

ESG and Its Critics

The amount of institutional capital ostensibly invested based, at least in part, on environmental, social, and governance (“ESG”) considerations saw an unprecedented surge in the last five years—a vast increase since the United Nations first officially coined the term “ESG” in 2004.¹ In 2020, ESG funds comprised approximately a quarter of all money flowing into U.S. stock and bond mutual funds.² In 2021, Reuters announced it was the “year of ESG investing.”³

For its proponents, ESG represents a synergy of profit and social purpose—“doing well by doing good,” as one CEO put it.⁴ During the years of growth among both ESG and non-ESG funds, ESG proponents’ claims that ESG was “here to stay” remained untested and largely unquestioned. But 2022 brought dramatically different market conditions: a bear stock market, the Russia-Ukraine war, continuing global supply-chain failures, and pandemic lock-downs. In the first quarter of 2022, flows into ESG funds decreased globally by 36%, and ESG investment returns dropped in Europe and the United States by 11-14%.⁵

These events have triggered a closer look at ESG and raised questions about its proper role in fiduciary investment decisions and its ability to deliver on financial and societal goals. This article evaluates the primary criticisms of ESG and concludes that the amorphous nature of ESG—for which there are now over 600 disclosure provisions globally, calculating aggregate ESG scores in different ways⁶—may explain many of its perceived shortcomings. We suggest that the prevailing concept of ESG may need to be retired and replaced with more specific, concrete standards that bear upon financial and operational risk—consistent with the original conception of ESG. If cabined in this way, ESG may become a more reliable and enforceable indicator that bears upon actual corporate behavior and results.

¹ UNITED NATIONS GLOBAL COMPACT, *Who Cares Wins: Connecting Financial Markets to a Changing World* (2004), available at https://www.unepfi.org/fileadmin/events/2004/stocks/who_cares_wins_global_compact_2004.pdf; UNITED NATIONS FINANCE INITIATIVE, REPORT OF FRESHFIELDS BRUCKHAUS DERINGER, *A Legal Framework for the Integration of Environmental, Social, and Governance Issues Into Institutional Investment* (October 2005), available at https://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf.

² G. Iacurci, CNBC, *Money Invested in ESG Funds More Than Doubles in a Year* (February 11, 2021), available at <https://www.cnbc.com/2021/02/11/sustainable-investment-funds-more-than-doubled-in-2020-.html>.

³ R. Kerber and S. Kessop, REUTERS, *Analysis: How 2021 Became the Year of ESG Investing* (December 23, 2021), available at <https://www.reuters.com/markets/us/how-2021-became-year-esg-investing-2021-12-23/>.

⁴ S. Steward, MASTERCARD NEWSROOM, *What Does ESG Mean – and How to Make It Meaningful* (June 2, 2022), available at <https://www.mastercard.com/news/perspectives/2022/what-is-esg-environmental-social-and-corporate-governance-podcast/>.

⁵ N. White and Frances Schwartzkopf, BLOOMBERG, *Goldman Investigation Tarnishes ESG Halo as Investors Bail* (June 14, 2022), available at <https://www.bloomberg.com/news/articles/2022-06-15/investors-are-increasingly-skeptical-of-esg-this-is-why>.

⁶ ERNST AND YOUNG, *The Future of Sustainability Reporting Standards* (June 2021), available at https://assets.ey.com/content/dam/ey-sites/ey-com/en_gl/topics/sustainability/ey-the-future-of-sustainability-reporting-standards-june-2021.pdf.

