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**To:** House Committee on Financial Institutions and Pensions

**From:** Melissa Renick, Assistant Director for Research

**Re:** Overview of ESG Standards; State and Federal Responses; Kansas Perspective

This memorandum outlines the emergence of Environmental, Social, and Governance (commonly referred to as ESG) standards and applicability of these standards to issues and topics before the Kansas Legislature and this committee.

## What is ESG, and how are these standards used to screen potential investments?

The U.S. Securities and Exchange Commission (SEC) defines **Environmental, Social** and **Governance** investing as "a way of investing in companies based on their commitment to one or more ESG factors."[1] Potential factors identified by the SEC include the risks and opportunities associated with the impacts of climate change on the company, its business, and its industry; the company's relationship with people and society; and how the company is run and its executive compensation. In practice, investment advisers and registered funds ("investors"), both retail and institutional, can apply ESG standards to their investment strategies. ESG considerations vary between investors, and some investors may also focus only on specific criteria within a factor.

Investors' interest in ESG factors has increased in recent years, with a reported growth in U.S. sustainable investments from nearly $640 billion in assets under management (AUM) in 1995 to $17.1 trillion by 2020.[2] The end of the last decade saw the steepest growth in the total of U.S. domiciled assets integrating these ESG strategies growing from a reported $12.0 trillion in 2018 to $17.1 trillion by 2020; in consideration of this level of assets considering ESG criteria, this level equates to 33 percent, or 1 in 3 dollars, of total U.S. assets that are professionally managed.[3]

1 Environmental, Social and Governance (ESG) Investing (accessed Jan. 31, 2023) https://www.investor.gov/introduction-investing/investing-basics/glossary/environmental-social-and-governance-esg-investing

2 *See* Carlson, Debbie, "ESG Investing Now Accounts for One-Third of Total U.S. Assets under Management", *Market Watch* (Nov. 17, 2020)

3 *See* US Sustainable Investing Forum, The Report on U.S. Sustainable and Impact Investing Trends" (Nov. 16, 2020).

### *Investor Strategies*

Following are two examples of asset management by investors utilizing ESG factors to inform ESG integration (BlackRock, Inc. or "BlackRock") or ESG and impact investing (Goldman Sachs Asset Management).

*ESG Integration*

In January 2020, BlackRock "committed to putting sustainability at the center of [its] investment process, based on the conviction that integrating sustainability-related information into the investment process can help [its] portfolio managers manage risk and make better informed investment decisions." BlackRock's investment teams follow the same principles in their approach to ESG integration: regularly reviewing exposure to ESG risks, using a breadth of sustainability-related data and analytics to develop investment-relevant insights, providing transparency around how sustainability-related information informs portfolio management practices.

Using this approach, ESG may include or cover:

- **Environmental**: climate risks, natural resources scarcity, pollution, and waste and environmental opportunities;
- **Social**: labor issues and product liability, risks such as data security and stakeholder opposition; and
- **Governance**: items relating to corporate governance and behavior, such as board quality and effectiveness.[4]

*ESG and Impact Investing*

The Goldman Sachs Asset Management (Goldman Sachs) 2022 statement on ESG and impact investing provides that ESG factors are "important tools for identifying investment risk and capturing opportunity." Investment teams (equities, fixed income, and liquidity and alternatives) analyze ESG information in a "manner consistent with their investment style and specific strategy guidelines." Further, ESG factors could be utilized to set exclusions, drive tilts, or seek to select securities with strong ESG ratings. Setting a broader framework, Goldman Sachs also states its commitment to "promoting and exercising effective stewardship" and elements of its stewardship approach in the key areas of proxy voting, direct engagement, and industry leadership.

