Cover story

Greenbashing

Conservatives are behind a wave of anti-ESG legislation at the state level. Liberals demand that ESG policies deliver real progress. GPs have to weave through the blows as they fall from both sides. Rob Kotecki reports on how private markets investors are navigating through the backlash

Not so long ago, ESG policies were boilerplate affairs, highlighting little more than good intentions and entailing, perhaps, a training session or philanthropic campaign. As such, it was hard to use ESG as a political flashpoint. But in recent years, the American left, amplified by the mainstream media, has begun demanding that corporations do more than say all the right things. As companies and their investors have stepped up to meet that demand, they were rewarded with backlash from the American right.

That backlash has taken the form of state legislation, both proposed and enacted, that attempts to divest from any managers with ESG priorities. However, some of those laws are running into trouble already, being overly broad in their bans, and increasing costs to taxpayers. At the same time, liberals are scrutinizing more deeply than ever, and certain ESG policies are being labeled as merely "greenwashing," a slur implying that they are nothing more than PR cover for the same old bad behavior. And federal regulators are watching to ensure "ESG" branded funds live up to their label.

Unfortunately, GPs may need to pick a side, either abandoning ESG priorities or committing to a full embrace. However, all this political heat may add specificity to such bans, making them specific enough that GPs can work within them, and add rigor, perhaps even standardization, to ESG metrics, which could help LPs who want to ensure they are, in fact, doing good as they do well. Unfortunately, the only certainty so far is that ESG remains, and will remain, controversial.

Lone Star landmark

Texas was the first to turn anti-ESG sentiment into legislation. In 2021, the Texas state legislature passed SB 13, a pioneering piece of legislation which bans any jurisdiction from contracting with banks that have ESG guidance that might discriminate against oil, gas and guns, citing the state's reliance on those industries. And by January of this year, Energy Monitor reports that 50 percent of states have some anti-ESG restriction at work or proposed some variety of ESG boycott as a legislative priority.

Kristin Snyder, white collar and regulatory defense partner at Debevoise & Plimpton, says these state limits on ESG considerations fall into two broad categories: "anti-boycott" bills and "no

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ESG investment" bills. "The anti-boycott bills such as Texas SB 13 and the accompanying comptroller's list of boycotted firms, target specific firms or funds, on the basis that the relevant state government authority has made a determination that the firm or fund 'boycotts' a specific industry.

"The 'no ESG investment' bills generally are concerned with investment advisers using ESG considerations when making investment decisions. These bills seek to make it a breach of advisers' fiduciary duties if they consider non-pecuniary interests, which they consider ESG to be when making investment decisions for public monies."

Josh Lichtenstein of Ropes & Gray finds that, in general, these anti-ESG efforts are rooted in the state's perception that their assets are going to be invested to advance specific goals, not to drive returns. But ironically, recent studies show that these bills might end up eating away at those returns.

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>
> **JOSH LICHTENSTEIN**
> **Ropes & Gray**

The price of policy

One study published in June of last year from The Wharton School of Business found that in the first eight months following SB 13's passage, it cost Texas taxpayers $300 million-$500 million in additional interest on the $31.8 billion the state borrowed during that period. The costs were attributed to less competition among finance firms.

Another study commissioned by environmental activist group The Sunrise Project expanded on that work, using its data to predict the cost to taxpayers in six other states considering such bills. It found that such states could pay more than $708 million in additional charges on municipal bonds every year if Texas-style restrictions were in place. Those charges could also be attributed to less competition since restrictions would force states to boycott any number of banks and asset managers who have ESG policies.

But higher interest rates aren't the only side effect of such bills. "Definitions in these bills (such as the term 'fiduciaries') or the broad scope of what is considered an ESG consideration could lead pension funds to make forced early sales of assets, potentially resulting in increased costs," says Snyder, adding that they could "require pension funds to divest from companies that were likely not the intention of the bills."

So there's little wonder a backlash to the backlash has already begun. One of the most instructive examples of how

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> **Debevoise & Plimpton**

hard it may be to execute some of these proposals ocurred in February when anti-ESG legislation drafted in Indiana did not take into consideration how it would impact private markets.

"Taking measures that are not designed for private markets could have cost Indiana, by their own estimates $6.7 billion," says Michael Eisenberg, a partner of ESG integration at ERM. "Once private markets were excluded by the sponsors of the legislation via amendment, the cost to implement fell to $5.5 million."