I. Four Criticisms of ESG

Criticism 1: ESG Has No Place in Business

Perhaps the earliest and most common critique of ESG is that it has no place in business. As the economist Milton Friedman wrote more than 50 years ago: “There is one and only one social responsibility of business ... to increase its profits so long as it stays within the rules of the game.”⁷ According to this school of thought, the goal of commerce is to generate a return to investors—not to force social or environmental goals onto potentially unwilling stakeholders, particularly not at the expense of profits.⁸ In line with this criticism, anti-ESG proposals have doubled this proxy season, increasing from 26 resolutions filed in 2021, to 52 this year.⁹ Such proposals demonstrate growing anti-ESG fervor among at least a segment of the population, though they tend to receive few votes—typically earning less than 3% of shareholder support.¹⁰

Fiscally-conservative politicians have seized upon ESG as a conspiracy by “the left” to impose a particular agenda on the markets. In May, former Vice President Mike Pence wrote in the *Wall Street Journal* that “ESG is a pernicious strategy, because it allows the left to accomplish what it could never hope to achieve at the ballot box or through competition in the free market,” namely “left-wing environmental, social and governance goals (ESG)” that “ignor[e] the interests of businesses and their employees.”¹¹ He compared ESG ratings to “the social credit scores issued by the Chinese Communist Party.”¹² The same month, Republican Senators proposed an “Investor Democracy is Expected Act,” which would allow individual shareholders to vote their shares, instead of having Wall Street firms cast proxy votes supporting ESG proposals.¹³

⁷ M. Friedman, THE NEW YORK TIMES, *A Friedman Doctrine—The Social Responsibility of Business Is to Increase Its Profits* (September 13, 1970), available at <https://www.nytimes.com/1970/09/13/archives/a-friedman-doctrine-the-social-responsibility-of-business-is-to.html?searchResultPosition=1>.

⁸ L. Hoffman and C. Grant, THE WALL STREET JOURNAL, “*Woke, Inc.*” *Author’s Startup to Take on BlackRock* (May 10, 2022), available at <https://www.wsj.com/articles/upstart-money-manager-gets-billionaires-to-back-the-anti-blackrock-11652134919>.

⁹ D. Rhys, BLOOMBERG, *Conservative Shareholder Proposals Rise Amid Anti-ESG Rumbles* (August 31, 2022), available at <https://news.bloomberglaw.com/securities-law/conservative-shareholder-proposals-rise-amid-anti-esg-rumbles>.

¹⁰ *Id.*, see also J. Yant Rohr, MORNINGSTAR: SUSTAINABILITY MATTERS, *Public Pensions Overwhelmingly Vote for ESG* (August 29, 2022), available at <https://www.morningstar.com/articles/1111714/public-pensions-overwhelmingly-vote-for-esg> (confirming that even pension funds in conservative states show average support of 80% for shareholder proposals encouraging companies to consider environmental, social, and governance issues alongside financial results).

¹¹ M. Pence, THE WALL STREET JOURNAL, *Opinion: Republicans Can Stop ESG Political Bias* (May 26, 2022), available at <https://www.wsj.com/articles/only-republicans-can-stop-the-esg-madness-woke-musk-consumer-demand-free-speech-corporate-america-11653574189>.

¹² *Id.*

¹³ Investor Democracy Is Expected, S. 4241, 117th Congress (2022), available at <https://www.congress.gov/bill/117th-congress/senate-bill/4241/text?r=1&s=1#:~:text=To%20amend%20the%20Investment%20Advisers,or%20the%20%E2%80%9CINDEX%20Act%E2%80%9D>.

In July, Florida Governor Ron DeSantis proposed that pension funds in conservative states band together to form a block vote to restrict the use of ESG in investment decisions.¹⁴ Multiple conservative governors and legislators have also proposed rules to prohibit state public fund managers from adopting ESG investment criteria.¹⁵ Others have blocked state contracts with banks that are perceived as favoring divestment in fossil fuels.¹⁶ And just this August, 19 Attorneys General from states including Arizona, Texas, and West Virginia, wrote to Blackrock complaining that it was pursuing a “climate agenda” and boycotting energy companies, purportedly at the expense of investors.¹⁷

In reality, the available evidence on the economic impact of ESG considerations is mixed. A 2021 analysis by a group of law and finance professors, published in the *Michigan Law Review*, evaluated over 300 ESG mutual funds. The analysis concluded that the funds successfully supported ESG principles—at least as reflected in portfolio company ESG ratings and voting behavior—all without increasing costs or reducing returns during the 2018-2019 time period.¹⁸ And in the first seven months of 2022, a portfolio manager reportedly outperformed all peers using Europe’s strictest sustainable fund category.¹⁹

