RealClear Foundation

Capitalism, Socialism and ESG

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> In the short run, the market is a voting machine but in the long run, it is a weighing machine.
>
> — Benjamin Graham

ESG is sweeping the investment world. Its advocates claim that ESG will both deliver superior investor returns and change the world for the better. These claims demand critical scrutiny.

This paper is in four parts:

- **Part I** provides an overview. It sets out the key claims made for ESG; notes the absence of an agreed-upon, internally consistent definition of ESG; observes that different ESG raters come up with different ratings for the same firms; and traces the evolution of ESG from the ethical investment movement, which accepted that excluding "sin stocks" incurs a financial penalty.
- **Part II** examines ESG's central claim that it boosts risk-adjusted investment returns. This defies modern investment theory, as it requires the stock market to systematically fail to incorporate positive ESG investment factors in stock prices. The underperformance of "sin stocks" is also an ESG claim falsified by the evidence.
- **Part III** looks at the legal context and briefly reviews the Trump Department of Labor's 2020 rulemaking.
- **Part IV** places ESG in the debate on capitalism, stakeholderism, and the trend to corporatism, whereby businesses become instruments for achieving public policy goals. It presents evidence that ESG's investment claims—especially those made by the climate-risk disclosure movement—mask a political agenda more efficiently enacted democratically by governments.

Bypassing democratic structures raises profound questions of legitimacy, while merging politics and business is likely to impair business efficiency and innovation, investor returns, and overall economic performance.

ABOUT THE AUTHOR

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RealClearFoundation is a nonprofit organization working in partnership with RealClearPolitics to mount journalistic and educational programs in the public interest.

KEY POINTS

- Environmental, social and governance (ESG) is the biggest trend in finance and business. Index funds focused on sustainability oversee $250 billion of assets. Corporate leaders signaled their alignment with ESG when more than 180 CEOs signed the Business Roundtable statement on business purpose.
- In contrast to the older ethical investment movement, which accepted that morally constrained investment strategies incur costs, ESG proponents claim that investors following ESG precepts earn higher risk-adjusted returns because companies with high ESG scores are lower-risk. Thus, their stock price will outperform, whereas those firms with low ESG scores are higher-risk, leading them to underperform.
- This supposition conflicts with finance theory. Once lower risk is incorporated into a higher stock price, the stock will be more highly valued, but investors will have to be satisfied with lower expected returns. Unsurprisingly, claims of ESG outperformance are contradicted by studies.
- Claims that ESG-favored stocks outperformed during the Covid-19 market meltdown disappear once other determinants of stock performance are controlled for. ESG factors were negatively associated with stock performance during the market recovery phase in the second quarter of 2020.
- The corollary of the ESG thesis—that low-ESG-rated "sin stocks" are condemned to underperform the stock market—is decisively refuted by the data. When institutional investors "went underweight" by selling down their holdings in tobacco stocks, it made them cheaper for other investors to buy and make money, especially when they subsequently outperformed the market.
- The profit opportunities that ESG creates for Wall Street, however, are clear. BlackRock charges 46 cents annually for every $100 invested in its iShares Global Clean Energy ETF and just 4 cents for its iShares fund linked to the S&P 500.
- The Trump Department of Labor's controversial rule on ESG in corporate retirement plans became final in October 2020. In effect, the rule calls Wall Street's ESG bluff: "You claim ESG investing boosts investment returns net of costs; Show us on the basis of generally accepted investment theories." Rather than use the Congressional Review Act to nullify this rule, the Biden Department of Labor says it won't enforce it.
- ESG is supposedly about the objective assessment of investment risk. The stated purpose of the Sustainability Accounting Standards Board (SASB), a body supported and funded by Michael Bloomberg, is to provide a disclosure regime that better enables investors to assess risk, climate risk being a major one.
- At the same time, the SASB aims to harness the power of capital markets for political ends. Just as the Covid pandemic was sweeping the globe, Bloomberg declared climate change the biggest threat to America and the world. "How do you replace dirty energy?" he asks. "Stop rewarding companies from making it." ESG thus becomes politics pursued by other means.
- Climate risk is primarily about the potential costs of future climate regulation, but the cookie-cutter climate disclosures required by ESG standard-setters are systematically misleading because they treat the world as a homogenous regulatory space. Climate regulations are made by states and vary from the stringent and unachievable in parts of Europe to the virtually nonexistent in many other parts of the world.
- Requiring corporations to bind themselves to unilateral greenhouse-gas targets imposes a penalty in competing against companies less beholden to ESG ratings (the unlevel playing field). Forcing corporations to lose market share and shrink their operations constitutes a covert form of divestment. Shareholders lose for no climate gain.
- Regulation by governments is not only more efficient but also possesses democratic legitimacy. Proponents claim that ESG is necessary to achieve inclusive capitalism, but political power wielded by a handful of billionaire Wall Street oligarchs provides a pretty good definition of insider capitalism.
- The weaponization of finance by billionaire climate activists, foundations, and NGOs threatens to end capitalism as we know it by degrading its ability to function as an economic system that generates higher living standards. This usurpation of the political prerogatives of democratic government invites a populist backlash.

I. OVERVIEW

Big claims are being made for ESG (environmental, social, and governance) investment strategies: ESG will reconcile society to capitalism while making investors—and Wall Street—more money.

BlackRock, the world's largest fund manager, is pushing ESG as part of a marketing pitch to millennials, who put "improving society" ahead of "generating profits."[1] Much of the buy-side pressure for ESG comes from state and municipal pension funds playing politics with taxpayers' and pensioners' money, many of which are in poor financial shape.

Contradictions abound. "G" for "governance" supposedly stands for enhanced shareholder control, but the thrust of ESG is to dethrone shareholders in favor of "stakeholders." ESG investing shrinks the universe of stocks that can be invested in, defying modern investment theory, which emphasizes portfolio diversification; yet somehow, we're told, ESG will boost investor returns.

Same initials, different meaning

ESG means different things to different people—and even to different ESG ratings agencies. Tesla has been rated best, worst, and middling by three different ESG raters (MSCI, CLSA, and Sustainalytics, respectively) for global auto ESG at the same point in time.[2] A May 2020 MIT Sloan working paper finds the correlation between ESG ratings across different providers is around 0.3. With credit ratings, the correlation between S&P and Moody's is around 0.99, demonstrating extremely high consistency and agreement among raters.[3]

ESG ratings can make ESG-favored stocks more risky. In June 2020, ESG rater MSCI gave UK fast-fashion retailer Boohoo a AA rating and an 8.4 out of 10 for "supply chain labor standards." Allegations then emerged that workers in Boohoo's UK supply chains were being paid as little as £3.50 ($4.14) an hour. The shares promptly lost a third of their value as sustainable funds dumped the stock. "Clinging to pseudoscientific scoring systems in the face of common sense is one habit the [sustainable investment] industry needs to change," the FT's Sarah O'Connor commented.[4]

The contrast with ethical investing

ESG emerged from the ethical investment or Socially Responsible Investing (SRI) movement. Ethical investing was originally a prohibition: thou shalt not profit from business harmful to one's neighbors, John Wesley, the founder of Methodism, exhorted his followers. The first SRI fund, Pioneer Investments, began in 1928 as an ecclesiastical fund committed to Christian values emphasizing "the avoidance of morally questionable investments, not the pursuit of better risk-adjusted returns."[5]

