise discriminating against certain industries. If found to be discriminating against certain industry sectors or specific companies, banks or asset managers would be placed on a blacklist and a process of divesting from their services to the state would commence. In some states banks could even be prohibited from operating at all. In others, companies could be prohibited from contracting with the state. To be removed from the list, a blacklisted entity would have to establish they were no longer discriminating. Like with the non-pecuniary/financial restrictions, there were important exceptions to being placed on a blacklist included in the law. The exceptions typically dealt with whether there would be a defined financial loss from divesting or canceling contracts from a blacklisted entity. Notably, most legislation does not clearly define how a financial loss is determined nor over what time period it is to be considered.

3. Consequences

The proliferation of "anti-ESG" laws resulted in 373 bills being introduced in 39 states since 2021, with 42 laws passed in 19 of those states. The proliferation of these bills in a relatively short period of time was bound to result in some unintended consequences. While the intent to remove politics from investment and business decisions is certainly a reasonable endeavor, restricting the way ESG factors can be used and the penalties for misusing those factors, with significant exceptions, may well end up undermining the original intent of the laws. Moreover, the implementation and interpretation of those laws can have consequences that need to be thoroughly analyzed to help mitigate any negative economic results as well as any legal challenges.

The consequences are amplified by the confusion over ESG which can lead to unnecessarily complex and potentially counterproductive legislative solutions. The confusion appears to be based in not fully understanding or distinguishing between using ESG for impact or integration purposes. While most of the "anti-ESG" laws are focused on "impact," how they distinguish, if at all, from ESG "integration" could well lead to economically relevant data not being properly analyzed for both business and investment decisions. Most of the laws attempt to mitigate this through the inclusion of exceptions, but how those exceptions are ultimately implemented is still an open question. In addition, when the exceptions become the focal point, one has to ask whether these laws were the most prudent way to address the problem of removing political or social considerations from decision making. This issue is likely a contributing factor to the sheer number of bills that have been proposed and ultimately defeated in otherwise supportive legislatures.

The use of divestment as a political remedy can have negative economic consequences, and unreasonably restricting the use of ESG can undermine the fiduciary duty of corporate boards, asset owners, and asset managers, as well as long established industry-based risks assessments in the banking and insurance sectors.

Those consequences include reduced competition in the capital markets. There were two studies that found reduced competition in the state of Texas after it passed its 2021 anti-boycott law. A separate study conducted in Oklahoma, after it passed a similar law, found similar results. Whether the reduction in competition was considered and justified in reaching their policy objectives is less clear. All three studies found increased interest rates in the bond market that risked reduced economic development. The two studies in Texas also found cost increases ranging from $240 to $500 million for the state. The Oklahoma study found costs exceeding $180 million for the state. Overall, the broader body of research shows real negative economic effects from using divestment as a public policy strategy. In addition to state costs, divestment-related ESG laws have real costs for companies in compliance, including the oversight needed to comply with those laws.

Other consequences include undermining the fiduciary duty of corporate boards, management, asset owners, and asset managers as well as hinder long established banking and insurance sector policy in evaluating risks and opportunities. This adds to the uncertainty that companies must address when dealing with a patchwork of state laws. This uncertainty inevitably leads to a no-win situation for companies that must contend with investors that have different goals and the current hyper-partisan political environment.

Therefore, when responding to a highly politicized issue such as ESG, state legislatures should prudently analyze their existing laws to ensure that any unintended consequences are mitigated. This process starts with having a thorough understanding of ESG and how it is being used in relation to the problem the legislature is trying resolve. In the end, a state's citizens and pension beneficiaries win when the political rhetoric of ESG, either always being good or always being bad, is replaced with sound business and investment judgment.

INTRODUCTION

Language becomes incredibly important when discussing and legislating topics as dynamic and subjective as ESG-related issues. As with any law, it's not just the written text but how it is interpreted that will be a harbinger of whether it is judged to accomplish its intended goal. Whenever a law is drafted to prohibit certain business or investment-related actions, it should be narrowly tailored to achieve its intended objective so as to avoid unintended consequences to all relevant stakeholders.[1] However, when significant political rhetoric is added to the process, the risk of unintended consequences increases, which may ultimately harm a state's citizens and economy.

[1] For the purpose of this paper "banks" refer to financial services-related entities, "asset managers" refer to entities that manage investment funds on behalf of clients (investors) including asset owners, "asset owners" refer to state entities, such as public pension funds, that act as an investor on behalf of a beneficiary and can act as an asset manager or hire a third-party asset manager, "companies" and "businesses" are given general definitional meaning, "corporations" refer to publicly traded entities, and "financial companies and institutions" as used in several state bills, means a publicly traded financial services, banking, or asset management company."

BACKGROUND ON ESG

Environmental, Social, and Governance ("ESG") in general should be understood as a subjective concept describing dynamic nontraditional economic factors that may affect financial returns. From early religious investors who excluded "sin stocks" (e.g., alcohol, gambling, oil and gas, and tobacco) from their portfolios to modern quantitative investors searching for ESG outperformance or corporate boards and management integrating it into business decisions to maximize shareholder value and create long-term value, stakeholders have considered nontraditional factors in a myriad of ways. As a result, there is no one standardized definition of ESG and no one way that investors or businesses incorporate ESG into their decision making. This has created confusion about what it is and how it should be used. Both Congress and the U.S. Securities and Exchange Commission ("SEC") have had multiple opportunities to define ESG but have not come to a consensus.[2] This has meant that investors and corporate boards have to determine what specific ESG-related factors are material to their portfolios or business decisions. It is therefore not up to the SEC to define the risk factors, but only to ensure any material risks identified are disclosed. For discussion purposes, ESG is divided into two basic uses from both an investment and corporate perspective: 1) Impact and 2) Integration.

Integration, sometimes referred to as "outside/in" is when ESG factors that are economically relevant are integrated in either an investment or business decision. Most of the fortune 500 corporations use certain ESG factors in this way; however, it is the least acknowledged in the current political rhetoric surrounding ESG. From the investment side, all economically relevant factors, including ESG, are integrated in investment decisions. From the corporate side, all economically relevant factors are integrated in making decisions about value creation. ESG factors can be difficult to evaluate because "economic relevance" can be inherently subjective. However subjective it may be, determining economic relevance is guided by a fiduciary duty.

Impact, sometimes referred to as "inside/out," arguably the most controversial, is when ESG factors are used to mitigate a negative externality or create a positive one, in addition to acquiring a reasonable rate of return or creating long-term value. This type of use sometimes conflates the "benefits" in an investment context or "reasonable business decisions" in a corporate context typically associated with a fiduciary duty, with those associated with pursuing an impact in the context of a political, social, or ideological goal. From the investment side, "impact investing" has been around much longer than the term ESG and is historically connected to religious-based goals or environmental impacts. More recently, this type has focused on climate-related goals, though this is becoming more economically integrated requiring a competitive rate of return. In some cases, so called "concessionary investing," the ESG impact is based on the idea that one would concede a certain level of return on investment if it meant the identified goal would be achieved. From a corporate perspective, this type of use is most closely associated with a "corporate social responsibility" goal, though this has more recently shifted toward a broader focus involving sustainability.

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[2] *See* Statement of SEC Commissioner Hester Peirce, "Statement on Environmental, Social, and Governance Disclosures for Investment Advisers and Investment Companies," (May 25, 2022); *available at* https://www.sec.gov/newsroom/speeches-statements/peirce-statement-esg-052522; *see also* H.R. 1187, "Corporate Governance Improvement and Investor Protection Act," 117th Congress (2021-2022); (Passed the House, but died in the Senate), (While the bill includes a provision that the sense of Congress is that ESG metrics are *de facto* material with regard to SEC disclosure, the bill does *not* define ESG.); *available at* https://www.congress.gov/bill/117th-congress/house-bill/1187/text

The politicization of ESG is in part due to a lack of understanding of how ESG is being used. On the one hand, claiming ESG is *always bad*, as is commonly done by those that don't agree with using ESG to achieve political, social, or ideological goals, implies they don't fully understand that ESG factors can be no different than other risks and opportunities that a prudent person would consider before making an investment or business decision. Here investment advisors or business executives must be given the flexibility, within their fiduciary duties, to make decisions using all relevant factors. On the other hand, a relevant ESG factor to one company or to an investment strategy may not be considered as such to another. Thus, claiming that ESG is *always good*, as is commonly done by those that think societal problems should be addressed through the capital markets because of a lack of Congressional action, implies they don't fully understand that ESG factors are not always going to be relevant to an investment or business decision. Here the proper venue for society's greatest challenges must be addressed by our elected officials. This hyper-politicization of ESG has led both academics and more recently Fortune 100 CEOs to call for either the breakup of the term "ESG" into its individual parts or to simply stop using the acronym altogether.[3]

NON-PECUNIARY/FINANCIAL RESTRICTIONS & ROLE OF FIDUCIARY DUTY

Background

1. *DOL's ERISA and Fiduciary Duty*

To understand the rationale behind adding "pecuniary" or "financial" restrictions on using ESG at the state level, one has to understand the duties of loyalty and prudence, coupled with the dynamic assessment of collateral issues, when evaluating investment options. More than 50 years ago, fiduciaries began considering non-financial factors, in particular what was at the time referred to as "social investing," when making investment decisions.[4] Legal challenges began to emerge, and it became increasingly clear that Congress needed to act. In response, Congress created the Employee Retirement Income Security Act of 1974 ("ERISA") under the U.S. Department of Labor ("DOL").[5] One of rationales for ERISA was to clarify what type of information a fiduciary could consider in making investment decisions.[6] Under ERISA, the DOL regulates employer-sponsored, as opposed to state sponsored,

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[3] *See* Confino, Paolo, *Fortune*, "Companies are getting it from all sides on ESG. They're either 'going too far' or 'not doing enough," (Jan. 8, 2024); *available at* https://fortune.com/2024/01/08/esg-criticism-ceos-stay-course-going-too-far-not-doing-enough-teneo-survey/; *also* Raine, Clinton, *Fast Company*, "Blackrock CEO Larry Fink says he's officially retiring 'ESG' as an investing term," (Jun. 26, 2023); *available at* https://www.fastcompany.com/90915196/esg-investing-meaning-blackrock-ceo-larry-fink-definition; *also* Vanham, Peter, *Fortune*, "'ESG' is dead. Long live E,S,G." (Jun. 8, 2023); *available at* https://fortune.com/2023/06/08/esg-is-dead-long-live-e-s-and-g/; *also* Kishan, Saijel, *Bloomberg*, "How to Fix 'ESG' by Changing Its Name," (Jan. 29, 2024); (Professor of Finance at London Business School Alex Edmans calls for "ESG" to be called "rational sustainability."); *available at* https://www.bloomberg.com/news/articles/2024-01-29/a-finance-professor-s-guide-to-fixing-esg-starts-with-its-name

[4] *See* Purcell, Patrick and Staman, Jennifer, *Congressional Research Service*, "Summary of the Employee Retirement Income Security Act (ERISA)" ("ERISA"), (*Update* May 19, 2009); *available at* https://www.google.com/url?q=https://crsreports.congress.gov/product/pdf/RL/RL34443/6&sa=U&ved=2ahUKEwiYn5X00a6HAxW5E1kFHSh3DywQFnoECAcQAg&usg=AOvVaw2LAVmGZiHneFOg12q8Ta02;

[5] Employee Retirement Income Security Act of 1974, 29 USC 18.

