OUR VIEW ON CORPORATE GOVERNANCE MATTERS

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The ESG Debate: Where Does Your Company Stand?

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A University of Oxford and Protiviti global survey reports that North American companies are less committed to ESG than their counterparts in Europe and the Asia-Pacific region.[1] The questions are why this disparity exists, and where does your organization stand?

The Oxford and Protiviti survey findings suggest that North American companies may be underrating the importance of external pressures — stakeholder expectations and regulatory commitment — that appear to be key drivers for companies in other parts of the world. The distinction relating to stakeholder concerns is likely underpinned by the predominance of the Friedman doctrine[2] in the United States over a period of 50 years, notwithstanding the recent Business Roundtable Statement. North American respondents also may be influenced more significantly by a growing number of environmental, social and governance (ESG) critics whose messaging makes it difficult to understand the true meaning of the concept.

Following is a look at the general themes advanced by these critics. Our intent in presenting these themes is to frame both sides of the debate — the criticism and the counterpoint.

[1] "Executive Outlook on the Future of ESG, 2032 and Beyond," University of Oxford and Protiviti, September 2022: vision.protiviti.com/insight/protiviti-oxford-survey-shows-north-america-enthusiasm-gap-about-esgs-future-impact.

[2] The Friedman doctrine advanced the view that corporations exist solely to serve the interests of shareholders and that decisions concerning social responsibility rest with the shareholders and not corporate management.

Criticism: The U.S. Securities and Exchange Commission (SEC) is exceeding its statutory authority. A 2022 U.S. Supreme Court case involving the Environmental Protection Agency (EPA) (*West Virginia v. EPA*) concluded that agencies in the executive branch cannot "work around" the legislative process on matters of economic and political significance. Many ESG critics believe that is exactly what the SEC is doing in proposing its climate change disclosure enhancements rule. For example, they argue that the rule tosses aside the materiality standard for disclosure and expands regulatory reach to upstream and downstream partners that are not publicly traded.[3] They assert the proposal will equip climate activists with data they need to run political pressure campaigns against companies, often to the detriment of shareholders.[4]

While the content of the SEC's final rule remains to be seen, the market is largely leading in this space, and the Commission is following.

Counterpoint: Before Congress, SEC Chairman Gary Gensler has vigorously defended the SEC's climate disclosure proposal, arguing that "investors today want to know about climate risk because it matters to … future … performance."[5] Observers would be wise to presume that the Commission is well aware of the criticism in the market, including the threats of litigation, and is positioning the final rules to remain within its established mandate to improve disclosures to investors. Over 95% of S&P 500 companies have already voluntarily provided ESG disclosures. With the exception of the Scope 3 emissions disclosure (which is only required of larger companies exceeding $75 million in equity shares available to the public) and audit requirement provisions of its proposed rules, the SEC will largely be catching up to the market and non-regulatory stakeholders (e.g., institutional investors and employees) when it issues its final rules.

Eight countries have passed laws that are aligned with the recommendations of the Financial Stability Board as a Task Force on Climate-Related Financial Disclosures (TCFD), a voluntary framework embraced by more than 3,000 companies. However, the U.S. would remain an outlier without the SEC rule, i.e., the Commission's rule is basically the U.S. playing catch-up with standards the mainstream global corporate community has already backed through applying the TCFD recommendations.[6] Thus, while the content of the SEC's final rule remains to be seen, the market is largely leading in this space, and the Commission is following.

[3] "The SEC Can't Transform Itself Into a Climate-Change Enforcer," by Bernard S. Sharfman and James R. Copland, *The Wall Street Journal*, September 14, 2022: www.wsj.com/articles/securities-exchange-sec-climate-change-esg-major-questions-doctrine-west-virginia-v-epa-supreme-court-disclosure-rule-11663178488.