In the 1980s, SRI morphed into an activist divestment campaign directed against South Africa's apartheid regime. A 1999 analysis found little evidence that firms hit by sanctions and legislative actions performed unusually poorly in the 1980s. In particular, the study found *no* discernible effect on the valuation of banks and corporations with South African operations or on South African financial markets. Overall, the study concluded that the South African boycott had "little valuation effect on the financial sector."[6]

Self-evidently, the purpose of the South African divestment campaign was political. By contrast, ESG advocates frame the case for ESG in terms of *maximizing* risk-adjusted investor returns. "Voluminous research has shown conclusively that businesses properly integrating ESG factors into their plans are typically more successful and profitable," former vice president Al Gore claims in a June 2020 *Wall Street Journal* op-ed.[7] At the same time, the emphasis has shifted from divestment to stewardship, where groups of activist shareholders work to force companies to divest themselves of activities deemed immoral or antisocial. Whereas divesting stock risks exposing the underperformance of divesting shareholders and the possibility of their being in breach of their fiduciary duties, the stewardship mode of divestment forces all investors to bear the financial consequences of business line divestment in proportion to their shareholding.

In contrast to the “doing well by doing good” sales patter of today’s ESG advocates, ethical investors in the past accepted that avoiding “sin stocks,” such as tobacco and defense contractors, involved making a financial sacrifice for the sake of one’s moral principles. Like its forebear, ESG introduces a constraint, but one that supposedly boosts risk-adjusted returns. For example, the S&P 500 ESG index excludes some 200 companies, among them Berkshire Hathaway, Johnson & Johnson, and S&P’s rival Moody’s. Similarly, the MSCI KLD 400 Social Index excludes securities of companies involved in nuclear power, military weapons, and genetically modified organisms.[8] There is no financial or investment rationale for the systematic exclusion of such businesses.

Modern investment theory emphasizes the importance of portfolio diversification to maximize risk-adjusted returns. In principle, an unconstrained investor can replicate exactly the same portfolio as an ESG-constrained investor, whereas the latter is barred from the range of investment choices open to the unconstrained investor. As a result, the unconstrained investor will always possess an advantage, as Professors Bradford Cornell and Aswath Damodaran explain in their March 2020 paper “Valuing ESG: Doing Good or Sounding Good?”:

> [T]he notion that adding an ESG constraint to investing increases expected returns is counter intuitive. After all, a constrained optimum can, at best, match an unconstrained one, and most of the time, the constraint will create a cost.[9]

II. ESG CLAIMS VS. THE EVIDENCE

Advocates of ESG delivering superior investment performance (“risk/return ESG”) must assume that the stock market doesn’t behave as modern finance theory suggests it will. It is not sufficient merely to assert, as Al Gore does, that companies incorporating ESG considerations into their business are more profitable. Proponents of risk/return ESG conflate “evidence of a relationship between an ESG factor and firm performance with evidence that such a relationship, if it exists, can be exploited by an investor for profit,” argue law professors Schanzenbach and Sitkoff in a 2020 paper.[10]

For the risk/return ESG hypothesis to hold, it is necessary that the stock market systematically fails to fully incorporate information on this superior performance into stock prices. Once the market has fully incorporated such information, the outperformance of ESG-favored stocks (by generating above-average risk-adjusted returns) will cease. As the market incorporates relevant ESG data into stock prices, the discount rate (the return required by investors) for highly rated ESG companies will fall, and that for low-rated ones will rise, leading to rising stock prices of ESG companies and falling prices of low-rated ESG stocks. Cornell and Damodaran explain the process:

> [D]uring the adjustment period the highly rated ESG stocks will outperform the low ESG stocks, but that is a one-time adjustment effect. Once prices reach equilibrium, the value of high ESG stocks will be greater and the expected returns they offer will be less. In equilibrium, highly rated ESG stocks will have greater values, but investors will have to be satisfied with lower expected returns.[11]

After this one-off adjustment, the higher discount rate of low-rated ESG stocks implies that they offer higher returns, while the higher ratings of ESG-favored stocks mean that they offer investors lower expected returns. In the words of Nobel laureate Eugene Fama, widely recognized as the father of the efficient market hypothesis:

> lower costs of capital for E&S [environmental and social] accredited firms mean that for E&S investors, virtue is its own reward since investors get lower expected returns from the shares of virtuous firms.[12]

In his March 2020 book *Grow the Pie*, Alex Edmans, professor of finance at London Business School, takes to task ESG claims that outperformance of ESG strategies is beyond doubt. “Such a claim is unfortunately not true, but often accepted uncritically given confirmation bias,” he writes.[13] A 2008 analysis shows that SRI funds in the US, the UK, and several European and Asian countries generally don’t beat the market. In a separate meta-analysis, the same researchers found that SRI funds perform similarly to non-SRI funds in the US and the UK but underperform in Europe and Asia.[14]

Is ESG a vaccine for Covid?

The popularity of ESG investment strategies soared during the Covid-induced market sell-off in the first quarter of 2020. Morningstar dubbed ESG an equity vaccine. “Stocks, too, now need this improved immunity,” it argued.[15] Seven out of 10 sustainable-equity funds finished in the top halves of their Morningstar Categories, and 24 of 26 ESG-tilted index funds outperformed their closest conventional counterparts, Morningstar reported. “More stable, more secure, well-managed companies with solid environmental, social and governance (ESG) practices have generally responded well to the crisis,” claimed John Streur, CEO of the ESG-focused investment manager Calvert.[16]

Elizabeth Demers, financial accounting professor at the University of Waterloo, tested this proposition with three colleagues in an August 2020 paper, “ESG Didn’t Immunize Stocks Against the COVID-19 Market Crash.” Importantly, their analysis controls for the full array of other determinants of expected stock market performance, such as accounting-based measures of financial performance, firm age and market-share industry affiliation, and market-based variables that are known determinants of returns. Their conclusion:

> [O]ur results provide robust evidence that ESG is not significantly associated with stock market performance during the first quarter of 2020 once the full array of other expected returns have been controlled for.[17]

Instead, their results show that Covid-crisis returns are associated with firms’ leverage and cash positions, as well as with industry-sector indicators and market-based measures of risk. Three groups of variables offer almost all the model’s explanatory power for returns: market-based risk variables, industry effects, and accounting-based measures such as liquidity and leverage. “ESG is responsible for a meager 1% of the total explained variation.”[18] It gets worse. During the market’s Covid recovery period (second-quarter 2020), the finding is even starker: ESG scores are significantly negatively associated with returns during the market’s recovery phase.[19]

Sin stocks and the falsification of ESG

According to the risk/return ESG investment theory, the negative reputation of poorly rated ESG companies—the risk of litigation, ever-tightening government regulation, and so on—should lead these stocks to underperform the stock market. The data, however, decisively disprove this component of the risk/return ESG investment thesis. “Another inconvenient truth is the outperformance of ‘sin’ industries,” writes Edmans in *Grow The Pie: How Great Companies Deliver Both Profit and Purpose*.[20]

In their 2009 paper, “The Price of Sin: The Effects of Social Norms on Markets,” Professors Harrison Hong and Marcin Kacperczyk found that “sin” stocks—alcohol, tobacco, and gaming—had an 18% lower institutional-ownership ratio than stock of their comparable companies during 1980–2006.[21] The relative neglect of sin stocks by institutional investors means that the prices of those stocks are depressed relative to their fundamental values. In turn, this means sin stocks should have higher expected returns than otherwise comparable stocks. Sin stocks also tend to benefit from very conservative accounting because their industries come under intense regulatory scrutiny, meaning that their reported earnings are at lower risk of being subsequently restated or hiding nasty surprises.[22]

“In the short run, the market is a voting machine but in the long run, it is a weighing machine,” said

Benjamin Graham, the father of value investing. Institutional underweighting of sin stocks caused by noneconomic factors interposes a price signal implying greater risk (reflected in depressed valuations and, by extension, higher cost of capital) than warranted by business fundamentals—Graham's voting machine depressing the stock price. As unwarranted risk fails to crystallize and cash flows materialize, the stock price appreciates, as Graham's weighing machine takes over.

