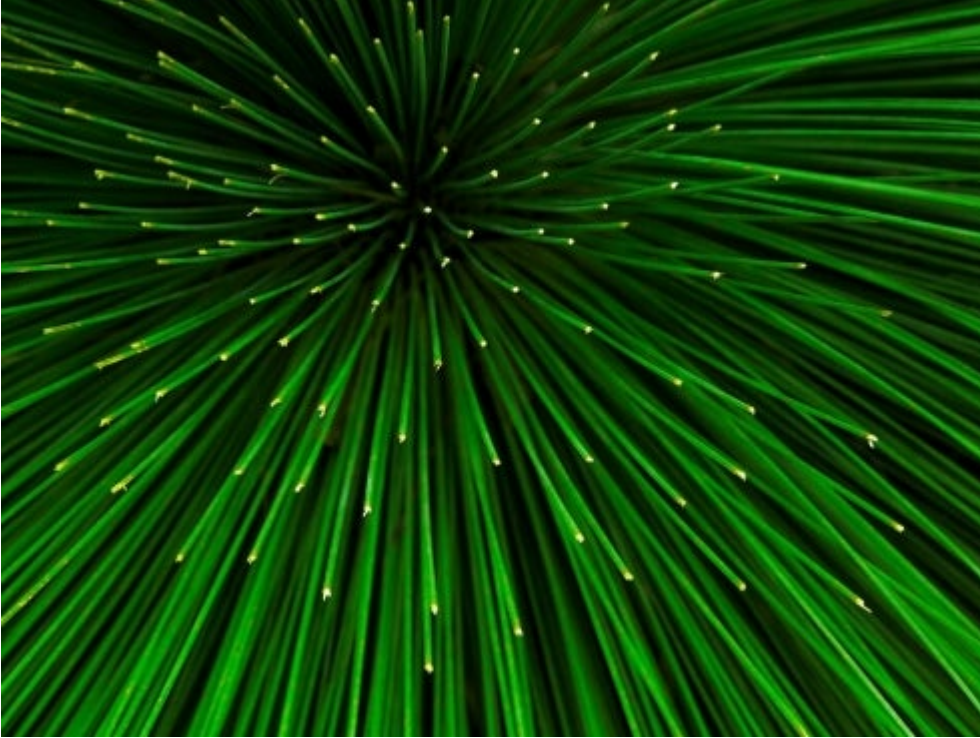
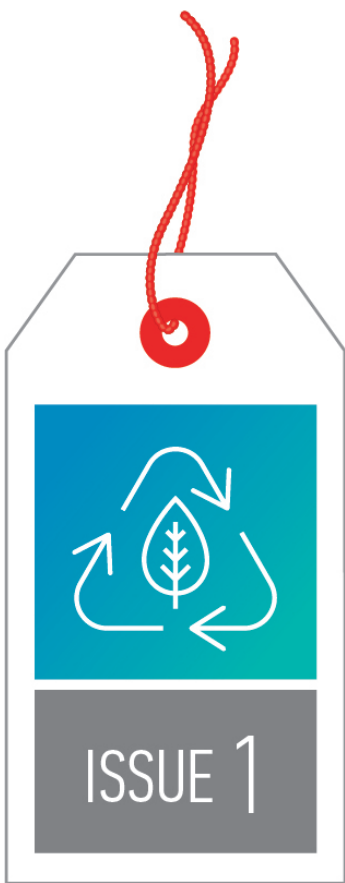


[Updates](#)

July 15, 2022

So, What Is Sustainable Investing Anyway?





Sustainable investing is a big and growing business. It is also widely misunderstood.

Many of the predominant investment tools used to assess public company environmental, social and governance (ESG) practices have been widely criticized as inadequate and potentially misleading. The ambiguity created by these tools is among the primary factors contributing to some investors' perception that there is a lack of transparency and accountability among investment advisers and public companies on ESG matters. The U.S. Securities and Exchange Commission (SEC) agrees that "greenwashing" is a concern and is stepping in with new disclosure-based regimes. Investors of all types, big and small, should consider what this changing regulatory landscape means for them and their portfolio companies.