[4] "SEC's Gensler Talks Climate Disclosure, Crypto Regulation in Senate Testimony," by Brian Croce, Pensions & Investments, September 15, 2022: www.pionline.com/regulation/secs-gensler-talks-climate-disclosure-crypto-regulation-senate-testimony.

[5] Ibid.

[6] "The SEC Did a Sensible Thing on Climate Change. A Right-Wing Campaign Is Trying to Kill It." Rebecca Leber, *Vox*, June 21, 2022: www.vox.com/23058987/sec-climate-finance-disclosure.

Criticism: Asset and pension managers are violating their fiduciary obligations. A letter sent to BlackRock's CEO by 19 state attorneys general and letters sent by two state attorneys general to their respective state pension boards issued warnings concerning ESG investing. For example, there are concerns about the concentration of wealth in BlackRock, Vanguard and State Street, and their collective economic clout to advance social and political agendas. It is argued that the clout of these firms is accentuated by their collective ownership of the largest voting bloc for most of the S&P 500 as well as ownership of each other and of controlling shares of many institutional stockholders holding their stock.[7] There are also assertions of selective application of ESG criteria to U.S. companies but not to Chinese companies due to conflicts of interest.[8] Some have gone so far as to advance concerns over antitrust issues.[9] Amid the chatter, public pension trustees are getting a message that they are violating their fiduciary duties if they knowingly invest in an asset manager that is violating its fiduciary duties. In fact, one of the two aforementioned states recently announced it would withdraw $794 million from BlackRock because of the impact of ESG investing on the state's energy industry.[10]

> This concentration of wealth and power is ... due to the growth of index funds through a business model built on scale and lower fees to investors. Accordingly, policymakers will need to weigh the perceived dangers of concentration against the realized low-cost benefits to investors.

Counterpoint: BlackRock issued a response to the attorneys general, asserting that their letter is inaccurate in describing the firm's motives. The firm stated that, in managing its clients' assets, it "seeks to realize the best long-term financial results consistent with each client's investment guidelines … [and that] participation in these initiatives is entirely consistent with [its] fiduciary obligations." This response also noted, among other things, that the firm does not boycott energy companies, coordinate its votes with others or assume that the Paris Agreement will be implemented in full within the United States. Rather, its focus is on companies disclosing "material issues that impact their businesses so that investors can make informed decisions and better understand, quantify, and mitigate their risks, including climate risk."[11]

[7] "Break Up the ESG Investing Giants," by Dan Morenoff, *The Wall Street Journal*, August 31, 2022: www.wsj.com/articles/break-up-the-esg-investing-giants-state-street-blackrock-vanguard-voting-ownership-big-three-competitor-antitrust-11661961693.

[8] "ESG Can't Square With Fiduciary Duty," by Jed Rubenfeld and William P. Barr, *The Wall Street Journal*, September 6, 2022: www.wsj.com/articles/esg-cant-square-with-fiduciary-duty-blackrock-vanguard-state-stree-the-big-three-violations-china-conflict-of-interest-investors-11662496552.

[9] "ESG May Be an Antitrust Violation," by Mark Brnovich, *The Wall Street Journal*, March 6, 2022: www.wsj.com/articles/esg-may-be-an-antitrust-violation-climate-activism-energy-prices-401k-retirement-investment-political-agenda-coordinated-influence-11646594807.

[10] "Louisiana to Remove $794 Mln From BlackRock Funds Over ESG Drive," Reuters, October 5, 2022: www.reuters.com/business/sustainable-business/louisiana-remove-794-mln-blackrock-funds-over-esg-drive-2022-10-05/.

[11] "BlackRock Response re: Attorneys General Letter, dated August 4, 2022," September 6, 2022: https://thetexan.news/wp-content/uploads/2022/09/BlackRock-Response-to-AGs-09062022_Final.pdf.