[6] *Supra,* ERISA, notes 4 and 5.

retirement plans such as 401(k) accounts and employer pensions,[7] which today covers roughly $12 trillion in retirement savings for over 150 million Americans.[8]

ERISA statutorily established the duties that a fiduciary owed to its beneficiaries.[9] This first was a duty of *loyalty* requiring a fiduciary to act "solely in the interest of the participants and beneficiaries."[10] The second is a duty of *prudence* requiring decisions be made for the "exclusive purpose and benefit of the participants and beneficiaries" including defraying reasonable expenses.[11] The duty of prudence is intended to prevent self-dealing, conflicts of interest, and unreasonable service fees.[12] It should be noted that these duties have not substantively changed since 1974 and have, in fact, been reaffirmed by each successive administration[13] and are held as the highest form of duty in the law.[14]

Even with the reaffirmation of fiduciary duty in ERISA, the limits of what could be considered slowly began to reappear. Specifically, fiduciaries began considering broader economic factors in addition to the narrower financial factors. The question became how broad of an "economic" issue could be considered and still be consistent with ERISA? While these early decisions were handled on a case-by-case scenario at the DOL, eventually the Clinton Administration developed guidance to assist fiduciaries in determining how and when they could consider what became known as economically targeted investments ("ETFs").[15] The guidance stated that ETFs can be selected for the "economic benefits they create apart from the plan" as long as they do not subordinate the financial returns of the plan.[16] The preamble to the guidance explained that an ETF must have an expected rate of return commensurate to alternative plans with similar risk factors.[17] This analysis eventually came to be known as the "all things being equal" or "collateral benefits" test.[18]

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[7] *Id.*

[8] *See* Wiessner, Daniel, *Reuters*, "Republican-led US states appeal ruling allowing Biden ESG investing rule" (Oct. 26, 2023); *available at* https://www.reuters.com/legal/republican-led-us-states-appeal-ruling-allowing-biden-esg-investing-rule-2023-10-26/

[9] *Supra,* ERISA, notes 4 and 5.

[10] *Id.*

[11] *Id.*

[12] *Id.*

[13] *See* Watkins, Paul and Barceleau, Kathleen, *The Federalist Society*, "The 30-Year History of Diluting ERISA's Fiduciary Duty," (Jan. 16, 2024); *available at* https://fedsoc.org/fedsoc-review/the-30-year-history-of-diluting-erisa-s-fiduciary-duty

[14] Hayes, Adam, *Investopedia*, "Fiduciary Definition: Examples and Why They Are Important," (*Updated* Mar. 19, 2024); *available at* https://www.investopedia.com/terms/f/fiduciary.asp#:~:text=The%20fiduciary%20standard%2C%20meanwhile%2C%20requires,their%20own%20at%20all%20times.

[15] DOL, Interpretive Bulletin 94-1, relating to the fiduciary standard under ERISA in considering economically targeted investments, 29 CFR 2509; *available at* https://www.govinfo.gov/content/pkg/FR-1994-06-23/html/94-15162.htm

[16] *Id.*

[17] DOL, Interpretive Bulletin 2015-01, "Relating to the Fiduciary Standard Under ERISA in Considering Economically Targeted Investments," (Oct. 26, 2015); *available at* https://www.federalregister.gov/documents/2015/10/26/2015-27146/interpretive-bulletin-relating-to-the-fiduciary-standard-under-erisa-in-considering-economically

[18] *Id.*

2. *The Ping-Pong of ERISA Guidance: Successive Administrations*

Since the Clinton Administration's guidance, allowing the consideration of "collateral benefits" other than the those considered in the "sole interest" and for the "exclusive purpose and benefit" of participants and beneficiaries, allegations have been made that it violated ERISA.[19] While no subsequent administration has attempted to prohibit its use, each successive administration has modified how collateral benefits could be used. First, the Bush Administration attempted to curtail the alleged misuse of considering collateral benefits by clarifying that, while allowable, its use should be rare and well documented.[20] Further, a fiduciary must "never subordinate the interests of a plan to unrelated interests" and when comparing plans they must be "truly equally, taking into account a quantitative and qualitative analysis of the economic impact."[21] The Obama Administration, arguing that the Bush Administration's guidance "unduly discouraged" the use of both ETFs and ESG factors, rescinded it and reinstated the Clinton Administration era guidance.[22] However, the Obama Administration also included ESG as a collateral benefit and in the preamble indicated that if ESG was considered solely as an economic consideration or benefit under ERISA, a "collateral benefits test" would be unnecessary.[23] This change arguably led to much of the consternation and confusion regarding the role of ESG in making investment decisions.

This interpretation under ERISA led to the question of whether ESG is merely a "collateral benefit" to be considered only in limited circumstances, or whether it can be considered as a (traditional) "benefit" under the text of ERISA? The 2014 unanimous Supreme Court case *Fifth Third Bancorp v. Dudenhoeffer* may offer some indication of how certain ESG factors will be evaluated by the courts.[24] In the Dudenhoeffer case, the court clarified that a fiduciary's consideration of a "benefit," as defined under ERISA, "does not cover nonpecuniary benefits."[25] So whether ESG could be considered "pecuniary," as in the *Dudenhoeffer* case, as opposed to "economic" under the Obama guidance, became the seminal question, though arguably in practice it might be merely semantics.[26] It's worth noting that the court did not define pecuniary in the *Dudenhoeffer* case, but the term became remarkably important for the DOL under Presidents Trump and Biden, as well as with the related state action discussed in this paper.

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[19] Joint Economic Committee (Republicans), "Stopping the Clinton Pension Grab," (Jun. 7, 1995); *available at* https://www.jec.senate.gov/public/_cache/files/c1a0057a-8284-430f-a887-a6897f2026ec/stopping-the-clinton-pension-grab---june-7-1995.pdf

[20] *See* DOL, Interpretive Bulletin 2008-01, "Relating to Investing in Economically Targeted Investments," 73 FR 61734 (29 CFR 2509) (Oct. 17, 2008); *available at* https://www.federalregister.gov/documents/2008/10/17/E8-24551/interpretive-bulletin-relating-to-investing-in-economically-targeted-investments

[21] *Id.*

[22] DOL, Interpretive Bulletin 2015-01, "Relating to the Fiduciary Standard Under ERISA in Considering Economically Targeted Investments," 80 FR 65135 (29 CFR 2505) (Oct. 26, 2015) (This was the first time that the term ESG was used with regard to ERISA.); *available at* https://www.federalregister.gov/documents/2015/10/26/2015-27146/interpretive-bulletin-relating-to-the-fiduciary-standard-under-erisa-in-considering-economically

[23] *See id.*

[24] *Fifth Third Bancorp v. Dudenhoeffer*, 573 U.S. 409 (2014).

[25] *Id at* 420-1.

[26] Eccles, Robert and Doyle, Timothy, *RealClear Energy*, "It's Time to Take the Unnecessary Politics Out of ESG and Retirement Savings," (May 9, 2023); *available at* https://www.realclearenergy.org/articles/2023/05/09/its_time_to_take_the_unnecessary_politics_out_of_esg_and_retirement_savings_898242.html

As the ERISA guidance ping-pong continued, the Trump Administration first issued guidance that advised caution to fiduciaries in evaluating the economic relevancy of ESG factors, analogous to what the Bush Administration had done.[27] However, the issue continued to be debated and was amplified by the increasing growth of ESG investment strategies that included *both* pecuniary and nonpecuniary goals.[28] The Trump Administration, citing the constantly changing interpretive guidance as well as the increase in the use of ESG factors in investment strategies, proposed a regulation, as opposed to additional guidance, to address the issue.[29] During the rulemaking process, public comments expressed concern of the potential chilling effect that the proposed rule would have on the use of ESG, arguments similarly made under the Obama Administration.[30] As a result, the DOL removed the term "ESG" from the final rule. However, the final rule required that investment decisions must be made on pecuniary factors, except in very limited situations where a choice was between investments that were indistinguishable based on pecuniary factors, and it also reinstated the documentation requirement.[31] The term "pecuniary" was used 330 times in the final rule and defined as a factor that a "fiduciary prudently determines is expected to have a material effect on risk and/or return of an investment based on appropriate investment horizons consistent with the plan's investment objectives … ."[32] However, in the preamble to the final rule, the DOL did indicate that ESG factors *may* be considered a material business risk or opportunity for a company that a prudent investor would treat as an appropriate economic factor.[33] The key analysis is whether the factor is a "pecuniary factor relevant to an evaluation of the investment or course of action under consideration."[34] Arguably, what the rule was attempting to avoid was a situation where ESG factors were used to pursue a non-pecuniary goal such as for a political or social objective. When the rule was published, Secretary of Labor Eugene Scalia indicated that:

> *"The rule will ensure that retirement plan fiduciaries are focused on the financial interests of plan participants and beneficiaries, rather than on other, non-pecuniary goals or policy objectives."*[35]

It is important to note, that the DOL's definition of a pecuniary factor has been used in several ESG-related state laws in defining the terms "pecuniary" and "financial."

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[27] DOL, Field Assistance Bulletin 2018-01 (Apr. 23, 2018); https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2018-01.

[28] DOL, "Financial Factors in Selecting Plan Investments," ("2020 ESG Rule"), 85 FR 72846, 72848 (29 CFR 2509;2550) (Nov. 13, 2020); *available at* https://www.federalregister.gov/documents/2020/11/13/2020-24515/financial-factors-in-selecting-plan-investments

[29] *Id.*

[30] *Id.* at 72862.

[31] *Id.*

[32] *Id* at 72857, ("In the preamble to the proposal, the Department recognized that there could be instances when ESG issues present material business risk or opportunities to companies that company officers and directors need to manage as part of the company's business plan and that qualified investment professionals would treat as economic considerations under generally accepted investment theories.").

[33] *Id*.

[34] *Id.*

[35] Secretary of Labor Scalia, Statement, *DOL Press Release* (Oct. 20, 2020); *available at* https://www.dol.gov/newsroom/releases/ebsa/ebsa20201030#:~:text=The%20amendments%20require%20plan%20fiduciaries,based%20on%20appropriate%20investment%20horizons

While the 2020 ESG Rule was supposed to stop the ERISA guidance ping-pong, the Biden Administration had their own ideas of what the rule should include. In responding to President Biden's 2021 executive orders,[36] the DOL indicated it would not enforce the 2020 ESG Rule and subsequently proposed and finalized its 2022 Amendments to the 2020 DOL ESG Rule.[37] The 2022 Amendments removed the term "pecuniary" from the 2020 Rule and instead required that fiduciaries should focus on "relevant risk and return factors" that may include the economic effects of climate change and ESG.[38] It also indicated that a fiduciary's duty requires that they "not subordinate the interests of participants and beneficiaries (such as by sacrificing investment returns or taking on additional investment risk) to objectives unrelated" to the plan, similar to the Obama and Clinton guidance.[39] Also similar to the Obama guidance, the 2020 Amendments removed the documentation requirement under the "collateral benefits" test.

Importantly, one thing that has been constant in the political ping-pong of ERISA is that fiduciaries must maintain their duties of loyalty and prudence in making investment decisions. While there has arguably been some sematic-based confusion over how to use ESG factors when making investment decisions, there is at least an apparent consensus from the investment community that the "collateral benefits" test would actually be quite rare *if* properly analyzed.[40] However, proper analyzation and subsequent action have continued to be at the forefront of the politization of this issue.[41] This politization continued after the Biden Administration finalized their amendments to the 2020 ESG rule. In response, a Republican led Congress passed a Congressional Review Act ("CRA") resolution, receiving some Democrat support, that would have rescinded the 2022 amendments.[42] However, President Biden vetoed the resolution on March 20, 2023.[43] The 2022 amendments are now the subject of a pending legal challenge currently in the 5th Circuit Court of Appeals.

Rationale: Non-Pecuniary/Financial Restrictions and Fiduciary ESG bills

Understanding the background of ERISA and subsequent changes in successive administrations' policies is important to understanding the initial rationale for what would become a wave of "anti-ESG"

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[36] *See* Executive Order (E.O.) 13990, "Protecting Public Health and the Environment and Restoring Science to Tackle the Climate Crisis," (Jan. 20. 2021); *available at https://www.whitehouse.gov/briefing-room/presidential-actions/2021/01/20/executive-order-protecting-public-health-and-environment-and-restoring-science-to-tackle-climate-crisis ;* and E.O. 14030, "Climate-Related Financial Risk," (May, 20, 2021); *available at* https://www.whitehouse.gov/briefing-room/presidential-actions/2021/05/20/executive-order-on-climate-related-financial-risk

[37] DOL, "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights," ("2022 Amendments") (Dec. 1, 2022); *available at* https://www.federalregister.gov/documents/2022/12/01/2022-25783/prudence-and-loyalty-in-selecting-plan-investments-and-exercising-shareholder-rights

[38] *See id* at 73827.

