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ESG in 2023: Politics and Polemics

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Editor's note: David N. Katz is a Partner and Laura A. McIntosh is a Consulting Attorney at Wachtell, Lipton, Rosen & Katz. This post is based on their Wachtell memorandum. Related research from the Program on Corporate Governance includes The Illusory Promise of Stakeholder Governance (discussed on the Forum here) and For Whom Corporate Leaders Bargain (discussed on the Forum here) both by Lucian A. Bebchuk and Roberto Tallarita; Restoration: The Role Stakeholder Governance Must Play in Recreating a Fair and Sustainable American Economy—A Reply to Professor Rock (discussed on the Forum here) by Leo E. Strine, Jr.; and Stakeholder Capitalism in the Time of COVID (discussed on the Forum here) by Lucian Bebchuk, Kobi Kastiel, and Roberto Tallarita.

ESG is poised to become a major element of nonfinancial reporting at the very moment that it is becoming highly controversial and politicized. New European Union rules regarding mandatory ESG reporting will affect public and private U.S. companies that meet certain EU-presence thresholds or—significantly—are part of the value chain of an entity that is required to make the mandatory disclosures. This development represents a significant departure from past practices and will reach much farther than many companies may have anticipated. In the United States, the Securities and Exchange Commission is on the verge of adopting climate-related disclosure rules, possibly heralding the start of increasingly onerous ESG reporting obligations. These regulatory developments are supported by many, though not all, institutional investors, and the extent of such support going forward is likely to influence the future direction of ESG disclosure.

Over the past year, an anti-ESG backlash has flourished in the United States, led by conservative politicians and investors. Florida governor Ron DeSantis summarized the thesis of the backlash in a recent statement: "Corporate power has increasingly been utilized to impose an ideological agenda on the American people through the perversion of financial investment priorities under the euphemistic banners of environmental, social, and corporate governance and diversity, inclusion, and equity." At the World Economic Forum summit in Davos last week, a number of executives expressed frustration and concern over the intensifying drama around ESG. Like it or not, however, executives and investors will have to contend with ESG controversies and disclosure obligations for the foreseeable future while staying focused on their strategic priorities. Proactive board oversight—of both ESG disclosure practices and ESG-related controversies—will be essential to managing companies' reputational risk strategy around ESG.

Breaking Down the Acronym

The acronym ESG has become shorthand for corporate social responsibility, a nebulous concept with no clear limits. However, not all of its components are controversial. "Governance" has been a key element of corporate housekeeping and management for two decades, ever since high-

profile corporate crises at the turn of the millennium spurred new legislation and regulations aimed at improving directorial oversight at public companies. The ideals of good governance are at this point fully integrated into corporate housekeeping (i.e., maintaining good corporate "hygiene") and are, by and large, not controversial. Governance practices and policies have evolved to become so inextricable from day-to-day corporate management, in fact, that "governance" does not really belong in ESG as the acronym has come to be understood. For the most part, governance is handled separately from ESG as a matter of corporate organization.

"Environmental" issues are implicated in both corporate actions, on the one hand, and investment decisions, on the other. Generally speaking, the view that corporations should steward rather than exploit natural resources is at this point widely accepted. The current debates revolve largely around the questions of how much, if any, financial downside to shareholders is acceptable in order to pursue environmentally friendlier operations (and for fund managers, how much, if any, financial underperformance is acceptable or necessary in order to pursue a "green" investment strategy); and to what extent current scientific knowledge enables companies or investors to undertake applicable cost-benefit analyses. These are genuinely difficult questions with answers that will necessarily evolve over time. It is important that any regulatory action in this area preserves the latitude for corporate decisionmakers to adapt to changing facts and circumstances.

On the investing side, the avoidance by ESG fund managers of entire industries—based on a belief that these enterprises are inherently harmful to the environment regardless of how responsibly they are undertaken—has led to political backlash in states dependent on so-called "brown energy" sources. The state of Texas passed legislation in 2022 barring state retirement and investment funds from doing business with ten firms that "boycott" fossil fuels; BlackRock is on that list, along with some banks, investment firms, and funds. Reportedly, at least fifteen other states are considering similar legislation.

Social issues, filed under "S," are notoriously broad and vague and represent the ripest target for controversy. The "Social" of ESG has been defined to include workforce requirements and composition, labor issues, product and employee safety, employee compensation, human rights abuses in international supply chains, geopolitical factors, and societal trends relating to current events, such as anti-gun, antiabortion, and anti-tobacco movements. Tesla founder Elon Musk offered a new definition recently when he tweeted, in response to the news that the World Economic Forum incorporates ESG criteria in its own investment strategy: "The S in ESG stands for Satanic." While Musk has a flair for hyperbole, it is no coincidence that the "S" was the target of his ESG jibe. A concept as broad as "social issues" is susceptible to overuse and overreach, and it is this vulnerability that has caused most of the recent politicization and backlash to ESG as a concept. Musk's highly visible comments on ESG include tweets stating that "ESG is a scam" and that an ESG score merely "determines how compliant your business is with the leftist agenda." The association of ESG values with the political left has exacerbated the divisiveness of the substantive issues.

