POLICY BRIEFING

US GUIDANCE: ENABLING STATE-LEVEL SUSTAINABLE FINANCIAL SYSTEMS

November 2024

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To inform this briefing the following investor group has been consulted: PRI Regional Policy Reference Group for the United States.

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ABOUT THE PRI

The Principles for Responsible Investment (PRI) works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social, and governance (ESG) issues and to support signatories seeking to integrate these issues into investment and ownership decisions, where consistent with their fiduciary duties. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate, and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system. More information: www.unpri.org

ABOUT THIS BRIEFING

This briefing was prepared for US state and local lawmakers and regulators who are seeking to support more sustainable financial markets in their jurisdiction. It adapts PRI's Policy Toolkit project to present baseline steps that state and local officials can consider to support responsible investment practices and build a more sustainable financial system within their markets. Establishing responsible investment practices at the state level can help protect local and regional markets from shocks and support them in becoming more diverse and productive in the long term. States need not wait for the federal government to take action in order to reap the benefits of an enabling environment for responsible investment and the baseline conditions for a more sustainable financial system.

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EXECUTIVE SUMMARY

Given the existing political hyperpolarization around many policy areas at the federal level in the US, including topics such as sustainable finance policy, states should be empowered to advance sustainable investment activity within their own jurisdictions.

States must be prepared to navigate risks and opportunities presented by the global transition to lower-carbon economies. If executed effectively, the economic transition can underpin future economic prosperity by encouraging innovation and supporting low-carbon sectors, enabling the economic revitalization of communities built around legacy industries, creating new jobs and more inclusive labor markets, and increasing long-term market competitiveness in a rapidly changing global economy. Proactive reforms best position states to attract capital from investors and create more sustainable, stable, and resilient markets.

The PRI, in partnership with the World Bank and Chronos Sustainability, has previously published policy toolkits intended to support government policy makers and regulators in implementing national-level reforms to support responsible investment practices and build a more sustainable financial system. The PRI has also previously supported sustainable finance policy in specific US states, including via the California and Ohio Fiduciary Duty in the 21st Century Roadmaps.

This report adapts PRI's previous work into five high-level baseline recommendations that US states can evaluate and adapt to build a more sustainable financial system in the absence of, or in conjunction with, policymaking at the federal level:

1. **Adopt a state-wide approach to enable responsible investment** by promoting and encouraging responsible investment practices at the highest levels of government.
2. **Clarify investors' ability** to incorporate material ESG-related considerations into investment decision-making, and to report on their ESG incorporation policies and performance targets.
3. **Align corporate sustainability disclosures with global best practices** by following the ISSB's disclosure recommendations for ESG-related information.[1]
4. **Support investor stewardship practices** that enable asset owners to leverage the full scope of their rights as shareholders—including the right to cast votes at shareholder meetings and engage portfolio companies on material issues—on behalf of plan participants, clients, and beneficiaries.
5. **Pursue policy alignment between states** to facilitate the efficient allocation of capital by investors and create a sustainable market environment that attracts capital from investors seeking long-term, sustainable returns.

[1] International Financial Reporting Standards Foundation, "General Sustainability-Related Disclosures," https://www.ifrs.org/projects/completed-projects/2023/general-sustainability-related-disclosures/.

INTRODUCTION

Financial markets operate most efficiently when regulatory and legal regimes are aligned across local, state, and federal government levels. For investors seeking to generate long-term, sustainable returns, regulatory misalignment can hinder the responsible investment practices that are most beneficial to achieving investor and beneficiary goals.

Box 1: The PRI defines a "sustainable financial system" as "a resilient system that contributes to the needs of society by supporting sustainable and equitable economies, while protecting the natural environment." Such a system should enable savers to reliably manage and store their income for future use; custodians or trustees to protect and build financial value; and companies, governments, and other parties to access capital for investment, innovation, and consumption.

Public officials at every level of government can take steps to develop more sustainable financial markets and economic systems within their jurisdictions by enabling more sustainable financial practices, including responsible investment. Responsible investment practices, where consistent with fiduciary duties, can strengthen financial markets through enhancing the resilience and stability of financial systems and economies, improving market efficiency and increasing the attractiveness of jurisdictions to investment, and even supporting broader policy goals such as those on climate change, all while supporting investors seeking to enhance their risk-adjusted financial returns. Responsible investment practices that enable investors to contribute to a more sustainable financial system, such as by considering material ESG information in their decision making, does not require any changes to current fiduciary duties—the core promise that drives investment activities. In fact, a more sustainable and stable market environment can better serve investors seeking to protect and enhance long-term, risk-adjusted returns.

The PRI has previously outlined the key legal and regulatory elements of a national sustainable financial system through its Policy Toolkit project.[2][3] These baseline policies include adaptable, high-level regulations and guidance, as no two jurisdictions are exactly alike in their existing regulatory regimes and financial market design.

