POLITICS BEFORE PENSIONS: HOW NEW ESG RULES EXPOSE PUBLIC PENSION SYSTEM VULNERABILITIES

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As some of the largest institutional investors in the United States, public pension funds wield considerable power over investment decisions. A recent trend highlights this extraordinary power: state pension funds have started exploiting their retirees' pensions to force investment companies to invest in accordance with their respective states' political priorities. Nowhere is this trend more obvious than in the environmental, social, and governance field. On one hand, states like Maine have passed legislation prohibiting public pension funds from investing in fossil fuels companies. On the other hand, states like Texas have passed laws prohibiting state entities from doing business with companies that oppose the fossil fuel and gun manufacturing industries. Investment companies operating across state lines are therefore caught between a rock and a hard place: continue investing in fossil fuels and risk antagonizing liberal states like Maine or divest from fossil fuels and lose business from conservative states like Texas.

Pension funds can exploit public retirees' funds for political ends because of a subtle fiduciary orientation surrounding public pension funds. Whereas private pension funds are governed by uniform federal laws that center fiduciary duties around pension plan participants and beneficiaries, public pension funds are governed by a patchwork of state laws that center fiduciary duties around the funds themselves. Thus, states are free to tailor their own pension fund investment

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rules as they see fit, sometimes at the expense of retirees. The result is an assortment of fifty different legal systems, piled on top of the recent trend toward politicizing investment decisions. Often, as the cases of Texas and Maine show, investment companies will find themselves unable to simultaneously comply with the various public pension fund requirements from state to state. Moreover, because state treasurers exercise almost unbridled discretion over investment allocations, they can all but freely abuse pensions funds in pursuit of political ends.

With trillions of dollars under management, retirees stand to lose the most. This Note argues that public pension investment laws need urgent reform and standardization to prevent sacrificing retirees' financial security in service of political priorities. To do so, state legislatures should pass laws modeled after the Employee Retirement Income Security Act of 1974, which governs private pension plans. Such standardization will ease the burden of compliance for investment companies and investment advisers while simultaneously forcing pension fund managers to prioritize retirees' pecuniary gains.

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INTRODUCTION

In late 2020, coming off the heels of an eight-year long campaign by climate activists, New York State's pension fund announced its intention to divest from fossil fuel stocks.[1] In announcing the use of New York State retirees' pensions as a weapon in the fight against climate change, New York's comptroller Thomas DiNapoli lauded the divestment decision as a necessary and urgent step to stop companies in the state's investment portfolio from "spewing planet-warming gases."[2] New York state assembly assistant Félix Ortiz also applauded the divestment, noting that "[t]he ambitious goal to transition the New York State Common Retirement Fund's portfolio to net zero greenhouse gas emissions by 2040 is a victory for the environment."[3]

While the New York State pension fund might have appeased climate activists, the effects from the divestment are "unlikely to affect the production or distribution of fossil fuels on the part of targeted companies."[4] Moreover, divestment comes at a premium. Fossil fuel divestment costs attributable solely to lost diversification benefits run as high as 0.27 percent annually—and that excludes additional transaction costs like bid-ask spread, price impact of trades, and commissions.[5] Despite the costs to retirees and the relatively minor social impact of such divestments, other state pension funds are

1. Anne Barnard, *New York's $226 Billion Pension Fund Is Dropping Fossil Fuel Stocks*, N.Y. TIMES (Dec. 9, 2020), https://www.nytimes.com/2020/12/09/nyregion/new-york-pension-fossil-fuels [https://perma.cc/SB7D-GJH7].

2. *Id.*

3. *New York State Pension Fund Sets 2040 Net Zero Carbon Emissions Target*, OFF. OF THE N.Y. STATE COMPTROLLER (Dec. 9, 2020), https://content.govdelivery.com/accounts/NYOSC/bulletins/2b0442d [https://perma.cc/KG8F-FAUD].

4. DANIEL R. FISCHEL ET AL., FOSSIL FUEL DIVESTMENT AND PUBLIC PENSION FUNDS 1 (2017), https://divestmentfacts.com/wp-content/uploads/2017/06/Divestment-and-Public-Pension-Funds_FINAL.pdf [https://perma.cc/2UMZ-W9KG].

5. *Id.* at 10, 15.

following in New York's footsteps.[6] As more state pension funds join the fight over environmental, social, and governance ("ESG") investing, divestments away from pro- and anti-ESG investments are set to increase to record levels.[7]

ESG investing has truly spiked in recent years; managed assets grew from 22.8 trillion dollars in 2016 to 30.6 trillion dollars in 2018.[8] While ESG investing clearly shows no signs of slowing down, what exactly counts as ESG in the first place is less clear.[9]

Typical ESG investing criteria are wide-ranging, and incorporate variables as diverse as "carbon emissions, pollution, data security, employment practices," and corporate board member diversity.[10] Proponents of ESG investing insist that "ESG issues are critical to producing long-term value."[11] Accordingly, investment advisers have faced increasing pressure

6. Margarida Correia, *ESG Culture War Heats up in Vermont with Fossil Fuel Divestment Bill*, PENSIONS & INV. (Feb. 27, 2023), https://www.pionline.com/esg/esg-culture-war-heats-vermont-fossil-fuel-divestment-bill [https://perma.cc/37E9-QU33].

7. *See* John Reitmeyer, *Divesting from Fossil Fuels Gets First Look*, N.J. SPOTLIGHT NEWS (Aug. 11, 2022), https://www.njspotlightnews.org/2022/08/fossil-fuels-clean-energy-divestment-public-worker-pension-funds-senate-environment-and-energy-committee-chair-bob-smith-climate-change-sea-level-rise-global-warming-divestnj-carbon-content-esg-policy [https://perma.cc/5BKH-HXXJ] (discussing New Jersey's effort to join "a growing list of institutional investors taking action against fossil-fuel companies in response to concerns about a warming climate and the role played by burning fossil fuels"); *see also* Ron Lieber, *Politicians Want to Keep Money Out of E.S.G. Funds. Could It Backfire*, N.Y. TIMES (Jan. 30, 2023), https://www.nytimes.com/2023/01/30/your-money/red-states-esg-funds-blackrock.html [https://perma.cc/5XTZ-EXTU] (discussing some conservative states' backlash against ESG investing).

8. Adeline Diab & Gina Martin Adams, *ESG Assets May Hit $53 Trillion by 2025, a Third of Global AUM*, BLOOMBERG LAW (Feb. 23, 2021), https://www.bloomberg.com/professional/blog/esg-assets-may-hit-53-trillion-by-2025-a-third-of-global-aum [https://perma.cc/GS43-4R5U].

9. For a brief history of developments in ESG investing, see Evan Slavitt, *ESG - It's Not Just Fluffy Bunnies Anymore*, S.C. LAW., Jan. 2023, at 44. For an exposition on law and economics from a trustee's perspective, see Max M. Schanzenbach & Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*, 72 STAN. L. REV. 381 (2020).

10. Hans Taparia, *One of the Hottest Trends in the World of Investing is a Sham*, N.Y. TIMES (Sept. 29, 2022), https://www.nytimes.com/2022/09/29/opinion/esg-investing-responsibility.html [https://perma.cc/U5YC-KTGA].

11. *See* Ashley C. Walter et al., *Profound Change: The Evolution of ESG*, 75 BUS. L. 2567, 2593 (2020).

to monitor ESG-related matters and "regularly assess and address ESG-related risks and opportunities."[12]

But not everyone is on board with ESG investing. States like Texas, Florida, Arizona, Indiana, North Dakota, Oklahoma, West Virginia, and Wyoming have implemented "aggressive anti-ESG legislation."[13] Recent legislative changes in Texas, for example, prohibit state entities from doing business with investment funds, companies, and lenders that boycott firearms and fossil fuel businesses.[14] Similarly, Florida Governor Ron DeSantis signed a resolution ordering state pension funds "to invest state funds in a way that prioritizes the highest return possible, without considering ESG criteria."[15] Similar enactments in other states complicate investment companies' efficient asset management. Adding to the conundrum, states have recently begun leveraging their vast pension funds to influence the ESG orientation of investment companies and seeking to align investments with their political priorities. State pension funds are massive, allowing pension fund managers disproportionate sway over investment decisions. For example, Florida's State Board of Administration alone controls over $240 billion in assets.[16] Thus, potential divestments by economically powerful states like Texas and Florida can seriously hamper the growth trajectory of even the world's largest investment companies. And as recent trends show, ESG-influenced divestments are far from theoretical. Louisiana recently pulled $794 million from BlackRock-managed funds, citing the fund's ESG focus as the main reason.[17] Missouri followed suit and pulled $500 million out of pension funds managed by BlackRock,

12. *Id.*

13. Heath Cheek & Mason Jones, *Why Companies Should Watch Anti-ESG Litigation*, BLOOMBERG LAW (Sept. 23, 2022), https://news.bloomberglaw.com/us-law-week/why-companies-should-watch-anti-esg-litigation [https://perma.cc/CM5L-H3LU].