Political Backlash vs. ESG

In the past year, ESG has come under attack from red-state attorneys general, treasurers, comptrollers, and governors. A number of state officials have made a point of publicly repudiating ESG as antithetical to the best interests of their constituents. BlackRock, whose chief executive

has been an outspoken proponent of ESG, has been a particular target: In 2022, states including Florida, Louisiana, Missouri, Arizona, and West Virginia withdrew billions of dollars in investment funds from under the management of BlackRock. Florida's chief financial officer described CEO Larry Fink's ESG goals as overly focused on "social engineering" and antithetical to the goal of maximizing financial returns for shareholders. The Arizona state treasurer said that in the view of Arizona's investment team, "BlackRock moved from a traditional asset manager to a political action committee [and] away from its fiduciary duty in general as an asset manager." Last August, Florida adopted a resolution requiring state pension fund investments to seek the highest return on investments, without consideration of "nonpecuniary factors" such as "social, political, or ideological interests." Other states may take similar actions.

Conservative lawmakers in Washington have also taken aim at asset managers over ESG issues. A December 2022 report published by the Republican senators on the banking committee blasted the "Big Three" asset managers—BlackRock, State Street, and Vanguard—for "proudly us[ing] the voting power gained from their investors' money to advance liberal social goals" and promoting "political movements unmoored from financial performance." The report raised the question of whether the Big Three should be able to continue to rely on the disclosure exceptions for passive investors in light of their active attempts to influence the businesses in which they invest. It included recommendations that Congress investigate the extent of the influence of the Big Three over portfolio companies and consider increasing the reporting obligations of passive investors. With the House of Representatives now under Republican control, it is likely that political scrutiny of ESG investing and corporate ESG practices will intensify over the next couple of years.

There are indications that the ESG backlash is having an impact. While investors' capital continues to flow into ESG funds, the high-profile withdrawals of state funds from BlackRock have garnered attention disproportionate to their financial impact on the behemoth asset manager. BlackRock has been obliged to publicly defend its investment philosophy and approach. Vanguard, for its part, announced in December 2022 that it was withdrawing from the Net Zero Asset Managers initiative, stating that its decision was consistent with a "singular goal to maximize [investors'] long term returns." Cynics criticized Vanguard's move as an empty gesture, but nevertheless it indicates that firms are becoming wary of being perceived as blindly following social trends rather than exercising independent judgment. For years, there appeared to be little downside for institutional investors in publicly embracing ESG, but that is no longer the case.

On the business side, there are also signs of a revolt against ESG in corporate strategy. Prominent conservative investor Vivek Ramaswamy has criticized Apple and Disney for taking controversial stances on social justice issues. In an open letter to Disney last September, he asked, "What risk-reward calculus justifies taking controversial political positions that risk derailing Disney's otherwise strong economic prospects by alienating a majority of your customer base?" And in an open letter to Apple, Ramaswamy objected to the company's decision to conduct a "racial equity audit," arguing that such audits are harmful to the companies that conduct them and that there is evidence that the "actual owners" of Apple stock—as opposed to "the institutions who claim to represent them"—do not support either racial equity audits or hiring practices based on race, sex, or political beliefs. Ramaswamy's Strive Asset Management recently announced its intention to target companies during the spring 2023 proxy season seeking to reverse previously approved shareholder proposals relating to ESG concerns.

New ESG Disclosures

Meanwhile, ESG disclosures are on the verge of becoming a significant obligation for corporations worldwide due to the European Union's recent adoption of the Corporate Sustainability Reporting Directive (CSRD). The CSRD covers all large EU companies (including EU subsidiaries of non-EU parent companies), nearly all companies that are listed on an EU market, and companies with significant business in the EU. Whereas prior EU non-financial disclosure requirements covered fewer than 12,000 companies, an estimated 50,000 companies will fall directly under the scope of the CSRD. Many more beyond that, including private and public companies outside the EU, will be drawn into the disclosure regime by virtue of being in the "value chain" of reporting firms and thereby becoming the subjects of reporting companies' due diligence obligations. Companies that are upstream and downstream from reporting entities will be obliged to complete ESG-related diligence questionnaires and will have to manage the disparate challenges arising from the diligence process, including board oversight, internal controls, and potential Regulation FD selective disclosure issues. Furthermore, reporting companies will be required to mitigate and account for any problematic practices conducted by entities in their value chains, regardless of whether they have any control over these third parties. The CSRD represents a far-reaching and fundamental change to the reporting landscape and is certain to affect a large number of U.S. enterprises.

In the United States, the SEC has ESG-related disclosure proposals currently pending, primarily addressing environmental issues. Additional proposals relating to human capital management and board diversity are anticipated in 2023. If implemented, these proposed rules will require corporations to spend significant time and effort to adapt and develop appropriate oversight and internal controls. While these proposed rules are less onerous for reporting companies than the obligations to be imposed by the CSRD, it is possible that they represent only the beginning of a new era in the regulation of ESG disclosures. Despite the growing political backlash in the United States, investor enthusiasm for ESG remains high. According to Kiplinger, 85 percent of investors today are interested in ESG financial products. And it is clear that trends toward increased data-gathering, disclosure, and corporate responsibility for entities in their value chains are gaining momentum globally. Boards will need to be proactive and develop oversight processes for the new reporting obligations. Directors should also pay close attention to the ongoing cultural and political conflicts relating to ESG. With high stakes on all sides, the level of reputational risk in this area is likely to increase for the foreseeable future.