Yet, studies that cast a wider net often reach a different conclusion. For example, a *Journal of Finance* analysis published in 2019 by professors at the University of Chicago Booth School of Business examined 20,000 mutual funds representing \$8 trillion of investor capital. They found that none of the funds rated highest for sustainability outperformed the lowest-rated funds.²⁰ While being categorized as low sustainability resulted in net investor outflows of more than \$12 billion, and being categorized as high sustainability led to net inflows of more than \$24 billion, there was no evidence that the high sustainability funds actually outperformed the lower-sustainability funds. Rather, the

¹⁴ I. Hanchett, DAILY HEADLINES LIVE, *DeSantis Said That if Conservative States Band Together in Pension Fund Use, They Can ‘Check a Lot of These ESG Votes’* (July 28, 2022), available at <https://dailyheadlineslive.com/economy/desantis-said-that-if-conservative-states-band-together-in-pension-fund-use-they-can-check-a-lot-of-these-esg-votes/>.

¹⁵ F. Schwartzkopff, BLOOMBERG, *GOP Fury Over ESG Triggers Backlash With US Pensions at Risk* (Aug. 25, 2022), available at https://www.bloomberg.com/news/articles/2022-08-25/esg-pros-say-republican-anti-woke-bashing-hurts-regular-savers?utm_campaign=news&utm_medium=bd&utm_source=applenews#xj4y7vzkg.

¹⁶ B. McElhinny, METRONews, *Treasurer Puts Financial Giants on List of Fossil Fuel Boycotters, Severing Banking Relations* (July 28, 2022), available at <https://wvmetronews.com/2022/07/28/treasurer-puts-financial-giants-on-list-of-fossil-fuel-boycotters-severing-banking-relations/>.

¹⁷ See, e.g., OFFICE OF THE ARIZONA ATTORNEY GENERAL, *Arizona Attorney General Mark Brnovich Calls Out Potentially Unlawful Market Manipulation by Investment Firm* (August 4, 2022), available at <https://www.azag.gov/press-release/arizona-attorney-general-mark-brnovich-calls-out-potentially-unlawful-market>.

¹⁸ Q. Curtis, J. Fisch, and A. Robertson, *Do ESG Funds Deliver on Their Promises?*, 120 MICH. L. REV. 393 (2021).

¹⁹ G. Ritchie, BLOOMBERG, *Fund Manager Beats 100% of Peers Using Toughest ESG Strategy* (August 31, 2022), available at [Fund Manager Beats 100% of Peers Using Toughest ESG Strategy - Bloomberg](https://www.bloomberg.com/news/articles/2022-08-31/fund-manager-beats-100-of-peers-using-toughest-esg-strategy).

²⁰ S. Hartzmark and A. Sussman, JOURNAL OF FINANCE, *Do Investors Value Sustainability? A Natural Experiment Examining Ranking and Fund Flows* (August 9, 2019), available at [Do Investors Value Sustainability? A Natural Experiment Examining Ranking and Fund Flows - HARTZMARK - 2019 - The Journal of Finance - Wiley Online Library](https://onlinelibrary.wiley.com/doi/10.1111/jofi.12700).

evidence was consistent with the view that nonpecuniary preferences for the concept of “ESG” were what prompted investment in high sustainability investments and drove fund flows.²¹

Another study, from the head of scientific investment research at Morningstar Investment Management, published in 2021 in the *Journal of Impact and ESG Investing*, provides results that arguably reconcile both the *Michigan Law Review* and *Journal of Finance* analyses. This study examined the impact of ESG risk on U.S. stocks using the Sustainability’s ESG risk-rating measure from September 2009 to November 2020.²² Consistent with the analysis published in the *Michigan Law Review*, it concluded that stocks and indices with low ESG risk ratings, or so-called “green investments,” did have higher realized returns and provided better tail-risk protection than stocks and indices with high ESG risk ratings, or so-called “brown investments,” especially during the height of the COVID-19 pandemic.²³ However, in line with the analysis published in the *Journal of Finance*, green investments attracted significantly more fund flow than brown investments, which might help explain their apparently superior returns during the period examined, given that fund flow can drive both investment performance and price momentum.²⁴