14. *Id.*

15. Danielle Moran, *DeSantis Amps Up ESG Attack, Banning Strategy for State Pensions*, BLOOMBERG LAW (Aug. 23, 2022), https://www.bloomberg.com/news/articles/2022-08-23/desantis-nixes-esg-criteria-from-state-pension-investments [https://perma.cc/7P6L-MC9F].

16. *Id.*

17. *Louisiana to remove $794 million from BlackRock funds over ESG drive*, REUTERS (Oct. 5, 2022), https://www.reuters.com/business/sustainable-business/louisiana-remove-794-mln-blackrock-funds-over-esg-drive-2022-10-05 [https://perma.cc/RR9G-RQLX].

citing the fund's prioritization of ESG "over shareholder returns."[18]

Pension funds' politicized approach to ESG investing is not solely a Republican-leaning state phenomenon. Democratic-leaning states have jumped on the bandwagon to defend ESG investments. A group of thirteen state treasurers and New York's Comptroller signed an open letter criticizing anti-ESG pushbacks and vowing to support ESG-focused investment groups.[19] Oregon State Treasurer, Tobias Read, recently called out Texas's anti-ESG initiatives for "ignor[ing] the financial risks associated with a warming world."[20] State Treasurer Read reaffirmed Oregon's pension fund support for ESG investments, which he views as a necessary step in mitigating climate change risks.[21]

Putting the merits of ESG investing aside, the divide over pension fund allocation is more than just a divide over politics. The overt politicization of public pension funds threatens the stability and predictability of retirees' investments. Moreover, inconsistent ESG policies across states are creating discrete problems for investment fund managers, who owe fiduciary duties to their pension fund clients. On the one hand, investment companies wishing to appeal to ESG-conscious investors may prioritize divestment from fossil fuel producers and turn to sustainable energy investments as an alternative. On the other hand, investment companies wishing to appeal to anti-ESG investors may actively seek investments in fossil fuel companies. These funds may also sideline ESG metrics in making investment decisions.

Before states started regulating pro- and anti-ESG investments, investment fund managers were largely free to craft financially prudent investments for their clients without weighing overtly political regulatory backlash in response to

18. *Missouri pulls $500 Mln from BlackRock over asset manager's ESG push*, REUTERS (Oct. 18, 2022), https://www.reuters.com/business/sustainable-business/missouri-pulls-500-mln-blackrock-over-asset-managers-esg-push-2022-10-18 [https://perma.cc/D96W-42T6].

19. *Open Letter, We Are in It For the Long Term*, FOR THE LONG TERM (Sept. 14, 2022), https://www.forthelongterm.org/current [https://perma.cc/SRN8-WX9Y].

20. Tobias Read, *A Sneaky Form of Climate Obstruction Hurts Pension Funds*, N.Y. TIMES (Sept. 17, 2022), https://www.nytimes.com/2022/09/17/opinion/climate-change-pension-texas-florida.html [https://perma.cc/6PZ9-6QCA].

21. *Id.* (commending ESG investment strategies for their apparent commitment "to considering how environmental risks will affect their bottom line now and in the future").

their investment decisions.[22] But the recent regulatory uptick surrounding public pension funds threatens this system. For example, a simple decision by fund managers to reorient an investment fund away from fossil fuels could prevent that investment fund from doing business with states like Texas. Because both pro- and anti-ESG investment legislation is a new development, investment advisers may be unable to successfully navigate this new and complex legislative patchwork at the state level. The evolving legislative landscape could create obstacles for public pension funds, preventing them from seizing opportunities to invest in prominent investment companies. Consequently, beneficiaries may end up with a less diversified portfolio, and ultimately with worse returns.

The lack of uniform ESG investment rules across states will raise the cost of compliance for investment companies. For instance, states like Utah, Minnesota, South Carolina, and Idaho have proposed anti-ESG bills "limiting state contracting with companies that refuse to finance energy companies, but have no legislation relating to the firearms industry."[23] But states like Wyoming, Arizona, Missouri, South Dakota, and Ohio "have proposed [a]nti-ESG [b]ills targeting companies that . . . discriminate against the firearms industry, but no legislation related to the energy industry."[24] Investment funds' regulatory compliance in both sets of states will require careful and detailed evaluation of state-by-state investment criteria, subjecting every investment decision to close scrutiny, and growing the investment companies' fees.

A large part of the problem is that state and local pension funds are not governed by a comprehensive federal statutory regime.[25] States can fashion their own pension system rules,

22. *See, e.g.*, Leah Malone et al., *ESG Battlegrounds: How the States Are Shaping the Regulatory Landscape in the U.S.*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Mar. 11, 2023), https://corpgov.law.harvard.edu/2023/03/11/ esg-battlegrounds-how-the-states-are-shaping-the-regulatory-landscape-in-the-u-s [https://perma.cc/7274-U48Q] (observing that recent legal enactments across states place "investment managers in the difficult position of navigating business and politics while seeking to protect their interests and investments").

23. Lance Dial et al., *The challenge of investing in the face of state anti-ESG legislation*, REUTERS (Aug. 24, 2022), https://www.reuters.com/legal/legalindustry /challenge-investing-face-state-anti-esg-legislation-2022-08-24 [https://perma.cc /76KX-VS3K].

24. *Id.*

25. Edward Siedle, *Your State Pension is Not Fully Protected Under Law*, FORBES (Sept. 8, 2021), https://www.forbes.com/sites/edwardsiedle/2021/09/08

resulting in conflicting public pension fund frameworks among different states.[26] Moreover, because states have wide latitude over pension fund investment decisions, there is a significant risk that state officials may exploit public pensions for political aims. With the widening divide over pro- and anti-ESG investing, the trend of state regulatory polarization will only accelerate. And whereas state control over public pension funds in theory only affects stakeholders within state borders, investment companies operate nationally. Unless curtailed, the state divide over ESG investments will have ripple effects across the U.S. economy and will likely raise the cost of capital while simultaneously risking retirees' financial security.

Drawing on the regulatory framework governing private sector pensions, this Note argues that states should enact fiduciary rules mirroring those promulgated under the Employee Retirement Income Security Act of 1974 ("ERISA").[27] Given the extensive guidance and interpretation of Title I of ERISA by the Department of Labor ("DOL"), states can adopt the existing, comprehensive guidance for private sector employee benefit plans and the accompanying fiduciary rules in crafting their own laws.[28]

To ease the burden of regulatory compliance, and to ensure that pension investments remain out of the reach of state politicians, states should adopt ESG investment rules consistent with ERISA's fiduciary obligations for private pension funds. Adopting uniform standards across states would not only prevent states from exploiting public pension funds to push political agendas, but it would also provide the most protection for retirees by making their investments more resilient. Such standardization would free investment advisers to pursue prudent investment strategies without fear of political retribution and loss of business. The relative ease of complying with uniform state pension investment rules would lower the administrative burden and reduce management costs, providing additional benefits for pension fund participants. With over 5,500 state and local government pension funds serving over 21

/your-state-pension-is-not-fully-protected-under-law [https://perma.cc/T3NC-J45C].

26. *Id.*

27. *See* 29 U.S.C. § 1001–1461.

28. *See* Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, 87 Fed. Reg. 73822 (Dec. 1, 2022) (to be codified at 29 C.F.R. pt. 2550) [hereinafter "DOL Prudence Rule"].

million members,[29] the stakes are already high. By substituting the current pension fund-centered fiduciary duty approach with an ERISA-like retiree-centered fiduciary duty approach, states and localities could ensure that public pension beneficiaries' pecuniary gains remain front and center.

This Note proceeds as follows: in Part I, this Note will provide an overview of ESG investing by examining the investment landscape of state public pension systems. Part II will detail the current regulatory framework governing state public pension systems, contextualizing the divergent state approaches in regulating their pension funds. In Part III, this Note will compare Texas's and Maine's approaches to regulating public pensions, highlighting the risks of misappropriating retirees' pension funds for political gains. Part IV will explain how divergent state laws create problems for investment advisers operating on a national level. In Part V, this Note will introduce the Governmental Accounting Standards Board as the institution capable of swaying state pension funds toward adopting ERISA-like investment rules. Part VI will argue for the implementation of uniform, retiree-centered state pension fund rules. Lastly, this Note concludes by considering the likely ramifications of adopting such uniform pension fund investment rules.

I. AN OVERVIEW OF ESG INVESTING

ESG investing is the "consideration of environmental, social and governance factors alongside financial factors in the investment decision-making process."[30] At its most basic form, ESG investing is broken down into environmental, social, and governance factors that inform investment decisions. Environmental factors center around the impacts of investment on the environment, including carbon footprint, toxic chemicals, and sustainability efforts by companies' supply chains.[31] Social

29. *State and Local Government Pensions*, URB. INST., https://www.urban.org/policy-centers/cross-center-initiatives/state-and-local-finance-initiative/projects/state-and-local-backgrounders/state-and-local-government-pensions [https://perma.cc/5KZR-DF8J].