The same week Indiana rewrote its proposal, North Dakota's House of Representatives struck down its own anti-ESG legislation by a 90-3 vote, which would have maintained a list of financial institutions that boycotted energy companies, ostensibly due to ESG

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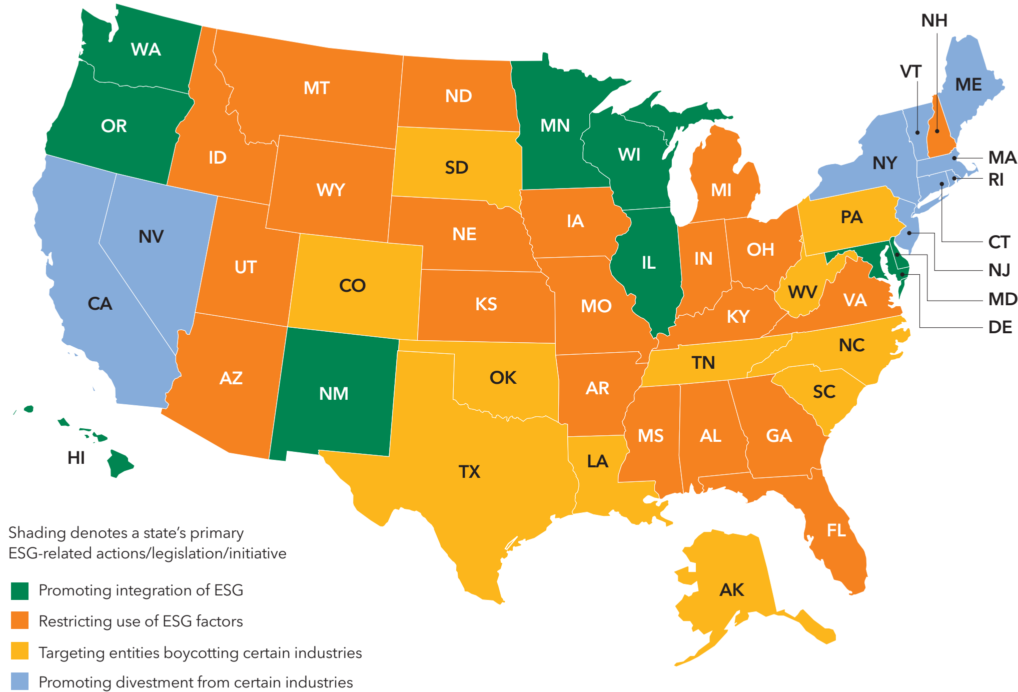
Navigating state regulation of ESG investments



Shading denotes a state's primary ESG-related actions/legislation/initiative

- Promoting integration of ESG
- Restricting use of ESG factors
- Targeting entities boycotting certain industries
- Promoting divestment from certain industries

Source: Ropes & Gray

policies in place. February also saw the Kentucky County Employee Retirement Systems vote to approve a letter to the State Treasurer arguing the state not divest of any of the 11 institutions identified as "boycotting" energy companies.

It remains to be seen whether this trend will eventually reverse the harshest anti-ESG proposals. But the end of February still saw former Vice-President Mike Pence tweeting about how President Biden is putting "ESG" and "woke policies" over the retirement accounts of hard-working Americans. Once an issue gets gobbled up into the broader culture war, it's hard to dislodge it.

On the other side of that culture war, liberals have their own bone to pick with ESG policies, namely that they don't do enough. In April 2021, a joint study from Columbia Business School and the London School of Economics found ESG-branded funds have allegedly violated more labor and environmental laws than non-ESG funds. And they perform no better in monetary terms than their peers without the label.

In some circles, ESG has become synonymous with the idea of "greenwashing," which refers to when companies' environmental commitment is little more than a marketing ploy. And regulators have placed greenwashing tactics in their sights.

"The world of ESG is quickly transitioning from one of voluntary frameworks and soft law to one that is much more heavily governed by hard law, with detailed criteria for reporting, and consequences for inaccurate or unsubstantiated reporting," says Ulysses Smith, ESG adviser at Debevoise & Plimpton.

Snyder adds: "The major enforcement activity we've seen so far – including that led by the SEC's Climate and ESG Enforcement Task Force as well as the more limited enforcement efforts we've seen in Europe – has focused on disclosure failures around ESG investing."

In May last year, the Securities and Exchange Commission targeted greenwashing with a new "Fund Names" proposal that would expand the number of funds that must invest 80 percent of their assets in line with their names and investment policies, along with increased disclosure requirements for ESG strategies in

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reporting and promotional materials. "This is similar in some ways to the EU's Sustainable Finance Disclosure Regulation, and both have an underlying policy goal to reduce so-called greenwashing," says Betty Moy Huber, a partner and global co-chair of ESG at Latham & Watkins.

Best policy

So how can managers square the ESG circle? "The fundamental question is what is the firm's long-term strategy?" asks Doug Davison of law firm Linklaters. "A manager has to decide the nature and contours of its investments, how the manager will interact with its investments, and the extent to which the manager may have an influence over its investments.

"It may well be possible to find some middle-of-the-road approach, but my instinct is that a manager needs to be prepared to pick a side and defend it. Is ESG part of that strategy or not? And how? Because that long-term strategy is what informs day-to-day decisions."

Others feel more confident that a balance can be struck, especially through a communications strategy. "For instance, some firms may continue their ESG commitments and plans but do so in a less outspoken manner, in an effort to balance the firm's efforts to advance net-zero commitments and transition plans, for example, while minimizing the risk of attracting regulatory attention in the current political environment," says Smith.