The combined $22 trillion in assets managed by BlackRock, Vanguard and State Street is the equivalent of more than half of the combined value of all shares for companies in the S&P 500.[12] (Fidelity, as a privately held company, adds another $3.7 trillion.[13]) Currently, the three firms cast about 25% of the votes at shareholder meetings of S&P 500 companies and, according to a Boston University study, may control up to 40% of the votes at most S&P 500 companies within the next 20 years.[14] For some, this concentration of wealth and power is a source of controversy. The reality is that the concentration itself is due to the growth of index funds through a business model built on scale and lower fees to investors. Accordingly, policymakers will need to weigh the perceived dangers of concentration against the realized low-cost benefits to investors.

Criticism: ESG investing is not outperforming the market. Investing in funds prioritizing ESG goals is intended to improve the environmental and social sustainability of business practices. However, close analysis suggests that such investment strategies may actually be directing capital to poor business performers.[15] The evidence regarding investment returns is conflicting, with some studies finding companies with high ESG ratings outperforming, other studies finding no measurable effects and still others documenting lower monetary returns.[16]

Counterpoint: Numerous studies have examined associations between ESG and equity returns, with a slight majority documenting a positive relationship between ESG attributes and stock performance. ESG investing can limit profit-maximization strategies because it either screens out or underweights profit-generating companies with undesirable ESG characteristics. Historically, this results in investors paying a relative valuation premium (a “greenium”) for companies with desirable ESG characteristics. What makes historical analysis of returns difficult is the inability to separate the positive

[12] “What BlackRock, Vanguard and State Street Are Doing to the Economy,” by Farhad Manjoo, *The New York Times*, May 12, 2022: https://www.nytimes.com/2022/05/12/opinion/vanguard-power-blackrock-state-street.html.

[13] “Our Company,” Fidelity: www.fidelity.com/about-fidelity/our-company. (Accessed October 2022.)

[14] “Should Index Funds Step Up Their Corporate Governance Game?” by Rebecca Beyer, *The Record*, 2019: www.bu.edu/law/record/articles/2019/should-index-funds-step-up-their-corporate-governance-game/.

[15] “An Inconvenient Truth About ESG Investing,” by Sanjai Bhagat, *Harvard Business Review*, March 31, 2022: https://hbr.org/2022/03/an-inconvenient-truth-about-esg-investing.

[16] “New Evidence of the Double-Edged Sword of ESG Investing,” Kenan Insight, Kenan Institute of Private Enterprise, August 17, 2022: https://kenaninstitute.unc.edu/kenan-insight/new-evidence-of-the-double-edged-sword-of-esg-investing/.

performance attributable to a growing greenium (due to demand for such investments from persistent growth in ESG-integrating capital) from the performance results going forward. The market reality is that historical variability in results is often attributable to trade-offs from shifting investor preferences.[17]

From the investee point of view, there are numerous investment funds focused only on investing sustainably, and no significant funds specifically focused on investing unsustainably. This means more capital is available to the enterprise that meets sustainability criteria. The bottom line is that this supply-and-demand dynamic in the marketplace favors the sustainable capital-seeker.

Criticism: ESG ratings are not evaluated consistently. ESG rating and investment-screening methodologies can vary widely. For example, is a major oil producer evaluated based on its plan to decarbonize the business or whether it currently sells oil and plans to sell natural gas for years?[18] Is the focus on investment risk or whether the company contributes to making the planet a better place? "Greenwashing" by investment managers is another concern.[19] Rating "ESG quality" reliably and discerning exactly what constitutes an "ESG activity" is also a point of debate, particularly for activities indistinguishable from normal ongoing business decisions to maximize shareholder value.[20]

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Counterpoint: While it appears that work is needed to provide clarity, transparency and consistency to investors so they understand the message and trade-offs ESG ratings are attempting to convey, there is a broader issue to consider. A world in which companies are 100% transparent and ESG disclosures are standardized does not exist. Absent that world, asset managers are essentially left to their own devices in promulgating ESG ratings and screening

[17] Ibid.