While policies at the national level provide overarching regulatory support for responsible investment, investors also look to state and local governments and the vital role they serve in fostering sustainable financial practices that are most appropriate based on regional or local differences—such as the needs of a rural community versus an urban center. States have the prerogative to create an enabling environment for responsible investment, both to support state-managed funds and programs and to attract private investors seeking to operate in more sustainable markets. Through supportive sustainable finance regulation and laws, every state can build healthier markets within their borders that attract patient capital and support long-term economic and community growth and prosperity.

[2] Principles for Responsible Investment, "Sustainable Financial System: Nine Priority Conditions to Address," https://www.unpri.org/download?ac=5510.

[3] The PRI has identified the inter-related characteristics of a sustainable financial system as one that is: productive, transparent, well-regulated and well-governed, fair and equitable, informed, participatory, socially and environmentally sustainable, ethical, simple, efficient, and resilient. https://www.unpri.org/download?ac=322.

Why Focus on States?

State and local officials have long been leaders in sustainability practices and policies. Individual states and localities can act quickly and decisively, avoiding the complexities of aligning the broader Congress and national regulators. For example, states in the northeast launched a regional carbon market, the Regional Greenhouse Gas Initiative (RGGI), in 2009. In 2022 alone, proceeds funded an expected $1.8 billion in lifetime energy bill savings for households and businesses, while avoiding 7.5 million tons of carbon emissions.[4] At the local level, the Climate Mayors network has more than 750 members committed to more ambitious climate action than has been possible nationally. Though the broader sustainability of local financial systems goes beyond climate policy alone.

The current financial system is susceptible to multiple risks and sustainability challenges.[5] These risks, whether they lead to specific shock events or compound over time, can limit the ability of financial systems to operate efficiently and equitably. In addition, system-level risks,[6] such as climate change, have the potential to damage the entire financial system, which can harm even the most diversified and risk-averse investors and markets.[7] In particular, larger or longer-lived institutions—such as state governments and municipalities—have a significant stake in the long-term stability and effectiveness of financial systems. State and local economies can also be more concentrated and dependent on a certain industry or market, such as agricultural commodities or automobiles. These local challenges can be a hinderance to attracting capital investments from increasingly globalized, competitive financial markets.

The federal government is taking initial steps to support a more sustainable financial system at a national level. For example, at the time of writing, the federal government has sought to support key regulations with implications for state financial systems. These include the Department of Labor's (DOL) "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights" rule,[8] which applies to ERISA funds in line with international guidance for private pension funds,[9][10] and the Securities and Exchange Commission's (SEC) rule, "The Enhancement and Standardization of Climate-Related Disclosures for Investors."[11] However, significant risk exists that these and other federal policies could shift, whether it be via future changes to underlying law, administrative actions or court decisions. For example, the aforementioned SEC rule has, at time of publication, been temporarily stayed by the SEC pending resolution of a consolidated lawsuit seeking to overturn it.[12]

[4] Regional Greenhouse Gas Initiative, "The Investment of RGGI Proceeds in 2022" (July 2024), https://www.rggi.org/sites/default/files/Uploads/Proceeds/RGGI_Proceeds_Report_2022.pdf.

[5] World Economic Forum, "Global Risks Report 2024" (January 2024), https://www.weforum.org/publications/global-risks-report-2024/.

[6] In the PRI's Reporting Framework glossary, "systematic risk" (interchangeable with "market risk" or "market-wide risk") refers to risks transmitted through financial markets and economies that affect aggregate outcomes, such as broad market returns, https://www.unpri.org/reporting-and-assessment/reporting-framework-glossary/6937.article.

[7] Financial Stability Board, FSB Roadmap for Addressing Climate-Related Financial Risks (July 7, 2021), https://www.fsb.org/wp-content/uploads/P070721-2.pdf.

[8] Employee Benefits Security Administration, United States Department of Labor, "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights" (December 1, 2022), https://www.federalregister.gov/documents/2022/12/01/2022-25783/prudence-and-loyalty-in-selecting-plan-investments-and-exercising-shareholder-rights.

[9] International Organisation of Pension Supervisors, IOPS Supervisory Guidelines on the Integration of ESG Factors in the Investment and Risk Management of Pension Funds (2019), https://www.iopsweb.org/IOPS-Supervisory-guidelines-integration-ESG-factors.pdf.

[10] While the rule may impact state pension fund behavior, it is only legally controlling for ERISA funds. However, the rule (and ERISA more broadly) sets a normative expectation for pension fund governance.

[11] Securities and Exchange Commission, "The Enhancement and Standardization of Climate-Related Disclosures for Investors" (March 6, 2024), https://www.sec.gov/rules/2022/03/enhancement-and-standardization-climate-related-disclosures-investors.

[12] Isla Binnie, Reuters, "US SEC stays climate disclosure rule amid legal challenges" (April 4, 2024), https://www.reuters.com/legal/us-sec-stays-climate-disclosure-rule-amid-legal-challenges-2024-04-04/.