[39] *Id*.

[40] *See id* at 73829

[41] *See id* at 73829; *also supra*, note 26.

[42] H.J.Res.30, 118th Congress (2023-24), Congressional disapproval of DOL's "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights" Rule, (Mar. 1, 2023) (Passed the House 216-204 and passed the Senate 50-46); *available at* https://www.congress.gov/bill/118th-congress/house-joint-resolution/30

[43] The White House, "Message to the House of Representatives — President's Veto of H.J. Res 30," (Mar 20, 2023); *available at* https://www.whitehouse.gov/briefing-room/presidential-actions/2023/03/20/message-to-the-house-of-representatives-presidents-veto-of-h-j-res-30/#:~:text=TO%20THE%20HOUSE%20OF%20REPRESENTATIVES%3A,Investments%20and%20Exercising%20Shareholder%20Rights.%E2%80%9D

legislation. While ERISA does not apply to state action or state sponsored public pension plans, several states incorporated language from ERISA and subsequent regulations in their "anti-ESG" legislation.

It is also worth noting that some Democrat controlled state legislatures had already past "pro-ESG" bills starting in 2015.[44] While only seven states are included in that list, the majority of the laws were passed between 2020 and 2023, with the exception of Illinois which, since 2019, has passed a "pro-ESG" law almost every year.[45] In early 2023, most of the national attention to state ESG action was on California's package of climate-related disclosure bills.[46] Given the impact of these particular bills on the broader economy, it can be reasonably assumed that their debate in the California legislature had some impact on the "anti-ESG" bills at the time.[47]

Florida had one of the most noted responses to the federal government's action first by passing a resolution to "eliminate ESG consideration" from state pension investment.[48] Then, Governor Ron DeSantis took the lead in spearheading an alliance of governors ("Alliance") from 19 states[49] to purportedly push back on President Biden's "ESG agenda."[50] The jointly-signed Alliance statement indicated that it was the Biden Administration's DOL *proposed* 2022 Amendments, which were thought of as a de facto "mandate" to consider ESG factors, and subsequent threatened veto of a resolution to rescind the 2022 Amendments, that led to a formal multi-state response.[51] It's worth noting that the final version of the 2022 Amendments removed the controversial language and made other changes in response to public comments in the rulemaking process.[52]

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[44] *Infra,* California SB 185, note 174.

[45] *See* Malone, Leah (Partner) and Holland, Emily (Counsel), Simpson Thatcher & Bartlett, LLP, "ESG Battlegrounds: How the States Are Shaping the Regulatory Landscape in the U.S.," (Update August 2024); (A special thanks to the great work that Leah and Emily have done in the ESG space including compiling this "database" of state action.); *available at* https://www.stblaw.com/docs/default-source/publications/esg_updatedbattlegroundsalert.pdf (Accessed August 8, 2024).

[46] Ibid.

[47] *See* Vanderford, Richard, *Wallstreet Journal*, "New California Climate Law Pulls In Private Companies," (Sept. 21, 2023); *available at* https://www.wsj.com/articles/new-california-climate-law-pulls-in-private-companies-76acfea8

[48] State Board of Administration of Florida, "A resolution directing an update to the investment policy statement and proxy voting policies for the Florida retirement system defined benefit pension plan…" ("Resolution"), (Aug. 23, 2022); (Governor DeSantis' press release on the resolution conflated the idea that ESG only involves a political or social agenda by claiming that the resolution "eliminates ESG consideration," when in fact the text of the resolution merely prohibits non-pecuniary factors from being considered.); *available at* https://www.flgov.com/wp-content/uploads/2022/08/ESG-Resolution-Final.pdf

[49] Alliance includes the governors of Florida, Alabama, Alaska, Arkansas, Georgia, Idaho, Iowa, Mississippi, Missouri, Montana, Nebraska, New Hampshire, North Dakota, Oklahoma, South Dakota, Tennessee, Utah, West Virginia, and Wyoming.

[50] Office of the Governor, *Press Release*, "Governor Ron DeSantis Leads Alliance of 18 States to Fight Against Biden's ESG Financial Fraud," (Mar. 16, 2023); *available at* https://www.flgov.com/2023/03/16/governor-ron-desantis-leads-alliance-of-18-states-to-fight-against-bidens-esg-financial-fraud/

[51] All alliance members signed a joint statement, ("Alliance" or "Alliance Statement") (Mar. 16, 2023); *available at* https://t.e2ma.net/click/og0o8k/8z0tiag/kp858db

[52] *See supra,* DOL 2022 Amendments, note 37 at 73822, (The final rule removed language indicating that a prudent evaluation of a projected return "may *often require* an evaluation of the economic effects of climate change and other [ESG] factors on the particular investment or investment course of action." [emphasis added]. It also removed a detailed description of what it considered to be relevant ESG factors, both DOL changes were

The Alliance statement held that President Biden's actions threatened "the pensions of thousands of hardworking Americans at risk to the radical … ESG movement, rather than prioritizing investment decisions on the highest rate of return."[53] The Alliance proclaimed that:

> *"The proliferation of ESG throughout America is a direct threat to the American economy … and inject(s) political ideology into investment decisions, corporate governance, and the everyday economy."*[54]

The Alliance adopted two types of ESG-related policies. The first was to "protect taxpayers from ESG influences" by prohibiting the use of ESG "in all investment decisions at the state and local level" that were *not* based on "financial" factors considered to "maximize the return on investment."[55] It was suggested that this could be accomplished by prohibiting ESG factors from being used when considering the issuance of bonds or by state fund managers in making investment decisions.[56] The second was to "protect citizens from ESG influences in the financial sector."[57] This was to be accomplished by "stopping financial institutions from discriminating against customers [including other companies] for their political, or social beliefs, such as owning a firearm, securing the border, or increasing our energy independence."[58]

Compare/Contrast: Non-Pecuniary/Financial Restrictions and Fiduciary ESG bills

1. *Model ESG Legislative Language*

Since 2021, 21 states have enacted laws or policies restricting how ESG factors are used in investment or business decisions or clarifying the fiduciary duty owed to beneficiaries.[59] In reviewing the text of the bills, there is clearly a similarity in language to model legislation from two separate nonprofit organizations. The first is the Heritage Foundation's ("Heritage") "State Pension Fiduciary Act" model legislation.[60] The second is the American Legislative Exchange Council's ("ALEC") "State Government Employee Retirement Protection Act" model legislation.[61]

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considered a response to negative comments received arguing that the proposed amendments showed bias toward including ESG.); *see also supra,* DOL 2020 ESG Rule, note 29 at 57232.

[53] *Supra,* Alliance Statement, note 51.

[54] Ibid.

[55] Ibid.

[56] Ibid.

[57] Ibid.

[58] Ibid.

[59] *Supra*, note 45.

[60] The Heritage Foundation ("Heritage"), "State Pension Fiduciary Act" model legislation; (Heritage is a Washington D.C. based 501(c)(3) organization with a mission to "formulate and promote public policies based on the principles of free enterprise, limited government, [and] individual freedom…"); *also* (While both forms of model legislation and the progeny of the DOL ESG Rules references the importance of proxy advisors, that topic is outside the scope of this paper.); *available at* https://www.heritage.org/article/state-pension-fiduciary-duty-act

[61] The American Legislative Exchange Council ("ALEC"), "State Government Employee Retirement Protection Act" model legislation; (ALEC is an Arlington, VA based 501(c)(3) nonpartisan voluntary membership organization of state legislators dedicated to the principles of limited government, free markets, and federalism."); *available at* https://alec.org/model-policy/state-government-employee-retirement-protection-act/

The Heritage model appears to be based off the language included in ERISA, specifying the fiduciary duty owed, and requiring that only "financial factors," defined similarly to "pecuniary factors" in the DOL's 2020 ESG Rule, be used in making investment decisions.[62] Notable is that Heritage only uses the term ESG in the preamble to the text, just as was done in the DOL's final 2020 ESG Rule.[63] ALEC's model also borrows from the 2020 ESG Rule as well as the *Dudenhoeffer* case by using the term "pecuniary." ALEC defines pecuniary *exactly* as was done in the 2020 ESG Rule.[64] It also defines "non-pecuniary" as an act taken by a fiduciary to "further environmental, social, or political *goals*. [emphasis added]."[65] The model legislation suggests restricting investment decisions by requiring that it be based on pecuniary factors and prohibits the use of non-pecuniary factors.[66] Prohibiting non-pecuniary factors is likely the basis for claims that the model legislation calls for a "ban" on ESG or that it is "anti-ESG."

2. North Dakota, Idaho, Texas, and Oklahoma

In March of 2021, North Dakota was one of the first states to address using ESG factors when making investment decisions.[67] In Senate Bill ("SB") 2291, North Dakota prohibited the investment of state funds for a "social purpose" and required a study on how asset managers evaluate ESG, and the implications of divestment as a remedy.[68] While Idaho passed a similar bill in 2022,[69] it was not until the 2023 legislative session that several states passed multiple restrictions on using ESG factors in evaluating investment decisions.[70]

As discussed later in this paper, while Texas led the way with "anti-boycotting" legislation along with similar laws in Oklahoma, neither state has been able to pass legislation that restricts the use of ESG factors when making investment decisions.[71] Texas tried in 2023 with varying bills in the House and Senate; however, both died in Committee.[72] Oklahoma also attempted to pass similar bills in 2023, one of which passed the House, but ultimately it died in the Senate.[73] In Texas, the attempt to restrict the

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[62] *Supra*, Heritage, note 60; (Financial is defined as "having been prudently determined by a fiduciary to have a material effect on the financial risk or the financial return of an investment … [and] does not include any action taken, or factor considered, by a fiduciary with any purpose whatsoever to further social, political, or ideological interests.").

[63] *Id.*

[64] *Supra*, ALEC, note 61; ("The term 'pecuniary factor' means a factor that has a material effect on the financial risk and/or financial return of an investment based on appropriate investment horizons consistent with the plan's investment objectives and the funding policy." The term "excludes non-pecuniary factors.").

[65] *Supra*, ALEC, note 61.

[66] *Id.*

[67] North Dakota SB 2291 (2021-2022, 67th Legislative Assembly); *available at* https://legiscan.com/ND/bill/SB2291/2021

[68] *Id.*

[69] Idaho SB 1405 (2022 Regular Session); *available at* https://legiscan.com/ID/bill/S1405/2022

[70] *See supra,* note 59.

[71] Mindock, Clark & Ross Kerber, "Oklahoma anti-ESG law blocked by state judge" *Reuters*, (May 8, 2024); available at, https://www.reuters.com/sustainability/oklahoma-anti-esg-law-blocked-by-state-judge-2024-05-08/

[72] *See* Texas SB 1446 and HB 2068 (2023-2024 88th Legislature); (SB 1146 would have prevented public pensions from considering "non-financial" factors; HB 2068 would have added restricted the use of "non-pecuniary" factors, both bills died at the end of 88th legislative session.); *available at* https://legiscan.com/TX/bill/SB1446/2023 and https://legiscan.com/TX/bill/HB2068/2023

[73] *See* Oklahoma HB 2777, SB 470, and SB 1004, (2023 Regular Session); *available at* https://legiscan.com/OK/bill/HB2777/2023; and https://legiscan.com/OK/bill/SB470/2023%20-%202/7/23; and https://legiscan.com/OK/text/SB1004/id/2651542.

use of "non-financial" factors in SB 1446[74] raised concerns about the increased costs for asset managers in providing attestation for their investment decisions.[75] The Executive Director of the Texas County and District Retirement System indicated that:

> *"If we had to adjust our asset allocation, we estimated it could cost us over $6 billion over the next 10 years. And this would cause our employers cost to more than double."*[76]

While Texas and Oklahoma have currently been unable to pass this type of "anti-ESG" legislation, Florida has received a good deal of attention in proposing legislation that went beyond what was passed in North Dakota and Idaho.