Read together, these analyses suggest some form of generalized enthusiasm for ESG may be a factor in driving ESG fund flows and investment returns, which may reverse when and if that enthusiasm dims. And indeed, by the second week of June, European ESG equity funds had, on average, lost 14%, compared with an 11% decline in the Stoxx Europe 600 index. In the United States, they lost 16%, which was only marginally better than the S&P 500.²⁵ This, despite the fact that fees for managing ESG funds tend to be higher than for non-ESG funds.²⁶

Beyond the studies discussed above, commentators have offered a variety of explanations for ESG’s financial under- or over-performance and its prospects for the future. Many note that it is can be very profitable for a business to externalize costs like pollution onto society, and thus it may be difficult for “clean” companies consistently to outperform others.²⁷ Others say that if ESG investing really did provide higher returns, then profit-seeking investment managers would already be pursuing “green” investments and there would be no need for ESG funds.²⁸ Yet others point out that there is rarely, if ever, a “free lunch” in investing, and institutional investors in portfolios that exclude non-

²¹ *Id.*

²² J. Xiong, *The JOURNAL OF IMPACT AND ESG INVESTING, The Impact of ESG Risk on Stocks* (Fall 2021), available at <https://doi.org/10.3905/jesg.2021.1.025>.

²³ *Id.*

²⁴ *Id.*

²⁵ N. White and F. Schwartzkopff, BLOOMBERG, *Goldman Investigation Tarnishes ESG Halo as Investors Bail* (June 15, 2022), available at <https://www.bloomberg.com/news/articles/2022-06-15/investors-are-increasingly-skeptical-of-esg-this-is-why>.

²⁶ A. Kessler, THE WALL STREET JOURNAL, *The Many Reasons ESG Is a Loser* (July 10, 2022), available at <https://www.wsj.com/articles/esg-loser-funds-costs-basis-points-blackrock-500-environment-green-sec-11657461127>.

²⁷ THE ECONOMIST, *ESG Should Be Boiled Down to One Simple Measure: Emissions* (July 21, 2022), available at <https://www.economist.com/leaders/2022/07/21/esg-should-be-boiled-down-to-one-simple-measure-emissions>.

²⁸ R. Armstrong, FINANCIAL TIMES, *The ESG Investing Industry Is Dangerous* (August 23, 2021), available at <https://www.ft.com/content/ec02fd5d-e8bd-45bd-b015-a5799ae820cf>.

sustainable stocks may simply push share prices down, offering other buyers higher returns.²⁹ Finally, some posit that ESG strategies may in fact pay off over long horizons so long as they are material to a company's core business—such as a manufacturer of electric vehicles accounting for climate change—but many ESG funds simply fail to act accordingly and instead focus on short-term strategies relating to non-core issues.³⁰

Criticism 2: ESG Does Not Help the E, S, or G

Beyond these financial considerations, a number of commentators doubt whether products and funds that adhere to high ESG standards are effective even in advancing the social and environmental goals the ESG movement espouses. A 2021 study by researchers at Columbia University and the London School of Economics examined companies in 147 ESG fund portfolios and 2,428 non-ESG fund portfolios. The study found that the companies in the ESG portfolios actually had *worse* labor and environmental records than the non-ESG portfolio companies.³¹ ESG scores correlated with the quantity of voluntary ESG disclosures, but not with actual compliance records or carbon emissions, suggesting that businesses could essentially game the system and improve their scores simply by making additional disclosures, rather than improving underlying environmental, social, or governance initiatives.³²

