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Kansas Public Employees Retirement System Warns of Adverse Consequences From "Anti-ESG" Bills: Cadwalader

Earlier this month, the Kansas Public Employees Retirement System (KPERS) urged legislators to reject key aspects of "anti-ESG" bills introduced in the Kansas Senate and House of Representatives. Both bills are designed, in part, to restrict the ability of investment managers engaged by KPERS to consider ESG factors in investment decisions, either directly or indirectly. The Senate bill (SB 224), which the state's Attorney General, Kris Kobach, promoted as the "strongest anti-ESG bill in the country," operates by prohibiting KPERS from investing in or through financial entities "engaged in ideological boycotts," a term defined to include "any commercial action that is intended to penalize, inflict economic harm on, limit commercial relations with or change or limit the activities of a company" based on ideological or political considerations, including the company's failure to satisfy certain environmental criteria. The House bill (HB 2436) operates by requiring all investment decisions on behalf of KPERS to be made "solely in the financial interest" of beneficiaries, while defining "financial interest" to exclude any consideration of certain policy objectives, such as eliminating, reducing, offsetting, or disclosing greenhouse gas emissions.

KPERS objected to the bills as both unnecessary and costly. The bills are unnecessary, according to KPERS, because (1) as fiduciaries, members of the KPERS Board and its investment managers are already duty-bound to make "[a]ll investment decisions . . . for the sole purpose of providing promised benefits"—an obligation that the proposed bills could disrupt; and (2) an existing Kansas law, in operation since 1992, already prohibits investments "if the sole or primary investment objective is for economic development or social purposes or objectives." More critically, under either of the bills, all or nearly all of the current KPERS investment managers would be disqualified because they offer ESG products, resulting in a complete divestment and restructuring of the KPERS fund. Such a restructuring would lead to "asset losses of approximately $1.14 billion due to the early sale of assets from illiquid investments" and would reduce future returns by an estimated 0.85%, resulting in a $3.6 billion reduction in fund earnings over the next 10 years. This underfunding would in turn cost state and local employers billions of dollars in the form of higher mandated contributions. Finally, by restricting the ability of KPERS to delegate its proxy voting rights unless it is not "economically practicable," and the investment manager commits in writing to "act solely on pecuniary factors" (a term not defined in the bills), the bills would require KPERS "to research and evaluate each of the nearly 100,000 proxy votes based solely on financial factors," meaning that "an entire team of investment professionals would have to be hired to manage proxy voting." That, in turn, would "create an unnecessary layer of bureaucracy that will make KPERS less competitive with private market and real estate investments."

To help mitigate the impact of the bills, KPERS proposed several amendments. First, KPERS recommended narrowing the restrictions placed on investment managers to apply only to assets managed on behalf of KPERS. This would allow KPERS to continue its relationships with current investment managers as long as they commit to managing state assets according to the requirements of the bills. Second, KPERS recommended exempting alternative or real estate investments, "which rarely have proxy votes due to the nature of the investment," from restrictions related to proxy voting, and clarifying that KPERS could continue to delegate its proxy voting

authority to third parties who commit to exercising that authority according to the requirements of the bills. Third, with respect to the Senate bill, KPERS recommended that the divestment requirement "be limited to direct holdings and exclude private markets and real estate to mitigate extraordinary divestment costs from these illiquid investments." Finally, with respect to the House bill, KPERS recommended a provision that would require the state to defend and indemnify the KPERS Board and staff from any liability arising from compliance with the requirements of the bill—a protection already included in the Senate bill.

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