3. Florida

In 2022, before spearheading the Alliance, Florida's State Board of Administration implemented a policy to prioritize the highest return on investments without consideration of social, political, or ideological interests.[77] After the formation of the Alliance, the Florida legislature passed House Bill 3 ("HB 3"), which codified the State Board's policy and expanded it to other areas addressed in the statement of the Alliance, and was subsequently signed into law on May 2, 2023.[78] HB 3 requires that all state and local government investment decisions must be based on "pecuniary" factors only and prohibits the furtherance of any "social, political, or ideological interests."[79] A "pecuniary" factor is defined as one that is expected "to have a material effect [and be prudently assessed and weighted] on the risk or return of an investment based on appropriate investment horizons consistent with applicable investment objectives and funding policy."[80] This is the same language as the DOL 2020 ESG Rule. From a textual reading of the law, "ESG" factors could be considered if those factors are shown to be consistent with a pecuniary-based assessment. While the law certainly restricts how ESG factors may be used, it does not prohibit or "ban" their use *per se*. Unfortunately, that distinction was not included in Governor DeSantis' comment in signing the bill into law:

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[74] *Supra*, Texas SB 1446, note 72.

[75] Texas House, Committee on Pensions, Investments, and Financial Services, Hearing, Testimony of Texas County and District Retirement System Executive Director, Amy Bishop (2023); *available at* https://tlchouse.granicus.com/MediaPlayer.php?view_id=78&clip_id=24838

[76] Segal, Mark, *ESG Today*, "Texas Anti-ESG Investing Bill Faces Pushback Over $6 Billion Cost to Pensions" (Mar 30, 2023); *available at* https://www.esgtoday.com/texas-anti-esg-investing-bill-faces-pushback-over-6-billion-cost-to-pensions/

[77] *See supra,* Resolution, note 48.

[78] *See* Florida HB 3 (2023 Legislative Session); (HB 3 addresses how ESG is to be used by asset managers, banks, and companies); *available at* https://www.flsenate.gov/Session/Bill/2023/3

[79] *See id.*

[80] *See id*.

> *"[the new law] protects Floridians from the corporatist environmental, social, and corporate governance (ESG) movement — a worldwide effort to inject woke political ideology across the financial sector…."*[81]

In fact, nowhere in Governor DeSantis' statement does he acknowledge that ESG factors *may* be pecuniary and therefore lead to investment opportunities or create value. It appears that the Governor's focus was merely on preventing ESG "impact" investing and not on the possibility the some ESG factors may be pecuniary. Unfortunately, without this vital distinction being made, we are left with comments such as those from the Florida House Speaker claiming that "[c]ompanies that engage in ESG hurt their customers and the communities they serve… ."[82] However, if a fiduciary is evaluating an investment that includes a company that engages in "ESG integration" to create long-term value, but does not advance a political or social agenda, then a law that broadly restricts ESG considerations may decrease investment opportunities and increases the risk of economic loss.

4. *Arkansas*

Arkansas was another state that signed onto the Alliance and subsequently passed HB 1253 in 2023.[83] HB 1253 adopted the ERISA definition of fiduciary duty, restricted ESG considerations to pecuniary factors, and defined non-pecuniary as "an action or factor considered by a fiduciary with any purpose to further environmental, social, political or ideological *goals*. [emphasis added]."[84] Importantly, and distinguishable from Florida's HB 3, the Alliance statement, and Governor DeSantis' public comments, it included an exception when considering ESG factors found to be pecuniary. Specifically, the law states that:

> *"[a]n environmental, social, corporate governance, or similarly oriented consideration is a pecuniary factor only if it presents an economic risk or opportunity that a qualified investment professional would treat as a material economic consideration under generally accepted investment theories."*[85]

While this version of an "anti-ESG" law adds restrictions to using ESG, the exception clearly shows that the legislature acknowledged the nuances of evaluating ESG-related factors in making investment decisions.

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[81] Office of Governor Ron DeSantis, *Press Release*, "Governor Ron DeSantis Leads Alliance of 18 States to Fight Against Biden's ESG Financial Fraud," (Mar 16, 2023); *available at* https://www.flgov.com/2023/03/16/governor-ron-desantis-leads-alliance-of-18-states-to-fight-against-bidens-esg-financial-fraud/

[82] Office of Governor Ron DeSantis, *Press Release*, "Governor Ron DeSantis Signs Legislation to Protect Floridians' Financial Future & Economic Liberty," (May 2, 2023); *available at* https://www.flgov.com/2023/05/02/governor-ron-desantis-signs-legislation-to-protect-floridians-financial-future-economic-liberty/

[83] Arkansas HB 1253 (2023 94th General Assembly); "The State Government Employee Retirement Protection Act," (Apr. 10, 2023); (The law went into effect on August 1, 2023); *available at* https://legiscan.com/AR/text/HB1253/id/2777649

[84] *Id*.

[85] *Id* at Sec. 24-2-804 (c)(1); *available at* https://legiscan.com/AR/text/HB1253/id/2777649/Arkansas-2023-HB1253-Chaptered.pdf

It is worth noting that most of the "anti-ESG" bills in states that signed onto the Alliance do not "ban" ESG, but rather add potentially unnecessary guidelines to its use given the exceptions included and the existing fiduciary duty present in making investment decisions. While provisions such as those found in Arkansas HB 1253 may have been included in earlier versions of other states' "anti-ESG" bills, what HB 1253 clearly show is the legislature acknowledged that ESG *can* be a pecuniary factor for investment decisions or conversely materially relevant for value creation, though that is not always the case. Maybe most important is that it places that determination with financial professionals, not government bureaucrats, who understand fiduciary duty, wealth creation, and sound investment advice.

PROHIBITING BOYCOTTS & DEBANKING THROUGH DIVESTMENT

Background

As previously discussed, several Republican controlled state legislatures have responded based on what had occurred under previous administrations and what individual companies have been perceived as continually doing in furtherance of that action.[86] Operation Choke Point, under the Obama Administration's Justice Department, targeted financial institutions doing business with what they determined to be "high risk" sectors.[87] The Department of Justice ("DOJ") targeted certain industries disfavored by the administration and put pressure on other agencies to do the same.[88] As a result, financial institutions were pressured by the FDIC and the Office of the Comptroller of the Currency ("OCC") to increase their scrutiny of the services they provided to certain disfavored or "high risk" industries.[89]

While the fossil fuel industry and other sectors associated with high levels of CO2 emissions were not on the original list of 30 industries, the fact that other "high risk" industries such as firearms, ammunition, tobacco, and gambling were on the list understandably created a concern that the list could be expanded to other politically disfavored "high risk" industries.[90] The inherent problem with an approach based on creating a list of "high risk" industries is that the target list could change with each successive administration and a new sector could be targeted with boycotts or debanking. This was eventually the position that the DOJ provided as a rationale for ending the program.[91] The political blowback from the DOJ program resulted in the Financial Institution Customer Protection Act of 2017 ("FICPA") overwhelmingly passing the U.S. House 395 to 2, in a bipartisan attempt at preventing this from occurring in the future.[92] Similar bills have been reintroduced several times in both chambers to address

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[86] *See* U.S. House Committee on Oversight and Government Reform Staff Report (113th Congress) ("Staff Report"), "The Department of Justice's 'Operation Choke Point': Illegally Choking Off Legitimate Businesses?," (May 29, 2014); *available at* https://oversight.house.gov/wp-content/uploads/2014/05/Staff-Report-Operation-Choke-Point1.pdf

[87] Fed. Dep. Ins. Corp. ("FDIC"), Office of Insp. Gen., "The FDIC's Role in Operation Choke Point and Supervisory Approach to Institutions That Conducted Business with Merchants Associated with High-Risk Activities"(Report No. AUD-15-008, Federal Deposit Insurance Corporation, Arlington, VA, September 2015); *available at* https://www.fdicoig.gov/sites/default/files/reports/2022-08/15-008AUD.pdf

[88] *Supra*, Staff Report, note 86.

[89] Alan Zibel and Brent Kendall, WSJ, "Probe Turns Up Heat on Banks (Aug. 7, 2013); *available at*, https://www.wsj.com/articles/SB10001424127887323838204578654411043000772

[90] *See supra,* Staff Report, note 86.

[91] Ibid.

[92] H.R.2706, "Financial Institution Customer Protection Act of 2017," 115th Congress (2017-2018),(H.R. 2706 eventually died in the Senate); *available at* https://www.congress.gov/bill/115th-congress/house-bill/2706/titles;

the issue.[93] In general, the bills prohibited federal banking regulators from either formally or informally requesting or ordering a "depository institution" from terminating customer accounts unless the agency has a valid reason, other than solely for reputational purposes.[94] As none of these bills have become law, it is therefore still an open question as to whether the initiative could be reinstated. Unfortunately, as a result of Operation Choke Point, financial institutions were put in a no-win situation. If they didn't scrutinize certain industries more closely, they risked additional government audits or other regulatory repercussions. On the other hand, if they did evaluate sectors and companies based on White House policy and pressure from influential federal regulators, investors, or third-party activists, they risked being targeted by state legislatures.

While the FICPA focused on the *government's* role in initiatives such as Operation Choke Point, there was also an effort to prevent banks from acquiescing to pressure from their regulators, investors, or third parties. This was initially led by the OCC, under the Trump Administration, in promulgating the "Fair Access" rule, which would have required "large banks" to conduct individual risk assessments of customers, as opposed to decisions based on categories or classes of customers, before "debanking" them i.e., canceling their services.[95] The rule was finalized on January 14, 2021, just a week before President Biden was sworn in. After taking office, the Biden Administration instructed the OCC to pause the publication of the rule.[96] This led to the introduction of bills in the U.S. Senate and House referred to as the Fair Access to Banking Act ("FABA"), which would amend the Federal Reserve Act in an attempt to codify the OCC's "Fair Access" rule.[97] It is worth noting that both versions of FABA have significant Republican support, yet neither bill has been voted out of committee.[98]

Considering the history of debanking certain industries via Operation Choke Point and concerns about its continued use, the refusal of the Biden Administration to publish the OCC's Fair Access Rule, and the stalled Congressional legislation, it is understandable why it was the second area of interest for the Alliance of states to address.[99]

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[93] S.245, 118th Congress (2023-24); (Senators Ted Cruz (R-TX) and Mike Lee (R-UT) originally introduced the Financial Institution Customer Protection Act of 2016. It was reintroduced on Feb. 2, 2023 by Sens. Cruz (R-TX), Cornyn (R-TX), and Crapo (R-ID)); *available at* https://www.congress.gov/bill/118th-congress/senate-bill/245?q=%7B%22search%22%3A%22%5C%22Financial+Institution+Customer+Protection+Act%5C%22%22%7D&s=2&r=1

[94] *Supra*, note 92.

[95] OCC, *New Release*, Rule 55.1 "Fair Access to Financial Services" rule (Jan. 14, 2021); (Rule 55.1 was finalized but never published as required by law.); *available at* https://www.occ.gov/news-issuances/news-releases/2021/nr-occ-2021-8.html; *also* OCC, "Fair Access to Financial Services," 85 FR 7562 (12 CFR 55), (Nov. 25, 2020); *available at* https://www.federalregister.gov/documents/2020/11/25/2020-26067/fair-access-to-financial-services

[96] The OCC, "OCC Puts hold on Fair Access Rule," (Jan. 28, 2021); *available at* https://www.occ.gov/news-issuances/news-releases/2021/nr-occ-2021-14.html

[97] S.293, Fair Access to Banking Act ("FABA"), 118th Congress (2023-2024); (Sen. Kevin Cramer (R-ND) introduced S.293 on Feb. 23, 2023, with 36 Republican co-sponsors. The rationale for the bill is found in the "Findings of Congress."); *available at* https://www.congress.gov/bill/118th-congress/senate-bill/293/text; *also* Cong. Andy Barr (R-KY) introduced H.R. 2743 (Fair Access to Banking Act) on Apr. 20, 2023, with 83 Republican co-sponsors. section.); *available at* https://www.congress.gov/bill/118th-congress/house-bill/2743

[98] *Id*.

[99] *See supra*, Alliance Statement, note 51.

