SEVEN MYTHS OF ESG

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INTRODUCTION

The trend to incorporate Environmental, Social, and Governance (ESG) matters into corporate boardrooms and capital markets is pervasive. Corporate executives tout their dedication to social and environmental initiatives. The Business Roundtable has broadened its statement of corporate purpose to include heightened commitment to stakeholder interests (see Exhibit 1).[1] Significant capital flows have been made into ESG and sustainability stock and bond funds.[2] Institutional investors, including major passive index and exchange-traded fund managers, have agitated for their portfolio companies to increase social and environmental commitments.[3] And stock exchanges and regulators are compelling companies to do more and disclose more information about their stakeholder initiatives.[4]

Despite this movement, considerable uncertainty exists over what ESG is, how it should be implemented, and its financial and nonfinancial impacts on corporate outcomes and fund performance. We explore seven commonly accepted myths surrounding ESG, many of which are not supported by empirical evidence. A greater understanding of the limits and uncertainties of ESG will allow corporations, investors, and regulators to take a more thoughtful approach to incorporating stakeholder objectives into the corporate planning process.

MYTH #1: WE AGREE ON THE PURPOSE OF ESG

Despite the near universal push for ESG, consensus does not exist about the problem ESG is expected to solve.[5]

To some, ESG is fundamentally a time-horizon problem. Under this theory, capital markets are short-term oriented.[6] The market rewards companies that meet quarterly earnings estimates and punishes those that miss them. Managers who are compensated largely through equity awards focus too much on achieving quarterly earnings targets to boost the value of their awards and not enough on long-term investment to support the profitability of companies over time.[7]

This view is effectively a "grow the pie" argument, and ESG investment is offered as a solution that reduces long-term risk, thereby leading to future profits that are larger and more sustainable.[8] For example, companies that invest in employees are expected to end up saving in the long term through higher satisfaction, lower turnover, and higher productivity; companies that invest in the sustainability of their supply chains will exhibit greater resiliency during periods of market disruption; and companies that properly mitigate wastewater, air pollution, and carbon emissions will face lower future remediation costs.

The time-horizon argument for ESG has been advanced by prominent lawyer Martin Lipton of Wachtell, Lipton, Rosen & Katz:

> *The economic impact of a short-term myopic approach to managing and investing in businesses has become abundantly clear and has been generating rising levels of concern across a broad spectrum of stakeholders.*[9]

It has also been espoused by institutional investors, such as Vanguard…

> *By taking a broader, more complete view of corporate purpose, boards can focus on creating long-term value, better serving everyone—investors, employees, communities, suppliers, and customers.*[10]

… and by CEOs, such as that of Progressive:

> *CEOs work to generate profits and return value to shareholders, but the best-run companies do more. They put the customer first and invest in their employees and communities. In the end, it's the most promising way to build long-term value.*[11]

An alternative viewpoint is that capitalism in itself does not advance the needs of stakeholders, and that corporate focus on shareholder returns causes harm to non-investor constituents. According to this viewpoint, corporate profitability and stakeholder betterment work in opposition to one another, shareholder maximization leads to reduced welfare for others (evidenced through income inequality, environmental damage, etc.), and the solution is to find an equitable balance between investor and societal interests.[12]

This is a "sharing the pie" argument, and the solution is a more inclusive form of capitalism in which investment is voluntarily redirected away from investors and toward stakeholders.

A third viewpoint, held by many investors and members of the public, is that ESG is synonymous with corporate responsibility.[13] Under this viewpoint, corporations should exclude socially or environmentally undesirable practices or promote positive practices because it is the right thing to do. This viewpoint sidesteps the economic implications of the decision and is essentially a normative (values-based) argument.[14] To those who hold this belief, ESG effectively represents a revival of the historical push for Corporate Social Responsibility (CSR) and Socially Responsible Investing (SRI) seen in previous decades. The solution is to inject social consciousness into both corporate and individual investment decisions.