30. *ESG 101: What Is Environmental, Social and Governance?*, MSCI, https://www.msci.com/esg-101-what-is-esg [https://perma.cc/ZS28-K4EN].

31. E. Napoletano, *Environmental, Social and Governance: What Is ESG Investing?*, FORBES (June 22, 2023, 11:08 AM), https://www.forbes.com/advisor/investing/esg-investing [https://perma.cc/E7PW-ALBU].

factors focus on the impacts of investment on society, including LGBTQ+ equality, board and staff-level racial diversity, inclusivity programs and hiring practices, and corporate advocacy "for social good in the wider world, beyond its limited sphere of business."[32] Governance factors focus on business commitments to societal changes, executive pay, leadership diversity, and commitments to sustainability.[33]

Additionally, ESG investors expand their focus beyond investment impact on shareholders, and concurrently focus on investment impact on stakeholders, including workers, communities, customers, and the non-investing public.[34] Thus, financial considerations are only part of ESG investing.[35] Bank of America, for instance, has dedicated over $200 billion to financing "low-carbon and sustainable business activities across the globe" to help spur "innovative solutions to climate change and other environmental challenges."[36] The global investment management company Blackstone has integrated diversity, equity, and inclusion considerations both inside the firm and throughout the equity industry by partnering with like-minded businesses.[37]

Because ESG investors expand beyond the traditional focus on financial pecuniary gain, some critics have argued that ESG investing violates the sole interest rule.[38] As a legal principle, the sole interest rule stems from the duty of loyalty, which requires a trustee to "administer the trust solely in the interest of the beneficiary."[39] The sole interest rule thus seeks to

32. *Id.*

33. *Id.*

34. *Id.*

35. For a discussion on the social origins of ESG investing and the increasing demands for nonfinancial information in investing, see Robert G. Eccles et al., *The Social Origins of ESG: An Analysis of Innovest and KLD*, 33 ORG. & ENV'T 575, 575 (2019).

36. *Our Commitment to Environmental Sustainability*, BANK OF AM., https://about.bankofamerica.com/en/making-an-impact/environmental-sustainability [https://perma.cc/6W6P-7NBZ].

37. *Diversity, Equity & Inclusion*, BLACKSTONE, https://www.blackstone.com/careers/diversity-equity-inclusionanchor [https://perma.cc/4PAM-XZ3Q].

38. Jed Rubenfeld & William P. Barr, *ESG Can't Square with Fiduciary Duty*, WALL ST. J. (Sept. 6, 2022), https://www.wsj.com/articles/esg-cant-square-with-fiduciary-duty-blackrock-vanguard-state-stree-the-big-three-violations-china-conflict-of-interest-investors [https://perma.cc/7UQM-NTVG] (positing that ESG investing is violative of the sole interest rule and likely constitutes a violation of fiduciary duty).

39. Restatement (Second) of Trusts § 170(1) (Am. L. Inst. 1959).

"advance the best interest of the beneficiaries."[40] In serving beneficiaries, a trustee's consideration of ESG factors, "if motivated by the trustee's own sense of ethics or to obtain collateral benefits for third parties, violates the duty of loyalty."[41] Importantly, when managing the investments of a trust, a trustee must set aside any personal views concerning pressing social or political causes and focus on achieving the trust's pecuniary goals, therefore promoting beneficiaries' best interests.[42]

Not everyone agrees that ESG investing is necessarily opposed to the sole interest rule. The DOL, for instance, has stressed that its own ERISA-interpretative rules "are designed to ensure that plans do not improvidently avoid considering relevant ESG factors when selecting investments."[43] Hence, "there could be instances when ESG issues present material business risk or opportunities," as when particular environmental, social, and governance considerations may influence the economic value of the plan's investments.[44] Moreover, as Goldman Sachs has noted, "neglecting to address certain aspects of ESG," like concerns over oil spills, water contamination, or improper waste disposal, "could introduce substantial investment risks."[45] Thus, proponents of ESG argue for efficient allocation of ESG considerations to investment managers with a track record of translating ESG investing into positive investment returns.[46]

40. John H. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?*, 114 YALE L. J. 929, 932 (2005).

41. Max M. Schanzenbach & Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*, 72 STAN. L. REV. 381, 381 (2020).

42. Restatement (Third) Of Trusts § 90 cmt. c (Am. L. Inst. 2007).

43. DOL Prudence Rule, *supra* note 28, at 73879.

44. *Id.* at 73824 ("As appropriate economic considerations, such ESG issues should be considered by a prudent fiduciary along with other relevant economic factors to evaluate the risk and return profiles of alternative investments.").

45. *Fiduciary Responsibility: Integrating Environmental, Social and Governance Issues*, GOLDMAN SACHS, https://www.gsam.com/content/gsam/global/en/market-insights/gsam-insights/gsam-perspectives/2015/esg/ESG-and-fiduciary-duty.html [https://perma.cc/G6D5-YSKW].

46. *Id.*

II. AN OVERVIEW OF PUBLIC PENSION SYSTEMS

Public pension systems are pooled retirement plans that offer state employees predictable and defined retirement benefits that are guaranteed for the remainder of each retiree's life.[47] Public sector employees contribute to common pension trust funds while working and then gain access to those funds in retirement.[48] These funds are usually overseen by trustees who serve as working employees of the retirement funds and who must ensure that these funds continue to operate in the best interest of retirees.[49] Because there are over 5,500 state and local pension funds with over 21 million participants,[50] trustees' allocation of public pension resources can have tremendous impact on the lives of millions of retirees.

Public pension funds' risk appetite has grown somewhat in recent decades, which has produced demand for engaging external investment advisers to help with asset management. Although a steady portion of pension funds are allocated to safe bonds, the last few decades have seen public pension funds increasingly turn to riskier stocks, hedge funds, and alternative investments to increase returns.[51] States and localities rely on external investment advisers to invest assets on behalf of state and local pension funds. The level of investment discretion afforded to external investment advisers varies, but external advisers are usually bound by some fiduciary duties to the beneficiaries of the pension fund, as defined by state and local laws.[52] Because the "legal protections that apply to state

47. BETH ALMEIDA & WILLIAM B. FORNIA, NAT'L INS. ON RETIREMENT SEC., A BETTER BANG FOR THE BUCK: THE ECONOMIC EFFICIENCIES OF DEFINED BENEFIT PENSION PLANS 2 (2008), https://www.nirsonline.org/wp-content/uploads/2008/08/Bang-for-the-Buck-Report.pdf [https://perma.cc/BB39-JBTZ].

48. *Id.*

49. NAT'L INS. ON RETIREMENT SEC., PUBLIC PENSION BASICS 5 (2010) [hereinafter PUBLIC PENSION BASICS], https://www.nirsonline.org/wp-content/uploads/2017/11/final_module1_public_pension_basics.pdf [https://perma.cc/32QG-72D8].

50. *State and Local Government Pensions*, *supra* note 29.

51. Susan Banta, *State Public Pension Fund Returns Expected to Decline: Review of Investment Practices and Performance for 2018 and 2019*, PEW TRUSTS (May 3, 2022), https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2022/05/state-public-pension-fund-returns-expected-to-decline [https://perma.cc/W6GH-EXYK].

52. *See, e.g.*, GENERAL INVESTMENT POLICIES FOR THE NEW YORK STATE COMMON RETIREMENT FUND, OFFICE OF THE N.Y. STATE COMPTROLLER 8 (Apr. 7,

employee pension benefits are a matter of state, and not federal, law," states can fashion their own rules on pension fund investments.[53] In practical terms, this means that despite the general obligation for professional "asset managers and pension trustees" to act on their "fiduciary obligations to the fund" and ensure that "pension plans and the investments within them are prudently managed,"[54] states have wide latitude in defining the goals and objectives of their respective pension systems.

Before the proliferation of ESG investments, public pension system trustees carefully navigated political pressures to cater to local concerns and needs, and focused instead on maximizing the fund's pecuniary gains despite various political pressures.[55] Whatever political pressure was exerted over investment advisers by state and local officials, such pressure was usually "geographically constrained compared to that created by private sector financial relationships, because state officials are most concerned with effects on local labor markets."[56]

The proliferation of ESG investing changed the operating environment of public pension funds. ESG considerations have started influencing public pension funds' investment decisions irrespective of their financial impact on pension fund beneficiaries. This development is particularly risky for certain public sector employees who are ineligible for social security payments.[57] One analyst estimates that "approximately one-fourth of public sector employees do not participate in Social Security, including over one-third of public school teachers and two-thirds of firefighters, police officers, and first responders."[58] Given that state employees in retirement often rely exclusively on pensions to sustain themselves and their families, public pension funds' ESG and political bargaining could hurt

2021), https://www.osc.state.ny.us/files/common-retirement-fund/pdf/general-investment-policies.pdf [https://perma.cc/CWW9-HRZN].