The "sustainable investment universe" in the United States is estimated to be worth [\\$17.1 trillion](#), driven in part by dire warnings about climate change. Climate change has been credited with causing extreme weather patterns globally. In the first half of 2022, [extreme weather patterns](#) included monsoon rains in Bangladesh and heat waves in the United States, Europe, Asia, and Africa. The western United States is experiencing a megadrought that has been cited as the worst drought since at least 800 A.D. These conditions are expected to worsen, causing severe flooding, drought, megafires, famine, displacement of climate refugees, and loss of animal habitat and human life.

In this environment, ESG assets now make up the fastest-growing segment of the global financial services industry and are expected to hit [\\$53 trillion](#) globally by 2025. In 2020, Larry Fink, the CEO of BlackRock (the world's largest asset manager), [stated](#) that the world was "on the edge of a fundamental reshaping of finance" that would result in a significant reallocation of capital towards ESG investments. This reallocation is [reflected](#) in BlackRock's most popular suite of model portfolios, which includes the BlackRock ESG fund. Other large institutions with significant impact on investment allocations are taking steps to increase investment in ESG assets. For example, the U.S. Department of Labor (DOL) [proposed regulations](#) in 2021 that are expected to encourage the consideration of ESG factors.

There are many potential benefits to public companies and investors to categorizing a company as an ESG asset. Inclusion of a public company in an ESG fund or strategy can result in a [lower cost of capital](#) for that company and a positive impact on its brand. Fund managers are well compensated for ESG fund management. Although the average expense ratio paid by fund investors has been falling for years, an [October 2021 Morningstar report](#) found a higher asset-weighted average expense ratio for ESG funds compared with their traditional peer funds. For example, BlackRock's ESG Aware fund, which is labeled as "sustainable," has fees that are [five times](#) those for BlackRock's S&P 500 fund, even though both funds track an index and have substantially similar portfolio companies.

Many investors perceive ESG-labeled funds as holding companies that have a positive impact on the environment or society. However, what is considered an ESG investment is often more focused on the sustainability of a company's profits due to effects of, or risks presented by, climate change, social justice, and corporate governance considerations. One of the predominant investment tools used by investment advisers to determine whether a company qualifies as an ESG investment has been MSCI's ESG rating services. BlackRock and other prominent investment advisers have utilized MSCI's ESG ratings of portfolio companies as among the factors justifying a "sustainable" label on ESG funds and other strategies. In December 2021, *Bloomberg Businessweek* published an [investigation](#) of MSCI ratings (the Bloomberg Investigation). The Bloomberg Investigation analyzed every ESG rating upgrade that MSCI awarded to public companies in the S&P 500 from January 2020 through June 2021. It found that the ratings were designed to not measure the companies' contributions to positive change, but rather to measure the potential harm caused by ESG factors and related government regulations to a company's profitability. In other words, investors had erroneously assumed that ESG ratings and ESG funds and strategies were aimed at measuring the positive or improving impact of a company on the environment or society, not the other way around. To illustrate the discrepancy, the Bloomberg Investigation pointed out that out of 155 ESG upgrades of S&P 500 companies, only one cited reduction of greenhouse gas emissions as a key factor in its upgrade. Because the ESG ratings analyzed in the Bloomberg Investigation do not consider whether a company has a positive impact on the environment or society, sustainable and ESG-labeled funds and strategies have included portfolio companies that the Bloomberg Investigation considered to be among the worst offenders of environmental and social responsibility.

The blending of multiple different ESG factors into a single rating also allows a deficiency in one factor to be offset by an improvement in another factor. For example, although D.R. Horton, the largest U.S. home builder, decreased the number of homes it built with the industry's green certification standards, its ESG rating was still upgraded due to its "corporate behavior" score for policies on business ethics and corruption. A more in-depth analysis of the company's ESG performance was further complicated due to D.R. Horton's failure to disclose its greenhouse gas emissions. Another example of a potentially misleading ESG rating was a company that increased its greenhouse gas emissions in the same year that it received an ESG upgrade. In that instance, MSCI determined that climate change did not pose a financial risk to the upgraded company.