Rationale: Prohibiting Boycotts and Debanking

As previously discussed, the Alliance was created to "protect citizens from ESG influences in the financial sector."[100] This was a response to what was perceived as a concerted effort by financial institutions to unfairly boycott or debank certain industries that are important to a state's economy. The concern regarding debanking was that it was based on ESG-related issues not normally considered by the banking industry in assessing credit or other traditional risks evaluations. The stated purpose of the "anti-ESG" laws was to prohibit the discrimination of customers based on their industry or for their "political or social beliefs."[101] The remedy provided for violating these types of laws is to be placed on a blacklist that could eventually lead to divestment, contract nullification, or in some cases prohibition from operating in the state. Further, what initially started as a response to debanking certain industries expanded in some states to include any discrimination or boycotting of a company or individual based on using ESG factors in pursuit of a political, social, or ideological agenda. The concern was amplified by the fact that Democrat controlled state legislatures have attempted to use divestment as a means of addressing disfavored industries.

At the federal level, proponents of FABA claim that certain large banks use subjective criteria (including prejudice and favoritism) and "category-based evaluations" to essentially accomplish the goals of Operation Choke Point, although in this case the pressure would be coming from the banks themselves in response to their investors, employees, and third-party advocacy groups.[102] There is also a claim that banks are not "well-equipped" to assess unrelated non-financial risks and may violate basic principles of sound risk management if they are not restricted to "quantitative, impartial risk-based standards."[103] The rationale is that "fair access" does not require a bank to offer a particular service, operate in a geographical location, or to provide service to any person. However, the underwriting process must be based on empirical data in accordance with a pre-established "impartial risk management process."[104]

Compare/Contrast: Anti-Boycotts, Debanking, and Divestment ESG bills

1. *Model ESG Legislative Language*

Heritage has model legislation and ALEC has a discussion draft that incorporates various anti-boycotting or debanking language as it relates to ESG issues.[105] While ALEC's discussion draft focuses on the discrimination of energy companies, Heritage takes a broader view of the types of companies and industries that may be boycotted based on a broad set of ESG-related issues.[106]

The Heritage model legislation, referred to as the "Eliminate Economic Boycotts Act," suggests prohibiting the state from contracting with a company unless there is written verification that the company does not engage in ESG-related economic boycotts.[107] There is an exception if the company is

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[100] Ibid.
[101] Ibid.
[102] *See supra,* Findings of Congress, note 97.
[103] *Id.*
[104] *Id.*
[105] *See infra*, notes 107 and 111.
[106] *Id.*
[107] Heritage, *model legislation*, "Eliminate Economic Boycotts Act," *available at* https://www.heritage.org/article/eliminate-economic-boycotts-act#

"small" and the contract amount is of minimal value.[108] Further, it addresses the boycotting of companies that engage in lawful activities, unless the exclusion is based on an "ordinary business purpose." [109] Though the model text does not define an "ordinary business" purpose, it does attempt to distinguish it from a purpose that furthers a "social, political, or ideological interest" by including a non-exhaustive list of activities that a company should be protected from engaging in without the threat of an economic boycott.[110]

ALEC's discussion draft, referred to as the "Energy Discrimination Elimination Act," provides draft language that is reactive to "financial companies" boycotting or otherwise debanking energy companies to "decarbonize" their lending portfolio and achieve the greenhouse reduction goals of the Paris Agreement.[111] The discussion draft sets out a framework for a state to require the creation, maintenance, reporting, and ultimately use of a "blacklist," with some exceptions relating to size and value, to prevent contracting with "financial companies" that boycott energy companies.[112] It also sets out provisions for the state to divest from companies on the blacklist, though with *significant* exceptions. These include taking action that would violate a state's fiduciary duty, was otherwise part of an investment plan, indirectly held, or would result in a loss.[113]

On the federal level, FABA provides similar language found in Heritage's model legislation and ALEC's discussion draft. Substantively, FABA requires "banks," with more than $100 billion in assets, to provide financial services "to all persons in the geographic market served by the covered bank on proportionally equal terms."[114] A bank may not deny services unless justified by a "quantified and documented failure of the person to meet quantitative, impartial risk-based standards established in advance … ."[115] A bank also may not deny services "in coordination with or at the request of others… ."[116] If services are denied, the bank must provide written justification explaining the basis for the denial.[117] FABA also provides a civil cause of action against the banks for violating the law.[118] This proposed federal legislation would amend the Federal Reserve Act, so slightly different than what the state bills would attempt to accomplish, but the intent to protect consumers including companies is the same.

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[108] *Id.*

[109] *Id.*

[110] *See id.*

[111] ALEC, *discussion draft,* "Energy Discrimination Elimination Act," ("Financial company" is defined as "a publicly traded financial services, banking, or investment company."); *available at* https://web.archive.org/web/20211204022222/https:/www.alec.org/model-policy/energy-discrimination-elimination-act-2/; *see also,* Trotter, Joe, *ALEC*, "Setting the Record Straight," (Feb. 17, 2022); (It should be noted that while ALEC proposed several versions of the Energy Discrimination Elimination Act for internal review, no version received the request support to be considered model legislation); *available at* https://alec.org/article/setting-the-record-straight-the-energy-discrimination-elimination-act/

[112] *See id*; (A "blacklist" is used to designate a company that is found in violation of the terms of the law.).

[113] *Id.*

[114] *See supra*, Findings of Congress, note 97.

[115] *Id.*

[116] *Id.*

[117] *Id*.

[118] *Id*.

2. *Texas*

In response to President Biden's climate-related Executive Orders,[119] Texas Governor Greg Abbot issued his own Executive Order in an attempt to protect the oil and gas industry from federal influence.[120] A full two years before Governor DeSantis spearheaded the Alliance, the Texas legislature was already debating SB 13, which eventually was signed into law on June 14, 2021.[121] The rationale given for SB 13 was to protect and acknowledge the importance of the oil and gas industry to the state's economy, operating budget, as a means to prevent increased energy costs, and to address national security concerns.[122] Substantively, SB 13 requires the State Treasurer to create a list of "financial companies" that have been found to boycott the fossil fuel-based energy industry.[123] Once compiled, state entities are required to divest from those on the list, and be prohibited from contracting with other companies that continue to boycotting the affected industries.[124] Importantly, the law has exceptions for divestment if there is clear and convincing evidence that it would cause a loss in value, is inconsistent with the state entity's fiduciary duty, or is an indirect holding or passively managed fund.[125] There are also exceptions for contracting based on the value of the contract and size of the company or if it is also inconsistent with the entity's statutory or fiduciary duty.[126]

There was concern raised as to how the law may affect the $46 billion Texas Permanent School Fund, the $165 billion Teacher Retirement, and the $31 billion Employees and Municipal Retirement Systems.[127] State Representative Gene Wu (D-Houston) also expressed free-speech concerns, claiming:

> *"[the bill would] … punish companies for their thoughts and internal policies, whether they carry them out or not."*[128]

The insurance industry also came under scrutiny. After multiple attempts, similar ESG-based restrictions were eventually applied to the industry with the 2023 passage of SB 833. This law prevents insurance providers from using ESG-related factors in the underwriting process that are unrelated to "sound actuarial principles" or "expected losses and expenses" related to insurance risks.[129] The intent of the

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[119] *See supra*, President Biden Executive Orders, at note 36.

[120] Texas Executive Order No. GA-33, "Relating to protection of Texas's energy industry from federal overreach," (Jan. 28, 2021); *available at* https://gov.texas.gov/uploads/files/press/EO-GA-33_protection_of_Texas%e2%80%99s_energy_industry_IMAGE_01-28-2021.pdf

[121] Texas SB 13 (Legislative Session 87/R), ("SB 13"); (Introduced on March 11, 2021.); *available at* https://capitol.texas.gov/billlookup/text.aspx?LegSess=87R&Bill=SB13

[122] Senate Research Center, SB 13 bill analysis, (Jun. 6, 2021); *available at* https://capitol.texas.gov/tlodocs/87R/analysis/pdf/SB00013F.pdf#navpanes=0

[123] *Supra*, SB 13, note 121.

[124] *See id.*

[125] *Id.*

[126] *Id.*

[127] Douglas, Erin, *The Texas Tribue*, "Texas Legislature advances bills to shield oil and gas from climate initiatives," (May 3, 2021); *available at* https://www.texastribune.org/2021/05/03/texas-house-fossil-fuel-oil-divest/

[128] Ibid.

[129] Texas SB 833 (2023-2024 – 88th Legislature); (Signed into law Jun. 6, 2023); *available at* https://legiscan.com/TX/text/SB833/id/2817495

law was to prevent a "political or social agenda" from influencing the insurance market, and to reaffirm that underwriting decisions must be based on an "ordinary insurance business purpose."[130]

3. Florida

As previously discussed, Florida's HB 3 was a multi-faceted bill that was consistent with the Alliance's dual recommended state action.[131] Florida originally took a slightly different approach in responding to how it evaluated whether "financial institutions" use ESG-related factors in their business risk assessments. HB 3 included a provision that would subject financial institutions to "administrative sanctions" if they engaged in a newly created "unsafe and unsound business practice" standard.[132] This standard prohibits financial institutions from "debanking" or refusing financial services based on political beliefs, a social credit score, or association with certain groups that is not a "quantitative, impartial, risk-based standard."[133] Unlike other state action, HB 3 did not create a framework for creating a blacklist and corresponding prohibitions on engagement from state agencies.

However, on May 2, 2024, Governor DeSantis signed into law HB 989 amending HB 3.[134] HB 989 provides that both customers and members of a financial institution may file a complaint with the state if there is evidence that a financial institution engaged in the previously discussed "unsafe and unsound business practice."[135] Once a timely and properly reported allegation is submitted to the Florida Office of Financial Regulation ("OFR"), an investigation would commence.[136] If the OFR determines that a violation may have occurred, the accused financial institution can defend itself against the allegations.[137] Sanctions and penalties remain the same as created in HB 3, including possible review under the Florida Deceptive and Unfair Trade Practices Act which includes criminal and civil liabilities.[138]

One significant amendment to HB 3, that has likely grabbed the attention of national banks, is that HB 989 removed language that narrowed the applicability of HB 3 to state-charted or authorized banks and credit unions.[139] HB 3 now appears to apply to all banks that operate in Florida. This change certainly appeared to be top of mind when Governor DeSantis signed the bill stating that:

> *"We are not going to allow big banks to discriminate based on someone's political or religious beliefs … ."*[140]

With HB 989 going into effect on July 1, 2024, the real question is whether there will be any unintended consequences from limiting the banking market in an attempt to obtain a broader public policy goal.

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[130] *Id.*
[131] *Supra*, Alliance Statement, note 51
[132] *Supra,* HB 3, note 121.
[133] *Id.*
[134] Florida HB 989 (2024 Regular Legislative Session); *available at* https://legiscan.com/FL/bill/H0989/2024
[135] *Id.*
[136] *Id.*
[137] *Id.*
[138] *Id.*
[139] *See id.*
[140] Office of the Florida Governor, Press Release, Governor DeSantis Signs Legislation to "Strengthen Florida's Protections Against the Agenda of the Global Elite"

While there may be some comparisons to the federal efforts to pass FABA, it is probably still too early to tell whether other states will follow Florida's lead.