But playing coy about ESG might not always be sufficient. "We have clients that are being asked questions by states where a law is merely being proposed," says Lichtenstein. "These investors want assurances that they can still invest with that manager if the law passes, and that means managers need to comprehend the full context in a given state. That's not just laws; it's about public statements and proposals under review."

And managers might not be able to wait out the controversy. "ESG remains a politically controversial issue and will likely be hotly debated through at least the November 2024 US elections, so it is important for GPs and their boards to focus on the key themes and formulate strategy around trend lines," says Huber.

"Three key pointers [for managers] to keep in mind: clear business rationales and messaging is critical; tie initiatives to commercial and market driven necessities, not primarily to social or ideological objectives; and strike the right balance between conflicting state requirements and state and federal and international requirements, which is of course, no easy task."

Striking that right balance will

Cuts both ways

The double bind created for managers by mixed ESG policy across the US is best exemplified by the treatment of BlackRock of late.

States such as Louisiana and Missouri have publicly divested from the firm over its ESG policies, with Florida just this past December divesting $2 billion from the firm's management. Texas, despite its own regulatory moves, has not divested from BlackRock yet, with the firm still managing $4 billion for that state.

In response to the first stirrings of anti-ESG laws, BlackRock's CEO Larry Fink defended its priorities in his annual letter to CEOs in January 2022, arguing that his "stakeholder capitalism" wasn't "woke" and that if a company fails key ESG tests, BlackRock might be forced to liquidate its holdings in that business.

Then in August, Fink critiqued the anti-greenwashing proposals of the SEC in a letter that said: "The granular nature of [disclosure] requirements will inevitably lead to the disclosure of proprietary information about these strategies, reducing the competitive advantage of those unique insights."

This prompted the New York City Comptroller Brad Lander to send a letter to Fink in September saying: "BlackRock cannot simultaneously declare that climate risk is a systemic financial risk and argue that BlackRock has no role in mitigating the risks that climate change poses to its investments by supporting decarbonization in the real economy." So BlackRock found itself critiqued, and in some cases, losing business, for simultaneously being too faithful to ESG priorities and not faithful enough.

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require that managers stay consistent and disciplined, not merely in terms of public messaging, but private behavior.

"We advise clients to be absolutely certain of the accuracy of their statements," says Lichtenstein. "A manager could agree to a side letter promising ESG considerations to one LP, but they should expect that state pension plan will learn of that, so everything needs to be negotiated with the idea that the process will be made public at one point or the other. It's vital for managers to fully understand what they're agreeing to with each and every LP."

A new rigor

Although Lichtenstein also argues that the controversy might have an upside in the long term. "The pressures that we're seeing from both sides of this debate will have the effect of moderating and clarifying the way that ESG is described as part of an investment process." He explains that when talking up ESG was considered an unqualified good in public, there wasn't much incentive to narrowly define the intent and the process.

"The reality is that a lot of managers, even those not touting ESG labels, will bake in ESG concerns as part of their financial risk analysis, and that's not about ideology, but performance. That's worth pointing out, and this moment might lead to the industry speaking more humbly and accurately about ESG."

That sounds appealing, but many feel that what's flaming the political blowback from both sides of the aisle is how hard it is to define what ESG does, and does not do, and that speaks to the lack of standardization in metrics. Conservatives may rail against ESG because they don't know exactly its intent and what it's measuring, and liberals may rail against ESG because it's so hard to measure the impact of those

"ESG remains a politically controversial issue"

BETTY MOY HUBER
Latham & Watkins

policies. As challenging as standardization of ESG data may be, that hasn't stopped regulators or the industry from trying. Debevoise & Plimpton's Smith says: "Many of the reporting frameworks being developed by regulators globally are based on the Task Force on Climate-related Financial Disclosures, in an effort to converge around a common framework.

"There are also significant efforts by non-governmental entities, including the International Sustainability Standards Board, which will launch its reporting standards later this year and which seeks to provide ESG reporting standards that can be adopted by regulators and used by voluntary initiatives as the basis of their standards or as an acceptable alternative."

And the private markets industry is launching its own efforts.

"The ESG Data Convergence Initiative (EDCI) for private equity has gathered GPs, LPs and influential trade groups to participate in the ESG Integrated Disclosure Project, announced last year, which in part incorporates the EDCI's metrics, for private credit and syndicated loan markets," says Huber. "Many asset owners and investment managers have also been signatories to the Principles for Responsible Investment for years and have been publishing annual transparency reports thereunder on a range of ESG factors."

Of course, even with a more standardized set of metrics, GPs shouldn't expect to devote less time or effort to managing ESG.

Brian Chmelik, senior vice-president of private equity at Malk Partners, an ESG consultancy, says: "The standardization [of data] will make the bespoke program development and execution more important, since consistent improvement and strong performance will be more valuable to GPs in LP relations than ever before." ■

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