Analyzing data from 1965 to 2006 using conservative cross-sectional regression analysis, Hong and Kacperczyk found that US sin stocks outperformed their comparables by 29 basis points a month. They also compared valuation ratios of sin stocks to those of other stocks and found that they are, on average, 15%–20% lower than those of other companies. Using a Gordon growth-dividend model, these valuation ratios imply excess returns of about 2% a year, which is not statistically different from the 29 basis points derived from the cross-sectional analysis. Extending their analysis to Canada and six European markets with similar attitudes toward sin stocks, sin stocks outperformed other stocks by about 2.5% a year, similar to estimates for the US.[23]

These findings on US markets hold even when excluding tobacco stocks. Tobacco smoking is subject to stringent controls and is heavily taxed. As a result, tobacco consumption has declined. At the same time, tobacco company profits rose. For example, the number of cigarettes smoked in the UK fell by 12.2% in the five years to 2011. Over the same period, the profit margins of the UK market leader, Imperial Tobacco, rose from 62% to 67%.

"Every time the government increases tobacco duty, tobacco companies put their prices up further," an article in the *Financial Times* noted. "One tobacco analyst, who asked not to be named, described the relationship between the tobacco companies and the government as 'a cosy conspiracy.' "[24] Since 1998, the shares of UK market leader Imperial Brands (formerly Imperial Tobacco) rose more than fivefold against a 5% rise in the FTSE 100 index.

Savvy investors like nothing better than an exogenous, noninvestment constraint on other players in the market. Perhaps the most famous is Black Wednesday (September 16, 1992), when George Soros made about $1 billion by shorting sterling when, for political reasons, the Bank of England had to buy its overvalued currency, thanks to Britain's membership of the European Exchange Rate Mechanism. Similarly, when ethical investors shun sin stocks, it makes them cheaper for other investors to buy and make more money.

In their 2020 paper, Schanzenbach and Sitkoff suggest that the lower ratings effect of non-ESG stocks could create a rationale for a contrarian-ESG investment strategy, as

> a trustee might reasonably conclude that the market has overreacted to negative ESG factors for a tobacco or oil company, depressing the firm's stock price, thereby giving rise to a profit opportunity.[25]

A 2003 study finds that, from the perspective of an investor who seeks to create an optimal portfolio from mutual funds, limiting oneself to funds that include social objectives can be very costly.[26] The managers of the teachers' pension fund TIAA ascribed its underperformance in 2017 to following ESG criteria, which meant that the fund did not invest in a number of stocks and bonds, "the net effect [of which] was that the Account underperformed its benchmark."[27] CalPERS decided in 2000 to divest from tobacco, concluding that this would cost roughly $3 billion in returns.[28] CalPERS, which funds the pensions of 1.6 million California public employees, had unfunded liabilities of more than $138.9 billion in 2019.[29]

The importance of materiality

As noted in Part I, ESG bundles attributes that are scored and weighted differently by different ESG raters. Neither do ESG ratings differentiate between ESG factors that are material to the individual business and those that are not.

In a November 2016 paper (pre-print March 2015), Professors Mozaffar Khan and George Serafeim and Aaron Yoon of Harvard Business School aggregated performance of 2,396 enterprises across 51 stakeholder dimensions scored by KLD (now part of MSCI) over 21 years. Those with high sustainability scores beat the market only by what the authors describe as a statistically insignificant 1.5% a year.

Firms that scored high on material issues to their business (derived from industry-specific guidance from the Sustainability Accounting Standards Board [SASB]) and low on immaterial ones beat the market by a statistically significant 4.83% a year, but those with high investment in immaterial issues and low investment in material ones lagged the market by 0.38% a year—a difference of 5.20%.[30] ESG performance measures that take into account materiality are more likely to clarify "the relation between sustainability and a firm's financial performance," they conclude.[31]

Edmans pioneered research into a highly material aspect of "S": employee—in his terminology, colleague—satisfaction. Examining the stock performance of the 100 Best Companies to Work for in America from 1984 to 2011, Edmans found that they delivered stock returns that beat their peers by an average of 2.3%–3.8% a year, or 89%–184% cumulatively.

The Parnassus Endeavor Fund, started in 2007 with the sole criterion of employee satisfaction, has delivered annual returns of 12.2% a year, compared with 8.5% for the S&P 500. "Treating colleagues as partners in the enterprise, rather than as a resource to be exploited or a cost to be minimized, benefits both workers and Wall Street," Edmans concludes.[32]

III. THE LEGAL CONTEXT

Making money for trust beneficiaries is what trustees are legally required to do; a trustee must consider only the interests of the beneficiary. Seeking collateral benefits, whether in the form of a just and sustainable world, higher corporate tax revenues, or lower greenhouse-gas emissions, would violate trustees' exclusive duty of loyalty.

ERISA and ESG

For corporate employee retirement-income plans, this exclusivity requirement is enshrined in Section 404 of the Employee Retirement Income Security Act of 1974 (ERISA), which imposes tightly defined duties on retirement-plan fiduciaries. Its purpose is to ensure that those responsible for managing retiree-income plans (plan fiduciaries) act solely in the interests of plan beneficiaries and aim to maximize the risk-adjusted financial value of plan assets.

In June 2020, the Trump administration's Department of Labor sought to operationalize this requirement with respect to ESG. It proposed a "financial factors" rule to enable plan fiduciaries to satisfy themselves that they are complying with the law in considering only pecuniary factors. This unleashed a hugely negative response from the investment community. Nonetheless, the DOL went forward and published the final rule in November 2020.[33]

The rule does not prohibit plan managers from incorporating ESG factors into the investment process. It does require that, if the plan managers incorporate such factors, they demonstrate that they are material economic considerations under generally accepted investment theories. In truth, opponents of the rule really oppose ERISA's stringent fiduciary requirements. To campaign openly to repeal and replace Section 404 with an ESG-friendly provision would alert current and future retirees that their retirement savings are to be deployed for the benefit of other causes. Instead, they targeted the DOL financial-factors rule rather than the law that it is the DOL's duty to execute. (Appendix I—ERISA and the Department of Labor's Proposed Rule "Financial Factors in Selecting Plan Investments").