4. Oklahoma

One year after Texas enacted SB 13, Oklahoma passed HB 2034, which uses similar language. HB 2034, the Energy Discrimination Elimination Act ("EDEA") was signed into law by Governor Kevin Stitt on May 9, 2022 and went into effect on November 1, 2022.[141] EDEA requires the State Treasurer to create a list of "financial companies" that have been found to boycott the fossil fuel-based energy industry.[142] Once the list is compiled, state "entities," including municipalities, will be required to divest from those on the list as well as be prohibited from contracting with any company that is found to be boycotting the industry.[143] Importantly, the law has exceptions for divestment if there is clear and convincing evidence that it would cause a loss in value, is inconsistent with the state entity's statutory or fiduciary duty, or is an indirect holding or passively managed fund.[144] As with the Texas law, there are also exceptions for contracting based on the value of the contract and size of the company.[145]

As one of the first examples of a state entity taking advantage of the "exceptions," the Trustees for the Oklahoma Public Employee Retirement System voted 9-1 to avoid divesting from asset manager BlackRock, who had previously been added to the blacklist.[146] The Trustees indicated that an outside investment advisor estimated that it may cost upwards of $10 million to divest from BlackRock as well as banks on the blacklist.[147] However, State Treasurer Todd Russ, the single vote against using the exception, indicated that the administrative costs associated with divesting should not be included in the calculation given that the EDEA specifically referenced only loss in "asset value."[148] Russ recommended that the Trustees obtain a legal opinion from the Oklahoma Attorney General to resolve the dispute.[149] In response to the controversy, Glen Mulready, Oklahoma Insurance Commissioner, member of the pension system's board, and former Republican state lawmaker indicated that:

> *"We were talking about a potential $10 million hit to our pensioners … [i]f we thought that we could have abided by the law without hurting the pension fund we would have done that in a heartbeat. But we have a fiduciary responsibility."*[150]

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[141] Oklahoma HB 2034, "Energy Discrimination Elimination Act of 2022," (2022 Regular Session), ("EDEA"); *available at* https://legiscan.com/OK/text/HB2034/2022

[142] *See id.*

[143] *Id*.

[144] *Id.*

[145] *Id.*

[146] Monies, Paul, *Oklahoma Watch*, "Oklahoma Public Employees' Pension System Takes Exemption to Banking Law," (Aug. 23, 2023); *available at* https://oklahomawatch.org/2023/08/23/oklahoma-public-employees-pension-system-takes-exemption-to-banking-law/

[147] Ibid.

[148] Ibid.

[149] Ibid.

[150] Rives, Karin, *S&P Global*, "Wall Street thrived, small towns lost as anti-ESG campaign raged in 2023," (Jan. 3, 2024); *available at* https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/wall-street-thrived-small-towns-lost-as-anti-esg-campaign-raged-in-2023-79749380#:~:text=%22If%20we%20thought%20that%20we,to%20be%20resolved%2C%20Mulready%20said.

Another example of using an "exception" happened a few months later when Treasurer Russ indicated that it would be impractical to sever ties with blacklisted banks JPMorgan Chase and Bank of America without resulting in a financial loss to the state.[151] It's worth mentioning that asset manager BlackRock has over $15 billion invested in energy companies in Oklahoma, JPMorgan provided more than $2 billion in financing to fossil fuel companies in Oklahoma between 2021 and 2022, and that Bank of America has "a wide range of oil and gas clients in Oklahoma."[152] The Treasurer attempted to distinguish between using banks for investments and financial services.[153] That did not; however, stop Oklahoma House Speaker Charles McCall from using his authority to replace two of the nine Trustees who voted against divestment after a state Senate "interim study" on the 2022 law.[154]

The following month, on November 20, 2023, the former president of the Oklahoma Public Employees Association filed suit claiming that EDEA is unconstitutional and conflicts with the long-standing position that "decisions about pension funds must be made for the 'exclusive benefit' of its beneficiaries."[155] An Oklahoma District Court judge granted a temporary injunction and then on July 19, 2024 ruled that the state is barred from enforcing the law citing the same arguments made when issuing the temporary injunction.[156] In initially enjoining the state, the judge found that the law may well be unconstitutionally vague and violative of the Oklahoma Constitution's "exclusive benefits" provision.[157] The Oklahoma Attorney General's office indicated that it would appeal the ruling.[158]

Before the judicial decision to temporarily suspend the law, the legislature attempted to pass multiple amendments to EDEA, including HB 3541 that would have broadened the definition of "boycotted

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[151] Monies, Paul, *Oklahoma Watch*, "Oklahoma treasurer criticizes pension system for taking exemption his office exercised," (Nov. 26, 2023); *available at* https://www.oklahoman.com/story/news/2023/11/26/oklahoma-treasurer-todd-russ-using-exemption-to-energy-discrimination-elimination-act-he-criticized/71677942007/; *also* Pitcher, Jack, *Wall Street Journal*, "Oklahoma Finds It Hard to Break Up With JPMorgan and BlackRock," (Dec. 14, 2023); *available at* https://www.wsj.com/finance/banking/oklahoma-finds-it-hard-to-break-up-with-jpmorgan-and-blackrock-9d022e05?mod=livecoverage_web

[152] Ibid.

[153] Ibid.

[154] Monies, Paul, *Oklahoma Watch*, "Politics, Policy Clash Over Energy Boycott Law," (Oct. 10, 2023); *available at* https://oklahomawatch.org/2023/10/11/politics-policy-clash-over-energy-boycott-law/

[155] Forman, Carmen, *Oklahoma Voice*, "State retiree files legal challenge over Oklahoma's bank boycott law," (Nov. 20, 2023); *available at* https://oklahomavoice.com/2023/11/20/state-retiree-files-legal-challenge-over-oklahomas-bank-boycott-law/

[156] Prang, Allison, *Politico Pro,* "Oklahoma judge scraps state anti-ESG boycott law," (Jul, 19, 2024); *available at (behind paywall)*; https://subscriber.politicopro.com/article/2024/07/oklahoma-judge-scraps-state-anti-esg-boycott-law-00169892?source=email, *also,* Webb, Dominic, *responsible investor*, "Oklahoma court issues temporary injunction against state energy boycott law," (May 8, 2024); *available at* https://www.responsible-investor.com/oklahoma-court-issues-temporary-injunction-against-state-energy-boycott-law/

[157] *See* LaClair, Tara and Timmons, Jeanette, *Steptoe & Johnson PLLC,* "Oklahoma Court Says State Cannot Enforce Anti-ESG Law for Now," (May 15, 2024); *available at* https://www.steptoe-johnson.com/news/oklahoma-court-says-state-cannot-enforce-anti-esg-law-for-now/

[158] Oklahoma Office of the Attorney General, *New Release*, "Attorney General's Office set to appeal injunction against state's anti-ESG law," (Jul. 19, 2024); *available at* https://oklahoma.gov/oag/news/newsroom/2024/july/attorney-generals-office-set-to-appeal-injunction-against-state-s-anti-esg-law.html

company" to include "timber, mining, and agriculture."[159] In addition, and presumably in response to the confusion over implementing EDEA, SB 1536 was introduced to require an opinion from the Oklahoma Attorney General if the State Treasurer disagrees with a divestment decision by a government entity.[160]

While EDEA focuses on how the state will respond to allegations that financial institutions are boycotting the fossil fuel sector, there was also an attempt in Oklahoma to restrict financial institutions from either debanking or refusing financial services to otherwise qualified customers.[161] SB 672, the "Fair Access to Financial Services Act," is similar to FABA in that it mandates financial institutions to provide service unless a "documented failure to meet quantitative, impartial, risk-based financial standards established in advance by the financial institution."[162] This provision uses identical language as FABA, though other provisions are slightly different.[163]

It is of course difficult to say with certainty that politics has not played a role in the aftermath of EDEA's passage, but it is clear that there is confusion with its implementation.

5. Arkansas

Arkansas, also a member of the Alliance, addressed the anti-boycott issue by passing HB 1307, the "State Government Employee Retirement Protection Act."[164] In a slightly different approach, HB 1307 created a five-person ESG Oversight Committee that determines which financial service providers to place on a blacklist maintained by the State Treasurer.[165] The law is broader than other states in that the discrimination addressed applies not only to the energy and firearms industries, but also has a catch-all provision that includes discrimination for any non-pecuniary ESG-related reasons, specifically listing environmental impact and diversity and inclusion policies.[166] However, discrimination does not cover actions taken by financial institutions that are "in accordance with the investment-related guidelines, policies, or preferences of its clients."[167] While a broader set of industries will be included, it does allow financial institutions some flexibility with actions they take with other clients. The legislative intent is an attempt to prevent financial institutions from having "general discriminatory policies" against companies based on non-pecuniary ESG-related factors.[168]

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[159] Oklahoma HB 3541 (2024 Regular Session); (Introduced Feb. 5, 2024, passed the House 78-15, but died in the Senate); *available at* https://legiscan.com/OK/bill/HB3541/2024
[160] Oklahoma SB 1536 (2024 Regular Session); (Introduced Feb. 5, 2024, passed the Senate 43-1, but died in the House.); *available at* https://legiscan.com/OK/bill/SB1536/2024
[161] Oklahoma SB 672 (2023 and 2024 Regular Sessions); (Originally introduced Feb. 7, 2023, but died in Committee.); *available at* https://legiscan.com/OK/text/SB672/2024
[162] *Id.*
[163] *Id.*
[164] Arkansas HB 1307 (2023 94th General Assembly); (Passed Mar. 30, 2023.); *available at* https://legiscan.com/AR/bill/HB1307/2023
[165] *Id*; (One member of the committee shall be appointed by the Governor, President Pro Tempore of the Senate, Speaker of the House of Rep., Attorney General, and Treasurer).
[166] *Id.*
[167] *Id.*
[168] *See id.*

Similar to other states, the law also prevents public entities from investing funds in and requires the Treasurer to divest from those on the blacklist.[169] However, slightly different than other states, the Treasurer must divest from both direct and indirect holdings over a period of time depending on the type of investment.[170] Also, exempted are investments that are locked in with a maturity date that divestment from would result in a financial penalty or negative impact to the state.[171]

Arkansas also prohibited contracting with companies, excluding financial services providers addressed in SB 62, that boycott "energy, fossil fuels, firearms, and ammunition industries."[172] This narrowly drafted law has exceptions for contracts with values less than $75,000 or that the goods and services provided are offered "at 20% less than the lowest certifying business."[173]

6. *California, New York, and Maine*

Democrat controlled states have also expressed their political will through mandatory divestment laws of certain industries. In 2015, California led the divestment effort when it passed California SB 185, which mandated that the state's (and country's) two largest public pension funds, the California Public Employees' Retirement System ("CalPERS") and the California State Teachers' Retirement System ("CalSTRS"), divest from thermal coal by 2017.[174] In New York, no divestment legislation has been able to pass; however, several state retirement systems announced their divestment from fossil fuel companies in December of 2021.[175] In 2023/4 California SB 252 was introduced in an attempt to require CalPERS and CalSTRS to divest from oil and gas.[176] However, both CalPERS and CalSTRS objected.[177] While they both indicated that they recognized the material risk of climate change, they stated that the risk should be addressed through advocacy and engagement, not divestment.[178] Further, if the goal was to effect change, divestment was not the right strategy because fossil fuel companies would get other

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[169] *Id.*
[170] Id.
[171] *Id.*
[172] Arkansas SB 62 (2023 94th General Assembly); (Passed Mar. 30, 2023); *available at* https://legiscan.com/AR/bill/HB1307/2023
[173] *Id*.
[174] California SB 185 (2015-16 Regular Session); (Passed Apr. 8, 2015); *available at* http://www.leginfo.ca.gov/pub/15-16/bill/sen/sb_0151-0200/sb_185_cfa_20150528_124751_sen_comm.html;
[175] New York City Comptroller, New Release, (Dec. 22, 2021); *available at* https://comptroller.nyc.gov/newsroom/comptroller-stringer-and-trustees-announce-successful-3-billion-divestment-from-fossil-fuels/#:~:text=Stringer%20and%20trustees%20of%20the,to%20an%20estimated%20%243%20billion.
[176] California SB 252 (2023-24 Regular Session); *available at* https://legiscan.com/CA/bill/SB252/2023
[177] CalPERS, *Perspective*, "Why We're Opposing Divestment in Senate Bill 252," (2023); *available at* https://news.calpers.ca.gov/why-were-opposing-divestment-in-senate-bill-252/ ; CalSTRS, "Bill Analysis" of SB 252 as amended May 18, 2023, (Oppose); *available at* https://www.calstrs.com/files/711684e4c/SB252-amended-5-18-23.pdf
[178] *See* CalPERS, *Perspective*, "Why We're Opposing Divestment in Senate Bill 252," (2023); *available at* https://news.calpers.ca.gov/why-were-opposing-divestment-in-senate-bill-252/ ; *see also* CalSTRS, *Path to new zero,* "CalSTRS' perspective on fossil fuel divestment (2021); *available at* https://www.calstrs.com/calstrs-perspective-on-fossil-fuel-divestment; *see also* CalPERS & CalSTERS, "The Importance of Corporate Engagement on Climate Change" ("Our fiduciary obligations generally prohibit us from sacrificing investment performance for the purpose of achieving goals that do not directly relate to our operations or providing promised retirement benefits."); *available at* https://www.calpers.ca.gov/docs/corporate-engagement-climate-change.pdf

investors.[179] Finally, they both acknowledged their fiduciary duty to make investment decisions based on long-term growth as well as incorporate diversification as a strategic principle in prudent investing.[180] Their support of strategic investing was bolstered by the fact that the energy sector, including fossil fuels, began its market recovery in 2021.[181]

While California and New York were unable to pass divestment bills, in 2021, Maine was able to pass a divestment bill by an overwhelming majority.[182] The bill required divestment from fossil fuel companies by January 1, 2026, "consistent with sound investment criteria and fiduciary obligations."[183] Unfortunately for the supporters of the mandate, it does not appear that the Maine Public Employee Retirement System will meet the 2026 deadline, arguing that its fiduciary responsibility dictates that they not fully divest by the 2026 deadline.[184] The fund's CEO Rebecca Wyke explained to lawmakers that:

> *"The trustees absolutely have to act in the best interests of those pension recipients as beneficiaries, not as people who live on this earth, but as beneficiaries … it is a very high standard…."*[185]

As with mandatory divestment for companies that boycott others, mandates for divestment for political or social reasons must allow investment professionals to exercise their fiduciary responsibility in making investment decisions even if doing so effectively circumvents the primary intent of the law. Whether one is including or excluding based on ESG-related investment principles, in the end, the fiduciary duty owed should protect investment decisions from political interference.