Rather than waiting for federal progress addressing these issues, states should look to continue their legacy of acting as "laboratories of democracy" by addressing these risks and opportunities for their constituents and markets directly. State regulators and policy makers should also strive to create reasonable benchmarks that allow other states to effectively align regulation and avoid market fragmentation. While some sustainable finance policies are more appropriate for national regulators to implement—for example, taxonomies of sustainable activities—states can still work together by aligning terminology, and by considering areas where state and regional goals may align. States are no stranger to economies of scale on other issues and sustainable finance should be no different.

THE NEED FOR ACTION

The need for states to enable more sustainable financial markets is urgent, given not only the accelerating impacts of climate change and other sustainability-related risks, but also the political context in which many states are enacting or considering constraints on responsible investment practices. In 2023, opponents of responsible investment introduced 156 bills and nine resolutions in 37 state legislatures across the country designed to hinder responsible investment practices by discouraging or limiting investors' ability to engage on or even consider certain information relating to ESG factors and systemic risks, among others.[13] Beyond legislative proposals, regulatory actions and various inquiries, investigations, and lawsuits from state officials, including state attorneys general, continue to create a chilling effect on progress towards more sustainable state financial systems.

While "anti-ESG" bills have seen a low success rate across the country—in large part due to unified opposition from a diverse array of stakeholders including labor, business groups, and public pension fund officials[14]—the volume of such proposals reflects coordinated and well-funded opposition to responsible investment at the national and state level. The PRI has previously outlined how anti-ESG bills are based on fundamental misconceptions about responsible investment's purpose, value, and practice. The PRI has also interviewed signatories to understand the negative impacts of anti-ESG laws on their operations. Many anti-ESG bills seek to restrict or otherwise constrain investors from undertaking responsible investment practices, with large potential and actual costs to Americans and businesses.[15] It is increasingly clear that regulation seeking to prevent responsible investment practices can adversely impact the interests and financial goals of investors' beneficiaries.

Political opposition to responsible investment comes as the global transition to lower-carbon economies accelerates, and as investment increasingly flows towards clean industries and technologies. Communities that do not adapt risk missing out on the economic opportunities afforded by this transition.[16] Laws and regulation that acknowledge this reality and enable markets to better adapt to, and take advantage of, the transition are more critical than ever.

[13] Pleiades Strategy, "2023 Statehouse Report" (2023), https://www.pleiadesstrategy.com/state-house-report-bill-tracker-republican-anti-esg-attacks-on-freedom-to-invest-responsibly-earns-business-labor-and-environmental-opposition.

[14] Pleiades Strategy, "2024 Statehouse Report" (2024), https://www.pleiadesstrategy.com/state-house-report-bill-tracker-republican-anti-esg-state-legislative-attacks-on-responsible-investing-continue-weakened-and-reshaped-by-their-costly-reality-and-a-year-of-continued-opposition.

[15] Freedom to Invest, "Economic Impacts" (2024), https://www.freedomtoinvest.org/economic-impacts/.

[16] Joel Jaeger et al., World Resources Institute, "EVs Could Create Thousands of Jobs in Michigan and Revitalize Its Auto Industry" (May 3, 2023), https://www.wri.org/insights/michigan-electric-vehicle-job-creation.

BENEFITS OF SUSTAINABLE FINANCIAL REGULATION

The financial system is an integral part of modern economies. For example, it allows workers to save and invest for retirement; it also supports productive investment and innovation, such as facilitating medical breakthroughs and more efficient means of agriculture. However, growing risks and challenges—those that can lead to specific shocks or accumulate over time—can undermine investor efforts to fulfil their goals and achieve long-term, sustainable returns for clients and beneficiaries.

The PRI has previously analyzed the priority conditions for a more sustainable financial system.[17] These include managing principal-agent problems, re-aligning incentives, and focusing on long-term performance, consistent with the investment horizon of patient capital, such as pension funds.[18] The PRI has tracked the global growth of regulation seeking to address these issues through the Regulation Database,[19] a repository of almost 900 policy tools that support, encourage or require markets to address certain conditions. The steady increase in the number of such policies is indicative of global demand for progress on these issues and the resulting positive effects.

These policy tools include direct efforts to ensure that the local, regional, national, and global financial systems our economies rely upon remain stable and productive for years to come. They can also support responsible investment practices which contribute to long-term financial stability by allowing investors to evolve their practices in response to an increasingly complex world, evaluating emerging issues across their portfolios, and creating more transparent and resilient financial systems.

Given the challenges and risks posed in the previous section, there is a need for state policy makers to address gaps in state legal and regulatory frameworks that may exacerbate or ignore risks to the financial system. By addressing these gaps, policy makers can secure key macro-level benefits for investors, and thus, their clients and beneficiaries[20], including:

- Improved investment decision making through access to information on material sustainability risks and opportunities, including those that may not be reflected in financial reporting.
- Flexibility to consider material issues over longer timeframes, allowing investors to take fuller account of system-level risks, like the energy transition and increase in severe weather events.
- Improved dialogue with companies due to better information on practices and performance.
- Improved management and board oversight of performance on key issues.
- Increased clarity on social and environmental expectations of investors and other stakeholders.