Additionally, the Trump DOL proposed a new fiduciary duties regarding proxy voting rule.[34]

(Appendix II—Fiduciary Duties Regarding Proxy Voting and Shareholder Rights).

The Biden administration could have used the 1996 Congressional Review Act to nullify recently finalized federal regulations with simple majority votes in the House and the Senate. Instead the Department of Labor decided not to enforce the rulemaking, illustrating how the rule's faithfulness to the underlying statute makes repeal and replace challenging.

IV. THE BIG PICTURE

We've seen that ESG's claims as an investment strategy delivering superior risk-adjusted returns do not withstand scrutiny. Such claims are better viewed as the lure for an essentially political project, which ESG provides the tools to bring about. These range from diversity quotas on corporate boards to decarbonization with the threat of proxy votes to encourage compliance.

The forked tongue of ESG disclosures

The investment premise of risk/return ESG is that high-scoring ESG firms build a stock of social capital to weather storms; poorly rated firms have lower levels of trust and are riskier. Pressing companies to disclose ESG data therefore enables investors and the market to price such risks more accurately—or so the argument goes.

Writing in the foreword to the SASB *Climate Risk Technical Bulletin*, former Treasury secretaries Hank Paulson and Robert Rubin argue for action to require climate-change disclosure. Investors, they say,

> face the important question of how different sectors and companies are accounting for and measuring climate risks, and how prepared they are to build up resilience to those risks.[35]

In their August 2020 paper on ESG and the Covid sell-off, Demers and her colleagues test the proposition that ESG improves firms' resilience by examining stock performance through the 2020 Covid-19 sell-off and the 2008 global financial crisis. They found that just two accounting variables—cash and firms' stock of internally developed intangible assets—are reliable indicators of a firm's resilience during a major global crisis, whether financial (2008) or humanitarian (2020).[36] ESG made no contribution to their model's predictive success. These results, they conclude, show that ESG

> adds little to accounting and market variables for purposes of out-of-sample prediction of crisis winners and losers.[37]

This finding demolishes the empirical justification of climate-risk disclosure as investor tools to identify winners and losers through periods of acute market turbulence. Why force companies to provide investors with reams of ESG disclosures when such data are immaterial to firms' performance through the two most severe financial crises in decades, when traditional accounting disclosures provide what investors need? The question then arises as to whether there might be other motives behind the pressure for such disclosure regimes.

In their paper on ESG materiality, Khan, Serafeim, and Yoon post a carefully worded warning against a "naïve" classification of sustainability issues:

> If the research process of organizations such as SASB is captured by special interests that seek to steer the output in preferred directions then this would lead to no improvement in the informativeness of ESG ratings. For example, it could be that NGOs that support environmental causes influence SASB's standards to classify as material environmental issues when they are not material in a given industry.[38]

A case in point is the SASB's determination of materiality for publicly quoted restaurant chains. A March 2020 *Wall Street Journal* editorial points out that the SASB requires restaurants to disclose the proportion of cage-free eggs and pork produced without gestation crates. These disclosure standards are set after consulting "advisory groups" consisting of businesses, investors, academics, and other "stakeholders"—such as Vegan Finance.[39] "Animals do not belong to us," Vegan Finance declares on its website. "Let's build a better world by financing the best animal-friendly and vegan projects." What is material to Vegan Finance is supposedly material to investors.

When it comes to energy and climate change, the SASB wasn't captured by NGOs supporting environmental causes; it was set up and financed as one and then decked out to look like an objective standard-setting body. Founded in 2011, the SASB received its first grant from Bloomberg Philanthropies the following year. Michael Bloomberg served as chair of the SASB Foundation Board from 2014 to 2018 and remains "supportive and engaged with our future effort," according to the SASB website. "Climate change is the biggest threat to America and the world. Full stop," Bloomberg says in a February 2020 video posted on his Facebook page, just as the Covid-19 pandemic was triggering the worst economic crisis since the Great Depression. "How do you replace dirty energy?" he asks. "Stop rewarding companies from making it." The intent is clear.

"We share the SASB's belief that the capital markets can affect the course of climate change for the better," Rubin and Paulson write.[40] This is not neutral, objective standard-setting; it is evidence that the exercise is about setting disclosure standards to drive a policy agenda.

In a similar vein, Larry Fink told CEOs in his January 2020 letter that

> the goal cannot be transparency for transparency's sake. Disclosure should be a means to achieving a more sustainable and inclusive capitalism.[41]

Does this cross the line between an investing approach designed exclusively for the interests of investment beneficiaries—as required of a fiduciary—and political activism?

In a January 2020 note on investment stewardship and SASB-aligned reporting, BlackRock says that climate-disclosure frameworks are currently voluntary but being incorporated into policy guidelines in several markets, including the European Union and the UK, a trend indicating "growing support for mandatory reporting on climate risk."[42]

Publication of the note followed intensive dialogue between BlackRock and a small group of activist shareholders threatening BlackRock with a shareholder resolution on climate change. The group included Boston Trust Walden. As a political activist, Boston Trust Walden is candid about viewing corporate governance and proxy voting as tools to advance political and legislative goals:

> As companies set science-based targets, they signal to lawmakers that addressing climate risk makes good business sense, enabling legislators and regulators to develop sound public policy solutions that, in turn, provide companies effective frameworks to support climate-related goals.[43]

CEOs vs. shareholder capitalism

The politicization of business received a boost in 2019 when more than 180 CEOs signed the Business Roundtable corporate purpose statement. "We share a fundamental commitment to *all* of our stakeholders," the statement said.[44] Signatories included BlackRock's Larry Fink. In his January 2020 letter to CEOs, Fink emphasized that companies should consider the needs of a broad range of stakeholders. Companies that champion transparency and demonstrate their responsiveness to stakeholders "will attract investment more effectively, including higher-quality, more patient capital," the CEO of the world's largest asset-management company told them.[45]

Harvard Law School's Lucian Bebchuk and Roberto Tallarita in a March 2020 paper were less than impressed with the Business Roundtable's stakeholderism. The statement explicitly denies the possibility that the interests of shareholders and stakeholders can clash, when in reality potential trade-offs between them are ubiquitous. Freeing directors from shareholder accountability puts directors in the position of adjudicating these trade-offs and elevates them to the role of social planner, "the ideal benevolent entity conjured up by economists to model socially optimal outcomes."[46]

Democracy or ESG oligarchy?

The idea of ESG underpinning an emergent parallel government with its capital on Wall Street has been advanced by Matt Levine, a lawyer and former Goldman Sachs investment banker. "There is a government of the US, consisting of a president and Congress and so forth, chosen through more-or-less democratic processes, and it makes big collective decisions for society," Levine writes. And there is a second government

> consisting of a handful of gigantic institutional asset managers—BlackRock, Vanguard, Fidelity, etc.—who own (on behalf of their customers) most of the stocks of most of the public companies…. They are not chosen democratically, exactly, but they are representative; millions of people give their money to those institutions and trust them to make decisions for them.

These asset managers tell companies to do things that they think are good for society as a whole,

> so the asset managers find themselves in the business of making big collective decisions about how society should be run, not just business decisions but also decisions about the environment and workers' rights and racial inequality and other controversial political topics.