A fair amount of criticism has been levied against investment managers for "greenwashing" by labeling funds and strategies as sustainable or ESG, but failing to adequately ensure that the portfolio companies have sustainable practices or have a positive ESG impact. The argument is that ESG investing, as currently practiced, is misleading and fails to hold public companies and investment managers accountable for the negative effects they have on the environment and society. Investors have been left wondering what ESG investing means. Should ESG investing refocus on the development and commercialization of new climate technologies that support a sustainable world? Should ESG investments exclude companies with poor labor relations or governance practices? Should ESG investment solely be concerned with the potential harm caused by climate and social factors on a company's profitability?

Increasing investor focus on climate and ESG-related disclosure and advertising drew the attention of the SEC. In [March 2021](#), the SEC established the Climate and ESG Task Force within the Division of Enforcement. The Task Force's goal is to develop initiatives to proactively identify ESG-related misconduct by public companies and investment advisers and investment funds. The initial focuses were (1) identifying any material gaps or misstatements in public company climate risk disclosures under existing rules and (2) analyzing disclosure and compliance issues related to ESG strategies of investment advisers and funds.

[Proposed rules](#) aimed at enhancing and standardizing public company climate-related disclosures were released by the SEC in March 2022. The stated goal was to provide investors with consistent, comparable, and useful information for making their investment decisions. The proposal would require public companies to include certain climate-related disclosures in their registration statements and periodic reports, including information about climate-related risks that are reasonably likely to have a material impact on their business, results of operations, or financial condition. Certain climate-related financial statement metrics would also need to be included in notes to audited financial statements. The proposed rule changes would require public companies to disclose information about the following matters:

- **Governance.** Public companies would be required to disclose the oversight and governance of climate-related risks by their boards and management.
- **Risk management.** Public companies would be required to disclose processes for identifying, assessing, and managing climate-related risks and whether any such processes are integrated into their overall risk management systems or processes.
- **Transition plans.** If a public company has adopted a transition plan as part of its climate-related risk management strategy, the company would be required to disclose a description of the plan, including the relevant metrics and targets used to identify and manage any physical and transition risks.
- **Scenario analysis.** If a public company has conducted a scenario analysis to assess the resilience of its business strategy to climate-related risks, the company would be required to disclose a description of the scenarios used, as well as the parameters, assumptions, analytical choices, and projected principal financial impacts.
- **Climate-related targets or goals.** If a public company has publicly set climate-related targets or goals, the company would be required to disclose (1) the scope of activities and emissions included in the target, the defined time horizon by which the target is intended to be achieved, and any interim targets; (2) how it intends to meet its climate-related targets or goals; (3) relevant data to indicate whether it is making progress toward meeting the target or goal and how such progress has been achieved, with updates each fiscal year; and (4) if carbon offsets or renewable energy certificates (RECs) have been used as part of its plan to achieve climate-related targets or goals, as well as certain information about the carbon offsets or RECs.
- **Material impact risks.** Public companies would be required to disclose how any climate-related risks have had or are likely to have a material impact on their business and consolidated financial statements, which may manifest over the short-, medium-, or long-term.
- **Effects on strategy, business model, and outlook.** Public companies would be required to disclose how any identified climate-related risks have affected, or are likely to affect, their strategy, business model, and outlook.
- **Line-item impact.** Public companies would be required to disclose the impact of climate-related events (e.g., severe weather events and other natural conditions) and transition activities on (1) the line items of consolidated financial statements and (2) the financial estimates and assumptions used in financial statements.
- **Greenhouse emissions.** Public companies would be required to disclose information regarding greenhouse gas emissions based on the following three categories:

- *Scope 1 (Direct greenhouse gas emissions)*. Public companies would be required to include disclosures regarding the amount of greenhouse gas emissions that they directly produce through their own business operations, such as manufacturing.
- *Scope 2 (Emissions from purchased energy)*. Public companies would be required to include disclosures regarding the amount of indirect greenhouse gas emissions from purchased electricity or other forms of energy to keep their businesses running.
- *Scope 3 (Emissions from value chain activities)*. If material or if a public company has set emissions targets or goals that include Scope 3 emissions, the company must include disclosures regarding emissions from upstream and downstream activities in its value chain, which include emissions from the goods and services it purchases.