[18] "Time to Take the 'E' Out of ESG Investing," by Rochelle Toplensky, THE-NEWS-PAGE, June 2, 2022: https://the-news-page.com/time-to-take-the-e-out-of-esg-investing-2/.

[19] "Deutsche Bank Raided by Authorities Over ESG 'Greenwashing' Claims: 'We've Found Evidence That Could Support Allegations of Prospectus Fraud,'" by Christiaan Hetzner, *Fortune*, May 31, 2022: https://fortune.com/2022/05/31/deutsche-bank-dws-esg-greenwashing-raid-evidence-seized-whistleblower-fixler/.

[20] *Seven Myths of ESG*, by David Larcker et al. Stanford Closer Look Series, November 4, 2021: www.gsb.stanford.edu/faculty-research/publications/seven-myths-esg.

methodologies for their investor clients. Without a framework that compels them to do otherwise, individual investee companies can “pick and choose” what to disclose. The reality confronting the market is that “selective choosing” is far more likely to be based on the best look for the company rather than the most meaningful data for stakeholders.

Criticism: ESG reporting is not consistent. With firms reporting different ESG metrics, and some using multiple frameworks (as many as three or four[21]), it is challenging for investors to compare disclosures — which is not conducive to optimizing the facilitation of capital flows in the market. While voluntary reporting frameworks can be useful in driving uniformity in reporting, there is a lack of consensus on how best to measure and report on ESG initiatives in an informative and cost-effective manner.[22]

Counterpoint: ESG reporting continues to be a work in process. The International Sustainability Standards Board has been established to deliver a global baseline of sustainability disclosures to meet capital market needs. Regulators in different countries will likely build on this baseline to drive further transparency around progress toward country commitments and priorities. By providing specific guidance, the SEC and other regulators across the world would actually streamline current reporting. The current trend toward excess reporting may be largely due to the lack of clear guidance.

Criticism: Milton Friedman was right. This debate conjures the endless conversation around shareholder versus stakeholder interests. Like it or not, there remains a strong constituency that believes a corporation’s sole purpose is to maximize shareholder value, meaning it should not engage with social, political and environmental issues. Thus, the ESG concept constitutes an effort to politicize investing.

This debate conjures the endless conversation around shareholder versus stakeholder interests. Like it or not, there remains a strong constituency that believes a corporation’s sole purpose is to maximize shareholder value.

Counterpoint: This is likely the heart of the debate — shareholder versus stakeholder interests. While companies are not alike, the commitment of each organization to all of its stakeholders versus only its shareholders should not be viewed as mutually exclusive, but rather as integral to the purpose of generating sustainable long-term shareholder value. It is hard to argue that shareholder value can be maximized by an organization whose customers, employees, vendors and local communities (in other words, its stakeholders) are disaffected

[21] “S&P 500 and ESG Reporting,” Center for Audit Quality (CAQ), August 9, 2021: www.thecaq.org/sp-500-and-esg-reporting/.

[22] *Seven Myths of ESG*.

by its sustainability status. The concept of considering stakeholder interests is supported in the United States by the Business Roundtable, which rejected the Friedman doctrine in 2019.[23] It is also embraced by the World Economic Forum.[24] As one noted author points out:[25]

> "[A] false dichotomy between ESG and shareholder value mirrors … confusion sewn by critics of stakeholder governance who pit shareholders against other stakeholders through the misleading allure of an existential conflict that requires directors to choose between value for one versus the other. But … the law of corporate fiduciary duties nowhere demands that choice — and opponents of stakeholder governance know it, as do critics of ESG."

> This is an environment that will more than likely reward companies choosing to be proactive. A resilient, ethical and trust-based culture founded on values best equips companies to confidently face the future.