BlackRock makes decisions on broad social and environmental issues, Levine says, "and then companies are somewhat compelled to do what BlackRock decides."[47]

That a handful of Wall Street titans should make decisions on behalf of society gives an ironic twist to the term "inclusive capitalism"—in truth, it's the essence of insider capitalism. It would be hard to imagine a more effective way to undermine the legitimacy of capitalism than to have financial oligarchs usurping the functions of democratic institutions and the legitimacy of the ballot box by taking political and societal decisions.

In *Grow the Pie*, Alex Edmans argues that companies should focus on their comparative advantage, such as making great products, rather than tackling public policy objectives. Bebchuk and Tallarita are alive to the danger of stakeholderism crowding out governmental regulation:

> Corporate governance reforms in general, as well as stakeholderism in particular, are not an effective tool for addressing "the catastrophic effect of climate change." To the contrary, directing efforts to reforming corporate governance, rather than to policies that could effectively fight climate change, would be a serious mistake.[48]

On climate change, Cornell and Damodaran write that a substantial part of the global economy, as well as our consumption needs, depends on the continued production of fossil fuels. If public policies provide tax incentives that fail to adequately discourage the production and consumption of fossil fuels, then it points to a problem with government policy, not with the fossil fuel companies:

> Clearly within a diverse society like the United States there will be large groups of people who think that current policies are too lax, too stringent, or just about right, when it comes to fossil fuel production and usage. In short, for those whose primary concern is reducing the use of fossil fuels to combat climate change, the focus should be on electing officials who will enact laws consistent with those objectives.[49]

Corporatism vs. capitalism

ESG and stakeholderism are the latest manifestations of corporatism, a philosophy that views business and markets as tools of public policy—wherein business works in partnership with governments and NGOs to deliver on public policy goals. Taken to its maximalist form, as outlined by Matt Levine, finance becomes a parallel government wielding political power.

In its less extreme form, corporatism is a mainstream view. "It's way past time we put an end to the era of shareholder capitalism," said Joe Biden, launching his economic plan last July.

> The idea the only responsibility a corporation has is with shareholders. That's simply not true. It's an absolute farce. They have a responsibility to their workers, their community, to their country.[50]

In his famous 1970 essay on the social responsibility of business, Milton Friedman argued that when a corporate executive makes expenditures on pollution reduction beyond what is in the best interests of the corporation or required by law, that executive is, in effect, imposing taxes and deciding how the tax proceeds should be spent. These are governmental functions.

> We have established elaborate constitutional, parliamentary and judicial provisions to control these functions, to assure that taxes are imposed so far as possible in accordance with the preferences and desires of the public—after all, "taxation without representation" was one of the battle cries of the American Revolution.[51]

In contrast to the commingling of business and governmental functions intrinsic to the corporatist worldview, the classical view of capitalism sees a clear division of functions and responsibilities between the two, with profit-oriented enterprises operating within the framework of competitive market economies. To function, a market economy requires a structure of laws, institutions, and political stability. "The main responsibility for creating the necessary framework, which goes beyond norms and rules of conduct for enterprises," the economist David Henderson wrote in his 2004 pamphlet "The Role of Business in the Modern World," "rests with governments rather than business."[52]

There are sound reasons that this division of labor is socially optimal. The world of business is characterized by ever-increasing specialization, whereas, over the last century or so, government activity has moved in the opposite direction. Its span of activity has broadened through an agglomeration of responsibilities and functions. The opposing evolution of business and government helps account for the success of business and the capitalist system in transforming the world vastly for the better. It is harder to make the case that the performance of governments has improved as the span of its activities has widened.

It might be that there is no other option but to accept as inevitable the expansion of government activity and a concomitant decline in its performance and efficiency. But this is an argument for resisting the colonization of private business by the culture, modes, and preoccupations of government, which will likely reduce the performance of both. As Bradford Cornell recently commented, "A company that loses its business focus because of its desire to do good for society, may end up being bad both for both business and society."[53]

Business accountability

A powerful factor behind the superior performance of capitalist enterprise is its dual lines of accountability. The first and most important is to customers, who exercise choice in competitive markets. As Eugene Fama puts it, "consumers vote via their purchase decisions."[54]

The second is to shareholders who provide the business with its equity capital. Cash left idle on corporate balance sheets is worth less than in the hands of investors, who can then reallocate capital to where it's more productive. Market data demonstrate that diluting investor rights to protect incumbent management has a negative impact on stock performance. A 2003 paper that analyzed company data on 24 mechanisms designed to protect incumbent management from investors found that companies with the strongest investor rights beat those with the opposite by 8.5% a year.[55]

Not all markets are highly competitive, so firms' accountability to customers via the exit mechanism—Fama's "no buy"—doesn't work, or works less well. The ability to engage in the widening of corporate objectives beyond business objectives is correlated with the availability of monopoly rents and is prima facie evidence of them. These can then be used to fund the ESG indulgence without the businesses going broke (because customer exit is sluggish).

CEOs have an incentive to expand this corporatist "tax base" and protect it from being eroded by dissatisfied customers and the demands of shareholders. CEOs and ESG investors can be allies in this venture and engage in all kinds of lobbying for protective positions because the most productive supplier of monopoly protections is the state, so politicians get to join the alliance, too. This creates incentives for CEOs and Wall Street to act in concert with NGOs and politicians in a coalition of corporatism. In shorthand, there is rent-seeking behavior (such as lobbying politicians to protect their markets from competitors), and then there is rent-dissipating conduct (diverting shareholder wealth to nonbusiness objectives). The price is paid in reduced consumer welfare, impaired economic performance, and a damaged democracy.

ESG vs. government regulation

There is a practical reason why the attempt to regulate corporations through ESG disclosures is both misconceived and risks misleading investors. Take climate-change disclosures, which loom largest. According to the SASB's rubric, there are broadly two categories of climate risk: risks arising from the direct physical effects of climate change; and transition risks, which relate to the future regulation of greenhouse-gas emissions.

The former is a subset of business-disruption planning. It's safe to say that the actual impacts of future climate change are extremely unlikely to be comparable with the impact of the Covid-19 pandemic because of the difference in speed and timescales. Global warming is measured over decades and centuries; SARS CoV-2 was spread around the globe in a matter of weeks.

BlackRock vs. climate data

Nonetheless, there is a tendency to overstate climate risk. For example, BlackRock claims that climate risk is not being adequately priced by the market. "This is due to the fact that the pace of future change is unlikely to align with the pace of change that has informed the models of the past," BlackRock claims.[56]

The evidence points in the opposite direction. A November 2019 paper (revised March 2020) by Patrick Bolton and Marcin Kacperczyk contradicts BlackRock's claim on investors not pricing carbon risk. "Our evidence is that investors are discerning these cross-sectional differences and are pricing in carbon risk," the paper's authors conclude.[57*] They interpret the data as showing that investors are already demanding compensation for their exposure to carbon-dioxide emission risk in the form of higher returns. An alternative explanation is that higher CO2-emitting firms are more profitable.