CONSEQUENCES OF POLITICS OVER POLICY

The proliferation of "anti-ESG" bills in a relatively short period of time was bound to result in some unintended consequences. While the intent to remove politics from investment and business decisions is certainly a reasonable endeavor, restricting the way ESG factors can be used and the penalties for misusing those factors, with significant exceptions, may well end up undermining the original intent of the laws. Moreover, the implementation and interpretation of those laws have consequences that need to be thoroughly analyzed to help mitigate any negative economic results from them.

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[179] *Ibid.*

[180] *Ibid.*

[181] *See* International Energy Agency (IEA), "World Energy Outlook 2022," (2022); *available at* https://www.iea.org/reports/world-energy-outlook-2022/executive-summary ; *see also* Ed. Board, *Los Angeles Times*, "Shame on California lawmakers for killing fossil fuel divestment bill again," (Jun. 21, 2024); *available at* (https://www.latimes.com/opinion/story/2024-06-21/editorial-what-will-it-take-for-california-to-stop-investing-retirement-funds-in-dirty-fossil-fuels

[182] Maine LD 99 (2021-22 130th Legislature); (Effective Oct. 18, 2021); (Passed 313 to 18); *available at* https://legiscan.com/ME/bill/LD99/2021

[183] *Id.*

[184] Feinberg, Robbie, *Maine Public*, "Maine's public retirement system says 'fiduciary duties' limit divestment from fossil fuels," (Mar. 13, 2024); *available at* https://www.mainepublic.org/business-and-economy/2024-03-13/maines-public-retirement-system-says-fiduciary-duties-limit-divestment-from-fossil-fuels

[185] Popp, Evan, *Maine Morning Star*, "State pension fund criticized for failing to prioritize fossil fuel divestment despite 2021 law," (Mar. 14, 2024); *available at* https://mainemorningstar.com/2024/03/14/state-pension-fund-criticized-for-failing-to-prioritize-fossil-fuel-divestment-despite-2021-law/

Consequences are amplified by the confusion over ESG which can lead to unnecessarily complex and potentially counterproductive legislative solutions. Further, using divestment as a political remedy can have negative economic consequences, and unreasonably restricting the use of ESG can undermine the fiduciary duty of corporate boards, management, asset owners, and asset managers, as well as long established industry-based risks assessments in the banking and insurance sectors.

Confusion Over ESG Can Lead to Unnecessarily Complex and Potentially Counterproductive Legislative Solutions

1. *ESG: Impact vs Integration*

Understanding the difference between using ESG for impact vs. integration is vital to drafting laws that on the one hand, protect citizens from economic decisions being made to foster a political, social, or ideological agenda, and on the other, protect citizens from the negative consequences of unreasonably restricting investment and business decisions made under the obligation of a fiduciary duty. The subjectivity inherently involved with assessing ESG does in fact make this a difficult, but not an impossible task. How this assessment is conducted and then implemented is key to drafting laws that allow for the integration of financially based ESG factors.

However, to accomplish this task, laws must be carefully drafted to avoid unreasonably restricting those individuals with the expertise to make investment and business-related decisions. These individuals must be given the ability to adequately analyze all relevant facts and circumstances, which often requires analyzing subjective data including non-financial factors. The failure to allow this kind of analysis will undoubtedly mean that economically relevant data will not be properly assessed in the decision-making process and eventually result in a loss. This is precisely why those with this vitally important responsibility have been charged with a fiduciary duty. If laws are enacted that too narrowly apply pecuniary/financially related data restrictions, states risk significant economic harm. While the stated goal of these types of "anti-ESG" legislation is to prevent state sponsored "impact investing," states need to be careful not to overlook the importance of ESG integration both at the investment and business level analysis and decision making.

2. *Exceptions Become the Rule*

Another consequence of unnecessarily complex rules is that when integrated with existing laws many times the exceptions to the laws become the "rule." Here most of the ESG-related laws in both Republican and Democrat states have significant exceptions incorporated in the laws. While exceptions to laws tend to mitigate unintended consequences, they nonetheless heighten the risks that those exceptions will not be applied or interpreted as legislatively intended. As a practical matter, if the exceptions to the rules become the focus of the law, one must seriously consider whether the law was prudently drafted or needed at all. While the intent to fix the problem may be reasonable, the law itself may not be the best way to solve the problem.

3. *Numerous ESG Bills Attempted, But Most Fail*

The confusion over and complexity of several "anti-ESG" issues can be seen in the sheer number of bills that have been introduced over the past few years. Since 2021, there have been 373 "anti-ESG" bills introduced in 39 states resulting in 42 laws passed in 19 of those states, compared to 17 "pro-ESG" laws

enacted in just eight states since 2021.[186] Further, in 2023, arguably the height of the "anti-ESG" movement, 36 states introduced 198 bills and only 23 were passed into law.[187] While the legislative process was designed to propose and debate bills and amendments, the sheer number of bills introduced may be a sign that the confusion over ESG has led to both proponents and opponents talking past each other through the legislative process. Taking the time to better educate policymakers should continue to be a priority for anyone that understands the complexity of ESG and acknowledges the hyper-partisan environment that these political discussions occur in.

State Divestment of Banks, Asset Managers, and other Targeted Companies Can Have Negative Financial Consequences

1. In General: Reduced Competition

States that agree to divest from companies that play an important economic role need to understand that such action will likely result in less competition.

In response to concern over the passage of Texas SB 13 & 19, the Brookings Institute commissioned a paper ("Brookings Paper") to evaluate how the Texas legislation may negatively impact the Texas financial markets, in particular *competition* in the municipal bond market.[188] The paper found that due to the legislation, five of the largest municipal bond underwriters departed the Texas market.[189] Unsurprisingly, the departure of five of the largest municipal bond underwriters decreased competition, though they did eventually come back in a limited capacity,[190] which drove up the cost of borrowing because the remaining banks had increased market power and could negotiate higher rates.[191]

In response to the findings from the 2023 Brookings Paper, the Texas Association of Business Chambers of Commerce Foundation commissioned a study ("Chamber Study") on the same Texas legislation.[192] While the Brookings Paper looked at the competition in the bond market, the Chamber Study looked at the *transaction costs* associated with issuing debt and its impact on the Texas economy.[193] Similarly to the Brookings Paper, the Chamber Study argues that a constrained bond market resulted in less

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[186] Pleiades Strategy, "Live Anti-ESG State Action Tracker," (Jun. 16, 2024); *available at* https://drive.google.com/file/d/1e1PkwVGbMPb7ZhI1W3CYxNce3jJWHBmY/view (accessed July 18, 2024); *see also supra*, note 45.

[187] Ibid.

[188] Garrett, Daniel, University of Pennsylvania and Ivan Ivanov, Federal Reserve Bank of Chicago, *Brookings Hutchins Center on Fiscal & Monetary Policy*, "Gas, Guns, and Governments: Financial Costs of Anti-ESG Policies,"("Brookings Paper"), (April, 2023); *available at* https://www.brookings.edu/wp-content/uploads/2023/03/WP85-Ivanov-Garrett_formatted.pdf

[189] Ibid.

[190] Garrett, Daniel and Ivan Ivanov, *Brookings Institute Blog*, "Gas, guns, and governments: Financial costs of anti-ESG policies," (Apr. 12, 2023); (The departed banks returned to Texas in a limited capacity a year after the law passed); *available here* https://www.brookings.edu/articles/gas-guns-and-governments/

[191] *See supra*, Brookings Paper, note 186.

[192] Texas Association of Business Chambers of Commerce Foundation commissioned TXP, Inc., "The Potential Economic and Tax Revenue Impact of Texas' Fair Access Laws," ("Chamber Study"), (Winter, 2024); *available at* https://cb9cdd3c-61f1-494f-94da-c77c057de62c.usrfiles.com/ugd/cb9cdd_d0b8b35ea13b4294be456e4113abef3b.pdf

[193] Ibid.

competition which in turn led to higher interest costs.[194] In a normal market environment, if a business left the market another would emerge to fill its place. Unfortunately, as was found to be the case here, when legal and/or regulatory hurdles are set too high, potential market participants become unable to overcome the cost of entry, resulting in less competition and higher overall costs.[195]

In response to concerns expressed regarding Oklahoma HB 2034 (EDEA), the Oklahoma Rural Association ("ORA") commissioned a study ("ORA Study") on the economic impacts of EDEA on the borrowing conditions for municipalities in the state of Oklahoma.[196] The ORA Study, though recently criticized,[197] also found reduced competition with the passage and implementation of EDEA.[198]

Competition, being a foundational element to a well-functioning capitalist-based economy, is something that state legislatures should carefully consider when drafting and implementing restrictive laws. While a state may conduct a cost-benefit analysis and determine that the cost of less competition, and its negative economic consequences, is acceptable when achieving the benefit of protecting certain industries, such action should receive heightened scrutiny, be thoroughly debated, and be based on sound financial and economic data including a full understanding of all possible consequences. This would be the same analysis and heightened scrutiny if a state decided that a certain level of negative economic consequences was justified in achieving a broader political or social goal.

2. *State Costs: Higher Interest Rates, Less Economic Development, Reduced Portfolio Performance*

This decreased competition, in the previously cited studies, resulted in hundreds of millions of dollars in higher interest costs. In addition, there were costs related to forgone associated economic activity, including state funded projects.

The Chamber Paper found, when *costs* were compared to averages from 2015 to 2021, that the Texas laws would result in increased costs of over $240 million for the state.[199] The Brookings Paper concluded that if the impact analyzed continued, Texas could expect an additional $300-$500 million in interest costs.[200] The ORA Study found that the Oklahoma EDEA raised borrowing costs by 59 basis points, which

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[194] Ibid.

[195] *See* Ibid.