The distinction between these viewpoints is very important because without agreement on the fundamental problem that ESG is addressing, corporations, investors, and stakeholders will not be able to agree on what ESG activities to pursue, how much to invest in them, and what outcomes to expect.[15]

MYTH #2: ESG IS VALUE-INCREASING

A second myth, and one closely related to the first, is that ESG improves outcomes for shareholders and stakeholders (so-called "doing well by doing good"). Despite widespread claims to this effect, the evidence is extremely mixed and very dependent on the setting.

Margolis, Elfenbein, and Walsh (2009) conduct a meta-analysis of 35 years of research on corporate social responsibility and find no meaningful improvement in performance.[16] Similarly, Kitzmueller and Shimshack (2012) conduct a literature review and conclude that corporate social responsibility is not associated with improved performance.[17] Manchiraju and Rajgopal (2017) show that a law in India requiring corporate social responsibility investment among large corporations was value-destroying.[18]

Research on the investment returns of sustainability and ESG funds reaches similar conclusions. Atz, Liu, Bruno, and Van Holt (2021) provide a literature review of over 1,100 primary peer-reviewed papers and 27 meta-analyses and find that "the financial performance of ESG investing has on average been indistinguishable from conventional investing."[19,20] Berk and van Binsbergen (2021) show that divestment policies (the practice of institutional investors selling or avoiding assets that are not deemed to be ESG friendly) has little impact on the financial performance of those companies or their cost of capital.[21]

Similarly, the corporate managers responsible for directing ESG investment are divided over its financial impact. A 2019 survey of more than 200 CEOs and CFOs of S&P 1500 companies finds that a nearly equal percentage of executives believes ESG investment produces net long-term *benefits* for the company (45 percent) as believes ESG investment produces net long-term *costs* (42 percent). Interestingly, the results are even more scattered when short- and long-term impacts are combined. In this case, only 12 percent believe addressing stakeholder interests involves a short-term cost (upfront investment) in order to generate long-term value.[22] Instead, most managers believe either that investing in ESG activities requires both short- and long-term costs (37 percent), or that investing in these activities generates both immediate and long-term benefits (28 percent—see Exhibit 2).[23]

In summary, we do not know the financial impact of ESG.

MYTH #3: WE CAN TELL WHETHER A CLAIMED ESG ACTIVITY IS ACTUALLY ESG

The challenge of assessing the impact of ESG is complicated by the fact that we cannot always tell whether an initiative is truly ESG. Corporations promote their public initiatives to demonstrate a commitment to social and environmental causes.[24] However, many initiatives are closely aligned with the company's existing business model and are indistinguishable from standard business decisions to maximize shareholder value by mitigating operating risk. Are the following ESG?

- *Coca-Cola*. In 2021, Coke announced the production of plastic bottles made from 100 percent recycled materials. "Given our scale and resources, we realize our unique opportunity and clear responsibility to make a positive difference in the global plastic crisis."[25] The initiative was announced months after Coke was named the world's largest plastic polluter by a nonprofit advocacy group.[26] Coca-Cola launched its first recycling program for glass bottles and aluminum cans in the 1970s and its current "World Without Waste" plastic recycling initiative in 2018.[27]
- *Bank of America*. In 2021, Bank of America announced a $1.25 billion initiative to advance racial equality and economic opportunity through investment in health, job training, affordable housing, and small business over a five-year period.[28] Like other federally chartered U.S. banks, Bank of America is required under the Community Reinvestment Act to serve low- and moderate-income communities in which it operates.[29] Is Bank of America spending an incremental $1.5 billion that would otherwise fall to the bottom line, or is the company recategorizing regular, ongoing spending activities as socially responsible investment?

Examples such as these highlight the grey area where companies brand initiatives as "ESG" when it is not clear what new activity, if any, they are engaging in beyond what they would have done anyways (the counterfactual—see Exhibit 3).[30]

A more extreme form of misrepresenting ESG efforts is "greenwashing." Greenwashing is the practice of overstating ESG to the point of falsification. A corporation engages in greenwashing when it promotes a new product as more environmentally friendly than previous products when it is not.[31] On the investment side, a fund manager engages in greenwashing when it advertises its investment funds as sustainable without engaging in a rigorous process to evaluate ESG quality.[32] A deep body of research demonstrates the economic damage of greenwashing.[33] Recent events suggest that securities regulators and shareholder groups will become more aggressive in challenging ESG claims.[34]

MYTH #4: A COMPANY'S ESG AGENDA IS WELL-DEFINED AND BOARD-DRIVEN

A fourth myth is that companies have a rigorous, well-defined ESG framework driven by the board and management.

