The “anti-ESG” movement: a rather different view from America.

Prologue

ESG (Environmental, Social, and Governance) scores are used to evaluate companies based on their performance in these three areas. However, there are several potential problems with ESG scores:

1. Lack of standardization: Different providers may use different criteria and methodologies to evaluate ESG performance, which can result in inconsistent or unreliable scores.

2. Limited data availability: Some companies may not disclose information about their ESG performance, making it difficult to accurately assess their scores.

3. Subjectivity: ESG scores are based on subjective judgments about a company's performance in environmental, social, and governance areas. Different evaluators may have different opinions about what constitutes good or bad performance.

4. Lack of transparency: Some ESG score providers may not disclose the underlying data or methodology used to calculate scores, making it difficult for investors to fully understand how a company was evaluated.

5. Focus on scoring rather than impact: Some critics argue that ESG scores place too much emphasis on evaluating companies rather than on driving positive impact in the areas of environment, social, and governance.

6. Lack of comparability: ESG scores for different companies may not be directly comparable, as they may be based on different criteria and methodologies. This can make it difficult for investors to compare the ESG performance of different companies.

Overall, while ESG scores can be a useful tool for evaluating companies, investors should be aware of these potential issues and consider them when using ESG scores to make investment decisions.

While Environmental, Social and Governance (ESG) considerations have captured the attention of corporations, investors, lawmakers, and regulators across the US as well as globally in recent years, a so-called “anti-ESG” movement has emerged recently in the United States. ESG critics cite, among other concerns, global economic uncertainty, antitrust concerns, unreliable ESG data and “greenwashing,” state anti-boycott and other anti-ESG legislation and other legal risks associated with ESG.

A. ESG in an era of economic uncertainty

With inflation on the rise, general global economic uncertainty and such events as the war in Ukraine which has, most notably, destabilized a major source of global natural gas, some investors may expect companies, particularly those with scarce resources, to focus on managing costs and consider scaling back on spend related to climate transition efforts. An unprofitable company is an unsustainable company, and companies managing limited resources, particularly in a time of crisis, might consider forgoing the production of voluntary, glossy ESG reports requiring extensive and complex data collection, or pursuing other costly ESG projects to focus on the company's "mission-critical" initiatives. In 2020, while demands from investors for more robust ESG information reached fever pitch, some publicly traded companies that had long produced annual sustainability reports did not issue one during the first year of the coronavirus pandemic. While some investors may expect companies to protect the bottom-line during times of economic uncertainty or turmoil, ESG will probably remain a major concern of major asset managers, customers, employees and other stakeholders, and that ESG will continue to serve as a critical lens through which to view corporate risks, opportunities and business decisions. Additionally, it is all but certain that companies will be subject to increased regulation concerning corporate carbon emissions, ESG reporting, and the environmental and social sustainability of corporate value chains in individual US states like California, Europe, the United Kingdom, and other parts of the world.

Further, regardless of legislative efforts, stakeholders such as investors, value-chain participants and employees, will continue to demand information from companies regarding climate and other ESG goals, initiatives and results, though these demands might be tempered somewhat by economic concerns and shifting attitudes and priorities.

B. Antitrust and ESG

Another chief concern of lawmakers, investors and other stakeholders is that ESG activities, like other types of competitor collaborations, raise concerns under antitrust laws such as the Sherman Act, which generally prohibit agreements or understandings between independent economic actors that unreasonably restrain competition. For example, coordinated conduct among financial firms or pension funds to ban investment in carbon-based energy be viewed as a boycott on the energy industry as a whole, and some group boycotts are unlawful per se under antitrust law.

Additionally, coordinated conduct by purchasers within a particular industry or other arrangements between competitors or other independent actors to restrict trade, such as a commitment to only do business with a list of certain "ethical suppliers," may pose an unreasonable restriction on competition. Other agreements or understandings, such as standard-setting among industry participants, may also raise antitrust concerns. Depending on the facts, coordinated conduct may be permissible if the activities do not produce anticompetitive effects that substantially outweigh any procompetitive benefits.

Violations under antitrust law can carry severe consequences, including criminal liability for companies and individuals, treble or punitive civil damages, the imposition of burdensome conditions on a company's business, debarment from government contracts, and significant reputational damage. Accordingly, climate transition plans and, in particular, coordination with other industry participates, should be assessed for antitrust risk and compliance.

C. ESG data reliability and "greenwashing"

Individual states, federal regulators like the Securities and Exchange Commission and Federal Trade Commission, as well as corporate stockholders, have raised concerns about the reliability of ESG data and "greenwashing" and even concerns about the value of ESG generally. Companies must ensure that their ESG practices and reporting are not false or misleading, while understanding that their data will be viewed through the lens of stakeholders who may have competing concerns.