Even if the final rules are a scaled-back version of the proposed rules, it is likely that public companies will need to significantly increase their ESG-related disclosures and potentially alter other significant business decisions and processes. [Preparation](#) for these new disclosures has already begun. Many public companies are increasing the size of their finance teams. They are also acquiring new technology and compliance staff to satisfy the SEC's proposed disclosure requirements. Once all public companies are making comparable quantitative ESG-related disclosures, it is likely that the data will be used by public companies and others, including investment advisers and regulators, for other reasons. For example, public companies may alter the mix of key performance indicators (KPIs) reported to analysts to include some of these ESG factors. They also may be pressured to improve their ESG metrics. To encourage improvements in ESG-related KPIs, companies may tie bonuses or other discretionary payments to attainment of certain measurable ESG-related performance metrics. Depending on the importance of ESG to a company and its institutional investors, use of ESG-related KPIs may be used for performance-based compensation for service providers ranging from C-suite executives and senior management to rank-and-file employees.

To the extent the final SEC rules require a comparable level of detailed quantitative disclosure, there may be pressure on ESG rating firms to reformulate their ratings by more heavily weighting the SEC's required quantitative disclosures. There may also be pressure to break the single ESG ratings into separate subcategories, such as an environmental rating, a social rating, and a governance rating. Subcategory ratings may be one way to ensure that an improvement in one ESG factor doesn't obfuscate a deficiency in another. For example, a company that increased its Scope 1 emissions would receive a lower environmental rating, regardless of changes to its governance rating in that period. Pressure for this level of granularity may result in the future if the SEC requires quantitative Scope 1 emission disclosures and the ESG rating in that year was upgraded despite deficient emission disclosures.

Much of the focus has been on how public companies would be directly affected by the SEC's proposed climate disclosure rules. However, if adopted, the proposed rules would have a trickle-down effect on private companies that are participants in value chain activities of public companies or that are, or desire to be, acquisition targets of public companies. To the extent that some form of the Scope 3 emissions disclosures is required by the final rules, private companies that supply goods and services to public companies will need to supply data on the greenhouse gas emissions of those goods and services to enable public company compliance with the SEC's disclosure requirements. Also, when public companies acquire private companies, they will inherit the private company's statistics for Scope 1 emissions and its climate-related risks, which will need to be integrated into the acquiror's public filings. As a result, public company acquisition diligence will likely evolve to include analysis of climate-related risks and the ability of acquisition targets, both public and private, to adequately report on, or potentially remediate noncompliance related to, those risks in a manner consistent with the SEC's final rules on climate-related disclosures. Private companies and their investors will not be able to ignore these rules. Their acquirors are already paying attention. A [majority](#) of mergers and acquisitions (M&A) executives already think that a target company's ESG performance is or will be justification for higher target company valuations. In fact, according to the [global lead](#) for capital markets, sustainability, and ESG at Bain & Co., one of the goals for

acquiring certain target companies is to help public company acquirors achieve their ESG goals. Therefore, private companies will have to take their own steps for compliance preparation.

The potential impact on private companies has not gone unnoticed by small business and their industry groups. The SEC received approximately [3,400 letters](#) commenting on the proposed rules, which is significantly more comment letters than the SEC typically receives in response to a proposed rule. The comment letters from small business and their advocates reflected substantial concern over the potential burden Scope 3 emissions disclosures pose on small businesses that lack the resources of large, public companies. Several industry groups cited concerns about small and medium-sized private companies being forced out of business. Others cited the risk of large public companies being incentivized to move away from sourcing products and services from small and medium-sized private companies and instead purchasing from larger, public companies with the resources to track and report ESG related disclosures.

