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Introduction to Financial Services: Environmental, Social, and Governance (ESG) Issues

ESG is a widely used acronym for environmental, social, and governance issues. Corporate governance—concerns about how companies should be managed—has evolved over time to include, arguably, a wider array of issues that encompass ESG. Some consider ESG factors to be an integral part of discussions about sustainability. According to one definition, *sustainability* at the firm level is "an approach that creates long-term shareholder value through managing opportunities and risks that derive from economic, environmental and social developments."

Over 7,000 signatories, with over $120 trillion in assets under management (i.e., client assets managed by the signatories) support Principles for Responsible Investment (PRI), a nongovernmental organization (NGO) that promotes sustainability through ESG. Although the United Nations initiated PRI in 2005, the six principles of responsible investment were launched at the New York Stock Exchange in 2006 with 100 initial signatories. Over the years, as more signatories have joined PRI, they have increasingly asked investment managers to incorporate ESG factors in their investment decisions. In addition, state regulators, NGOs, and some Securities and Exchange Commission (SEC) commissioners and advisory groups have increasingly taken interest in ESG concerns. Congressional interest has centered on what types of ESG disclosures, if any, should be required.

What Is ESG?

There is no universally agreed-upon definition of what constitutes ESG. Investors and other stakeholders consider a wide-ranging array of topics as part of ESG. The discussion below on the characteristics and risks that can accompany ESG is not definitive. It is meant to illustrate some of the perceived risks of either addressing or ignoring various ESG factors.

Characteristics and Risks

Environmental. Investors and stakeholders may examine a firm's impact on the environment. Some consider the interaction with the environment to be a form of capital—the stock of natural resources. Environmental risks include declining biodiversity; pollution; resource scarcity; and potential climate change impacts, including increasingly frequent and severe floods, hurricanes, and forest fires.

For individual firms, ignoring environmental risks could potentially harm their reputations, endanger employees, and imperil physical operations, which could lead to costly litigation. For other firms and communities, addressing environmental risks might cause economic harm, with diminished access to natural resources and the need to either physically relocate or seek alternative production inputs at a higher cost and diminished profits.

Social. Social factors encompass a firm's effects on its various stakeholders, such as consumers, employees, suppliers, contractors, and the local and broader communities. Risks include potential infringement on the rights of others, gender- or ethnicity-based discrimination when hiring or promoting employees, failure to monitor supplier and contractor pay, handling of customer data in a nontransparent and nonsecure way, political spending, and investing in projects or sectors that could be considered objectionable to specific segments of society. Companies that handle these risks poorly might experience effects similar to environmental risks, such as the inability to attract quality employees and exposure to costly litigation.

In addition, some stakeholders might consider certain business operations or funding of certain entities in various areas to be unacceptable, including tobacco, gun manufacturing, private prison industries, abortion providers, and gambling. On the other hand, other stakeholders might consider an infringement of their rights any limitations placed on their right to operate or fund such lawful entities.

Governance. A firm's self-governance and integrity when conducting business may raise questions. The policies, processes, and controls implemented by a firm help to define its self-governance and impact on various stakeholders. A firm's integrity is measured by whether it avoids corruption and bribery and engages with individuals and other firms that may pose a reputational risk to the firm.

If a corporation chooses not to address governance issues, the associated risks could include harm to its consumers and an environment leading to criminal activity and corporate reputational harm, potentially resulting in firm failure. Firm failure negatively affects stakeholders—employees may lose their jobs, suppliers might not be paid, and local governments may receive less tax revenue. Some examples are Enron (2001 bankruptcy), WorldCom (2002 bankruptcy), and MF Global (2011 bankruptcy). Recently, the fake account scandal at Wells Fargo Bank harmed its clients, resulted in the removal of many key executives, and prompted regulators to restrict the bank's growth.

Materiality and ESG

The disclosure of material information is an important accounting principle. The notion of materiality is at the center of SEC-regulated disclosure requirements. Materiality is deemed to be information that a reasonable investor would deem important in determining whether to purchase a security. In the ESG realm, there is an ongoing debate about what is material in determining which ESG factors a firm should target and disclose to investors. Discussion around what constitutes materiality is similar to discussion about what constitutes ESG—companies have discretion over what to include in both. Some proponents of ESG disclosure have stated that focusing on financial materiality would be most helpful to investors.