Two Takeaways: One for Policymakers and the Other for Organizations

The above discussion is complex and nuanced. It raises the need for a thoughtful, nonpartisan public policy dialogue. There are legitimate concerns hanging in the balance. Yes, climate change issues, social issues and governance dynamics have long-term implications. But in the meantime, economies must continue to function, pensioners expect to receive their checks, senior citizens must navigate inflationary pressures on fixed incomes, and people need dependable energy sources in conditions of extreme heat and cold.

Swinging the pendulum back and forth depending on which direction the political winds are blowing does not lead to an effective transition to the future. The conversation should be a smart strategic dialogue that balances the transition to the future while preserving a semblance of life quality that is affordable for the masses over the near term. It behooves policymakers to think in this manner.

It is also critical for companies and their boards to view ESG considerations with a long-term lens and an eye toward creating enterprise value that has staying power. The ESG debate is creating such a buzz, it is easy to forget that ESG "is merely a collection of … disparate risks that corporations face, from climate change to human capital to diversity to relations among

[23] "One Year Later: Does the Business Roundtable Statement Matter?" *Board Perspectives*, Issue 130, Protiviti, August 2020: www.protiviti.com/US-en/insights/newsletter-bpro130-brt-statement.

[24] *The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth*, International Business Council of the World Economic Forum, prepared by Martin Lipton, September 2, 2016: www.wlrk.com/webdocs/wlrknew/AttorneyPubs/WLRK.25960.16.pdf.

[25] "ESG, Stakeholder Governance, and the Duty of the Corporation," by Martin Lipton, Harvard Law School Forum on Corporate Governance, September 18, *2022:* https://corpgov.law.harvard.edu/2022/09/18/esg-stakeholder-governance-and-the-duty-of-the-corporation/.

the board, management, shareholders, and other stakeholders." Corporate law presumes that corporations "conduct lawful business by lawful means."[26] The *Caremark* doctrine[27] requires that companies design and implement reporting systems that provide reasonable assurance to management and the board that they are receiving timely, reliable information that informs their judgments, decisions and actions with respect to compliance with applicable laws and regulations. "The stakeholder governance model aligns closely with *Caremark*."[28]

This is an environment that will more than likely reward companies choosing to be proactive. A resilient, ethical and trust-based culture founded on values best equips companies to confidently face the future. Boards and their CEOs should consider ESG-related risks while rationalizing the appropriate balancing of stakeholder interests. Companies that balance shareholder interests with the interests of employees, the communities in which they operate, and other stakeholders are more likely to possess the resilience to adapt to inevitable longer-term change and megatrends than those focused solely on maximizing profits.

To that end, CEOs and their boards engaged in big-picture, outside-of-the-box, bold and disruptive strategic thinking should recognize that ESG risks are germane to their fiduciary responsibilities to ensure the long-term viability of the companies they serve. Accordingly, they should challenge leaders across the organization in a constructive manner with a long-term focus on appropriate sustainability objectives while keeping an eye toward delivering expected financial results.

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[26] Ibid.

[27] *In re Caremark International Inc. Derivative Litigation* is a seminal 1996 decision of the Court of Chancery that established the conditions for director oversight liability under Delaware law.

[28] "ESG, Stakeholder Governance, and the Duty of the Corporation," Lipton.

How Protiviti Can Help

Sustainability presents multidimensional and complex challenges, with varying levels of understanding across industries and companies. Protiviti works closely with organizational leaders to effectively evaluate what ESG means for their organizations, with an emphasis on helping to build, implement, execute, monitor and report on ESG objectives that will evolve and grow with the business. Our focus is on helping clients understand the bigger picture, and to clearly identify where they can have the greatest impact on society and the environment, while maximizing performance.

Our global ESG solutions enable sustainability in a way that positively impacts the organization and the communities in which it operates. Protiviti offers a holistic and integrated approach: ESG strategy and planning; operations, ESG performance and improvement; and ESG governance and reporting. For more information, see www.protiviti.com/US-en/business-performance-improvement/esg.