The absence of sustainable financial regulation, or worse, the adoption of regulations designed to inhibit responsible investment practices, can interfere with investors' ability as fiduciaries to evaluate material risks and opportunities, leading to inefficient allocation of capital and suboptimal investment decision-making, and the potential for poorer long-term financial and investment outcomes for state and local economies and their residents.[21]

[17] In 2016, the PRI consulted with signatories to identify 30 underlying conditions (risks or challenges) that could undermine the resilience of the financial system, or could cause the system to fail to support sustainable economic development. The PRI then determined nine priority conditions based on their impact and ability to cause other conditions (see footnote 17).

[18] Principles for Responsible Investment, "Nine priority conditions for a sustainable financial system," https://www.unpri.org/sustainable-financial-system/nine-priority-conditions-for-a-sustainable-financial-system/199.article.

[19] Principles for Responsible Investment, "Regulation database," https://www.unpri.org/policy/global-policy/regulation-database.

[20] Principles for Responsible Investment and The World Bank Group, "A toolkit for sustainable investment policy and regulation (part1)," https://www.unpri.org/policy/how-policy-makers-can-implement-reforms-for-a-sustainable-financial-system/6917.article.

[21] Freedom to Invest, "Economic Impacts" (2024), https://www.freedomtoinvest.org/economic-impacts/.

KEY ELEMENTS FOR SUSTAINABLE FINANCIAL MARKETS

As the need for action becomes increasingly clear and timely, states need not wait for progress at the national level to begin building a more sustainable, and attractive, financial system for their markets. The PRI has identified five high-level baseline policies that US states can evaluate and adapt now to begin building a more sustainable financial system in the absence of, or in conjunction with, policymaking at the federal level:

1. **Adopt a state-wide approach to enable responsible investment** by promoting and encouraging responsible investment practices at the highest levels of government.
2. **Clarify investors' ability** to incorporate material ESG-related considerations into investment decision-making, and to report on their ESG incorporation policies and performance targets.
3. **Align corporate sustainability disclosures with global best practices** by following the ISSB's disclosure recommendations for ESG-related information.
4. **Support investor stewardship practices** that enable asset owners to leverage the full scope of their rights as shareholders—including the right to cast votes at shareholder meetings and engage portfolio companies on material issues—on behalf of plan participants, clients, and beneficiaries.
5. **Pursue policy alignment between states** to facilitate the efficient allocation of capital by investors and create a sustainable market environment that attracts capital from investors seeking long-term, sustainable returns.

1. ADOPT A STATE-WIDE APPROACH TO ENABLE RESPONSIBLE INVESTMENT

States should enable and promote responsible investment at the highest levels of government.

It is critical that governments clearly signal the importance of sustainable finance—both for those managing state funds and those making investments in the state—to support sustainable markets and industries for the long term. An across-the-board focus on enabling responsible investment practices can help build an economy that is diversified, responsive to economic changes, insulated from major economic shocks, and oriented to support jobs that provide for decent work[22] for years to come. It can also help prepare states and investors to navigate the transition to lower-carbon economies.

States should coordinate a whole of government strategy to enable and promote responsible investment where appropriate. It may be useful to begin with an assessment of the current extent to which state, county, and municipal funds, as well as endowments, foundations, and other institutional investors in the state are engaging in responsible investment practices, beginning with integrating ESG factors in investment decision-making. This assessment can include representatives from both public and private entities and be led by the state treasurer or comptroller.

[22] "Decent work" is defined by the International Labour Organization (ILO) and the PRI as the aspirations of people in their working lives, including opportunities for work that provide a fair income, security in the workplace, and better prospects for personal development and social integration, among others. https://www.unpri.org/sustainability-issues/environmental-social-and-governance-issues/social-issues/decent-work.

States should also prioritize creating guidance on best practices, sharing detailed language to support practitioners, and engaging with those hesitant about or opposed to responsible investment practices or sustainable financial policies. With the emergence of a coordinated anti-ESG campaign which often misrepresents responsible investment practices, it is increasingly important to engage with and educate citizens and investors on what responsible investment does and does not include. To start, communications should stress that responsible investment practices do not encourage or require sacrificing financial returns, but rather seek to protect investors from otherwise missed or ignored risks and opportunities that could limit returns in the long run. States should emphasize that responsible investment is fully in line with longstanding fiduciary duties and no changes need to be made to these duties in order to engage in responsible investment practices. Preparing tools, responsive resources, and case studies on practices for pension fund managers and local finance officers can help support the adoption of responsible investment practices.