In theory, a company's ESG agenda is identified following a broad evaluation of the company's business activities, the identification of relevant stakeholders and their interests in relation to the business, and a categorization of risk and opportunities associated with each. Investment opportunities are evaluated in terms of their impact on strategy, operations, and risk and, once approved, are tracked to assess their effectiveness. Survey data, however, shows this is not the case.

A 2021 survey of corporate directors conducted by PricewaterhouseCoopers finds that only two-thirds (64 percent) say that ESG is linked to their corporate strategy. Only a quarter (25 percent) say their board understands ESG risk very well.[35] A study by Diligent has similar findings: Over half (58 percent) of directors and executives have little or no confidence in their ESG programs. Many do not have a formally documented ESG framework (46 percent), do not track ESG metrics (57 percent), nor do they have the data systems to do so (61 percent).[36] A study by Willis Towers Watson finds that, while half of S&P 500 companies include ESG-related metrics in their annual bonus programs, only 4 percent tie the value of long-term awards, where the bulk of CEO wealth is generated, to the achievement of ESG objectives.[37]

Instead, most companies appear to develop ESG priorities and investment in reaction to internal and external pressure. A study by the Rock Center for Corporate Governance at Stanford University finds that companies are highly reactive to advocacy by a range of constituents and most respond to social and environmental pressure by taking some form of action (see Exhibit 4).[38]

In the absence of a rigorous ESG framework, organizations risk being pulled into unexpected directions that weaken both ESG and corporate performance ("ESG drift"). The boundaries of the company's ESG agenda need not necessarily be broad or narrow; the important thing from a governance perspective is that they be well-defined in order to guide decision making.[39]

MYTH #5: G (GOVERNANCE) BELONGS IN ESG

A puzzling aspect of ESG is why governance is included as a third pillar, alongside the environment and social issues.

Governance is a system of checks and balances to ensure that corporate managers make decisions in the interest of the corporation. The theory underpinning a need for governance is that managers are self-interested, and without the proper incentives and controls in place, managers will have a tendency to make decisions to further their own interests, even when this conflicts with the interests of the organization. To counteract this tendency, a series of control mechanisms are put in place, including an independent board of directors to advise and monitor executives, internal controls to ensure financial reporting integrity, and compensation incentives that reward executives for achieving corporate objectives.[40]

The need for a governance system and the measurement of that system's quality are largely independent of the company's ESG agenda and independent of which non-shareholder stakeholders, if any, it chooses to prioritize. A company can have good governance quality and be strictly focused on shareholder maximization. Alternatively, a company can have good governance quality and adopt a stakeholder-centric view that balances profit with other societal objectives.

ESG advocates describe the "G" in ESG as involving board quality, appropriate compensation, accountability to ownership, and ethical business practices.[41] While these are required of a company that pursues ESG, they are also required of companies that place little or no emphasis on ESG. The need for governance quality is universal among organizations.

MYTH #6: ESG RATINGS ACCURATELY MEASURE ESG QUALITY

Despite perception to the contrary, ESG ratings developed by third-party agencies have only a weak (if any) association with corporate outcomes such as performance, risk or, failure thought to be indicative of ESG quality. Reliable ratings are important to markets. Fund managers market sustainability stock and bond

funds, investors make ESG investment decisions, and executives demonstrate ESG quality all in part through ratings developed by outside providers, such as MSCI, Sustainalytics, Refinitiv, and others.[42]

Unfortunately, the ratings assigned by these providers have an unproven correlation with performance and are also not correlated with one another. This is highly problematic, because in theory independent agencies seeking to measure corporate attributes in a rigorous (trustworthy) manner should converge in methodology and conclusions.[43] This is not the case for ESG ratings. Chatterji, Durand, and Touboul (2016) examine the ratings of six providers and find "a surprising lack of agreement," which the authors cannot explain by adjusting explicit differences in methodology. They conclude that ESG ratings have low validity.[44] Berg, Koelbel, and Rigobon (2019) find significant differences in both scope (the criteria used to evaluate ESG) and measurement (the metrics used to determine ESG). They conclude "raters disagree both on the extent of the definition of ESG, as much as they disagree on how the various aspects of ESG are measured."[45]