53. AMY MONAHAN, AM. ENTER. INST., UNDERSTANDING THE LEGAL LIMITS ON PUBLIC PENSION REFORM 1 (2013), https://www.nasra.org/Files/Topical%20Reports/Legal/Monahan1305.pdf [https://perma.cc/89GL-4CTL].

54. PUBLIC PENSION BASICS, *supra* note 49, at 9.

55. Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 796 (May 1993).

56. *Id.* at 797.

57. For instance, 42 U.S.C. § 410(a)(7) excludes state employees from social security by default (excluding employment related to "[s]ervice performed in the employ of a State, or any political subdivision thereof").

58. David H. Webber, *The Use and Abuse of Labor's Capital*, 89 N.Y.U. L. REV. 2106, 2109, n.10 (Dec. 2014).

financially vulnerable retirees. Yet, as the following Part demonstrates, states have persisted in politicizing their public pension funds in service of their political priorities, often despite incurring unnecessary transaction fees and threatening the pecuniary goals of state retirees.

III. CREATING REGULATORY CHAOS: DIVERGENT STATE LAWS ON ESG INVESTING

Recent ESG-related state laws best encapsulate the trend of politicizing public pension funds. This Part compares the approaches adopted by Texas and Maine, which provide representative examples of the broader spectrum of laws at the intersection of pension fund investing and ESG. As the discussion below makes clear, conflicting ESG laws across states will make it difficult, if not impossible, for investment funds to accommodate public pension funds in different states.

A. Texas's Anti-ESG Laws

Texas passed two major bills as part of the state's anti-ESG push. First, the state legislature passed SB13 in September 2021, which governs state contracts and investments in companies, funds, and financial institutions that boycott energy companies.[59] SB13 applies to a myriad of state-controlled pension and investment companies, and it prohibits investments in certain listed financial companies that boycott the energy industry.[60] Section 809.051 of SB13 instructs the State Comptroller to prepare and maintain a list of financial companies that boycott energy companies. State entities must consult the Comptroller's list before making any investment decisions.[61] Once a state entity has identified listed companies, it must notify the listed company of its status and of the state entity's intent to divest.[62] The listed company is then required to cease its boycott within ninety days of receiving the notice of the state entity's intent to divest. If the listed company fails to cease the boycott within that time period, the state entity is

59. An Act relating to state contracts with and investments in certain companies that boycott energy companies, S.B. 13, 87(R) (Tex. 2021).
60. *Id.*
61. *Id.*
62. *Id.*

required to divest its investments from the listed company within 360 days.[63] The divestment requirements are subject to limited exceptions under Section 809.055, which exempts state entity divestment from "any indirect holdings in actively or passively managed investment funds or private equity funds."[64] Lastly, Section 2274.002 prohibits state governmental entities from entering a contract for goods or services worth at least $100,000 and paid at least partly from public funds unless the company verifies in writing that it does not boycott energy companies and will not do so during the contract term.[65] Thus, under Texas's SB13, state pension funds "are prohibited from investing in companies that boycott the fossil fuel industry," regardless of the pecuniary benefits of such investments.[66]

Texas also passed SB19, "An Act Relating to Prohibited Contracts with Companies That Discriminate Against the Firearm or Ammunition Industries." SB19 seeks to prohibit state governmental entities (presumably including state pension funds) from entering a contract for the purchase of goods or services worth at least $100,000 and paid at least partly from public funds with any company which discriminates against firearm companies.[67] State entities are required, before entering into contracts worth $100,000 or more, to verify that companies do not have "a practice, policy, guidance, or directive that discriminates against a firearm entity or firearm trade association," and that the company "will not discriminate during the term of the contract against a firearm entity or firearm trade association."[68]

Texas's first major step towards enforcing its new regulatory approach to ESG investment came when Texas Comptroller Glenn Hegar announced a list of financial

63. *Id.*

64. *Id.* § 809.055.

65. *Id.* § 2274.002(a)–(b).

66. Brooke Goodlett et al., *The "anti-ESG" movement: Balancing conflicting stakeholder concerns and inconsistent regulatory regimes*, DLA PIPER (Feb. 21, 2023), https://www.dlapiper.com/en-au/insights/publications/2023/02/the-anti-esg-movement-balancing-conflicting-stakeholder-concerns-and-inconsistent-regulatory-regimes [https://perma.cc/25BS-PJ39].

67. An Act relating to prohibited contracts with companies that discriminate against the firearm or ammunition industries, S. 19, 87(R) (2021) https://capitol.texas.gov/tlodocs/87R/billtext/html/SB00019F.HTM [https://perma.cc/AF82-VGZE].

68. *Id.* § 2274.002(b)(1)–(2).

institutions that boycott energy companies.[69] Comptroller Hegar made clear that the listed companies were subject to the mandatory divestment provision under Texas Government Code 809.[70]

The issuance of this divestment list quickly caused uncertainty over how Texas's new rules would apply to existing investment companies operating in the state. An early Bloomberg analysis showed that many of the listed funds were not even ESG-focused funds. Out of 348 funds on the divestment list issued by the state comptroller, 14 percent did not technically qualify as ESG funds according to a Morningstar Inc. estimate.[71] But more importantly, 40 percent of funds actually invested in the oil and gas industry—the very industry Texas wanted to protect from private boycotts.[72] Nonetheless, Comptroller Hegar defended the state's approach, noting that "[t]he test isn't that the funds are ESG focused, the test is on whether the funds boycott energy companies based on state statute, which is broader than just having oil and gas investments."[73] Despite the commitment to remain flexible in evaluating investment companies' compliance with the new provisions, Texas's rocky rollout of its new ESG rules has created more turmoil in an already uncertain environment.

This uncertainty is perhaps best encapsulated by BlackRock, one of the largest multinational investment companies, which has been at the center of the ESG crossfire.[74] In August 2022, nineteen state attorneys general sent a letter to

69. *Texas Comptroller Glenn Hegar Announces List of Financial Companies that Boycott Energy Companies*, TEX. COMPTROLLER OF PUB. REL. (Aug. 24, 2022), https://comptroller.texas.gov/about/media-center/news/20220824-texas-comptroller-glenn-hegar-announces-list-of-financial-companies-that-boycott-energy-companies [https://perma.cc/XLE9-K5E6].

70. *Id.*

71. Frances Schwartzkopff, *Texas' ESG Attack Sweeps Up Some Funds That Aren't Really ESG*, BLOOMBERG LAW (Oct. 1, 2022), https://www.bloomberg.com/news/articles/2022-09-30/texas-esg-attack-sweeps-up-some-funds-that-aren-t-really-esg [https://perma.cc/N6GT-LZ75].

72. *Id.*

73. *Id.*

74. Amelia Pollard et al., *BlackRock Is Caught in the ESG Crossfire and Struggling to Get Out*, BLOOMBERG (Dec. 15, 2022, 6:19 AM), https://www.bloomberg.com/news/features/2022-12-15/blackrock-is-caught-in-the-esg-crossfire-and-struggling-to-get-out [https://perma.cc/PJD8-7LJK].

BlackRock criticizing its approach to ESG investing.[75] The letter accused BlackRock of "intentionally restrain[ing] and harm[ing] the competitiveness of the energy markets."[76]

As already indicated, BlackRock has made significant commitments to green energy. Occasionally, BlackRock has even penalized the board of directors of a partner company because of that company's investments in coal.[77] And as part of the Net Zero Managers Initiative, BlackRock has already charted a path for its investment partners to bring their carbon emissions to net zero.[78] At the same time, however, BlackRock's response to the letter from the attorneys general made clear that BlackRock remains a major investor in the energy sector, despite commitments to transition away from fossil fuels to cleaner energy.[79] BlackRock has over $100 billion worth of investments in Texas energy companies alone.[80] BlackRock's willingness to play both sides has been slammed by Democratic-led states, which have accused BlackRock of backtracking on its pledge to curb carbon emissions.[81]

The turmoil surrounding Texas's recent regulatory enactments could significantly affect the state's pension funds, and even threaten the viability of retirees' investments. State worker retirement funds, for example, might have to sell their shares in the 348 ESG-identified investment funds to remain compliant with Texas requirements.[82] The Texas government entities subject to the divestment provisions wield billions in investments, and cover the Employees Retirement System of

75. *See* Letter from Attorneys General, to Laurence D. Fink, CEO of BlackRock (Aug. 4, 2022), https://www.texasattorneygeneral.gov/sites/default/ files/images /executive-management/BlackRock%20Letter.pdf [https://perma.cc/H4GL-4B2K].

76. *Id.* at 5.

77. BLACKROCK, OUR APPROACH TO SUSTAINABILITY 12, https:// corpgov.law.harvard.edu/wp-content/uploads/2020/07/blackrock-our-commitment-to-sustainability-full-report.pdf [https://perma.cc/5VJP-WZ8A].