Yet another analysis, from the European Corporate Governance Institute (ECGI) in 2020, found no improvement in ESG scores or outcomes for portfolio companies held by U.S. institutional investors that had signed the United Nation's Principles of Responsible Investment. Signatories failed to follow through with their ESG commitments for a variety of reasons, including financial concerns, related worries about fiduciary duties to investors, lower market maturity, and other factors.³³

Finally, a study published in 2021, again by the ECGI, reviewed information from U.S. firms from 2010 to 2019 and found that ESG funds *did* successfully identify companies with superior performance in specific and limited categories within ESG, such as pollution, employee welfare, diversity, customer satisfaction, and workplace accidents.³⁴ However, investments in such companies did not improve their social or environmental performance, and, similar to the conclusions of the 2020 ECGI study, there was little evidence the funds even attempted to affect firm behavior through

²⁹ THE ECONOMIST, *The Warm Glow* (July 21, 2022), available at <https://www.economist.com/special-report/2022/07/21/the-warm-glow>.

³⁰ *Id.*

³¹ A. Raghunandan and S. Rajgopal, REVIEW OF ACCOUNTING STUDIES, *Do ESG Funds Make Stakeholder-Friendly Investments?* (Forthcoming) (April 19, 2021), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3826357.

³² *Id.*

³³ R. Brandon, S. Glossner, P. Krueger, P. Matos, and T. Steffan, EUROPEAN CORPORATE GOVERNANCE INSTITUTE, *Do Responsible Investors Invest Responsibly?* (Feb. 7, 2022), available at <https://ecgi.global/working-paper/do-responsible-investors-invest-responsibly>.

³⁴ D. Heath, D. Macciocchi, R. Michaely, and M. Ringgenberg, EUROPEAN CORPORATE GOVERNANCE INSTITUTE, *Does Socially Responsible Investing Change Firm Behavior? Finance Working Paper No. 762/2022* (May 5, 2021), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3837706.

shareholder proposals.³⁵ This again calls into question whether ESG-focused investing in its current form advances environmental and social goals.

Criticism 3: ESG Is So Vague and Broad As To Be Meaningless

A third criticism of ESG—and a potential explanation for its failure to produce all of its heralded benefits—is that the concept (or more accurately, concept^s) is simply too amorphous and broad to be meaningful. Because ESG potentially encompasses so many different considerations (some of which may actually be at odds with each other)—each of which lends itself to multiple interpretations—the concept resists uniform standards and accountability, and ultimately can be applied however one wants. As discussed in final section of this article, pending rules from the U.S. Securities and Exchange Commission (SEC) appear to take this criticism into account.

At its core, ESG appears to present a form of the index number problem familiar to students of economics.³⁶ That is, how should one aggregate information involving dozens, hundreds, or perhaps even thousands of disparate variables relating to *E*, *S*, and *G* into a smaller number of variables that bear meaningfully on corporate behavior and performance? Depending on who is performing the analysis, the metrics used to analyze ESG may include both qualitative and quantitative factors, along with considerations as diverse as economic performance, employee training and education, safety incidents, the ratios of entry-level wages compared to local minimum wages, lobbying activities, and how much waste businesses produce.³⁷ Critics of ESG complain that it fails to provide a uniform rubric to select, measure, and then rank these factors, or to address the inevitable trade-offs they present.³⁸

Perhaps as a result of this confusion, there are, as noted above, more than 600 ESG reporting provisions globally, and they do not share the same interpretations of sustainability.³⁹ While corporate credit ratings have a 99% correlation across ratings agencies, ESG scores reportedly converge only a little more than half the time,⁴⁰ with differences in measurement, scope, and weight accounting for the variation.⁴¹ In the words of the SEC, these methodological differences insert a “level of subjectivity”

³⁵ *Id.*

³⁶ See, e.g., E. Diewert, *Consumer Price Index Theory*, Chapter 2: Basic Index Number Theory (April 16, 2021).

³⁷ ESG Innovation Team, NOVISTO, *Understanding ESG Metrics* (May 10, 2022), available at <https://novisto.com/understanding-esg-metrics-definition-examples/>.