Dimson, Marsh, and Staunton (2020) study the ratings of three prominent ESG providers—MSCI, Sustainalytics, and FTSE Russell. They show that the correlation of aggregate scores (overall ESG ratings) and component scores (environment, social, and governance separately) are extremely low. They show these firms' methodologies differ in most every relevant aspect: input metrics, how metrics are evaluated relative to peers and the industry, how missing data is treated, and the treatment of specific companies (see Exhibit 5).[46]

A look at the methodology these firms use illustrates the challenge of developing reliable ESG metrics. MSCI, as an example, uses a framework that grades firms based on 35 high-level environmental, social, and governance dimensions, such as the following:

- *Environmental*. Carbon emissions, raw material sourcing, packaging material and waste, and renewable energy.
- *Social*. Human capital development, supply chain labor standards, product safety and quality, privacy data and security, and community relations.
- *Governance*. Board, pay, business ethics, and accounting (see Exhibit 6).[47]

The number of input variables is daunting. Rigorous measurement of each dimension constitutes a significant research challenge. Measuring all of them accurately and combining them into an overall composite ESG score that is predictive of outcomes is likely not possible.[48]

MYTH #7: MANDATORY DISCLOSURE WILL SOLVE THE PROBLEM

A final myth is that more disclosure will solve the problem market participants face in assessing ESG quality.[49] While disclosure is critically important to the proper functioning of capital markets, informative ESG disclosure will be difficult to produce in a cost-effective manner.[50]

Companies are currently required to disclose much of the information material to an informed investment decision, and an elaborate set of reporting standards have been developed to capture, organize, and report financial and nonfinancial information. In addition, internal control systems have been developed to test the accuracy of this information. Almost two decades following the passage of the Sarbanes-Oxley Act, which mandated many of these financial reporting and internal control standards, the cost-effectiveness of the act is still unclear.[51]

ESG disclosure would require a massive expansion of this information to include environmental and social metrics across dozens of dimensions. These would have to be standardized and audited by independent parties across companies and industries.[52] Regulators would have to weigh the tradeoff between informative disclosure of sensitive areas (such as human capital management, supply chain practices, and product safety) and the protection of proprietary information. Implementation would require a large investment in staff, advisors, and internal and external auditors to track and verify this information.[53] And companies in diverse industries no doubt would have trouble standardizing their reporting to specific metrics whose applicability to their circumstances varies.

While the output of this effort might increase information quality at the margin, the cost of doing so will not be trivial. To this end, Christensen, Hail, and Luez (2021) provide a literature review of corporate social responsibility disclosure and find that increased disclosure can benefit markets through greater liquidity and lower cost of capital but also can harm companies through the release of public information and exposure to litigation. They conclude that mandatory CSR reporting standards have the potential to improve information to investors and stakeholders, but the net effect is not "a priori obvious."[54]

WHY THIS MATTERS

1. The trend to incorporate ESG into corporate and institutional decision-making is pervasive. Still, little consensus exists about what ESG is and the problem ESG investment is expected to solve. Is ESG fundamentally a time-horizon problem whereby companies are too short-term oriented, or does it reflect a deeper problem of corporations profiting at the expense of

stakeholders or not adequately supporting them? How can companies decide which stakeholders to invest in, how much to invest, and how successful these initiatives are without first understanding what ESG is expected to accomplish?