Financial materiality issues, as defined by the Sustainability Accounting Standards Board, "are the issues that are reasonably likely to impact the financial condition or operating performance of a company and therefore are most important to investors."

Financial materiality and ESG outcomes vary by firm. Focusing on specific ESG factors at one firm or industry may lead to different outcomes than focusing on the same factors at another firm or industry. For example, improving fleet fuel efficiency at a company that transports goods could improve its financial results while benefitting air quality. Applying the same set of ESG factors to a data warehouse might not make sense; in that instance, lowering the cost of electricity (which could depend on the relative cost of fossil fuels versus renewable energy) would probably be more relevant.

Investors and other stakeholders might want to consider if a company is following the existing minimum federal and local statutory requirements. In addition, stakeholders might want to consider if a company's ESG issues can be addressed through the existing regulatory regime—for example, all employers are subject to hiring and employment practices based on Equal Employment Opportunity Commission requirements and workplace safety based on Occupational Safety and Health Administration (OSHA) requirements.

Policy Issues

Proponents of ESG disclosures in SEC filings argue that investors might positively perceive a company that includes additional ESG disclosures, which could result in positive financial results for the company. ESG disclosures could help address long-term risks. Increased disclosure could also benefit firms if it results in lower cost of capital, with comparable disclosures across peer groups.

Critics argue that existing regulations already address many ESG issues, and the status quo—required disclosure when information is material; otherwise, voluntary disclosure at the firm's discretion—is appropriate. Critics further argue that mandatory reporting of ESG factors based on an inflexible standard could be time-intensive and costly for companies and may be of minimal use if it is not material or comparable with reporting by peer companies. Such critics believe companies should focus on shareholder value, and some ESG proposals would distract from that goal.

Consistency of disclosures is another area of concern. Public companies discuss ESG-related issues in the Management Discussion and Analysis (MD&A) section of their annual financial reports. Any ESG issues discussed in the MD&A section are generally not subject to an independent audit. Some studies have found that many companies report on ESG issues, but the information published by the companies is not standardized, and investors can suffer from "information overload." Inconsistent disclosure standards make it harder for investors to measure a firm's performance on ESG issues. Standardizing the disclosure requirements by industry could help investors and firms compare peer groups. In this context, some have criticized the 2010 SEC climate guidance for resulting in inadequate and inconsistent climate-related disclosures.

SEC and ESG

Since the beginning of 2021, the SEC has expanded its focus on climate- and ESG-related risks and disclosures. Agency actions in this context include the following:

- In March 2021, the agency created a Climate and ESG Task Force in the Division of Enforcement tasked with proactively identifying ESG-related misconduct.
- In March 2022, the SEC proposed rules aimed at requiring publicly traded SEC-registered firms to provide more enhanced climate risk disclosure to investors.
- In May 2022, the SEC proposed rules aimed at enhanced ESG-related disclosure by funds and investment advisers who consider ESG factors in, respectively, their investment portfolios and the advice that they give to retail and institutional investors. Also, the SEC proposed rules aimed at providing greater clarity regarding ESG-related fund names.
- In July 2022, the SEC adopted final rules rescinding earlier unimplemented rules related to proxy advisory firms, which advise institutional investors on proxy voting. According to the SEC, "The final amendments aim to avoid burdens on proxy voting advice businesses that may impair the timeliness and independence of their advice."
- In November 2022, the SEC adopted final rules aimed at enhancing the information funds report on their proxy voting, including ESG-related matters. According to the SEC, "funds can influence the outcome of a wide variety of matters that companies submit to a shareholder vote, including matters related to governance, corporate actions, and shareholder proposals." The SEC intends for the reform to make funds' proxy voting disclosures more usable and easier to analyze, making it easier for investors to monitor fund voting and comparing voting across funds.

As discussed earlier, without a clear definition of what constitutes ESG, some of the adopted rules might be difficult to measure and enforce.

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