Similarly, BlackRock's claim that climate models underestimate global warming is also wide of the mark. The world has been warming more slowly than forecast by climate models. According to a 2017 paper coauthored by Professor Myles Allen, a lead author of the IPCC's 2018 Special Report: Global Warming of 1.5°C, since 2000, a discrepancy has opened up between climate models and observations.[58] "We haven't seen the rapid acceleration in warming after 2000 that we see in the models," Allen told the Times in September 2017. Too many of the models "were on the hot side," meaning that they forecast too much warming.[59]

Satellite-observed temperature trends show a warming trend of only 0.13°C per decade in the period 1979–2018. A statistical analysis in which the prominent El Niño, during 2000–2016, is removed from the record finds a remaining warming trend on the order of only 0.04°C per decade.[60] That the world's largest asset manager opts for climate hyperbole rather than hard data makes it difficult to view BlackRock's climate stewardship as a genuine attempt to understand climate risk from an investor perspective.

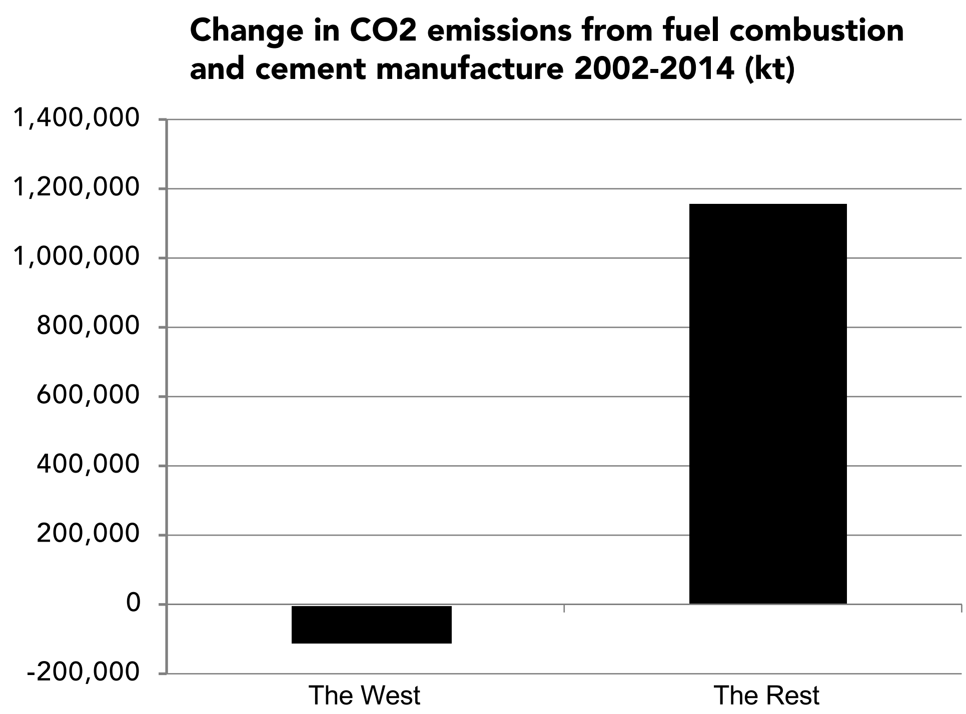
Why governments do it better

Here we come to a fundamental problem with the emerging ESG regime of climate-risk disclosure. Transition risk, the second category of climate risk, is misdescribed by the SASB as relating to "the market-based need to transition to a low-carbon economy."[61] If that were the case, there would be no need for governmental interventions. What the SASB's category of transition risk really speaks to is risks arising from future climate regulation.

Climate regulations are made by nation-states and vary by jurisdiction. In the EU, the nature and stringency of climate regulations vary between member states, as they can do between different states in the US. It is unlikely that a corporation's global footprint is coterminous with the borders of a state. Yet the SASB's climate-risk materiality map implicitly assumes homogeneous climate regulation across the world.

Unlike the Kyoto Protocol, which set top-down emissions-reduction targets for developed countries, the Paris Agreement is based on bottom-up Nationally Determined Contributions. The SASB's treatment of the globe as a single regulatory space thus generates information on climate regulatory risk that is systematically misleading and gives rise to ESG ratings that mislead investors as to actual investment risk—as distinct from involvement in activities that ESG-raters deem unethical.

FIGURE 1. THE WEST VS. THE REST OF THE WORLD: CHANGE IN ANNUAL CO2 EMISSIONS FROM FUEL COMBUSTION AND CEMENT MANUFACTURE 2002–14 (KT)



Source: Carbon Dioxide Information Analysis Center, Environmental Sciences Division, Oak Ridge National Laboratory, Tennessee

The risk/return ESG investment hypothesis claims that ESG investing strategies boost risk-adjusted returns because they are better at identifying and managing risk. This is demonstrably untrue when it comes to climate regulatory risk because the real world doesn't fit the SASB's homogeneity assumption. Dividing the world into the West and the Rest shows the trajectory of carbon-dioxide emissions moving at different speeds in opposite directions. Between 2002 and 2014, the West's carbon-dioxide emissions from fuel combustion and cement manufacture declined by 1.075 gigatonnes—a fall of 10.2%—while the Rest of the World's rose by 11.567 gigatonnes, an increase of 76.8%.

Climate-change regulations in the Rest of the World with surging carbon-dioxide emissions pose less business risk than in the West. Applying a uniform ESG screen penalizes investment in companies with operations in the Rest of the World, imposing a competitive disadvantage on them—while having no effect on local demand for energy. The result would merely be to cede market share to non-Western or privately held companies less beholden to ESG ratings. Shareholders suffer, but the climate doesn't benefit.

BlackRock goes a step further by threatening to use its proxy vote to encourage companies to adopt unilateral greenhouse-gas reduction targets. No investment rationale is provided for this. Instead, BlackRock talks of "our objective to encourage market-level progress" and advocates carbon pricing "to help achieve the significant acceleration of the transition to a low-carbon future necessary to keep global warming below 2°C."[62] BlackRock's declaration, rather than being motivated by pure investment considerations, instead offers evidence supporting Matt Levine's contention that the firm constitutes a leading part of a parallel government run from Wall Street.

Cui bono

Who benefits? "The potential to make money on ESG for consultants, bankers and investment managers has made them cheerleaders for the concept," write Cornell and Damodaran, "with claims of the payoffs based on research that is ambiguous and inconclusive, if not outright inconsistent with some of the claims."[63]

BlackRock is one of those cheerleaders. Its traditional low-cost index investing business has become cutthroat, says Bernard Sharfman, RealClearFoundation's corporate governance expert. The solution? Persuade state and city pension managers to switch into fashionable "sustainable" investment funds, which, Sharfman explains, command "higher fees to cover expenses such as identifying stocks to exclude and the purchase of virtue ratings to tell them which companies are politically correct."[64] For example, BlackRock charges 46 cents annually for every $100 invested in its iShares Global Clean Energy ETF, one of the largest ESG funds in the world, and just 4 cents for its iShares fund linked to the Standard & Poor's 500 index.[65]

… and who pays

The cost, on the other hand, can be viewed in terms of loss of focus; in the first instance, loss of focus on the essentials of business and of investing. For business, it is the focus on customers, anticipating market trends and innovating to create them and doing so profitably for shareholders. For investors, it is the hard search for risk-adjusted returns.