The PRI has previously recommended a similar state-wide approach, including in California and Ohio, in our Fiduciary Duty in the 21st Century Roadmaps. While states differ politically and economically, all have the capacity to encourage more responsible investment practices at the highest levels of government. Providing knowledge-sharing and education from experts convened by state officials can give clarity and guidance to investors acting in the best long-term interests of their beneficiaries.

2. CLARIFY INVESTORS' DUTIES

State officials should clarify that investors managing state funds may consider ESG-related information where relevant to maximizing risk-adjusted returns.

State government officials should clarify that state plan investment professionals, investment managers, and others involved in managing state funds can and should enable integration of material ESG factors into investment decisions and stewardship activities, starting with incorporating enabling language in their investment policy statement and related plan documents. Responsible investment practices already are fully compatible with prevailing fiduciary standards; however, being intentional and explicit in expectations around responsible investment as a tool in protecting and enhancing plan assets can provide critical clarity, enable more efficient management of plan resources, and empower investors to better grapple with the increasingly rapid changes in the global economy.

As described above, numerous states have recently considered and enacted new laws that limit the ability of investors managing state funds to consider information that legislators view as "non-pecuniary."[23] The PRI and others have extensively documented the fundamental and practical problems created by establishing such limitations on investment practices.[24][25] As such, state legislatures may need to review and repeal these recently enacted laws or regulations that unduly constrain investment decision-making, leading in many cases to immediate financial harm to the fund as well as future losses through premature exits, reduction in choice among investment managers and vendors, and constrained capital.

[23] Pleiades Strategy, "2024 Statehouse Report" (2024), https://www.pleiadesstrategy.com/state-house-report-bill-tracker-republican-anti-esg-state-legislative-attacks-on-responsible-investing-continue-weakened-and-reshaped-by-their-costly-reality-and-a-year-of-continued-opposition.

[24] Gregory Hershman, "PRI blog: Anti-ESG bills in the US will only create confusion for investors" (January 24, 2023), https://www.unpri.org/pri-blog/anti-esg-bills-in-the-us-will-only-create-confusion-for-investors/11077.article.

[25] Principles for Responsible Investment, "Policy briefing: Signatory responses to state anti-ESG laws" (June 12, 2024), https://www.unpri.org/policy-reports/policy-briefing-signatory-responses-to-state-anti-esg-laws/12491.article.

Investment managers require policy support as they seek to adapt their practices during periods of economic and technological change. Investors' fiduciary duty requires them to act solely in the interest of their clients, beneficiaries, and the plan, and the consideration of potentially economically relevant and decision-useful information is a part of the investment process. The PRI's work demonstrates that given the potential benefits of responsible investment, all fiduciaries—whether managing public or private funds—should have the ability to fully integrate material ESG factors into investment processes and decision-making where investment professionals, acting in accordance with their fiduciary duty, deem necessary and appropriate. Forcing plans to ignore such factors or placing restrictions on investors' ability to consider them can hinder the long-term financial well-being of beneficiaries, and as such may countervail prevailing fiduciary standards of duty, loyalty, and care.

The Department of Labor's "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights" rule, finalized in November 2022, clarified that fiduciaries of plans governed by ERISA, including most private pension plans, may integrate ESG-related information into their ordinary investment practices.[26] The rule provides clarity that confirms what investors have known for decades—integrating ESG-related information is well within an investors' remit if they believe it to be relevant to an investment or stewardship decision. While investors have never needed permission to do so, such regulation has proven important to establishing ESG integration as a baseline for investors seeking to freely and fully consider the universe of potentially relevant information.

Legislative Options: Investor Expectations

While the activities above do not require changes to existing law, states may consider passing legislation to clarify investor expectations or align certain investor activities, such as disclosure and product labelling. One such example is Illinois's Sustainable Investing Act. The original Act, passed in 2019, requires public agencies and other governmental units managing public funds to adopt sustainable investment policies in order to "prudently integrate sustainability factors into its investment decision-making, investment analysis, portfolio construction, due diligence, and investment ownership in order to maximize anticipated financial returns, minimize projected risk, and more effectively execute its fiduciary duty." These factors include corporate governance and leadership, environmental (e.g., carbon emissions), social capital, human capital, and business model and innovation.

The law was amended in 2023 to require investment managers acting as fiduciaries—such as when managing public funds—for covered governmental entities to disclose how they incorporate sustainability factors into their investment decision-making.[27] When choosing external managers, a governmental entity acting under the law should evaluate fund managers' sustainability practices as part of initial and ongoing due diligence.

Investor groups and advocates are evaluating Illinois's Sustainable Investing Act to propose improvements and additional components for state-level legislation that sets out investor duties. For example, Americans for Financial Reform has drafted a model bill based on the Sustainable Investing Act that more fully enumerates the sustainability factors that state funds can consider—both those that can affect individual investment decisions and those that may affect the entire portfolio. The model bill also requires more robust disclosures by the investment managers acting (or seeking to act) on behalf of state entities that include not just their sustainable investment practices, but also the

[26] While public funds, such as those managed by state pension funds, are not regulated by ERISA, ERISA guidelines are often viewed by non-ERISA funds as best practices and followed as a benchmark.