78. *Our fiduciary approach to sustainability and the low-carbon transition,* BLACKROCK, www.BlackRock.com/corporate/sustainability/committed-to-sustainability [https://perma.cc/4T7L-CVUH].

79. *Response to Attorneys General*, BLACKROCK, https://www.blackrock.com/us /individual/literature/press-release/blackrock-response-attorneys-general.pdf [https://perma.cc/M4QA-CQEJ].

80. Schwarzkopf, *supra* note 71.

81. *Id.*

82. Catherine Clifford, *Texas Accuses 10 Financial Companies, Including BlackRock, of 'Boycotting' Energy Companies and Orders State Pension Funds to Divest from Holdings*, CNBC (Aug. 25, 2022), https://www.cnbc.com/2022/08/25 /texas-says-10-companies-including-blackrock-boycotting-energy-.html [https:// perma.cc/P3BK-6Y93].

Texas, Teacher Retirement System of Texas, Texas Municipal Retirement System, Texas County and District Retirement System, Texas Emergency Services Retirement System, and the Permanent School Fund.[83]

Texas's decision to divest from certain ESG investment funds could destabilize the broader investment market as well. The Texas economy, for example, is larger than the entire economy of Canada.[84] And Texas's state pension funds nearly rival California's, so any divestment decisions could erode some of the financial strength of even the wealthiest investment companies, and could further inject political conflict into investment decisions.[85] With increasing pressure from both Democrat- and Republican-led states, it is unsurprising to see companies like BlackRock scrambling to provide a coherent response. Moreover, because investment companies operate across state borders, they may find it impossible to do business with public pension funds from Texas and Maine simultaneously, as the following Section demonstrates.

B. Maine's Pro-ESG Legislation

Maine's legislature took the opposite approach to Texas's, requiring state pension funds to divest from fossil fuel investments. In 2021, the Maine legislature passed a law called "An Act To Require the State To Divest Itself of Assets Invested in the Fossil Fuel Industry."[86] Maine's dual purpose in enacting this law was to divest public pension funds "of any assets invested in the fossil fuel industry and to limit any future investment in that industry."[87] The Maine law provides that the:

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83. *Texas Comptroller Glenn Hegar Announces List of Financial Companies that Boycott Energy Companies*, *supra* note 69; *see also* Spencer Grubbs & Amanda Williams, *Texas' Public Pensions,* TEX. COMPTROLLER OF PUB. ACCTS: FISCALNOTES (Feb. 2019), https://comptroller.texas.gov/economy/fiscal-notes/2019/feb/liabilities.php [https://perma.cc/4WZ7-7P9Q] ("Together, the state [pension] systems serve more than 2.5 million members including public school employees, emergency personnel and state employees.").

84. Clifford, *supra* note 82.

85. *Id.*

86. An Act To Require the State to Divest Itself of Assets Invested in the Fossil Fuel Industry, H.P. 65, 130 Maine Leg. 99 (Me. 2021).

87. *2021 Legislative Update: Legislation Enacted During the 130th First Regular and Special Sessions*, ME. PUB. EMP. RET. SYS., https://www.mainepers.org/wp-content/uploads/pdfs/legislative-updates/2021-Legislative-Update.pdf [https://perma.cc/M8AT-9ETP].

> Treasurer of State and the Board of Trustees of the Maine Public Employees Retirement System review the extent to which the assets of any state pension or annuity fund are invested in any stocks or other securities of any corporation or company within the fossil fuel industry or any subsidiary, affiliate or parent of any corporation or company within the fossil fuel industry.[88]

Maine's public pension funds must divest all fossil fuel investments by January 1, 2026.[89] The divestments must occur "in accordance with sound investment criteria and consistent with the board's fiduciary obligations."[90] The language of the Maine act potentially pits pension funds' fiduciary obligations against the mandate to divest from fossil fuel investments, even if fossil fuel investments remain in the retirees' best financial interest.

Although Maine's $17 billion public pension fund is smaller than pension funds from other more populous states, it still had over $1.3 billion invested in fossil fuel companies.[91] Like other states navigating divestments over fossil fuel investments, Maine's public pension funds, and by extension their beneficiaries, will face potential equity loss along with significant transaction costs and commissions.[92] According to Maine State Treasurer Henry Beck, grappling with the consequences of the divestment would require a careful weighing of "specific fiduciary issues" with the "acuteness of the climate crisis."[93]

As the divergent approaches by Texas and Maine indicate, investment companies seeking to do business with both Republican- and Democratic-leaning states must navigate conflicting laws while remaining loyal to the respective state retirement funds. The potential for conflict for investment managers is particularly acute when "restrictions may prohibit

88. 5 M.R.S.A. § 1957(2) (Me. 2021).

89. *Id.*

90. *Id.* § 1957(1).

91. Robert Tuttle, *Maine Becomes First State to Order Public Fossil-Fuel Divestment*, BLOOMBERG (June 17, 2021), https://www.bloomberg.com/news/articles/2021-06-17/maine-becomes-first-state-to-order-public-fossil-fuel-divestment [https://perma.cc/B8A7-ALPT].

92. Fischel et al., *supra* note 4, at 10.

93. Taylor K. Brown, *Maine Takes on Fossil Fuel Divestment. How Will It Happen?*, GOVERNING (July 13, 2022), https://www.governing.com/finance/maine-takes-on-fossil-fuel-divestment-how-will-it-happen [https://perma.cc/A8T2-ENDD].

a manager from considering investment factors it would otherwise view as significant for purposes of prudently investing state pension assets."[94] Because other states have enacted similarly confusing ESG requirements, investment companies interested in catering to various states will face increasing difficulties in complying with multiple state laws simultaneously.[95]

IV. EXAMINING THE REGULATORY CHAOS

Divergent ESG investment rules across states complicate compliance for large investment companies. Managing pension funds is "doubly complex because equal parts of law and investing are involved."[96] Thus, investment advisers must have the requisite investment skills and must also know how to navigate the increasingly complex ESG investment laws across states. Knowledge of local laws is critical, as new legislation has transformed formerly prudent investment decisions into potential divestment mines. Because public pensions are "regulated by a thin patchwork quilt of state and local laws,"[97] investment companies will face increased hurdles in catering to public pension funds in the face of conflicting laws on ESG investing.

The issue is largely traceable to states' decision to orient fiduciary duty to their own public pension funds instead of orienting fiduciary duties to the retirees themselves.[98] Accordingly, investment companies catering to state-owned pension funds owe a fiduciary duty to the pension fund itself, and not to the actual pension fund beneficiaries.[99] In principle,

94. Joshua Lichtenstein et al., *State Regulation of ESG Investment Decision-Making by Public Retirement Plans: An Updated Survey*, ROPES & GRAY 2 (Aug. 2022).

95. *See id.*

96. Siedle, *supra* note 25.

97. *Id.*

98. Webber, *supra* note 58, at 2106 (noting that state laws provide that "public pension trustees owe their allegiance to the fund itself, rather than to the fund's participants and beneficiaries").

99. State laws on public pension funds, though patchy, generally cover both state and local level pension funds. *See* Siedle, *supra* note 25*; see also* U.S. GOV'T ACCOUNTABILITY OFF., GAO -08-983T STATE AND LOCAL GOVERNMENT PENSION PLANS: CURRENT STRUCTURE AND FUNDED STATUS (July 10, 2008) (noting that localities in some states, in addition to state-level pension laws, have enacted local ordinances which protect and manage pension benefits and often include explicit

state pension funds should focus solely on their beneficiaries' financial security. However, because the fiduciary duty attaches to the state pension fund itself, the state pension fund can chart its goals in terms that transcend financial returns for beneficiaries and focus on broader policy goals as well. In stark contrast, ERISA "requires fund trustees to prioritize the interests of fund participants and beneficiaries in making investments."[100]

The current fiduciary duty orientation of state pension funds gives pension fund managers freedom to sideline beneficiaries' pecuniary gains at the expense of non-pecuniary, political considerations. For instance, City of Chicago Treasurer Kurt Summers has made clear that in making investment decisions, Chicago tries to "better ali[gn] city investments with the social interest of Chicagoans."[101] The Oregon State Treasury similarly focuses on non-pecuniary factors in making public pension fund decisions. Aside from integrating ESG factors into its investment model, Oregon also "emphasizes 'off-balance sheet' activities to improve market transparency and to align the priorities of portfolio companies' managers with those of their long-term shareholders."[102] The treasurer's office has stressed that "climate change risks, executive compensation and gender equity on boards of directors" are factors informing the state's pension fund investment decisions.[103]

These statements highlight public pension funds' freedom to fashion ESG investments, even if those investments come at the expense of retirees' financial security. First, available market data indicates that the effect of corporate social responsibility and ESG-related disclosures "on market and accounting-based financial performance remained statistically insignificant."[104] Second, though ESG investing may be socially desirable, available data suggests that ESG funds focused on

protection provisions stating that pensions promised to public employees cannot be eliminated or diminished).