ESG considerations, using Goldman Sachs analysis at the individual company level could include, but is not limited to:

- **Environmental**: water usage, waste generation, energy intensity, $CO_2$ emissions footprint, and $CO_2$ intensity;

4 *See* BlackRock webpage, sustainable investing and ESG integration (accessed Jan. 20, 2023). https://www.blackrock.com/ch/individual/en/themes/sustainable-investing/esg-integration

- **Social**: gender diversity of the company's workforce and UN Global Compact compliance; and

- **Governance and compensation**: board quality (*e.g.,* board independence and board term) and minority shareholder rights (*e.g.,* controlling shareholder and/or unequal voting rights).[5]

## State Legislature Responses to Investors—Anti-Boycott and No ESG Investment Legislation

Following are two representative examples of legislation passed in response to ESG investing. These responses include prohibitions on investment strategies that boycott certain companies as well as prohibitions on the use of certain funds on ESG investments.

### *Anti-Boycott*

In 2021, the Texas Legislature passed SB 13, which amended that state's Government Code to prohibit state agencies from contracting with or investing in financial companies that engaged in a boycott of fossil fuel-based energy firms. Among requirements of the law, which became effective September 1, 2021, the Comptroller of Public Accounts (Comptroller) must prepare, maintain, and provide to each state governmental entity (*i.e.* state public pensions system including the Teacher Retirement System of Texas and the Texas Municipal Retirement System), a list of all financial companies that boycott energy companies. A "financial company" under the law includes a publicly-traded financial services, banking, or investment company. The requirement applies to contracts between a governmental entity and a company with 10 or more full-time employees and those contracts with a value of $100,000 or more that is paid wholly or partly from public funds of the government entity. The law requires, in certain circumstances, the state's pension systems and the Permanent School Fund to sell, redeem, divest, or withdraw publicly traded securities of companies included in the Comptroller list.

The Comptroller posted the list in August 2022, which contained 10 financial companies, including BlackRock and nearly 350 individual funds (*i.e.,* index, equity, and money market funds).[6] Also in August 2022, 19 state attorneys general, including then Kansas Attorney General Derek Schmidt, submitted a letter to BlackRock's CEO in response to a prior BlackRock communication sent to several states that described BlackRock's position on energy investments with state pension funds. The letter outlined concerns about the goal to secure the best possible return on investment and concerns falling under jurisdictional authority as attorneys general (*e.g.,* neutrality, duty of care, and energy boycotts).

**Investor comment.** In response to the Comptroller's inclusion of BlackRock on the list of companies that boycott energy firms, BlackRock responded this opinion was not "fact-based,"

5 Goldman Sachs Asset Management's Statement on ESG & Impact Investing (accessed Jan. 30, 2023). https://www.gsam.com/content/dam/gsam/pdfs/common/en/public/miscellaneous/GSAM_statement_on_respon_sustainable_investing.pdf

6 The Comptroller maintains several divestment statute lists, including the "List of financial companies that boycott energy companies," at (accessed Jan. 30, 2023): https://comptroller.texas.gov/purchasing/publications/divestment.php

noting its investments of more than $100 billion in Texas energy companies.[7] A Texas legislative interim committee, the Senate Committee on State Affairs, conducted a road hearing in Marshall, Texas, on December 15, 2022. The Committee was charged with reviewing the investment practices of financial services firms and how those practices affect the state's public pensions. Responding to a question regarding BlackRock's relationship with cooperative initiatives (*e.g.,* Net Zero Assets initiative), a BlackRock official said the firm has maintained its independence with these groups, commenting "[W]e have one bias, and that's to get the best risk-adjusted returns for our clients."[8] [*Note*: Additional information regarding BlackRock is referenced in the discussion of the Kansas Pensions system and the investment policy and criteria assigned to the Kansas Public Employees Retirement System (KPERS) Board of Trustees.]

*ESG Investment Prohibition*

Another avenue proposed in recent states' legislation and law would prohibit the use of state funds for the purpose of ESG or, more broadly, social investment. North Dakota SB 2291 (2021 law) addressed social investments made by the State Investment Board to specifically prohibit the board (State) from investing in strategies that consider ESG standards or from any other purpose other than maximized returns to the State. An exception is provided in the law to permit investment of the legacy fund should the board be able to demonstrate a social investment would provide an equivalent or superior rate of return compared to a similar investment that does not include the same social factors and has a similar time horizon and risk. The law also required the Department of Commerce to study ESG criteria and its use for making determinations, decisions, or investments as it pertains to both the government and private industry in the state.