[27] Illinois General Assembly, "Bill Status of HB2782" (updated July 28, 2023), https://www.ilga.gov/legislation/BillStatus.asp?DocNum=2782&GAID=17&DocTypeID=HB&LegId=147908&SessionID=112&GA=103.

extent to which those practices are aligned with the fund's own sustainable investment policy. Under this bill, those disclosures would be publicly available. These amendments seek to give additional tools to investment managers to evaluate the extent to which those working on their behalf are aligned with their sustainable investment practices and policies.

Transparency sits at the core of the PRI's own Reporting Framework, the largest global reporting project on responsible investment. Enacting policy reforms to require disclosure of investor activities, both public and private, can help to ensure that investors are aligned with their beneficiaries' goals and that their actions are consistent with their public statements or marketing materials. It is reasonable that disclosure of responsible investment practices begins with those managing public funds, but it need not be limited to this sector of state financial systems.

3. MANDATE CORPORATE SUSTAINABILITY DISCLOSURES

States should support and align standardized disclosure of sustainability-related risks from companies doing business in their state, including disclosure of greenhouse gas emissions.

Efforts by both investors and companies to measure and manage their sustainability-related risks and opportunities continue to show a link to enhanced long-term performance. Disclosures of such information are increasingly viewed by investors as decision-useful[28] data that complements traditional financial reporting and help to better understand a company's sustainability-related risks and opportunities, and thus make more informed investment decisions. Sustainability-related disclosures can also help investors determine if companies are acting in line with responsible business practice norms as outlined by the US government and by the UN and the Organisation for Economic Co-operation and Development (OECD) (see Box 3).

Investor demand for sustainability-related information is evident. However, information that investors can use to understand and evaluate performance on sustainability-related practices is often provided through voluntary disclosures. Without mandatory and standardized sustainability disclosure regulations, such information is often distributed across a confusing array of reports that are not easily verifiable or comparable across markets, industries, and companies. This creates a barrier for investors seeking to consider sustainability-related information in their investment activities, while increasing costs to investors—and the plan—for seeking out decision-useful data.

Two examples of state-level initiatives to improve corporate sustainability disclosures are California's 2023 laws requiring climate-related disclosures from certain companies doing business in the state:

[28] As set out in the PRI's Investor Data Needs framework, to be decision-useful, sustainability information must be available, accessible, verifiable, comparable across multiple dimensions, a faithful representation and relevant to investors.

- **SB 253**[29] requires public disclosure of Scope 1, 2, and 3 greenhouse gas (GHG) emissions from companies with more than $1 billion in annual revenue, with Scope 1 and 2 reporting beginning in 2026 and Scope 3 in 2027. Reporting entities will have to measure and report GHG emissions in line with the GHG Protocol. Submission of reports prepared for other jurisdictions, including the SEC, is permissible if those reports satisfy all the requirements of the law.
- **SB 261**[30] requires biennial disclosure of climate-related financial risks from companies with more than $500 million in annual revenue, beginning in 2026 (excluding insurance companies). Disclosures must align with the recommendations of the Financial Stability Board's Task Force on Climate-Related Financial Disclosures (TCFD). Covered entities could also meet the requirements if they already prepare a different report in accordance with the requirements of SB 261, such as those aligned with the recommendations of the IFRS Foundation's ISSB.

It is estimated that SB 253 will cover over 5,300 companies, and approximately 10,000 for SB 261,[31] adding a wealth of consistent, comparable, and decision-useful data to the universe of information that investors consider as part of their decision-making processes.

When considering mandating such disclosures, states should aim to align with national and other state-level regulations to the greatest extent possible. Alignment limits the reporting burden on companies and allows investors to more easily find and analyze the information they seek (see Section 5). While the details of California SB 253 and SB 261 leave the state Air Resources Board to draft the final regulations, the likely outcome of the rules is to at minimum partially align with the SEC's rule requiring additional disclosure of climate-related financial information from publicly registered firms.[32] Regardless of the outcome of litigation against the SEC's rule, investor expectations around standardized corporate disclosures of sustainability-related information are clear.[33]

Box 3: Responsible Business Conduct

States should encourage responsible business practices from those operating within or doing business with the state. Not only does this protect workers, consumers, and markets, but it also mitigates the reputational, legal, and other risks for the business entity thereby protecting investor returns. It also reduces the burden on individual investors to evaluate and push companies to improve certain practices.

Since 2011, the UN and the OECD have provided Guiding Principles on Responsible Business Conduct, and Guidance on Responsible Business, respectively. The US Department of State has recently updated its own National Action Plan for Responsible Business Conduct, first published in 2016. Individual state governments highlighting or requiring certain baselines for responsible business practices for those receiving state investments or funding can further strengthen the long-term stability of communities and markets across the state by reducing certain risks like fraud or worker mistreatment.