[196] Roach, Travis, Univ. of Central Oklahoma, *Oklahoma Rural Association* ("ORA"), "Unintended Consequences of the Energy Discrimination Elimination Act," ("ORA Study") (April 22, 2024); *available at* https://www.oklahomarural.online/_files/ugd/283c8e_ea08d46831cd42798bd4c400bce0140e.pdf

[197] *See* Rice, Paul, *RealClear Energy*, "Oklahoma's Anti-ESG Law Is Not Hurting Sooner State Taxpayers or Retirees," (Jun. 13, 2024); *available at* https://www.realclearenergy.org/articles/2024/06/13/oklahomas_anti-esg_law_is_not_hurting_sooner_state_taxpayers_or_retirees_1038011.html; *also* Ginn, Vance and Byron Schlomach*, American Energy Institute*, "Examining Oklahoma's EDEA of 2022,"(June, 2024); *available at* https://americanenergyinstitute.com/docs/Fact_vs_Fiction_OEDEA_AEI_v2-1.pdf; *contra* (While the data and methodology used in the ORA Study may be questioned, and outside the scope of this paper, some of the ORA Study's conclusions are based on basic economic theory regarding competition. In addition, some of the findings in the ORA Study were also found, by analogy, in the Brookings' and Chamber's Studies regarding a comparatively similar law in Texas).

[198] *See supra,* ORA Study, note 195.

[199] *See supra,* Chamber Study, note 191.

[200] *See supra,* Brookings Paper, note 187.

is almost a 16% increase.[201] The increased borrowing costs, as of April of 2024, were calculated to be more than $184.7 million, or roughly $10.8 million a month.[202]

The Chamber Study also found that when applied to a statewide model, Texas lost over $668 million in *economic development activity*.[203] It also found over $187 million in decreased annual earnings and over $37 million in lost state and local tax revenue.[204] Further, it found that the decreased economic activity would cause the loss of over 3,000 full-time jobs.[205] Overall, the Texas economy lost roughly $2.84 billion in Gross State Product.[206] An example of a specific loss involved an East Texas area school district that approved an $18.6 million bond initiative to fix its schools.[207] UBS Group won the bid offering the best financial terms to the school; however, UBS had a week earlier been placed on the state blacklist and was therefore unable to fulfill the contract even though it offered the lowest interest rate amongst the competition.[208]

The Brookings Paper also found that implementing the Texas legislation created a heightened sense of uncertainty causing additional negative impacts on economic development.[209] The ORA Study in Oklahoma found that reduced competition led to higher borrowing costs that consequently had negative effects on other government developmental projects.[210] Further, the ORA study found that that the delays and possible cancellations in state projects also contributed to economic uncertainty in the state.[211]

Furthermore, the intent of creating blacklists with the threat of subsequent divestment is ultimately done to change corporate behavior. However, studies have found that divesting from a disfavored company with the intent of changing a company's action rarely has that intended effect.[212] In fact, divestment from a company or whole sector may well cost portfolios the protection of diversification, a

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[201] *See supra,* ORA Study, note 195.
[202] Ibid.
[203] *Supra,* Chamber Study, note 191.
[204] Ibid.
[205] Ibid.
[206] Ibid.
[207] Tomlinson, Chris, *Houston Chronicle,* "Texas started a war against 'anti-fossil fuel' banks. It could cost taxpayers $22 billion," (Feb. 21, 2024); *available at* https://www.houstonchronicle.com/business/columnists/tomlinson/article/texas-banks-climate-change-boycott-18672601.php
[208] Ibid.
[209] *See supra,* Brookings Paper, note 187.
[210] Roach, Travis, Univ. of Central Oklahoma, *Oklahoma Rural Association* ("ORA"), "Unintended Consequences of the Energy Discrimination Elimination Act," (April 22, 2024); *available at* https://www.oklahomarural.online/_files/ugd/283c8e_ea08d46831cd42798bd4c400bce0140e.pdf
[211] Ibid.
[212] Eccles, Robert G., Rajgopal, Shivaram and Xie, Jing, *S&P Global Market Intelligence*, "Does ESG Negative Screening Work?," (April 30, 2022); *available at SSRN:* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4150524; *see also* Gelfand, Alexander, *Stanford Graduate School of Business*, "Why Divestment Doesn't Hurt 'Dirty' Companies," (Oct. 27, 2021); *available at* https://www.gsb.stanford.edu/insights/why-divestment-doesnt-hurt-dirty-companies

bedrock investing principle for long-term investing and coincidentally a requirement under ERISA.[213] As such, states need to be cautious when divesting from companies, including asset managers and banks, because of how they evaluate ESG factors, especially with respect to internal decisions, as well as divesting from disfavored companies because of decisions made with regard to the interests of their other clients. Divesting for either reason may end up harming investment portfolios. While most of the "anti-ESG" laws have exceptions for these situations, uncertain implementation may be an unintended consequence causing economic harm that will ultimately be suffered by a state's citizens through increased taxes or reduction in services or projects.

3. Company Costs: Compliance, Diminished Returns, and Less Value Creation

There are also costs for companies associated with complying with the new laws regardless of whether the company can prevent the state from including it on a blacklist. Once on the list, there will be additional costs in responding to the allegations and efforts to be removed from the list. There are also costs associated with documenting the actions taken by a company in making business decisions that might be construed as being based on subjective criteria outside the definition of that based on pecuniary or financial factors. There are also costs due to the constantly changing definitions of what is considered ESG as well as the resources needed to evaluate the corresponding data associated with ESG. For example, Anthony DeMarco of the Florida Bankers Association indicated that bills such as Florida HB 3, and by analogy Oklahoma SB 672 and FABA, "will drastically increase compliance costs on the banking industry."[214]

"Anti-ESG" Legislation Can Undermine Fiduciary Duty of Corporate Boards & Management, Asset Managers & Owners, and Targeted Industries

It is important to remember the significance of a fiduciary duty as it is acknowledged as being the highest duty owed in the law. While violations of fiduciary duty certain occur, minimizing or disregarding the importance of this duty to solve a political issue undermines the duty and those that have come to rely on it.

1. Corporate Boards & Management

On the corporate side, boards and management, with reasonable input from their shareholders, must be allowed to exercise their fiduciary duty in making business decisions in the best interest of the company. Attempts to micromanage the decisions of corporate boards and management have consistently been criticized by pro-business legislators at the state and federal levels. One of the central purposes of having a board oversee the management of the day-to-day decisions is to ensure a certain level of oversight for investors, while allowing the business to successfully operate. This oversight, as has been referenced, includes a fiduciary duty. To the extent that a board or management violates their fiduciary duty to shareholders, there are existing legal remedies. A consequence of undermining that

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[213] *Supra,* ERISA, note 5 at Sec. 1104(a)(1)(C); *also see* California State Teachers' Retirement System ("CalSTRS") statement on divestment, "CalSTRS' perspective on fossil fuel divestment," *available at* https://www.calstrs.com/calstrs-perspective-on-fossil-fuel-divestment

[214] Florida House Commerce Committee Hearing, Florida Bankers Association, Anthony DeMarco, EVP of Government Relations (Comments at 01:03:50), (Mar. 8, 2023); *available at* https://www.myfloridahouse.gov/VideoPlayer.aspx?eventID=8550

responsibility and duty will lead to less efficient and effective decision making, not to mention the additional resources need to comply with the additional scrutiny for the laws in question.

2. *Asset Managers and Owners*

From the investor side, asset owners and asset managers must be allowed to use their expertise in making investment decisions for their beneficiaries and clients. As with corporate boards, asset owners and asset managers also have a fiduciary duty that must be followed. Asset owners can make investment decisions directly and/or use outside asset managers. In both cases these investment decisions must be made by a knowledgeable person who is able to evaluate all economically relevant factors and, importantly, use their judgment to assess those factors when making investment decisions. To the extent that asset owners or asset managers insert their own interests or that of a third party's agenda in their decision making, the beneficiaries or clients of that fiduciary duty have existing legal remedies. A consequence of unnecessarily increasing oversight and including unreasonable compliance thresholds will likely result in higher costs that will ultimately be passed on to beneficiaries or clients.

3. *Banking & Insurance Industries*

Infringing on the duties of banks and insurance providers addresses a slightly different issue than with other corporate boards. Both banks and insurance providers are in the business of assessing risks and opportunities. While the focus of this subsection is geared toward the banking industry, the insurance industry has also been affected with the same types of ESG-related restrictions along with the inclusion of industry-specific exceptions i.e., "ordinary insurance business purposes" such as those included in Texas SB 833.[215] The consequences of this type of industry specific law is yet unclear, though challenges to what an "ordinary insurance business purpose" consists of should certainly be carefully monitored.

As for the banking industry, how a bank interacts or provides services with the public is of the utmost importance. As such, decisions to debank a client should be given special care in the age of confusion surrounding the use of ESG. Access to banking is one of the most vital services necessary for economic growth and, as such, should receive heightened but nonetheless reasonable scrutiny. On the flip side, a bank fiduciary must have the flexibility to make economic decisions that involve assessing all relevant economic data including ESG. Most banks have years of experience in sorting through vast quantities of economic data and sometimes have to make subjective decisions.

In restraining a bank's ability to decide who to bank with, legislators must acknowledge that some banks just aren't specialized in financing certain sectors.[216] Further, to be successful, banks have to analyze risks and opportunities outside the confines of an objective standard to include decisions based on "operation, reputational, and regulatory" assessments.[217] As such, there should be nothing inherently wrong with making subjective decisions or considering qualitative factors when making sound business decisions.[218] Consistent with a "pro-business" approach, the banking industry argues that they "… should be able to bank who we think we should bank and not be told who to bank and not who to bank… ."[219]

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[215] *Supra,* Texas SB 833, note 129.
[216] *Supra*, note 214.
[217] *See* American Bankers Association, "ABA Letter to OCC on Fair Access to Financial Services Proposal" (Jan 4., 2021); *available at* https://www.aba.com/-/media/documents/comment-letter/aba-letter-to-occ-fair-access-to-financial-services-01042021.pdf?rev=bcfdbbf0929440e68cbca9bfc9ada4af
[218] *See* ibid.
[219] *Supra,* note 214.

Adding to the discussion will be the consequences of Florida's recent amendments to HB 3, which now encompasses national banks that operate within the state.[220] There are already questions as to whether the amended law will survive legal challenges under the U.S. Constitution's interstate Commerce Clause or Federalism issues with regard to the authority of the Federal Reserve Board. In addition, The Treasury Department has singled out Florida's recent law as "interfering with financial institutions' ability to comply with national security requirements" including that related to terrorism, organized crime, and corrupt foreign officials.[221] These concerns appear to be focused on the law's restriction in considering non-financial factors in making a risk assessment.

In the end, legislators should acknowledge the ongoing fiduciary duty a bank's board and executives have to abide by in making sound business decisions. Infringing on this fiduciary duty undermines the free market. If laws are not carefully written to respond to the threats of debanking, states run the risk of creating an overly regulated industry that will inevitably become less efficient, less effective, and have a negative impact on the economy.

CONCLUSION

Whether it's too narrowly defining the proper use of pecuniary/financial factors or addressing perceived boycotts through mandating divestment, anytime constraints are imposed on assessing risks or opportunities for long-term value creation, there will almost certainly be added costs and unforeseen consequences. The included exceptions in most of the legislation should mitigate those consequences, though how they are applied through the administrative process and ultimately interpreted by the courts remains unclear.

Therefore, when responding to a highly politicized issue such as ESG, state legislatures should prudently analyze their existing laws to ensure that any unintended consequences are mitigated. This process starts with having a thorough understanding of ESG and how it is being used in relation to the problem the legislation is intended to resolve.

When the political rhetoric of ESG as being either always good or always bad is replaced with reasonable policy solutions, a state's citizens and pension beneficiaries will benefit. There is a commonsense approach to many of these complicated issues, but it requires that both sides fully understand what's at stake and work toward a compromised solution.

[220] *Supra*, Florida HB 989, note 134.

[221] Vanderford, Richard, *Wall Street Journal*, "State Laws Barring 'Debanking' Could Harm National Security, Treasury Says," (Jul. 19, 2024); *available at* https://www.wsj.com/articles/state-laws-barring-debanking-could-harm-national-security-treasury-says-ca30503a

ABOUT CENTERLINE

Centerline Liberties is a 501(c)3 focused on advancing policy solutions capable of defending core constitutional liberties, preserving a free market economy, and limiting the role of government in Americans' everyday lives. Centerline Liberties is committed to addressing the needs and desires of this forgotten majority, by working to advance policies that will positively impact all Americans, defending core constitutional liberties, and harnessing the opportunity and innovation derived from a free market economy.

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