³⁸ THE ECONOMIST, *ESG Should Be Boiled Down to One Simple Measure: Emissions* (July 21, 2022), available at <https://www.economist.com/leaders/2022/07/21/esg-should-be-boiled-down-to-one-simple-measure-emissions>.

³⁹ ERNST AND YOUNG, *The Future of Sustainability Reporting Standards* (June 2021), available at https://assets.ey.com/content/dam/ey-sites/ey-com/en_gl/topics/sustainability/ey-the-future-of-sustainability-reporting-standards-june-2021.pdf.

⁴⁰ THE ECONOMIST, *ESG Should Be Boiled Down to One Simple Measure: Emissions* (July 21, 2022), available at <https://www.economist.com/leaders/2022/07/21/esg-should-be-boiled-down-to-one-simple-measure-emissions>; see also BLOOMBERG LAW, *Market Indexes Seen as New Targets in SEC's Greenwashing Fight* (Aug. 1, 2022), available at <https://news.bloomberglaw.com/securities-law/market-indexes-seen-as-new-targets-in-secs-greenwashing-fight>.

⁴¹ F. Berg, J. Kolbel, and R. Rigobon, REVIEW OF FINANCE, *Aggregate Confusion: The Divergence of ESG Ratings* (Forthcoming) (August 20, 2019), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3438533.

into the ESG calculus.⁴² That “level of subjectivity” can make it difficult to gauge the value of ESG data and hold businesses to account for related initiatives. This, in turn, fuels criticisms that environmental and social initiatives are flawed because they are too readily hijacked by self-interested actors, such as businesses and investment firms eager to promote their products.

There is evidence to support these concerns. For example, one recent study reports that managers tend to discuss ESG only when they miss earnings targets, and not when they beat them, potentially because it is easier to obfuscate ESG concepts than dollars and cents.⁴³ Perhaps managers do so because, as studies confirm, many investors are willing to pay more for sustainable investments than for the alternative.⁴⁴ However, this threatens to reduce ESG to little more than a marketing ploy.

Criticism 4: ESG Blunts the Urgency for Governmental Action

A final criticism of ESG is that it blunts the impetus for government action by giving the false impression that markets can and will solve the most pressing social and environmental problems. As Tariq Fancy, BlackRock’s former sustainable investing chief—and an early ESG proponent—has argued, ESG may be “a dangerous placebo that harms the public interest.”⁴⁵

According to this criticism, the most significant of today’s environmental and social problems reflect collective market failures that markets alone cannot resolve. Instead, they require government intervention. A 2019 study in the journal *Nature* illustrates the problem. It found that, across six experiments involving a variety of participants, the use of “quick fix” solutions to address climate change—such as encouraging participants to use less electricity, promoting the notion that an overnight transition to “clean” energy is possible, or suggesting that certain industries, like manufacturing, currently have the ability to achieve net zero emissions goals without the help of tools like the emerging carbon credit markets—may have a “pernicious effect” by decreasing “support for substantive policies by providing false hope that problems can be tackled without imposing considerable costs.”⁴⁶

This type of effect, known as a “negative behavior spillover,” is well-known in the economics and environmental literature. It posits that people who increase one type of pro-environmental behavior, such as carpooling to work, sometimes “offset” resulting benefits by decreasing other types

⁴² SECURITIES AND EXCHANGE COMMISSION, Proposed Rule: Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices, 17 CFR Part 200, 230, 232, 239, 249, 274, and 279, available at <https://www.sec.gov/rules/proposed/2022/ia-6034.pdf>.

⁴³ R. Flugum and M. Souther, *Stakeholder Value: A Convenient Excuse for Underperforming Managers?* (July 22, 2022), available at [Stakeholder Value: A Convenient Excuse for Underperforming Managers? by Ryan Flugum, Matthew E. Souther :: SSRN](https://stakeholdervalue.com/2022/07/22/stakeholder-value-a-convenient-excuse-for-underperforming-managers/).

