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Markets or Regulators: Who Decides on ESG?

COMMENTARY By Max M. Schanzenbach and Robert H. Sitkoff Oct. 20, 2022 4:00 am ET

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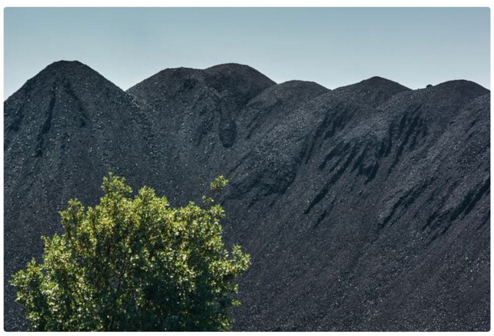

Coal piles at the Phola coal processing plant in South Africa. A more disciplined way of thinking about environmental, social, and governance issues would be to recognize that different contexts have different legal and policy considerations.
Waldo Swiegers/Bloomberg

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The current discourse on environmental, social, and governance investing yields two irresistible conclusions. The first is that fiduciary duty prohibits ESG investing. The second is that fiduciary duty mandates ESG investing. Wait, what? The situation is confusing, to say the least.

Regulators are partly to blame. The Department of Labor under President Trump all but said that ESG investing violates fiduciary duty before backtracking in its final rule. President Biden's Department of Labor has all but said that fiduciary duty requires ESG investing, though its final rule is still pending.

Some of the confusion is also semantic. "ESG investing" references two very different concepts. The first is that using ESG factors can improve risk-adjusted returns. The second is that ESG investing can save the world by starving "bad" firms of capital, providing collateral benefits to third parties. This second understanding of ESG is a rebranding of the older concept of "socially responsible investing."

Confusion and regulatory whipsaw are not good for financial markets or investors. Much is at stake, in particular the management of nearly $40 trillion in retirement savings. A more disciplined way of thinking about ESG issues would be to recognize that different contexts have different legal and policy considerations.

Let's take a simple example. Suppose Chevron declines to invest in a shale oilfield on the grounds that, though likely to be profitable, the oilfield would be especially polluting. How should we assess that decision by Chevron 's directors and, separately, the ensuing decisions by mutual funds and pension fiduciaries to buy or sell Chevron shares?

Whether a company can put ESG (or other) goals ahead of profits is a question of state corporate law. In general, directors run a legal risk if they openly subordinate profits. But if the directors can point to a connection between corporate policy and shareholder value, such as managing litigation or reputation risk, their decision will likely pass muster. The policy calculus behind this deferential treatment is that courts will do a poor job of second guessing ordinary corporate decisions, and that capital markets will better discipline directors. But efficient capital markets require honest disclosure of material financial information. A key question before the SEC in its current ESG rulemaking, therefore, is the extent to which ESG information is material to capital-market participants.

Now suppose Chevron decides, with appropriate disclosure, to invest in the shale oilfield. Can the "No-Shale-Oil ESG Mutual Fund" sell its Chevron shares? Yes. Indeed, if the fund promised not to hold shale oil companies, federal securities law *requires* the sale of its Chevron shares. Here, the public policy is one of truth-in-labeling, not dictating objectives. Individuals investing their own money are free to do so however and for whatever reason they desire. The role of the law is to enforce the promises made about the nature of those investments. Regulators could clarify by requiring ESG funds to disclose their objectives, in their name or elsewhere. One might be labeled a "risk-return ESG" fund versus a "social benefits/impact" fund.

Which brings us to the $40 trillion question. Could a pension fund *fiduciary*, investing other people's money, buy, sell, or vote Chevron shares on collateral-benefits ESG grounds, such as reducing pollution, distinct from risk and return? Under the federal Employee Retirement Income Security Act, the answer is a clear "no," backed by Supreme Court precedent and long-standing regulatory guidance.

The policy for captive retirement investors with tax-subsidized accounts is paternalistic toward one objective: the financial well-being of the worker in retirement. Once the worker receives a distribution, that money is theirs to spend as the worker wishes. But until then, ERISA requires the fiduciary managing the worker's retirement savings to consider only expected risk and return. Thus, a mutual fund that uses ESG factors to assess financial risk and return can be a permissible investment for an ERISA fiduciary, but a fund that uses ESG factors to advance collateral benefits is not.

Could a pension fiduciary pursue collateral benefits ESG while claiming a risk-and-return pretext? Such opportunities are limited. Unlike in corporate law, the duty of care for a fiduciary investor has teeth. A fiduciary investor must have a documented, reasonable analysis to justify its decisions, and it must prudently monitor and update its investment program. A fiduciary cannot continue indefinitely with a persistently underperforming ESG (or any other) fund.

ERISA prohibits investing for social impact, but gives ESG investing for risk and return as wide a lane as any other investment strategy for profit. Within that lane, the market rather than government should sort winners and losers. A governmental push for or against ESG investing will create regulatory uncertainty while variously freezing in place strategies that may stop working or freezing out strategies that may be beneficial. Fiduciary law has eschewed this approach, accommodating financial innovation subject to general fiduciary standards.

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