**Public Pensions Administrators comment.** The National Association of State Retirement Administrators (NASRA) does not have a position on ESG, but has adopted statements on the fiduciary duty assigned to boards/trustees and the ability of those entities and persons to execute their fiduciary duties. NASRA Resolution 2019-02 – Support for Strong Fiduciary Standards in Retirement Investment Systems[9] states, in part, that NASRA:

> 1. Supports strong fiduciary standards set in law by state and local governments and supports investment strategies for which the paramount goal is the financial security of pension fund assets.
>
> 2. Opposes any attempt, either implicitly or explicitly, to direct or influence state and local government retirement system investments that circumvent the trustees' fiduciary responsibility.

## Federal Response—U.S. Securities and Exchange Commission

Against this backdrop of state legislative interest, the SEC issued three rule proposals in March (climate risk) and May (ESG rules and disclosure forms) to "promote consistent,

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7 "Texas Blacklists BlackRock, UBS and Other Financial Firms Over Alleged Energy Boycotts," *Wall Street Journal*, 24 Aug 2022.

8 "Financial Executives and Texas Republicans Spar Over Climate Actions," *Reuters*, 15 Dec 2022.

9 Resolution 2019-02 - Support for Strong Fiduciary Standards in Retirement Investment Systems (accessed Jan. 31, 2022). https://www.nasra.org/resolutions#RESOLUTION%202019-02

comparable, and reliable information for investors concerning funds' and advisers' incorporation of [ESG] factors." The rules and forms would serve, according to the SEC, to enhance disclosure by:

- Requiring additional specific disclosure requirements regarding ESG strategies in fund prospectuses, annual reports, and adviser brochures;Implementing a layered, tabular disclosure approach for ESG funds to allow investors to compare ESG funds at a glance; and

- Generally requiring environmentally focused funds to disclose the greenhouse gas emissions associated with their portfolio investments.

Prior to the proposed rules, the SEC announced the creation of a Climate and ESG Task Force within its enforcement division in March 2021.

**What are other types of state legislative proposals addressing ESG and social investments? In addition to energy, what other businesses or industries are subject to these laws?**

State legislatures have, or are considering, legislation limiting state government from doing business with entities that "boycott" certain industries based on ESG factors. Elected officials and government agencies also have taken action (*i.e.* binding regulatory action by state investment boards and permissive regulatory actions by state officials, including state treasurers and attorneys general).

[*Note:* Appended to this memorandum is information provided by the National Conference of State Legislatures regarding both 2022 and preliminary 2023 states' legislation regarding financial services and ESG transactions and social investment or criteria (through January 13, 2023) as well as a survey on state regulation of ESG investment decision-making by public retirement plans (as of January 26, 2023).]

Among state legislative proposals are bills relating to:

- Financial institutions (discriminatory practices, prohibitions):
  - Arizona S 1182 provides that a financial institution doing business in the state, either directly or through a contractor, may not discriminate against any person based on a political affiliation or other social credit, ESG or similar values based on impact criteria; provides that a financial institution may offer investments, products, or services to a potential customer or investor that include subjective standards if the standards are fully disclosed and explained prior to a contract.
  - New York A 7112 (*see also* S 1015, S 8072) prohibits state-chartered banking institutions from investing and providing funding for private prisons.
- Firearms and ammunition, retailers:

- New York S 2154 requires credit card, debit card, or processor service companies to allow for the purchase of firearms and firearm ammunition with such services.
- South Carolina H 3506 [2021 bill] provides it is unlawful for a financial institution or government entity to discriminate against certain manufacturers and retailers of firearms, firearm accessories, or ammunition.
- West Virginia S 189 prohibits insurance discrimination against firearms manufacturers.