[29] California Legislature, "SB-253 Climate Corporate Data Accountability Act" (October 9, 2023), https://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=202320240SB253.
[30] California Legislature, "SB-261 Greenhouse gases: climate-related financial risk" (October 9, 2023), https://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=202320240SB261.
[31] Anne C. Mulkern, E&E News by POLITICO, "California climate disclosure laws face possible delay" (January 31, 2024), https://www.eenews.net/articles/california-climate-disclosure-laws-face-possible-delay/.
[32] Securities and Exchange Commission, "The Enhancement and Standardization of Climate-Related Disclosures for Investors" (March 6, 2024), https://www.sec.gov/rules/2022/03/enhancement-and-standardization-climate-related-disclosures-investors.
[33] Benjamin Taylor and Sam VanderMeulen, "PRI Blog: Why companies should start implementing the SEC climate disclosure rule" (August 28, 2024), https://www.unpri.org/pri-blog/why-companies-should-start-implementing-the-sec-climate-disclosure-rule/12618.article.

States should also consider international efforts to align sustainability-related reporting. The PRI supports the work of the IFRS Foundations International Sustainability Standards Board (ISSB) and has called on policy makers around the world to adopt disclosure requirements aligned with the ISSB's first set of standards. These standards are underpinned by the structure and concepts of accounting standards from the International Accounting Standards Board (IASB), build on the framework established by the TCFD—and other well-established voluntary sustainability reporting initiatives—and were endorsed by the International Organization of Securities Commissions (IOSCO).[34] The PRI continues to encourage the SEC and all entities requiring climate-related disclosure to align with the ISSB's disclosure regime as much as possible.

4. ENABLE STEWARDSHIP PRACTICES

States should support investor stewardship practices that enable asset owners to leverage the full scope of their rights as shareholders.

The PRI, the Global Sustainable Investment Alliance, and the CFA Institute define stewardship as "the use of investor rights and influence to protect and enhance overall long-term value for clients and beneficiaries, including the common economic, social, and environmental assets on which their interests depend."[35] Within this definition, investors have various methods to undertake stewardship activities, which can be split into investee stewardship, such as filing and voting on shareholder resolutions, and broader stewardship, such as policy engagement or engagement with stakeholders (NGOs, workers, etc.).[36] While stewardship can take many forms, all stewardship tools and activities can be used to protect and enhance overall value for clients and beneficiaries.

The PRI's Stewardship Policy Toolkit identifies many ways stewardship can create value, including:

- Improving governance of investee companies and strengthening accountability to investors.
- Supporting long-term growth of investee companies by monitoring and driving improved performance management of sustainability-related issues.
- Providing levers for investors interested in driving sustainability outcomes and impacts.
- Addressing system-level risks through collaboration with policy makers and key stakeholders along the investment and supply chains.

The legal duties placed on investors require them to invest in the best interests of their clients and beneficiaries. Those duties extend to all aspects of the investment process, including the full exercise of shareholder rights which encompasses the right to vote on items presented at shareholder meetings and the right to engage in stewardship activities. Furthermore, in the US, ERISA has long recognized that votes are considered plan assets, and the act of voting these ballots falls within a fund's fiduciary duty. While the rule governing fiduciaries' investment stewardship has been subject to frequent changes in the past,[37] this core principle has remained.

[34] IOSCO's endorsement recommends that its 130 member jurisdictions consider ways in which they might adopt, apply or otherwise be informed by the standards.

[35] Principles for Responsible Investment, CFA Institute, and Global Sustainable Investment Alliance, "Definitions for responsible investment approaches" (November 1, 2023), https://www.unpri.org/investment-tools/definitions-for-responsible-investment-approaches/11874.article.

[36] Principles for Responsible Investment, "About stewardship," https://www.unpri.org/stewardship/about-stewardship/6268.article.

[37] Employee Benefits Security Administration, United States Department of Labor, "Fiduciary Duties Regarding Proxy Voting and Shareholder Rights" (December 16, 2020), https://www.federalregister.gov/documents/2020/12/16/2020-27465/fiduciary-duties-regarding-proxy-voting-and-shareholder-rights.

As such, state policy makers and regulators should ensure that voting activities are treated in the same way as the underlying asset conveying the right to vote and engage in stewardship activities, as these are core tools to protect, and in some cases enhance, the value of the underlying asset.

Many state and local pension funds already see the value in managing long-term ESG-related risks and opportunities via stewardship. An analysis by Morningstar found that in 2022, state and local pension funds across the country “supported key ESG resolutions 88% of the time,” compared to general shareholders’ average 56% support.[38] State and local funds’ support levels exceeded even support from funds listed as “sustainable” by 14 percentage points,[39] reflecting the unique perspective of state and local funds such as their longer time horizon—given the diverse ages of their beneficiaries—than the average shareholder investing for retirement or saving for college.

