PAUL HASTINGS

Stay Current

September 2024

Follow @Paul_Hastings

Federal Court Rules That Missouri Anti-ESG Rules are Preempted by Federal Law and are Unconstitutional

By Tara K. Giunta, Michael D. Wheatley, Paige Rinderer, & Hunter Nagai

I. Introduction

On August 14, 2024, the United States District Court for the Western District of Missouri declared unconstitutional two anti-ESG disclosure rules issued by the Missouri Securities Division and applicable to broker-dealers and investment advisers.[1] The court's rejection of these two anti-ESG rules represents another chapter in the controversy surrounding ESG investing in the U.S.

The Missouri rules at issue required securities firms and professionals to obtain signed consent from Missouri investors before the firms and professionals incorporated a "social objective" or other "nonfinancial objective" into recommendations or investment advice for investors. The rules mandated that the consent form contain specific language or language "substantially similar" to the mandatory language. That language included an express investor acknowledgment that the securities recommendations or investment advice would result in investments and recommendations that are not focused solely on maximizing financial return for the investor.

The decision declaring the rules unconstitutional comes amid state legislatures' modifying or invalidating other proposed rules with similar disclosure and written consent requirements, such as those proposed in Kansas and Wyoming.[2] Against this backdrop, the Western District of Missouri's decision could be a blueprint for challenges to other state laws and regulations, such as a similar proposed rule in South Carolina, that have sought to curtail so-called ESG investing.[3]

II. Background

In July 2023, the Missouri Securities Division issued two rules governing broker-dealers and investment advisers. The first rule was captioned "Dishonest or Unethical Business Practices by Broker-Dealers and Agents" (the "B-D Rule").[4] The second rule was captioned "Dishonest or Unethical Business Practices by Investment Advisers and Investment Adviser Representatives" (the "IA Rule", and collectively with the B-D Rule, the "Rules").[5]

Both Rules had similar disclosure and written consent requirements. The Rules required broker-dealers, agents, investment advisers, and investment adviser representatives to obtain a written statement of consent from their customers any time the securities firm or professional recommended, solicited a transaction, or provided investment advice that "incorporates a social objective" or other "nonfinancial

objective."[6] The Rules defined "incorporates a social objective" as "the material fact to consider socially responsible criteria in the investment or commitment of customer funds for the purpose of **seeking to obtain an effect other than the maximization of financial return to the customer**." (emphasis added).[7] The Rules defined "nonfinancial objective" as "the material fact to consider criteria in the investment or commitment of customer funds for the purpose of **seeking to obtain an effect other than the maximization of financial return to the customer**." (emphasis added).[8] The Rules defined "socially responsible criteria" as "any criteria that is intended to further, or is branded, advertised, or otherwise publicly described . . . as furthering, any of the following: A. International, domestic, or industry agreements relating to environmental or social goals; B. Corporate governance structures based on social characteristics; or C. Social or environmental goals."[9]

The Rules prescribed the manner in which the securities firms and professionals must obtain customer consent. Customer consent could be obtained only if the written consent form contains "substantially similar" language to the templates provided in the Rules.[10] The Rules also imposed temporal requirements for obtaining written consent. Namely, written consent must be obtained "[a]t the establishment of the advisory relationship" or prior to "A. Effecting the initial discretionary investment for the client's account; B. Providing the initial recommendation or advice regarding the purchase or sale of a security or commodity in a client's account; or C. Selecting, or recommending or advising on the selection of, a third-party manager or subadviser to manage the investments in a client's account."[11] Thereafter, disclosures must be provided to the client annually, and the client's written consent must be renewed within every three years.[12]

Any non-compliant conduct by broker-dealers, agents, investment advisers, or investment adviser representatives would be deemed "dishonest or unethical business practices" and would be grounds for discipline or disqualification.[13]

The Securities Industry and Financial Markets Association (SIFMA), acting on behalf of its member firms, challenged the Rules by suing the Missouri Secretary of State and the Missouri Securities Commissioner. Several other industry groups filed amicus curiae briefs in support of SIFMA, including the Investment Adviser Association, the Financial Services Institute, and the Insured Retirement Institute.