- Foreign governments:
  - New York A 5886 relates to purchasing restrictions on persons boycotting Israel and the investment of certain public funds in companies boycotting Israel; requires the Commissioner of General Services to compile a list of companies boycotting Israel and establishes such companies will be considered non-competitive bidders.
  - Wisconsin SB 743 (2021 bill) prohibits the Board of Regents of the University of Wisconsin System from investing University of Wisconsin System trust funds in certain companies associated with the government of China.

- Social credit scores:
  - Oklahoma H 4201 enacts the Prohibiting Social Credit Systems Act, defines terms, and prohibits the use of social credit scores. Under this bill, “social credit scores” or “similar concepts” would mean:
    - The assigning of a numeric, alphanumeric, alphabetic, or other designation to an individual or business based on their behaviors or actions;
    - The purpose for those designations would include, but not be limited to, promptness of paying taxes, fines, debts, fees, or other financial obligation, compliance with government or bureaucratic guidance, compliance with regulatory standards, or the use of other factors, and;
    - The purpose of which is to limit access by the individual or business to government, public, or private services including, but not limited to, public transit, library systems, hotel accommodations, travel options, food services, entertainment facilities, or health care options.

- Study committee:
  - Louisiana HR 203 creates the Environmental, Social, and Governance Criteria Task Force to study and make recommendations regarding regulation of ESG criteria in lending and investment practices.

- Communication to Congress:

- Louisiana SR 223 memorializes the U.S. Congress and requests certain federal and state entities to refrain from enacting or adopting laws, rules, regulations, or guidance that restricts the ability of financial institutions from offering products or services to the fossil fuel industry.

### *Actions by state boards or elected officials*

**Florida.** Earlier this month, Florida Governor DeSantis announced the Governor and trustees of the State Board of Administration had approved measures to further block ESG factors (prior action taken in July 2022) and mandate "that all investment decisions focus solely on maximizing the highest rate of return."[10]

**Indiana.** Indiana Attorney General Rokita issued an advisory opinion (2022-3) regarding the Indiana Public Retirement System and ESG investments. The opinion acknowledges existing state law prohibits the state from considering ESG in its investment decision. The opinion addresses the sole motivation of the fiduciary, termed "Hoosiers' financial interest" and further advises "[a]ny other commitment or stated purpose is unlawful."

## The Kansas Perspective

### 2022 Legislative Session and Interim Session

During the 2022 Session and Interim, informational hearings and testimony was provided by KPERS regarding both investments in certain foreign countries (*e.g.,* China and Russia) and the broader policy discussion of ESG factors and requirements prescribed in Kansas law. One bill and one current resolution addressing ESG were filed during the session.

### *Legislation*

HB 2664, a bill sponsored by Representative Murphy and 24 co-sponsors, would have prohibited banks or trust companies doing business in Kansas, either directly or through an outside contractor, from discriminating against, advocating for, or causing adverse treatment of any individual, business, or other customer based on subjective or arbitrary standards, which include political affiliation, employer, social credit score, or ESG criteria.

HCR 5034, a concurrent resolution sponsored by Representative Murphy and 25 co-sponsors, would have provided several findings regarding ESG standards and the intended uses and impact of these standards on the state, businesses, and families, as well as the broader role of state government. The concurrent resolution would have directed the Joint Committee on Fiduciary Financial Institutions Oversight, the resolution's sponsors, and the State Treasurer where appropriate, at the direction of the Kansas Legislature, "to work with concerned parties to study the topic of ESG standards and draft legislation that protects the State of Kansas and its citizens from the use of ESG standards." The Joint Committee would have been required to report its findings and recommendations, along with proposed legislation,

10 "DeSantis prohibits Florida state-run managers from considering ESG factors," *The Hill* (Jan. 17, 2023); and referenced DeSantis press release: https://www.flgov.com/2023/01/17/governor-ron-desantis-further-prohibits-woke-esg-considerations-from-state-investments/

to the Legislative Coordinating Council in November 2022 and to the Kansas Legislature on or before January 9, 2023.

Both the bill and concurrent resolution died in committee at the conclusion of the 2022 Session.