2. Many ESG advocates promote the "win-win" nature of ESG and its benefits to both shareholders and stakeholders. Rigorous empirical research, however, does not show a definitive association between ESG and performance. Does ESG increase corporate value, or does it represent an incremental cost incurred for the betterment of society? If ESG is value increasing, wouldn't corporate managers already voluntarily be making this type of investment?
3. Many large companies promote their ESG initiatives to investors and the public. How much of this represents new (incremental) investment, and how much does it reflect longstanding investment that companies are now repackaging and rebranding as ESG? How much of this investment is simply an attempt to appease ESG activists via greenwashing?
4. Despite being named as the third pillar of ESG, governance is quite different than environmental and social activities. A governance system is implemented to ensure alignment between managerial decisions and corporate objectives, without regard to whether these objectives are shareholder- or stakeholder-centric. Why is governance included in ESG?
5. ESG ratings developed by independent third-party commercial firms have yet to show useful correlations with future performance. They are also not correlated across providers. A look at the input variables ESG ratings firms consider demonstrates the sheer challenge of combining unrelated social, environmental, and governance attributes into a rating that is relevant and predictive. Is it even possible to develop a reliable measure of ESG quality? Would mandatory disclosure help? Can standardized ESG reporting be done in a cost-effective manner? ■

[1] Business Roundtable, "Business Roundtable Redefines the Purpose of a Corporation to Promote 'An Economy That Serves All Americans,'" press release (August 19, 2019), available at: https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans.

[2] According to US SIF Foundation, capital flows into ESG and sustainable investment funds have increased from $1 trillion in 1998 to $15 trillion in 2020. See US SIF Foundation, "Report on US Sustainable and Impact Investing Trends," (2020).

[3] For example, Larry Fink, CEO of BlackRock pens an annual letter to the CEOs of all of BlackRock's portfolio companies advocating greater to commitment to stakeholder concerns. Vanguard takes an activist stance when it perceives a material ESG risk among portfolio companies. And State Street actively uses the voting power derived from its exchanged-traded funds to advocate for increased gender diversity in the boardrooms of over 3,500 corporations in its portfolio. See BlackRock, "Larry Fink's Letters to CEOs," available at: https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter; Vanguard, "Principles and Policies: Responsible Investing Policy," available at: https://about.vanguard.com/investment-stewardship/principles-policies/; and State Street Global Advisors, "Asset Stewardship," available at: https://www.ssga.com/us/en/intermediary/etfs/capabilities/esg/asset-stewardship.

[4] In 2020, California passed a law requiring the boards of publicly traded companies headquartered in the state have at least one director on their board from an underrepresented community (based, essentially, or racial diversity or sexual orientation). That same year, NASDAQ revised its public listing standards to require listed companies to either have, or explain why they do not have, at least two diverse directors on their boards. The Securities and Exchange Commission is developing expanded climate and human capital disclosure requirements for all publicly traded companies. See David A. Bell, Dawn Belt, and Jennifer J. Hitchcock, "New Law Requires Diversity on Boards of California-Based Companies," *Harvard Law School Forum on Corporate Governance* (October 10, 2020), available at: https://corpgov.law.harvard.edu/2020/10/10/new-law-requires-diversity-on-boards-of-california-based-companies/; NASDAQ, "Nasdaq to Advance Diversity through New Proposed Listing Requirements," press release (December 1, 2020), available at: https://www.nasdaq.com/press-release/nasdaq-to-advance-diversity-through-new-proposed-listing-requirements-2020-12-01; and Securities and Exchange Commission, "SEC Response to Climate and ESG Risks and Opportunities," available at: https://www.sec.gov/sec-response-climate-and-esg-risks-and-opportunities.

[5] To this end, a survey of over 436 mostly small- and mid-sized companies finds that only 8 percent say that ESG encompasses a generally understood set of issues and can be easily defined by regulators; 61 percent say it is a subjective term that means different things to different companies and is difficult to define by regulators. See "Climate Change and ESG Reporting from the Public Company Perspective," sponsored by The U.S. Chamber of Commerce's Center for Capital Markets Competitiveness (CCMC), Nasdaq, NAREIT, The Real Estate Roundtable, National Investor Relations Institute, TechNet, BIO, and Silicon Valley Leadership Group (2021).

[6] Unfortunately, empirical evidence does not clearly support this claim. Denis (2019) reviews research evidence on shareholder investment horizon, shareholder activism, corporate investment, and shareholder reaction to corporate investment over a three-decade period and concludes that "there is little systematic evidence to suggest that short-termism is a pervasive problem plaguing U.S. companies." See David J. Denis, "Is Managerial Myopia a Persistent Governance Problem?" *Journal of Applied Corporate Finance* (2019).

