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The "Pro-ESG" Empire Strikes Back

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Senior finance officials from 18 states, as well as hundreds of investors, public and private companies and climate-focused nonprofits, joined together to urge policymakers to reject efforts by certain, primarily Republican state and federal legislators to preclude consideration of ESG factors in investment or company decision-making. Led by the financial industry climate group Ceres, the signatories to the investor/company letter state that they "remain wholly committed to sustainability and addressing the financial impacts of climate change because we factor relevant considerations in our business, investment, and risk management decisions that have a material impact on our own operations and investments." They add that "climate change poses a threat to the safety of our communities and the long-term value creation of the economy, and addressing its risks upholds investors' fiduciary duty." Taking on directly the "anti-ESG" side of the discussion, the signatories write that "our consideration of material environmental, social, and governance (ESG) factors is not political or ideological. Incorporating these issues into financial decision-making represents good corporate governance, prudent risk management, and smart investment practice consistent with fiduciary duty. We factor financially material considerations, including the impacts of climate change, into our standard investment and risk management decisions, in order to protect our operations and our investments."

The state finance official letter adopts a similar position, arguing that "blacklisting financial firms" based on their consideration of ESG factors "reduc[es] competition and restrict[s] access to many high quality managers," which will impose "real costs that ultimately impact" taxpayers. According to these signatories, states that adopt such an "anti-ESG" approach "refuse to acknowledge, in the face of sweltering heat, floods, tornadoes, snowstorms and other extreme

weather, that climate change is real and is a true business threat to all of us." The better course, they say, is "disclosure, transparency, and accountability," which "make companies more resilient by sharpening how they manage, ensuring that they are appropriately planning for the future," including by evolving their business models and their internal processes to "better address the long term material risks that threaten their performance."

Taking the Temperature: The consideration of ESG factors, and in particular climate-related issues, by companies, asset managers, investors and other capital market participants has become the subject of much controversy, as well as litigation in the United States, mostly along partisan lines. As the Freedom to Invest site notes, and as we have commented on previously, Republican lawmakers in states across the country have introduced legislation to prohibit consideration of ESG factors in making business, legal and investment decisions. In January, 25 Republican state attorneys general, along with two energy companies, also filed suit seeking to invalidate the U.S. Department of Labor (DOL) "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights" rule permitting (but not requiring) retirement plan managers to consider climate change and other ESG factors in their investment decisions. And, last month, the Republican governors of 19 states announced an alliance aimed at "push[ing] back against President Biden's environmental, social, corporate governance (ESG) agenda that is destabilizing the American economy and the global financial system." In their joint statement, the governors specifically mentioned the DOL rule and President Biden's then-intention (which he subsequently acted on) to veto H.J. Res. 30, the congressional measure to repeal the rule.

The partisan fighting has made its way to Congress, of course. In addition to H.J. Res. 30, House Republicans have established a nine-person Republican ESG Working Group to "combat the threat to our capital markets posed by those on the far-left pushing environmental, social, and governance (ESG) proposals." The group was formed in part as a response to the establishment of the Democrat-led Congressional Sustainable Investment Caucus in January.

While we do not foresee a quick resolution of this debate, we have observed certain cracks forming in the strictly partisan nature of the discussion. Recently, officials in certain Republican-controlled state governments have pushed back against proposed legislation or other efforts to penalize financial institutions in connection with ESG-related issues. Likewise, echoing points made by the state finance official letter, the Kansas Public Employees Retirement System recently urged state legislators to reject key aspects of "anti-ESG" bills as both unnecessary and costly to plan participants. The Indiana Chamber of Commerce recently adopted a similar stance.

In our view, corporations and financial institutions will benefit from the depoliticization of ESG so that they can freely determine the underlying factors and criteria that are material to governance and management of the company (for a board) or investment decisions and analysis (for an asset manager). Companies need to consider and report on material risks, developments and opportunities, whether arising from climate issues, social impact movements, or other forces. Asset managers need to consider those same issues when making investment decisions as well as reporting on the sustainability

characteristics of their investment portfolios – issues that have put them at the forefront of calling for greater issuer disclosure on ESG-related matters.