Measuring the effectiveness of a company's ESG initiatives depends on who you ask, what data they use and how they analyze the data. ESG is rife with data challenges- including data that is unstandardized, unreliable, difficult to collect and/or housed in different silos of a company or even outside of the company. Information about scope 3 GHG emissions and sustainability practices, in particular, is generally controlled by third parties up and down the company's value chain and can be difficult to collect and verify. These data challenges are a major driving force behind the Biden SEC's call for mandated GHG emissions reporting. In addition to these data challenges, there are many different ways to analyze whether ESG initiatives produce economic value and different measures of profitability- short term profitability, long term profitability and future projections about profitability relying on assumptions and hypotheses.

ESG critics note that these data challenges create an opportunity for analysts, academics, consultants, executives and others to "cherry pick" ESG data to fit a particular agenda or narrative. It also creates an opportunity for companies to practice "greenwashing," a term used for the practice of making false or misleading claims about the company's impact on the environment.

To avoid "greenwashing" accusations, is important that companies avoid vague statements or words with no clear meaning (like "eco-friendly"), avoid puffery or stretching the company's achievements, and rely on measurable data that is verified by effective disclosure controls and procedures. For example, in the environmental sphere, resources permitting, a company can utilize developed frameworks like the Taskforce for Climate-Related Financial Disclosures, or TCFD, to report GHG emissions and the Science Based Targets initiative, or SBTi's methodologies and practices to set and measure emissions reductions and net zero targets.

D. Inconsistent state and federal regulatory regimes

Recent "anti-energy boycott" lawmaking and activism has impacted the financial services sector and companies that do business with state governments. Generally, anti-energy boycott laws refer to the governments of states reliant on certain industries, like West Virginia and Texas, which are both reliant on the fossil fuels industry, divesting their pension funds from, or otherwise boycotting, funds, asset managers or companies that boycott fossil fuels. In August 2022, attorney generals from several states joined together to challenge ESG practices of a prominent investment management firm and to launch an investigation into an ESG ratings company. Among other theories, these states argue: , for example, that

First, as a fiduciary, financial firms, pension funds and other funds have a duty to act in the best interest of their clients to maximize profitability, while acting impartially. By focusing on ESG initiatives, investors are prioritizing social objectives ahead of financial returns.

Second, coordinated conduct among financial firms, pension funds and other funds to boycott the energy industry may violate antitrust law.

Third, ESG initiatives impede the US's energy independence and

Fourth, ESG investment strategies may violate state anti-ESG legislation.

In addition to Texas, whose anti-ESG bill, SB 13, is discussed in more detail in the next section, 13 states- Arizona, Florida, Idaho, Indiana, Kentucky, Louisiana, Minnesota, North Dakota, Oklahoma, Pennsylvania, South Carolina, Utah and West Virginia and have adopted similar legislation limiting state business with ESG investment funds or financial services and other companies that boycott coal, oil and gas or other energy companies or other critical industries impacting the environment like agriculture, lumber or mining. Similar laws have also targeted fund and asset manager boycotts of other "sin industries"- like the firearms- or individual countries like the country of Israel. An August 2022 attorney general letter sent to an ESG ratings company primarily concerns the practice of assigning lower ESG scores to companies doing business in Israel.

Texas anti-ESG legislation

In September 2021, the Texas governor signed Senate Bill 13 (SB 13) – widely referred to as the anti-ESG bill in Texas. The primary purpose of SB 13 is to protect the energy industry in Texas from decarbonization of investment portfolios by funds and asset managers. Under SB 13, Texas state investment entities, such as state pension funds and public-school endowments, are prohibited from investing in companies that boycott the fossil fuel industry. The law also prohibits governmental entities from entering into contracts valued over $100,000, unless the contracting company expressly represents that it does not and will not boycott energy companies during the term of the contract. Following the passage of SB 13, five of the largest municipal bond underwriters have exited from the state of Texas. A concern with SB 13 is its ambiguous definition of "boycott": "without an ordinary business purpose, refusing to deal with, terminating business activities with, or otherwise taking any action that is intended to penalize, inflict economic harm on, or limit commercial relations with a company because the company [is in the fossil fuel industry or does not commit to or pledge to meet any environmental standards beyond applicable federal and state law] or a company that does business with such a company."

The "sole interest rule" and other state legal challenges to ESG

In recent years, several more states with Republican-controlled legislatures have begun to look at model legislation to prevent asset managers from investing their state funds or exercising shareholder rights to advance ESG-related political and social goals. Examples of such model legislation considered are the American Legislative Exchange Council's State Government Employee Retirement Protection Act and the Heritage Foundation's State Pension Fiduciary Act. Both of these legislative models seek to define fiduciary obligations to explicitly exclude ESG factors in investing through a "sole interest"

rule. These model codes would also withdraw proxy-voting authority from all outside asset managers to further lessen the influence of ESG and other nonfinancial goals on investments. These laws may also reduce the ability of asset managers to elect directors or support shareholder resolutions.