⁴⁴ SIMON KURCHER & PARTNERS, *Global Sustainability Study 2021: Consumers are Key Players for a Sustainable Future* (October 2021), available at [https://www.simon-kucher.com/sites/default/files/studies/Simon-Kucher Global Sustainability Study 2021.pdf](https://www.simon-kucher.com/sites/default/files/studies/Simon-Kucher%20Global%20Sustainability%20Study%202021.pdf).

⁴⁵ T. Fancy, MEDIUM, *The Secret Diary of a “Sustainable Investor” – Part 1* (August 2021), available at <https://medium.com/@sosofofancy/the-secret-diary-of-a-sustainable-investor-part-1-70b6987fa139>.

⁴⁶ D. Hagmann, E. Ho and G. Loewenstein, NATURE, *Nudging Out Support for a Carbon Tax* (May 13, 2019), available at <https://www.nature.com/articles/s41558-019-0474-0>.

of pro-environmental behavior, such as conserving water at home.⁴⁷ In the context of ESG, such negative behavior spillovers are particularly unwelcome if they substitute arguably ineffective conduct—such as ESG investments that do not, in fact, produce significant ESG improvements—for more effective actions.

II. Ideas for Improvement

In view of these criticisms—and in particular, the concern that we are seeing the politicization of ESG—various solutions or improvements have been proposed. One potential course of action is to disregard any consideration of ESG in business and investing. As some have noted, however, that may be both impractical and counter-productive.⁴⁸ Businesses should and will continue to evaluate risk, and at least some risks that fall within the rubric of ESG are among them. For example, it would make little sense if companies like ExxonMobil did not consider the impact of electric vehicles or global energy policies, which bear upon the E prong of ESG. Indeed, Exxon does consider such factors in managing its business.⁴⁹ Similarly, in its response to the 19 Attorneys General, Blackrock stated that—contrary to accusations—it had invested “hundreds of billions of dollars” in energy companies. But its investment professionals nevertheless also considered climate change because it poses financial risks and opportunities to companies and investors alike.⁵⁰

Perhaps more compelling, others have suggested that the concept of ESG should be retired and replaced with more specific, concrete concepts that are both clear and enforceable. For example, some commentators have proposed dropping the *S* on the grounds that related data tend to be less trustworthy than for *E* and *G*, and may be particularly difficult to measure in some countries, such as in Europe, with strict privacy laws.⁵¹ Others say even concepts like *E* are too nebulous and should be boiled down to just one clear metric: greenhouse gas emissions.⁵²

A related proposal is for standard-setters to streamline their requirements by mandating non-financial disclosures *only if they are material to the risks an industry faces*.⁵³ For example, car manufacturers

⁴⁷ H.B. Truelove, A.R. Carrico, E.U. Weber, E. U., K.T. Raimi, and M.P. Vandenberg, GLOBAL ENVIRON. CHANGE, Vol. 29 at 127-128, *Positive and Negative Spillover of Pro-Environmental Behavior: An Integrative Review and Theoretical Framework* (2014), available at <https://www.sciencedirect.com/science/article/abs/pii/S0959378014001599>.

⁴⁸ DealBook Newsletter, THE NEW YORK TIMES, *BlackRock Seeks to Defend Its Reputation Over E.S.G. Fight* (September 8, 2022), available at <https://www.nytimes.com/2022/09/08/business/dealbook/blackrock-texas-defend-reputation-esg-fight.html?searchResultPosition=1>.

⁴⁹ ExxonMobil, Annual Report (Form 10-K)(February 23, 2022) at 3-4, 43-45, available at <https://ir.exxonmobil.com/static-files/43e2844e-a446-4193-8e3f-7a8e8ad9e224>.

⁵⁰ DealBook Newsletter, THE NEW YORK TIMES, *BlackRock Seeks to Defend Its Reputation Over E.S.G. Fight* (September 8, 2022), available at <https://www.nytimes.com/2022/09/08/business/dealbook/blackrock-texas-defend-reputation-esg-fight.html>.