Going green can lead business and investors to take their eye off the ball—or worse. Edmans reminds us that all that is green isn't necessarily good: shortly before its collapse in 2001, Enron was lauded for its corporate social responsibility, winning six awards in a single year from the US Environmental Protection Agency and a corporate conscience award from the US Council on Economic Priorities.[66]

One major oil company has already tried going green. In May 1997, BP's then–chief executive John Browne announced that the company was embarking on a green journey, rebranding itself as Beyond Petroleum. Extensive internal polling showed that 60% of BP staff saw addressing the environment as the most important priority for the company. Safety did not top the list.[67]

Aggressive cost-cutting—necessary to compensate for BP's green invest¬ments that yielded no return—helped propel BP's share price upward. Between May 1997 and April 20, 2010, the shares rose 71% in dollar terms, compared with a 30% increase in ExxonMobil's stock price. After the markets closed on April 20, an explosion occurred on the Deepwater Horizon drilling rig in the Gulf of Mexico. It was BP's third and most serious accident caused by safety short¬falls. Six months later, the share price had given up 97% of its dollar gains since May 1997.[68]

More transparency, more disclosure—that's the solution being pushed by the SASB, by its sister organization the Taskforce on Climate-Related Financial Disclosures (TCFD), and by BlackRock. "Increasing transparency makes markets more efficient, and economies more stable and resilient," Michael Bloomberg, TCFD chair, says. This, too, incurs a loss-of-focus penalty.

Seven years ago, SEC commissioner Daniel Gallagher spoke of the danger of "information overload." Disclosure rules were being used by special-interest groups that "do not necessarily have the best interests of all shareholders in mind, to pressure public companies on certain governance and business practices." Gallagher questioned whether mandated disclosures running into hundreds of pages "are at all understandable, and of any utility, to investors who are likely to miss key disclosures or not read them at all." [69]

Along with increased disclosure comes pressure for that information to be independently audited. Doubtless the Big Four accounting firms would welcome the opportunity of auditing reams of soft ESG disclosures as a more comfortable alternative to the serious business of verifying whether a company's assets and liabilities match management's claims. But for shareholders and stakeholders, the more that information accountants are expected to audit, the more likely they'll miss what really matters. This would reinforce a tendency, particularly in Europe, for the softening of standards, recently noted by the *Financial Times* with the adoption of modern accounting standards:

> Over the past three decades, these [modern accounting standards] have progressively dismantled the traditional system of historical cost accounting with its emphasis on the verifiability of evidence and using prudent judgment, replacing it with one based on the idea that the primary purpose of accounts is to present information that is "useful to users."[70]

Schumpeter's warning

"Dematerialized, defunctionalized, and absentee ownership does not impress and call forth the moral allegiance as the vital form of private property once did," economist Joseph Schumpeter warned in his epochal *Capitalism, Socialism and Democracy. Dematerialized*, defunctionalized, absentee ownership: Schumpeter could be describing ETF index trackers. "Eventually," Schumpeter maintained, "there will be nobody left who really cares to stand for it—nobody within and nobody without the precincts of the big concerns."[71]

The battle over ESG is a fight for the future of capitalism—for its continued capacity to generate economic growth and the higher living standards on which its legitimacy as an economic system rests. That legitimacy was not built by becoming an instrument of political power wielded by Wall Street oligarchs. The weaponization of finance constitutes a potentially lethal strategic move, one that would end capitalism as we know it. It remains to be seen whether Schumpeter's pessimism is justified.

APPENDIX I

ERISA and the Department of Labor's Proposed Rule "Financial Factors in Selecting Plan Investments"

On June 30, 2020, the Department of Labor (DOL) published a proposed rule "Financial Factors in Selecting Plan Investments." The DOL received more than 1,500 comments by the end of the 30-day comment period, the vast majority of them hostile. The rule was finalized and published in the *Federal Register* at the end of October.

Congress enacted the Employee Retirement Income Security Act of 1974 (ERISA) in order to set minimum standards to ensure the equitable character of retirement plans and their financial soundness. To this end, it requires that retirement plans have one or more fiduciaries who shall "have authority to control and manage the operation and administration of the plan," and it established "standards of conduct, responsibility, and obligation for fiduciaries of employee benefit plans."[72]

The core of the DOL rule, as first proposed, is found at (c)(1) and is aimed at plan fiduciaries:

> Plan fiduciaries are not permitted to sacrifice investment return or take on additional investment risk to promote non-pecuniary benefits or any other non-pecuniary goals. Environmental, social, corporate governance [ESG], or other similarly oriented considerations are pecuniary factors only if they present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories.[73]

Note that the DOL was not forbidding fiduciaries from considering ESG factors in appraising an investment (rather than explicitly identifying E, S, and G, the final rule speaks of pecuniary and non-pecuniary factors).[74] But these must be additive to the plan's sole objective of enhancing financial benefits and justified by reference to established investment theories, the only limited exception being a tiebreaker when economic considerations are otherwise exactly equal. ERISA fiduciaries, the DOL states, "must never sacrifice investment returns, take on additional investment risk, or pay higher fees to promote non-pecuniary benefits or goals."[75]

The rule outlines the steps that a fiduciary must take to demonstrate that an investment decision is taken solely in the interest of plan beneficiaries and must be based "solely on pecuniary factors that have a material effect on the return and risk of an investment based on appropriate investment horizons."[76]

The factors that a fiduciary should consider include:

- how the particular investment furthers the purpose of the plan, taking under consideration the risk of loss and the opportunity for gain;
- the composition of the plan with regard to diversification; and
- how the investment compares with available alternatives.[77]

In effect, the DOL is calling Wall Street's ESG bluff: *If you want to sell ESG products to retirement plans, you must then demonstrate how they financially benefit them.*

In his submission to the DOL, Bernard Sharfman, RealClearFoundation corporate governance senior fellow, observes that use of portfolio screening for passive index-tracking products is a process by which a plan manager reduces its universe of eligible investments based on non-pecuniary criteria.[78] The MSCI KLD 400 Social Index, used by BlackRock's iShares MSCI KLD 400 Social Index, constitutes less than one-fifth of the MSCI USA IMI Index.[79] For that reduced investment exposure, BlackRock typically charges 0.25% a year for its iShares MSCI KLD 400 Social Index, whereas fees for a plain vanilla tracker are as low as 0.01% a year. In other words, BlackRock charges 25 times more for an investment vehicle constituting less than one-fifth of the stocks.

No generally accepted modern investment theory justifies such shrinkage of diversification in return for higher costs. Sharfman points to a 2018 study showing that the best-performing 4% of listed companies account for gains in excess of the returns on one-month Treasury bills for the entire US stock market since 1926.[80] The risk to fund performance of not having exposure to stocks that might constitute part of that 4% is considerable. "The core of every investment portfolio should consist of low-cost, broad-based index funds," according to Burton Malkiel, author of *A Random Walk Down Wall Street* and acclaimed as the father of passive investing. Malkiel goes on to warn:

> [D]on't be misled by marketing claims. It isn't easy to do well by doing good, and ESG funds may accomplish neither objective.[81]

The bar that fiduciaries must meet in order to invest in ESG products was not conjured out of thin air by the DOL in 2020. Far from representing a recasting of legal doctrine, the proposed rule is grounded in the unambiguous language of ERISA in subsequent court rulings and is faithful to previous DOL Interpretative Bulletins issued under presidential administrations of both parties.