In May 2022, the SEC also [proposed new disclosure rules](#) for investment advisers and registered funds (not private funds) with ESG-related strategies, disclosures, and advertising. The new rules are aimed at preventing greenwashing and fall into the following three areas:

1. **Fund ESG disclosure.** Registered funds with ESG-related investment strategies would be required to include specific ESG-related disclosure in their prospectuses and annual reports depending on whether they meet the SEC's definition of "integrated funds," "ESG-focused funds," or "impact funds." "ESG-focused funds" and their subset "impact funds" would be required to disclose details about the criteria and data used to achieve their investment goals and to provide specific information about their strategies, including in a proscribed ESG overview table intended to encourage comparison between ESG fund strategies and in annual report disclosure on greenhouse gas emissions for certain environmentally focused funds.
2. **Fund names.** The so-called fund names rule would be amended to apply specifically to "green," "sustainable," and other names indicating that a fund's investment decisions incorporate ESG factors. Among other things, these funds would be required to invest at least 80% of their assets in the ESG investments suggested by their name.
3. **Adviser ESG disclosure.** Registered investment advisers and exempt reporting advisers with ESG-related strategies, policies, and/or marketing would be required to provide detailed disclosure on Form ADV regarding, among other things, their ESG strategies, affiliates, and methods of analysis, including whether their approach is ESG-"integrated," "focused" or "impact," and whether and how they use third-party ESG ratings, frameworks, indexes, or inclusionary or exclusionary screening of certain types of assets.

In addition to proposing new rules, the SEC and the DOJ have also been active in investigation and enforcement activities. In August 2021, the SEC commenced an [investigation](#) into Deutsche Bank AG's asset management arm, DWS Group. The investigation focused on ESG claims after DWS Group's former sustainability chief asserted that the firm exaggerated its use of sustainable criteria in managing advisory client assets. In April 2022, the SEC brought [charges](#) against a Brazilian mining company with American depository receipts publicly trading in the United States for making false and misleading ESG-related statements about its dam safety practices. The SEC alleged that, despite publicly declaring its commitments to "sustainability," "zero harm" for employees and local communities, and compliance with the "strictest" and best international practices for dam safety, the company's practices led to a catastrophic dam collapse. And, in May 2022, the SEC [announced](#) its first ESG-related settlement with an investment adviser and mutual fund group, which resulted in a \$1.5 million fine for making misleading statements about ESG investment funds. The SEC accused the fund of failing to consistently perform the ESG quality review that it disclosed as part of the investment selection process for all of its mutual funds.

Public companies that are currently part of, or desire to be part of, ESG indexes and funds will need to dedicate resources to measuring and improving ESG metrics on which the investment advisers and funds ultimately base their investment decisions. Otherwise, public companies will risk being removed from ESG indexes. A high-profile example of such removal is Tesla's recent removal from the S&P 500's ESG index. While recognizing Tesla's role in replacing fuel-powered cars, the S&P Dow Jones Indices disqualified Tesla from inclusion in the index. Tesla was disqualified due to the following ESG [factors](#):

- **Environmental.** Lack of a low carbon strategy;
- **Social.** Risks stemming from claims of racial discrimination and poor working conditions at Tesla's Fremont factory; and
- **Governance.** Risks stemming from claims that the company mishandled an investigation into multiple deaths and injuries linked to its autopilot vehicles.

Investors should consider what ESG investing means to them, as well as how their portfolio companies can help navigate that future.

© 2022 Perkins Coie LLP

Authors

Explore more in

[Sustainability & Corporate Responsibility](#) [Retail & Consumer Products](#) [Outdoor](#)

Related insights

Update

[California Court of Appeal Casts Doubt on Legality of Municipality's Voter ID Law](#)

Update

[February Tip of the Month: Federal Court Issues Nationwide Injunction Against Executive Orders on DEI Initiatives](#)