100. Webber, *supra* note 58, at 2109.

101. Lisa Woll, *State and Local Governments Eye ESG Investing Strategies for Returns and Impact*, PLANSPONSOR (June 25, 2019), https://www.plansponsor.com/state-local-governments-eye-esg-investing-strategies-returns-impact [https://perma.cc/W8KX-82VP].

102. *Id.*

103. *Id.*

104. Faisal Mahmood et al., *Corporate Social Responsibility and Firms' Financial Performance: A Multi-Level Serial Analysis Underpinning Social Identity Theory*, 34 ECON. RSCH. 2447, 2461 (Feb. 2021).

corporate social responsibility and sustainable finance do not always outperform market indices.[105] Third, ESG factors seem to influence stock prices only on the rare occasion that ESG-related information is material to the company's financial prospects.[106]

Thus, while some ESG-related investments may matter to a state's social policy aims, those same investments may not work to maximize the near-to-medium-term financial benefit of retirees. Under the current fund-centered model, states can justify financial losses because the investment companies working on behalf of state pension funds owe a fiduciary duty to the pension fund itself. The pension fund in turn has the freedom to define its goals in social policy terms that transgress pure pecuniary considerations.

A. The Fund-First Framework of Public Pension Funds

The fiduciary duties surrounding pension funds are rooted in trust doctrines, which oblige fund managers to "observe how men of prudence, discretion and intelligence manage their own affairs."[107] States have expanded traditional trust doctrines, however, to allow themselves greater latitude in managing and allocating public fund resources. For instance, the fund-first approach has persisted despite the strict requirements under the Restatement (Third) of Trusts that pension fund managers administer the funds "as a prudent person would, in light of the purposes, terms, and other circumstances" of the fund, with "reasonable care, skill, and caution."[108] Under prevailing trust doctrines, which theoretically govern public pension fund fiduciary duties, public pension funds must administer the funds "solely in the interest of the beneficiaries."[109] In practice, however, states have eroded traditional trust doctrines by

105. *See* Hao Ling & Luc Renneboog, *Corporate Social Responsibility and Sustainable Finance: A Review of the Literature* 16 (ESGI, Working Paper No. 701-2020, Sept. 2020) ("[T]here is no consensus about whether ESG-based investing helps or hurts performance.").

106. Aaron Yoon & George Serafeim, *Which Corporate ESG News Does the Market React To?* 16 (Har. Bus. Sch., Working Paper No. 21-115, 2021) (finding that "[s]tock prices only react to the news on ESG issues that is classified as financially material for a given industry . . . ").

107. Harvard Coll. v. Amory, 26 Mass. 446, 461 (1830).

108. Restatement (Third) Of Trs. § 77(1)–(2) (Am. L. Inst. 2003).

109. Paul Rose, *Public Wealth Maximization: A New Framework for Fiduciary Duties in Public Funds*, 2018 U. ILL. L. REV. 891, 896 (2018).

refocusing the fiduciary duty around the pension fund itself, whose interests may diverge from the pecuniary interests of the beneficiaries.[110]

Several arguments support the states' fund-first approach to fiduciary duties. The fund-first focus could relax strict fiduciary standards and allow states to engage in "more investment in sustainable enterprises and long-term projects."[111] Next, a fund-first approach allows states to allocate risk across the entire state population so that state residents other than direct plan beneficiaries benefit from socially desirable investments.[112] Relatedly, whereas private investors could ignore "uncompensated harms from pollution, depleted natural resources, or widespread health problems," states and their citizens are often forced to absorb such externalities.[113]

But despite the proffered benefits, the fund-first view of fiduciary duties suffers from serious flaws. Of primary concern, fiduciaries "might invest in their own interests, rather than those of their beneficiaries."[114] Thus, instead of maximizing returns on investments, public pension funds may sacrifice beneficiaries' financial security in pursuit of policy goals like solving climate change, which cannot be accomplished by a single state's investments in the first place.[115] While fighting climate change can benefit retirees in the long term, states also have a multitude of alternative ways to pursue climate change policy without risking retirees' hard-earned pensions.[116]

110. Webber, *supra* note 58, at 2110 (explaining that the "dominant interpretation of the fiduciary duties of public pension trustees requires them to prioritize the investment impact on the fund alone, and not its impact on the funds' participants and beneficiaries.").

111. Rose, *supra* note 109, at 895 (arguing that relaxation of fiduciary duties could allow state pension funds to increase socially responsible investing, even at the expense of wealth maximization).

112. *See id.*

113. *Id.*

114. Webber, *supra* note 58, at 2156.

115. *See* LENORE PALLADINO ET AL., ROOSEVELT INST., STATE PENSION FUNDS AND CLIMATE RISK: A ROADMAP FOR NAVIGATING THE ENERGY TRANSITION 14 (2023), https://rooseveltinstitute.org/wp-content/uploads/2023/03/RI_ State-Pension-Funds-and-Climate-Risk_brief_202303.pdf [https://perma.cc/3DQT-BQ72].

116. *See* Sam Ricketts et al., *States Are Laying a Road Map for Climate Leadership*, CTR. FOR AM. PROGRESS (Apr. 30, 2020), https://www.americanprogress.org/article/states-laying-road-map-climate-leadership [https://perma.cc/Y6CM-HSSZ] (documenting various state efforts ranging from enacting 100 percent clean energy legislation and clean energy bills, to enacting

Moreover, as one analyst has noted, "200 years' worth of work in economics and finance indicate that social welfare is maximized when all firms in an economy attempt to maximize their own total firm value."[117] The same argument applies "equally well to public funds, so that not only are fund beneficiaries better off by focusing on maximizing total value, but society as a whole is better off as well."[118]

The fund-first approach also ignores well-established duties under trust laws, which obligate managers to maximize the interests of the beneficiaries of the trust.[119] Although state pension funds' investments could tangentially impact the state citizenry writ large, the ultimate risk-takers are pension recipients themselves, whose hard-earned savings and retirement funds remain at the disposal of politically motivated state actors. Substituting social policy goals for investment maximization requires sacrificing the interests of pension fund beneficiaries in favor of the interests of non-retirees purportedly benefited by pursuing those social policy goals.[120] Aside from the convenience of diverting retirees' hard-earned money, states might find it difficult to justify risking retirees' old-age security, especially considering the myriad ways states can raise and spend money to pursue policy goals.[121]

V. SEARCHING FOR SOLUTIONS: THE GOVERNMENTAL ACCOUNTING STANDARDS BOARD

The divergent state approaches to ESG investing threaten to raise the cost of retirement fund investing more broadly. In a variety of different fields, analysts have observed significant

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sector specific clean energy policies, to reducing carbon pollution and setting low-carbon fuel standards).

117. Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 12 BUS. ETHICS Q. 235, 239 (2002).

118. Rose, *supra* note 109, at 893.

119. *See* Restatement (Third) Of Trusts. § 77 (Am. L. Inst. 2003).

120. UNIFORM PRUDENT INVESTOR ACT, § 5 cmt. at 14 (NAT'L CONF. OF COMM'RS ON UNIF. STATE L. 1995).

121. *See, e.g.*, David Gamage, *How Should Governments Promote Distributive Justice?: A Framework for Analyzing the Optimal Choice of Tax Instruments*, 68 TAX L. REV. 1 (2014) (discussing a number of policy and regulatory instruments, in addition to taxation, as a way to promote redistribution at the state level); *see also* Rachel Brewster, *Enabling ESG Accountability: Focusing on The Corporate Enterprise*, 2022 WIS. L. REV. 1367 (2022) (arguing how reforming corporate enterprise law can promote social policy aims).

inefficiencies when the cost of compliance varies from one state to another.[122] For example, the lack of standardization in benefit choices among healthcare plan participants has been blamed as one of the "many cost drivers resulting in increasing premiums."[123] Similarly, the lack of standardization in nuclear reactor regulation has been tied to lower investment and reduced innovation in nuclear energy in the United States.[124] In cybersecurity, the lack of regulatory standardization and the government's conflicting policies have contributed to increased costs for market participants and have stifled innovation.[125]

Similarly, the current patchwork of rules governing public pension funds makes the "regulatory implications of ESG investing . . . even more complex," and "certain ESG activities could result in the inability to do business with individual state governments."[126] The lack of standardization in public pension fund management is particularly acute given the wide-ranging consequences for investment companies. Investment companies transcend state borders and must simultaneously comply with regulatory requirements in all states where they do business. Adopting uniform ESG investing rules across states would introduce certainty for investment companies, and it would also make it easier to maximize returns for pension plan beneficiaries. Fortunately, as the next Section explains, the Governmental Accounting Standards Board could influence states to standardize pension fund investment rules to the benefit of retirees.