III. The Western District of Missouri Held that the Rules Were Preempted by Federal Statutes

The court found that the B-D Rule and the IA Rule were preempted by the National Securities Markets Improvement Act of 1996 ("NSMIA"). NSMIA regulates the federal government's oversight of nation-wide securities offerings and expressly preempts any rule that imposes requirements, including recordkeeping, on broker-dealers that "differ from, or are in addition to, the requirements" established under federal law.[14] NSMIA further preempts any state regulation of federally registered investment advisers beyond state licensing, registration, or qualification requirements.[15] The court held that the requirements under the B-D Rule and IA Rule to make and maintain a written and signed consent document were thus preempted by NSMIA because they constituted recordkeeping obligations beyond those imposed by federal law.

Additionally, the court held that the B-D Rule and the IA Rule were preempted by ERISA. ERISA preempts any state regulation that "relates to" ERISA by expressly referring to an ERISA plan or having a connection with such plan.[16] The court found that the Rules posed an obstacle to ERISA compliance by imposing recordkeeping and disclosure requirements beyond those necessary under ERISA and by

placing broad restrictions on the types of investments that may and may not be recommended to clients. In this regard, the Rules "related to" ERISA and were therefore preempted by ERISA.

IV. The Western District of Missouri Held that the Rules Were Unconstitutional Under the First and Fourteenth Amendments

The court also held that the Rules unconstitutionally compelled commercial speech, in violation of the First Amendment. First, the court deemed that the written consent requirement was not "narrowly tailored" to the government's interest in preventing fraud and deceit by broker-dealers and investment advisers. The court opined that the Rules "could have been more narrowly and carefully worded to avoid being inaccurate and/or misleading."[17] Second, the court determined that Missouri could have chosen a "less coercive" method to publicize its views on social investing, such as a public information campaign to advance its desired message without burdening investors with unwanted speech.[18] As the Rules were not narrowly tailored to a government interest and less coercive policy options were available, Missouri failed to meet the evidentiary burden necessary to establish rules that would compel commercial speech.

The court further held that the Rules were unconstitutionally vague, under the "void for vagueness" doctrine of the Fourteenth Amendment.[19] The court agreed with the Plaintiffs' argument that the Rules provided an ambiguous definition for "nonfinancial objective." The court held that Missouri additionally failed to provide any further guidance for covered broker-dealers and investment advisers to delineate this terminology and understand how to comply with the Rules. These issues were compounded further by the significant penalties imposed for non-compliance, which included loss of registration, civil penalties of up to $25,000 for each violation, and—if the violation was deemed willful—criminal penalties. Considering these factors, the court determined that the Rules lacked sufficient clarity to ensure compliance and were thus unconstitutional for vagueness.

The court declared the Rules unconstitutional and permanently enjoined them in their entirety.

V. Conclusion

The Western District of Missouri's order enjoining the Rules comes amid other actions by state legislatures to revise or invalidate other anti-ESG legislation with similar disclosure and written consent requirements. For example, in late April, the Kansas legislature struck down SB 224, which would have required registered investment advisers to make certain disclosures to clients and obtain written client consent before investing client funds in investments engaged in ideological boycotts.[20] Similar to the Missouri Rules, SB 244 specified exact language that must be included in a client's written consent. In Wyoming, Governor Mark Gordon used his line-item veto power in February 2024 to remove elements of the state's anti-ESG disclosure requirements for financial advisers and broker-dealers, including provisions requiring specific consent from clients in order to consider ESG factors.[21]

The Western District of Missouri's holding that the Missouri Rules are preempted under federal law and are unconstitutional may be a precursor to legal challenges against similar laws requiring additional disclosures for ESG investing. For example, South Carolina's proposed SB 583 would require insurance companies, banking institutions, trust institutions, and credit unions to disclose how pursuit of non-pecuniary factors affects their services, if applicable.[22] Like the Missouri Rules, SB 583 mandates that covered institutions provide disclosures to clients using mandatory language or language "substantially similar" to the mandatory language specified in the proposed rule.

Beyond disclosure requirements, the Western District of Missouri ruling may invite challenges to anti-ESG laws that use the terms "pecuniary" and "nonpecuniary" factors to distinguish between the considerations that investors can and cannot legally consider when making investment decisions. In our April 2024 client alert, available here, we analyzed the different ways in which these laws define pecuniary and nonpecuniary factors, as well as the impacts these definitions could have on investors and investment advisers.