⁵¹ THE ECONOMIST, *The Signal and the Noise* (July 21, 2022), available at <https://www.economist.com/special-report/2022/07/21/the-signal-and-the-noise>.

⁵² THE ECONOMIST, *ESG Should Be Boiled Down to One Simple Measure: Emissions* (July 21 2022), available at <https://www.economist.com/leaders/2022/07/21/esg-should-be-boiled-down-to-one-simple-measure-emissions>.

⁵³ THE ECONOMIST, *Measure Less, but Better* (July 21, 2022), available at <https://www.economist.com/special-report/2022/07/21/measure-less-but-better>.

might be required to disclose information regarding greenhouse gas emissions, medical insurance companies might disclose information regarding data protection and privacy, and consumer goods manufacturers might disclose information about labor standards for companies involved in their supply chains.

Regulators appear to be adopting some version of these “streamlining” proposals. For example, the SEC has focused its rulemaking on more defined issues like greenhouse gas emissions,⁵⁴ and has proposed that investment companies that choose to market themselves as having some other form of environmental or social focus “describe the specific impact(s) they seek to achieve and summarize their progress on achieving those impacts.”⁵⁵ Similarly, the EU taxonomy taking effect in 2023 will require a limited set of environmental disclosures relating to climate change, water use, resource efficiency, pollution prevention and control, and biodiversity and ecosystem preservation.⁵⁶

High-mindedness is easy when it is cost free. In the last decade of rising stock prices, low interest rates, and tame inflation, jumping on the ESG bandwagon was relatively pain free. Many made money charging for ESG-related services and products. Now that the party might be over, ESG is coming under more scrutiny and faces the prospect of becoming yet another tool of politicization. To reduce the risk of overreacting, the ESG nomenclature should be retired and the concept taken back to its roots in risk identification and management. Businesses and investment managers should focus on the identification and management of well-defined core risks—depending on the industry, that may be a subset of environmental or social issues, such as the impact of climate change, labor standards, or the disruption of supply chains from civil unrest. Narrowing ESG to well-defined, industry-relevant risk considerations will allow for clearer goals, more accountability via objective and comparable standards and measurements, and reduce the risk of greenwashing. It should also reduce confusion between investment *directly designed* to further social or environmental goals (impact investment) and fiduciary investing designed to generate maximal profit but which accounts for material environmental and social risks that may or may not *indirectly* have an external impact.

Let us know if you have any questions about the issues addressed in this article, or if you would like a copy of any of the materials we reference:

John B. Quinn

Email: johnquinn@quinnemanuel.com

Phone: 213-443-3200

Anthony P. Alden

⁵⁴ U.S. SECURITIES AND EXCHANGE COMMISSION, *Press Release: SEC Proposes Rules to Enhance and Standardize Climate-Related Disclosures for Investors* (March 21, 2022), available at <https://www.sec.gov/news/press-release/2022-46>.

⁵⁵ U.S. SECURITIES AND EXCHANGE COMMISSION, *Press Release: SEC Proposes to Enhance Disclosures by Certain Investment Advisers and Investment Companies About ESG Investment Practices* (May 25, 2022), available at <https://www.sec.gov/news/press-release/2022-92>.

⁵⁶ EUROPEAN COMMISSION, *EU Taxonomy for Sustainable Activities*, available at https://finance.ec.europa.eu/sustainable-finance/tools-and-standards/eu-taxonomy-sustainable-activities_en.

quinn emanuel trial lawyers

quinn emanuel urquhart & sullivan, llp

Email: anthonyalden@quinnemanuel.com

Phone: 213-443-3159

Danielle Shrader-Frechette

Email: daniellefrechette@quinnemanuel.com

Phone: 213-443-3710

Julianne Hughes-Jennett

Email: jhughesjennett@quinnemanuel.com

Phone: +44 20 7653-2220

October 13, 2022

To view more memoranda, please visit www.quinnemanuel.com/the-firm/publications/

To update information or unsubscribe, please email updates@quinnemanuel.com