### *Discussion*

*House Committee on Insurance and Pensions*

The House Committee held an informational hearing on the topics of KPERS investments relating to Russia and ESG criteria. The KPERS Executive Director provided summary information on the Retirement System's invest in Russian securities, which was detailed as a "very minor part of the total investment portfolio." As of February 25, 2022, the Retirement System held Russian stocks in the international equity portfolio with a total market value of $35.9 million, which is approximately 14 basis points (0.14 percent) of total assets. [*Note*: All other investments total $25.2 billion.]

**Trust Fund Investment Decisions and Divestment.** The Executive Director noted investment decisions are a delegated authority of the KPERS Board of Trustees (outlined later in this section). The Board, along with KPERS investment staff and external consultants, review investment information at each bi-monthly Board meeting. The Board would be permitted, should it elect to do so, to decide not to make any new investments in Russia. The Executive Director noted the Board will comply with any state or federal requirements on future investments in Russia or divestment of Russian holdings. He noted the process for divestment of the Retirement System's limited investment is complicated by the lack of market liquidity. There would be costs associated with divestment from specific investments, including transactions costs and tracking error costs.

**ESG and Investments.** The Executive Director addressed ESG criteria stating "KPERS does not have any policies regarding ESG investing and does not employ any ESG mandates in the System's investment portfolio." He provided an update on activities in state legislatures following the passage of the 2021 Texas law. The testimony addressed the significant impact a divestment requirement could have for the Trust Fund, stating the combined transactions costs and tracking error costs for the Retirement System's public equity portfolio alone related to divestment of the "listed financial companies" are estimated at $47.7 million to $81.7 million per year.

On the topic of ESG and investment policy, the Executive Director spoke to the following statutory language that would prohibit KPERS from ESG investing:

> KSA 74-4921, excerpted. (3) Moneys in the fund shall be invested and reinvested to achieve the investment objective which is preservation of the fund to provide benefits to members and member beneficiaries, as provided by law and accordingly providing that the moneys are as productive as possible, subject to the standards set forth in this act. No moneys in the fund shall be invested or reinvested if the sole or primary investment objective is for economic development or social purposes or objectives.

*Joint Committee on Pensions, Investments and Benefits*

The Joint Committee received an overview on two investment policy topics from the KPERS Executive Director and its Chief Investment Officer. The information presented indicated, as of September 30, 2022, the Retirement System's investment in China represented approximately 1.45 percent of total assets and investments in Hong Kong represented 0.80 percent of total assets. They further explained:

- The market value of publicly traded equity investments in China was $299.2 million (1.28 percent of assets). China is considered an "emerging market";
- The market value of publicly traded equity investments in Hong Kong was $187.4 million (0.80 percent). Hong Kong is considered a "developed market";
- The private equity investment portfolio held approximately $41 million of assets with exposure to China represented 0.17 percent of assets.

**ESG Criteria.** KPERS officials noted Board of Trustees conversations regarding the investment policy issues identified with ESG. The officials noted ESG considerations are most prominent in equity related investment mandates and can impact investors in three ways. Further, they noted "[t]he System does not invest in any ESG focused mandates, nor does the System impose any ESG consideration(s) on any of its managers."

The testimony pointed to the Kansas law previously noted (KSA 74-4921(3) and also referenced the Board's investment policy, which states as follow:

> SECTION 13: SOCIALLY/ POLITICALLY RESPONSIBLE INVESTMENT POLICY
>
> A. Fiduciary Responsibility: The Board recognizes that its first responsibility as fiduciary for the Kansas Public Employees Retirement System is to prudently invest the assets of the System solely for the benefit of members and beneficiaries.
>
> B. Standards by which to Judge Investment Opportunities: Investments will be judged on the same basis, that being that the investments are to be prudent, when considered as a part of the Fund and in light of this Statement of Policy, and that they provide the highest expected return commensurate with the lowest expected risk and are appropriately diversified.
>
> Criteria other than these will not override the above. [Testimony added emphasis to this sentence.]