122. *See, e.g.*, Daniel Castro et al., *The Looming Cost of a Patchwork of State Privacy Laws*, INFO. TECH. & INNOVATION FOUND. (Jan. 24, 2022), https://itif.org/publications/2022/01/24/looming-cost-patchwork-state-privacy-laws [https://perma.cc/E2VQ-GJRW] (detailing rising compliance costs due to diverging state bills regulating the commercial use and collection of personal data); *see also* William Dunkelberg, *The Insidious Cost Of Regulation,* FORBES (Apr. 4, 2017), https://www.forbes.com/sites/williamdunkelberg/2017/04/04/the-insidious-cost-of-regulation [https://perma.cc/A26X-LANV].

123. Troy J. Oechsner & Magda Schaler-Haynes, *Keeping It Simple: Health Plan Benefit Standardization and Regulatory Choice Under the Affordable Care Act*, 74 ALB. L. REV. 241, 242 (Oct. 2010).

124. *See* Margaret Cooney, *A Comparative Study of Nuclear Reactor Standardization Policy in the United States and France*, 2020 B.C. INTELL. PROP. & TECH. F. 1, 2 (2022).

125. *See* Michael Beckerman, *Americans Will Pay a Price for State Privacy Laws*, N.Y. TIMES (Oct. 14, 2019), https://www.nytimes.com/2019/10/14/opinion/state-privacy-laws.html [https://perma.cc/33W2-55ZG] (detailing the complex web of state privacy laws and highlighting common compliance issues).

126. Dial et al., *supra* note 23.

A. ESG Standardization Through the Governmental Accounting Standards Board

The Governmental Accounting Standards Board ("GASB") was established in 1984 as an independent, private sector organization that sets "accounting and financial reporting standards for U.S. state and local governments that follow [the] Generally Accepted Accounting Principles" ("GAAP").[127] Although the GASB functions as a private entity, its standards "are recognized as authoritative by state and local governments."[128] The Dodd-Frank Wall Street Reform and Consumer Protection Act added Section 19(g) to the Securities Act of 1933, which made funding for the GASB permanent.[129] Thus, as a permanent and highly respected institution, the GASB could lobby states to implement uniform investment rules for their respective public pension funds.

The GASB has already published a preliminary overview of the intersection of ESG investing and prudent accounting and financial standards.[130] However, the GASB has acknowledged that the definition of ESG can put some ESG matters outside the scope of accounting and financial reporting standards.[131] For instance, the "environmental" part of ESG can incorporate considerations of "how nature impacts a government or how a government performs as a steward of nature."[132] Likewise, the "social" part of ESG can include considerations of "how a government manages relationships with its employees, suppliers, resource providers (such as taxpayers and customers), and the community."[133] Lastly, the "governance" in ESG may incorporate governance considerations related to "the structure

127. *About the GASB*, GOVERNMENTAL ACCOUNTABILITY. STANDARDS BD., https://gasb.org/info/aboutgasb [https://perma.cc/L9AB-5BPE].

128. *Id.*

129. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

130. GOVERNMENTAL ACCT. STANDARDS BD., INTERSECTION OF ENVIRONMENTAL, SOCIAL, AND GOVERNANCE MATTERS WITH GOVERNMENTAL ACCOUNTING STANDARDS 1 (2022) [hereinafter "GASB ESG Overview"], https://gasb.org/document/blob?fileName=ESG%20Memo%20FINAL%2005312022.pdf [https://perma.cc/BQG9-JR9V].

131. *Id.* at 2.

132. *Id.*

133. *Id.*

and processes associated with how a government is managed and controlled."[134]

Thus, on their face, state and local pension funds' ESG considerations might exceed the defined parameters of the fiduciary duties attached to them. The GASB's focus to date has mostly centered on guidance for financial reporting because the board considers financial reporting disclosures fundamental in state and local governments' duty to remain "publicly accountable in a democratic society."[135] However, financial disclosures are only one facet of pension fund management. The more pressing need is for the GASB to provide guidance on how to incorporate ESG investing into public pension funds' investment decisions.

The GASB itself has made clear that it "has not issued standards with the specific intention of informing what are now known as ESG matters."[136] Thus, there remains a significant guidance gap for states wishing to abide by critical fund management and accounting principles.

VI. ESTABLISHING A UNIFORM FRAMEWORK FOR STATE-RUN PENSION FUNDS

The GASB should fill the current regulatory void by issuing guidelines for public pension funds' ESG investment considerations. Any such guidance should consider current DOL interpretations of ERISA's comparable obligations for private pension fund managers, as well as the Supreme Court's interpretation of "benefits" as the primary financial consideration.[137] GASB guidelines should make it clear that pension funds may not make ESG investment decisions if such decisions would impose undue financial costs or risks to beneficiaries, even if such investments would result in collateral social benefits.[138] At the same time, however, the GASB should

134. *Id.*

135. *Id.* at 3.

136. *Id.* at 1.

137. *See* Bancorp v. Dudenhoeffer, 573 U.S. 409, 421 (2014) (the term "benefits" under ERISA "must be understood to refer to the sort of financial benefits (such as retirement income) that trustees who manage investments typically seek to secure for the trust's beneficiaries").

138. *See* Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 72846, 72884 (Nov. 13, 2020) ("A fiduciary may not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits

make clear that where ESG and non-ESG investments would result in comparable cost and risk calculations, pension fund managers may weigh even those ESG factors that seemingly transgress pure financial considerations in order to better account for collateral social outcomes.

A. *ERISA's Existing Framework as Basis for GASB Guidelines*

In promulgating new guidelines, the GASB should build on ERISA's existing framework. As already indicated, private sector benefit plans are governed by Title I of ERISA, which sets the minimum operating and governing standards, including funds' fiduciary obligations toward pension plan participants.[139] ERISA mandates that fiduciaries maximize the interests of plan members and beneficiaries.[140] Specifically, the statute requires fiduciaries to "discharge [their] duties with respect to a plan solely in the interests of the participants and beneficiaries."[141] The applicable rules require persons with fiduciary obligations to act prudently, diversify plan investments, and minimize the likelihood of large losses.[142] Importantly, plan administrators are asked to provide benefits without unreasonable expenses and administrative costs to plan participants.[143] Thus, applicable ERISA rules strike a clear balance between the fund's purpose—the provision of benefits to plan participants—and the costs for achieving that purpose, which must remain reasonable.[144] Having fiscal prudence at the forefront

under the plan to other objectives, and may not sacrifice investment return or take on additional investment risk to promote non-pecuniary benefits or goals.").

139. *ERISA*, U.S. DEP'T OF LABOR (Oct. 13, 2023, 11:09 AM), https://www.dol.gov/general/topic/health-plans [https://perma.cc/G7PN-8EHH].

140. *See* 29 U.S.C. § 1103(c).

141. *Id.* § 1104(a)(1).

142. *Id.* § 1104.

143. *Id.* § 1104(a).

144. It is worth noting that even wealth-maximization oriented funds can underperform and deliver less than optimal returns for beneficiaries. *See, e.g.*, Huixin Bi & Trenton Herriford, *Examining the Recent Shift in State and Local Pension Plans to Alternative Investments*, KAN. CITY FED. RSRV. BANK, Sept. 27, 2017, at 1 ("Against the backdrop of pervasive underfunding, many state and local pension plans have increasingly turned to alternative investments such as private equity, hedge funds, and real estate in recent years."); Lina Lu et al., *Reach for Yield by U.S. Public Pension Funds*, FIN. AND ECON. DISCUSSION SERIES, FED. RSRV. BD., June 6, 2019 at 1, https://www.federalreserve.gov/econres/feds/files/2019048pap.pdf [https://perma.cc/KA6D-7CMX] (finding that under-funding and

necessarily limits pension fund managers' ability to skirt financial returns for the attainment of political goals, with the end result of risking financial returns and imposing plan management costs for retirees.

One immediate benefit of adopting ERISA-like guidelines for state-run pension funds would be a decrease in compliance costs at the state level because a large number of states have already adopted some of ERISA's basic governing framework into their pension fund legislation.[145] Moreover, ERISA is "authoritatively cited to interpret the fiduciary duties embedded in state pension codes."[146] States are therefore familiar with the basic outline of ERISA's private pension policy framework and adopting ERISA-like rules would not constitute a regulatory sea change at the state and local levels. Likewise, investment companies have years of experience with the ERISA framework, which would decrease the need for resource allocation toward compliance with state laws.

In addition, ERISA's beneficiary-centric approach can coexist with ESG investing. As the DOL has repeatedly emphasized, private fund managers can make climate and ESG-conscious investment decisions, as long as those decisions comply with ERISA's prudence and loyalty requirements.[147] At its core, ERISA prohibits investment decisions that "subordinate the interests of plans and their participants and beneficiaries to unrelated objectives."[148] Accordingly, some ESG-friendly goals might be prohibited under the prudence and loyalty

low risk-free rates account for around one-third of the total risk taken on by public pension plans); *Basic Legal Protections Vary Widely for Participants in Public Retirement Plans,* PEW (Nov. 21, 2017), https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2017/11/basic-legal-protections-vary-widely-for-participants-in-public-retirement-plans [https://perma.cc/TTD6-WDFC] ("In recent decades, public pension funds, in a bid to boost returns, have shifted funds away from low-risk, fixed-income investments . . . to a greater reliance on equities and alternative investments."). However, despite potential pitfalls, wealth maximization should become the guidepost for public pension funds. With wealth maximization front and center, pension funds can ensure that retirees' financial returns are never side-stepped by social policy goals. Moreover, wealth maximization better comports to the fiduciary nature of pension fund management, ensuring that fund managers act in the sole interest of retirees.