Additionally, states have already proposed or enacted bills or taken other actions that would restrict ESG investing. In September 2022, the Indiana Attorney General issued an opinion stating that the Indiana Public Retirement System's Board was prohibited from choosing investments or investment strategies based on ESG considerations, and that it must not invest for any reasons other than interests of fund beneficiaries. Earlier this month, the State of Florida announced plans to propose comprehensive anti-ESG legislation which, among other goals, prohibits the consideration of ESG factors in all investment decisions at the state and local level and codifies that only pecuniary factors can be considered in investing state funds. In January 2023, Wyoming introduced the Stop ESG State Funds Fiduciary Act which would, like the Florida bill, restrict ESG investing from state pension funds.

Lastly, state attorney generals and treasurers have either joined on letters or have worked together to challenge the use of ESG factors. One example is the Mississippi State Treasurer David McRae and the state treasurers signing a letter sent to congress urging federal law makers to challenge the Biden Administration's rule permitting the Department of Labor to allow fiduciaries of workplace retirement plans to consider environmental, social and governance risk factors when selecting plan investment options.

State decarbonization and sustainability laws

While some states have enacted anti-ESG legislation, others have enacted laws and rules that mandate the decarbonization of the state's investment portfolio, the consideration of ESG factors in investment and corporate sustainability due diligence. For example, around the same time of passage of Texas's SB 13, the state of Maine passed a law prohibiting the Maine Public Employees Retirement System from investing in the 200 largest publicly traded fossil fuels companies as determined by their carbon reserves. Additional states might take similar steps to decarbonize their state investments. Additionally, several state treasurers have signed statements and letters further affirming their approval of ESG factors while opposing bans on using such factors in investment decisions, and state attorney generals have also signed letters strongly supporting the consideration of ESG factors in investment decisions and supporting various social causes. Other states are considering more aggressive action mandating sustainability considerations by companies doing business in the state. For example, the New York Senate has in Committee Senate Bill S7428A, also known as the Fashion Sustainability Act. If made into law, it would require fashion sellers to be accountable to standardized environmental and social due diligence. It would also establish a fund to implement environmental benefit projects of labor remediation projects that benefit the workers and communities directly impacted.

Federal political division on sustainable investing and SEC climate rules

Since the 2022 election, the Republican-led House has ramped up its criticisms on environmental, social and governance investing. Since the change of power in the House, the Index Act and the Mandatory Materiality Requirement Act have regained the attention of House Republicans with Senator Bill Huizenga of Michigan seeking to re-introduce these bills this year. The Index Act intends to dilute the voting power of major investing firms by requiring investment advisers to vote proxies according to the specific wishes of the investors. The Mandatory Materiality Requirement Act would insert statutory language into the Securities Act of 1933 and the Securities Exchange Act of 1934 which

would require that the SEC determine if “there is a substantial likelihood that a reasonable investor of the issuer would consider the information disclosed to the commission under the requirement to be important with respect to an investment decision regarding the issuer” when imposing a new disclosure obligation. Responding to increased anti-ESG activism in the House, a group of House Democrats have formed a caucus to advocate for sustainable investing. The caucus notes that its goal is to educate members of Congress on the market-driven benefits of sustainable investing and to support federal agencies in advancing proposals and regulations which recognize the importance of using ESG criteria in the investment process through regular events and discussions. While companies can expect to see increased climate and ESG-related regulation from individual US states like California and globally, particularly in the United Kingdom and Europe, political division in the United States make the federal ESG regulatory regime uncertain.

E. Conflicting investor priorities

Companies must not only grapple with conflicting regulatory regimes within the United States and globally, but also conflicting investor priorities. ESG investors are betting that a company’s ESG investments will create long-term value and that companies that invest in sustainability and ESG initiatives will be better prepared to deal with climate-related physical risks, climate transition risks and rising carbon prices, and that these and other ESG investments will eventually pay off in the form of improved relationships with the company’s employees, customers, business partners and other key stakeholders, typically on a longer time frame. Other investors will solely focus on profits, and perhaps, given their investment strategy, only seek short-term gains, and may see ESG as a hinderance to their investment goals. Meanwhile, for other investors, traditionally called “socially responsible investors,” ESG may be an end in itself. Socially responsible investors are willing to accept potentially lower rates of return to ensure the companies they invest in create a positive social impact or avoid harmful social impacts. In sum, for some investors and other stakeholders, like values-driven employees or socially responsible investors, ESG is about a company’s values. For others, ESG is about the company’s value, particularly value over the long-term. For many investors and other stakeholders, ESG is about both. And some investor’s view ESG as a distraction that is not correlated with, or even a barrier to, profitability.

Notwithstanding the rise of the anti-ESG movement, sustainability will continue to be a major concern for regulators, investors and other stakeholders, and an important topic of discussion in boardrooms and day to day corporate operations. We are really at the dawn of ESG issues and regulations, and years will go by before a compromise between opposing parties will be met, both in the United States as well as globally, notably Europe where perhaps the society is more in line with such policies and regulations. What’s however interesting is that the initial ESG frenzy is slowing down a bit, making place for a more cautious approach to that topic.

Sure, perhaps the “anti-ESG” movement is extreme, as we all know that companies must adhere to some common ethical and environmental standards, but it carries the value of a critical approach that will eventually lead to a more sensible approach for future investing.

Marcello Tedeschi, July 18, 2023