Section 404 (a)(1)(A) of the act requires plan fiduciaries to discharge their duties for the exclusive purpose of:

> (i) providing benefits to participants and their beneficiaries; and
>
> (ii) defraying reasonable expenses of administering the plan.[82]

A 2015 DOL Interpretative Bulletin issued during the Obama presidency stated:

> Under ERISA, the plan trustee or other investing fiduciary may not use plan assets to promote social, environmental, or other public policy causes at the expense of the financial interests of the plan's participants and beneficiaries. Fiduciaries may not accept lower expected returns or take greater risks in order to secure collateral benefits.[83]

The 2015 Interpretative Bulletin, in turn, cited the preamble to a 1994 DOL Interpretative issued during the Clinton administration:

> [The DOL] has consistently held that fiduciaries who are willing to accept expected reduced returns or greater risks to secure collateral benefits are in violation of ERISA. It follows that, because every investment necessarily causes a plan to forgo other investment opportunities, an investment will not be prudent if it would provide a plan with a lower expected rate of return than available alternative investments with commensurate degrees of risk or is riskier than alternative available investments with commensurate rates of return.[84]

In reality, opponents of the rule oppose what Congress wrote in the 1974 act. Martin Lipton, a founding partner of Wachtell, Lipton, Rosen & Katz and a commenter who has built a distinguished legal career opposing shareholder rights in favor of stakeholders, was forced to make an about-face and argue that ESG investing was about "value and performance," though he couldn't quite bring himself to insert "shareholder" before "value."

> Numerous sophisticated investors have indicated that their ESG investments, social benefits notwithstanding, are fundamentally driven by expected financial returns, including considerations regarding long-term value.[85]

The proposed rules, Lipton writes,

> would prohibit a retirement plan fiduciary from making any investment, or choosing an investment fund, based on the consideration of an environmental, societal or governmental factor unless that factor independently represents a material economic investment consideration.[86]

No, it's ERISA that imposes the prohibition that Lipton objects to. All the proposed rule does is set out the standard by which the DOL would be satisfied that the relevant provisions of the act are complied with.

BlackRock takes a different tack in its comment on the proposed rule. To overcome the plain letter of law, it adopts the simple expedient of rewriting the law:

> We are concerned that the Proposal goes far beyond reiterating and clarifying the DOL's long-standing and consistent position that plan fiduciaries must put first the economic interests of plan participants and beneficiaries.[87]

Note the "put first," implying that there are secondary considerations as well. In a 1983 case brought by the DOL against officers of the Grumman Corporation acting as trustees of the corporation's retirement plan, the Court ruled that although trustees do not violate their duties merely because an action "incidentally" benefits the corporation,

> their decisions must be made with an eye single to the interests of the participants and beneficiaries.[88]

Thus, in BlackRock's rewriting of the exclusivity requirement of ERISA Sec 404 (a)(1)(A), "eye single" becomes one of many. The violation of meaning is clear. If Congress had wanted trustees to deploy the capital in retirement plans for ends additional to the pecuniary interests of plan beneficiaries, it wouldn't have written the exclusivity requirement into ERISA, and the courts would not rule that "[a]t the heart of the fiduciary relationship is the duty of complete and undivided loyalty to the beneficiaries of the trust."[89] That loyalty would be sundered and fiduciaries' accountability weakened if they were permitted multiple objectives.

If, instead, opponents of the rule were being honest, they would be campaigning to persuade Congress to repeal Sec 404 (a)(1)(A) of ERISA and replace it with a provision to permit plan fiduciaries to invest in objects calculated to be of wider social and planetary benefit. Doing so would make plain what is at stake and alert current and future retirees that their savings and future income are being socialized and deployed for wider societal ends. It's not hard to envisage what their response would be. And that, in a nutshell, is why Wall Street and much of the investment community are up in arms about the rule.

APPENDIX II

Fiduciary Duties Regarding Proxy Voting and Shareholder Rights

On September 4, 2020, the DOL proposed a new rule on proxy voting.[90] It expressed concern that some fiduciaries and the proxy advisory firms that provide them with advice on how to cast their proxies

> may be acting in ways that unwittingly allow plan assets to be used to support or pursue proxy proposals for environmental, social, or public policy agendas that have no connection to increasing the value of investments used for the payment of benefits or plan administrative expenses, and in fact may have unnecessarily increased plan expenses.[91]

As with the DOL's new financial factors rule, this rule, too, is grounded in ERISA and subsequent DOL Interpretative Bulletins. In the first, issued in 1994, the DOL recognized that fiduciaries may engage in shareholder activities where, after taking into account the costs involved, a reasonable expectation exists that these activities will enhance the value of the plan's investment in the corporation.

In October 2008, the DOL updated its guidance. In deciding how to vote proxies, fiduciaries should consider only factors that relate to the economic value of the plan's investment and shall not subordinate the interests of the participants and beneficiaries in their retirement income to unrelated objectives:

> Votes shall only be cast in accordance with a plan's economic interests. If the responsible fiduciary reasonably determines that the cost of voting (including the cost of research, if necessary, to determine how to vote) is likely to exceed the expected economic benefits of voting, or if the exercise of voting results in the imposition of unwarranted trading or other restrictions, the fiduciary has an obligation to refrain from voting.[92]

This was too much for the Obama administration. In December 2016, the DOL issued new interpretive guidance effectively loosening the 2008 changes, but prefaced it with a restatement of ERISA's fundamental principle of exclusivity:

> The Department has rejected a construction of ERISA that would render ERISA's tight limits on the use of plan assets illusory and that would permit plan fiduciaries to expend trust assets to promote myriad public policy preferences. Rather, plan fiduciaries may not increase expenses, sacrifice investment returns, or reduce the security of plan benefits in order to promote collateral goals.[93]

Then comes the "however":

> However, by focusing on a "cost-benefit analysis" demonstrating a "more likely than not" enhancement in the economic value of the investment, the Department believes that IB 2008-2 may be read as discouraging fiduciaries from recognizing the long-term financial benefits that, although difficult to quantify, can result from thoughtful shareholder engagement when voting proxies, establishing a proxy voting policy, or otherwise exercising rights as shareholders.[94]

It went on to argue that the existence of financial benefits associated with shareholder engagement was "suggested" by the number of institutional investors engaging companies on ESG issues.[95]

In its September 2020 rule, the Trump Department of Labor proposed to reverse much of what the Obama administration was trying to achieve. Thus the proposed rule forbids plan fiduciaries from subordinating the interests of participants and beneficiaries

> to any non-pecuniary objective, or sacrifice investment return or take on additional investment risk to promote goals unrelated to those financial interests of the plan's participants and beneficiaries or the purposes of the plan.[96]

The guidance also clarifies that plan managers have no duty to vote plan proxies:

> ERISA mandates that fiduciaries manage voting rights prudently and for the "exclusive purpose" of securing economic benefits for plan participants and beneficiaries—which may or may not require a proxy vote to be cast.[97]

As much as ESG adherents might object, the essence of the argument is whether retirement savings should be deployed for wider societal purposes—to which the law gives a clear answer.

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