Regulatory frameworks for effective stewardship

The PRI’s Stewardship Policy Toolkit supports policy makers in enabling effective stewardship by formalizing stewardship activities via frameworks for regulation. For states seeking to oversee fund managers, for example, it may be appropriate to define expectations on investors’ stewardship practices and reporting. The PRI’s framework, shared below, is a layered system that establishes an enabling policy environment for effective stewardship and also sets out key elements of stewardship expectations. The PRI groups the key elements of such a framework into two broad categories.

The first group covers measures that encourage a market for effective stewardship, such as:

- Clarification of investor rights, legal processes and mechanisms, and reduction of barriers for investors to engage in stewardship activities.
- Support for asset owners to embed stewardship requirements in investment mandates and selection of asset managers, including sustainability-related risks and opportunities.

The second group sets out measures to enhance accountability and transparency for stewardship activities. These can include, but are not limited to:

- Clarification that investors should exercise stewardship as part of investor duties, including to address material sustainability-related risks.
- Establishing key elements of stewardship responsibilities, such as monitoring portfolio companies; engaging with companies in which they invest, and with other stakeholders; and exercising investors’ rights, such as the right to vote and file shareholder resolutions.
- Enabling investors to align stewardship activities with clients’ and beneficiaries’ sustainability preferences and manage conflicts of interests.
- Enabling investors to establish stewardship policies and report stewardship policies, activities, and outcomes to clients and beneficiaries.

State policy makers can leverage the PRI’s Stewardship Policy Toolkit to identify gaps in relevant regulation in their own market. While not all of the above recommendations may be applicable to each state or regulated entity, states should encourage investors to conduct stewardship activities when it is reasonable and practical, in line with their fiduciary duties.

[38] Janet Yang Rohr, Morningstar, “U.S. Public Pension Plans Sustain Support for ESG Resolutions” (September 5, 2023), https://www.morningstar.com/sustainable-investing/us-public-pension-plans-still-supported-esg-resolutions-widely-2022-morningstar-study-shows.

[39] Ibid.

One example of a sustainable finance policy that supports effective stewardship in a state market is Colorado's SB 16.[40] Adopted in 2023, the law requires entities managing public funds to include as part of an annual investment stewardship report the process by which the entity identifies climate-related risks and their projected impacts on public funds, as well as any strategy changes and actions that the office has implemented in response to these risks.

Acting as both regulators and asset owners, states have significant leverage to promote adoption of certain stewardship practices or formal stewardship policies via legislation, regulation, or example. Entities managing state funds can work together to establish best practices, gradually raising the floor for stewardship practices that can serve as benchmarks for private investors seeking to compete for public fund management. States should not underestimate their ability to set and project best practices for investors and companies doing business in their market via effective stewardship.

5. PURSUE ALIGNMENT BETWEEN STATES

State policy makers and regulators should seek to align sustainable finance policies with other states to leverage economies of scale and reduce inefficiencies wherever possible.

The PRI has previously outlined the importance of alignment in sustainable finance policies.[41] For example, regulators in many markets across the world—including the US, Europe, Asia, and Oceania—have considered or adopted laws requiring corporate disclosures of sustainability-related information. As discussed above, California's SB 253 and SB 261 have language to reduce reporting burdens built into their regulatory framework, allowing submission of corporate reports prepared for financial regulators in other jurisdictions. In this way, California lawmakers sought to minimize costs of compliance for firms covered by similar disclosure requirements in multiple jurisdictions.

In the absence of interoperable disclosure regimes, both companies and investors will be left to navigate a patchwork of reports created for individual audiences. Should numerous jurisdictions require similar but not interoperable disclosures, the costs of compliance would unnecessarily increase, as would the difficulty for investors utilizing this information in their investment processes.

States considering their own regulation should ensure that requirements are aligned with existing state, national, and global regulations as much as possible to avoid creating a fractured and confusing regulatory landscape. Already, some states, such as Washington, are considering how best to implement climate disclosure regulations that are aligned with existing state and federal regulations.[42]

Prioritizing interoperability by aligning regulations will minimize costs of compliance while maximizing efficiency and usefulness for investors, the primary audience for corporate disclosures. If states fail to align their sustainable finance policies, the result could be markets that cost corporations and investors significant time and resources, harm competitiveness, and limit the risk- and cost-avoidance supported by sustainable financial systems.

[40] Colorado General Assembly, "SB23-016: Greenhouse Gas Emission Reduction Measures" (May 10, 2023), https://leg.colorado.gov/bills/sb23-016.

[41] Principles for Responsible Investment, the World Bank Group, and Chronos, "Implementation Guide for Sustainable Investment Policy and Regulation Tools – Taxonomies of Sustainable Economic Activities," https://www.unpri.org/download?ac=16315.

[42] Washington State House of Representatives Office of Program Research, "E2SSB 6092" (February 19, 2024), https://lawfilesext.leg.wa.gov/biennium/2023-24/Pdf/Bill%20Reports/House/6092-S2.E%20HBA%20ENVI%2024.pdf?q=20240301104223.