145. *See* Susan N. Gary, *Conflicts and Opportunities for Pension Fiduciaries in the ESG Environment*, 74 OKLA. L. REV. 607 (2022).

146. Webber, *supra* note 58, at 2109.

147. Department of Labor Interpretive Bulletin 2016–01, 81 Fed. Reg. 95879 (Dec. 29, 2016).

148. Department of Labor Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 39116 (June 30, 2020).

requirements of ERISA Section 404(a) if achieving those collateral goals risks investment returns or increases investment risks for plan participants.[149] For instance, pension plan managers would be unable to divest from fossil fuel companies if doing so would jeopardize returns for plan beneficiaries or would put plan beneficiaries' investments at greater risk. However, the DOL has repeatedly stated that under its "all things being equal" standard, private fund managers can consider collateral factors in making investment decisions when competing pro- and anti-ESG investments serve the plan's economic interests equally well.[150] This "all things being equal" standard is permitted only where selected investments (1) have "an expected rate of return at least commensurate to rates of return of available alternative investments with similar risk characteristics," and (2) otherwise comport with ERISA's "diversification" requirements and "the investment policy of the plan."[151]

True, ERISA fund fiduciaries "must not too readily treat ESG factors as economically relevant to the particular investment choices at issue when making a decision" because it is far from clear that all ESG-oriented investments are always a prudent choice for retirees or other investors.[152] Rather, the focus should be on meeting "the plan's articulated funding and investment objectives."[153] But the DOL has also emphasized that when ESG investments are consistent with the funding and investment objectives, prudency and loyalty obligations require

149. *See* 29 U.S.C. § 1104(a).

150. Department of Labor Interpretive Bulletin 94–1 (IB 94–1), 59 Fed. Reg. 32606 (June 23, 1994).

151. Financial Factors in Selecting Plan Investments, *supra* note 138, at 72846; *see also* Department of Labor Interpretive Bulletin Relating to the Fiduciary Standard Under ERISA in Considering Economically Targeted Investments, 80 Fed. Reg. 65135, 65135 (Oct. 26, 2015) (applying the "all things being equal test," and noting that ERISA does not "prevent plan fiduciaries from investing plan assets in [economically targeted investments] if the ETI has an expected rate of return that is commensurate to rates of return of alternative investments with similar risk characteristics that are available to the plan, and if the ETI is otherwise an appropriate investment for the plan in terms of such factors as diversification and the investment policy of the plan.").

152. U.S. DEPT' OF LAB., FIELD ASSISTANCE BULLETIN NO. 2018-01 2 (Apr. 23, 2018), https://www.dol.gov/sites/dolgov/files/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2018-01.pdf [https://perma.cc/R2RB-X4EM].

153. *Id.*

private fund managers to consider such investments as viable alternatives to non-ESG investments.[154]

B. *Implementing Uniform Beneficiary-Centered Laws Will Not Eliminate ESG Opportunities for State and Local Pension Funds*

Some worry that ERISA's prudence and loyalty duties require retirement plan providers to focus solely on "pecuniary factors," with the effect of fully "discouraging the inclusion of ESG investments in retirement plans."[155] Thus, the argument goes, adopting uniform ERISA-like standards for state and local pension funds might remove one avenue of pursuing or restricting an ESG agenda at the state level. Although some restrictions on ESG investing are likely, adopting ERISA-like standards will not fully eliminate ESG investment opportunities for state and local pension funds.

The GASB's existing ESG overview presents numerous areas where pecuniary considerations and ESG investing overlap. In terms of capital assets, environmental considerations "may intersect with the useful life and residual value determinations" for such assets.[156] State and local pension funds also need to account for asset retirement obligation liabilities related to government regulations that permanently remove assets, like nuclear reactors or sewage treatment plans, from operation.[157] Pension funds must account for such local and state regulations and measure the amount of liabilities and expenses stemming from such regulations.[158] Pension funds must similarly monitor environmental-related claims and judgments for potential liabilities.[159] Current GASB guidance requires governments to report post-closure costs stemming from municipal closings of solid waste landfills and subsequent management, including plans for meeting post-closure financial

154. *Id.*
155. Elizabeth S. Goldberg & Rachen Mann, *The Interplay Between ESG Investing and ERISA's Fiduciary Duties*, MORGAN LEWIS (Sept. 21, 2022), https://www.morganlewis.com/pubs/2022/09/the-interplay-between-esg-investing-and-erisas-fiduciary-duties [https://perma.cc/K649-SRLU].
156. GASB ESG Overview, *supra* note 130, at 7.
157. *Id.*
158. *Id.*
159. *Id.* at 8.

assurance requirements.[160] Pension funds must account for investments affected by government pollution remediation regulations, and track associated liabilities and investments.[161] Thus, even if the GASB adopts ERISA-like fiduciary guidelines for public pension funds' ESG investments, pension fund managers and their advisers will remain free to pursue financially prudent ESG investments.[162]

Furthermore, as the GASB definition of ESG aptly illustrates, the concept of ESG is broader than investing and incorporates key public social considerations and commitments, most of which can be achieved without the use of public pension funds. For instance, the political scientist John Pelissero has observed that states already adopt ESG goals within the existing governmental operations and services and implement ESG-focused policies and regulations.[163] Some cities, for instance, have joined in global climate initiatives.[164] School districts are starting to promote ESG considerations in developing school curricula.[165] States and local government have also implemented broad anti-corruption policies as well as corporate political contribution guidelines.[166] Critically, these public entities have done so without risking retirees' pensions.

The foregoing examples are part of the broad ESG framework that states and localities can adopt as they navigate

160. *Id.* at 8–9.

161. *Id.* at 9.

162. Adopting ERISA-like rules might also better immunize state pension funds from legal challenges as well, as a recent decision from the Northern District of Texas indicates. *See* Utah v. Walsh, No. 23-CV-016-Z, 2023 U.S. Dist. LEXIS 168696 (N. D. Tex. Sept. 21, 2023). In *Utah v. Walsh*, a coalition of twenty-six Republican attorneys general challenged DOL's "all things being equal" interpretation of ERISA, under which private retirement plan managers can consider ESG factors when picking between financially equivalent investment options. The court rejected the challenge, finding the DOL's interpretation "reasonable." *Id.* at *14. The court credited DOL's prior findings that "ESG factors 'may have a direct relationship to the economic value of the plan's investment,'" and that "failing to consider ESG-related risk-return factors could constitute a violation of the duty of prudence in some circumstances." *Id.* (internal quotations omitted). That is, "an ESG factor could be worth consideration," so long as it "is expected to have a material effect on the risk and/or return of an investment." *Id.* at *17 (internal quotations omitted).

163. John Pelissero, *Trends in the Implementation of ESG Policies in State and Local Governments*, MARKKULA CTR. FOR APPLIED ETHICS (Feb. 8, 2022), https://www.scu.edu/ethics/all-about-ethics/trends-in-the-implementation-of-esg-policies-in-state-and-local-governments [https://perma.cc/DWW8-V34R].

164. *Id.*

165. *Id.*

166. *Id.*

the increasingly polarized world of ESG investing. The sheer breadth of ESG considerations exceeds the more limited scope of pension fund management. To the extent that ESG considerations are irrelevant to the pecuniary interests of pension fund beneficiaries, they properly belong to the policy sphere. Relegating non-pecuniary ESG considerations to the political realm will increase political accountability among state and local officials, giving the voting public more say over important social policy decisions. At the same time, adopting ERISA-like rules would free pension fund managers to consider ESG investments when those investments offer comparable returns to non-ESG investments.

CONCLUSION

State pension funds harbor significant resources and provide old-age financial security for millions of state and local employees. But the advent of ESG investment rules at the state level threatens the stability and long-term viability of public pension funds because state legislatures have started exploiting their vast pension funds to pursue public policy goals. Because public pension systems often center fiduciary duties around the pension fund itself, instead of around the retirees, states can freely exploit pension funds' financial clout in pursuit of political goals at the expense of retirees' pecuniary interests. To avoid pension fund catastrophe, this Note demonstrates that the GASB can, and should, set new guidelines for state pension fund management inspired by ERISA's existing framework. The GASB can build on ERISA's existing framework, as well as decades of DOL regulations thereunder, to combat diversions of public pension funds towards public policy objectives while safeguarding the interests of plan beneficiaries. Critically, the GASB should recommend that states reorient pension funds to a retiree-centered model and abandon the fund-first model. Such reorientation would protect and prioritize retirees' life savings over politics, ensuring the financial well-being of millions of pensioners across the United States.