Market participants and others should stay up-to-date on the rapidly evolving ESG and anti-ESG landscape and work with counsel to ensure they are aware and responsive to the latest developments.

✧ ✧ ✧

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings Washington, D.C. lawyers:

Tara K. Giunta
1.202.551.1791
taragiunta@paulhastings.com

Paige Rinderer
1.202.551.1812
paigerinderer@paulhastings.com

Michael D. Wheatley
1.202.551.1702
michaelwheatley@paulhastings.com

Hunter Nagai
1.202.551.1968
hunternagai@paulhastings.com

[1] *Sec. Indus. & Fin. Markets Ass'n v. Ashcroft*, No. 23-CV-04154-SRB (W.D. Mo. Aug. 14, 2024).

[2] *See* SB 224, Kan. Sess. Laws (2023); ARR23-056 Securities Rules, chs. 2, 4, 5, and 10, Wyo. Sec'y of State (2023).

[3] *See* S. 583, 125th S.C. General Assembly (2023).

[4] Mo. Code Regs. tit. 15, § 30-51.170.

[5] Mo. Code Regs. tit. 15, § 30-51.172.

[6] Mo. Code Regs. tit. 15, § 30-51.170(3)(A); Mo. Code Regs. tit. 15, § 30-51.172(3)(A).

[7] Mo. Code Regs. tit. 15, § 30-51.170(3)(B)(1); Mo. Code Regs. tit. 15, § 30-51.172(3)(B)(1).

[8] Mo. Code Regs. tit. 15, § 30-51.170(3)(B)(4); Mo. Code Regs. tit. 15, § 30-51.172(3)(B)(4).

[9] Mo. Code Regs. tit. 15, § 30-51.170(3)(B)(5); Mo. Code Regs. tit. 15, § 30-51.172(3)(B)(5).

[10] *See*, e.g., Mo. Code Regs. tit. 15, § 30-51.170(3)(D), which provides the following template language: "I, [NAME OF CUSTOMER], consent to my [as applicable, NAME OF BROKER-DEALER OR AGENT] incorporating a social objective or other nonfinancial objective into any discretionary investment decision my [as applicable, BROKER-DEALER OR AGENT] makes for my account; any recommendation, advice, or solicitation my [as applicable, BROKER-DEALER OR AGENT] makes to me for the purchase or sale of a security or commodity; or the selection my [as applicable, BROKER-DEALER OR AGENT] makes, or recommendation or advice my [as applicable, BROKER-DEALER OR AGENT] makes to me regarding the selection of, a third-party manager or subadviser to manage the investments in my account. Also, I acknowledge and understand that incorporating a social objective or other nonfinancial objective into discretionary investment decisions, recommendations, advice, and/or the selection of a third-party manager or subadviser to manage the investments, in regards to my account, will result in investments and recommendations/advice that are not solely focused on maximizing a financial return for me or my account."; *see also* Mo. Code Regs. tit. 15, § 30-51.172(3)(D).

[11] Mo. Code Regs. tit. 15, § 30-51.170(3)(C)(1–2); Mo. Code Regs. tit. 15, § 30-51.172(3)(C)(1–2).

[12] Mo. Code Regs. tit. 15, § 30-51.170(3)(C)(3); Mo. Code Regs. tit. 15, § 30-51.172(3)(C)(3).

[13] Mo. Code Regs. tit. 15, § 30-51.170(4); Mo. Code Regs. tit. 15, § 30-51.172(4).

[14] 15 U.S.C. § 78o(i)(1).

[15] 15 U.S.C. § 80b-3a(b)(1)(A).

[16] *See Shea v. Esensten*, 208 F.3d 712, 717 (8th Cir. 2000).

[17] *Sec. Indus. & Fin. Markets Ass'n*, No. 23-CV-04154-SRB at *10.

[18] *Id*.

[19] *Id*. at *11.

[20] SB 224, Kan. Sess. Laws (2023).

[21] Letter from Governor Mark Gordan to Wyoming Secretary of State Chuck Gray, (Feb. 27, 2024), available at https://drive.google.com/file/d/1DM21eP1ufCDVXZzpbMa8WF6UxGX6dokf/view.

[22] S. 583, 125th S.C. General Assembly (2023).