[7] An important assumption to this argument is that shareholders do not recognize the financial damage caused by underinvestment in the company.

[8] This argument is advanced by Alex Edmans in his book *Grow the Pie*. Edmans argues companies that move away from an exclusive objective of growing economic value are freed up to make more or more efficient investment, which ultimately grows economic value. This result can be achieved by reorienting incentives toward long-term objectives, engaging major shareholders to adopt a stewardship mindset toward their investment, and restraining certain investment away from

destructive (low return, or value destroying activity) so that additional capital is available to create value in other areas of society. See Alex Edmans, *Grow the Pie: How Great Companies Deliver Both Purpose and Profit*, (Cambridge University Press, 2020).

[9] Martin Lipton, Steven A. Rosenblum, Sabastian V. Niles, Sara J. Lewis, and Kisho Watanabe, in collaboration with Michael Drexler, "The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth," World Economic Forum (September 2016).

[10] Business Roundtable, "Business Roundtable Redefines the Purpose of a Corporation to Promote 'An Economy That Serves All Americans,'" op cit.

[11] Ibid.

[12] See Andrew C. Baker, David F. Larcker, and Brian Tayan, "Environmental Spinoffs: The Attempt to Dump Liability Through Spin and Bankruptcy," Stanford Closer Look Series (2020).

[13] This view is demonstrated through a 2021 survey by Broadridge which shows retail investors—particularly millennials aged 25-40—view investing as a process of expressing environmental and social preferences. See Broadridge, "From the Retail Trading Frenzy to Growing ESG Trends, What Will be in Proxy Season 2021?" press release (May 3, 2021), available at: https://www.prnewswire.com/news-releases/from-the-retail-trading-frenzy-to-growing-esg-trends-what-will-be-in-proxy-season-2021-301281582.html.

[14] Research shows that many investors invest in sustainability funds for their societal benefits, even when knowing these investments are value reducing. See Patrick R. Martin and Donald V. Moser, "Managers' Green Investment Disclosures and Investors' Reaction," *Journal of Accounting and Economics* (2016); Arno Riedl and Paul Smeets, "Why Do Investors Hold Socially Responsible Mutual Funds?" *The Journal of Finance* (2017); Samuel M. Hartzmark and Abigail B. Sussman, "Do Investors Value Sustainability? A Natural Experiment Examining Ranking and Fund Flows," *Journal of Finance* (2019); and Rob Bauer, Tobias Ruof, and Paul Smeets, "Get Real! Individuals Prefer More Sustainable Investments," *The Review of Financial Studies* (2021).

[15] See Alex Edmans, Luca Enriques, Jesse Fried, Mark J. Roe and Steen Thomsen, "A Call for Reflection on Sustainable Corporate Governance," *The CLS Blue Sky Blog (Columbia Law School)* (April 29, 2021).

[16] Joshua D. Margolis, Hillary Anger Elfenbein, and James P. Walsh, "Does it Pay to Be Good...And Does it Matter? A Meta-Analysis of the Relationship between Corporate Social and Financial Performance," *Social Science Research Network* (March 1, 2009), available at: https://ssrn.com/abstract=1866371.

[17] Markus Kitzmueller and Jay Shimshack, "Economic Perspectives on Corporate Social Responsibility," *Journal of Economic Literature* (2012).

[18] Hariom Manchiraju and Shivaram Rajgopal, "Does Corporate Social Responsibility (CSR) Create Shareholder Value? Evidence from the Indian Companies Act 2013," *Journal of Accounting Research* (2017).

[19] The papers reviewed were originally published in the 2015 to 2020 period. See Ulrich Atz, Zongyuan (Zoe) Liu, Christopher C. Bruno, and Tracy Van Holt, "Does Sustainability Generate Better Financial Performance? Review, Meta-analysis, and Propositions," *Social Science Research Network* (September 9, 2021), available at: https://ssrn.com/abstract=3708495.

[20] The challenge for ESG fund managers is complicated by the fact that elements within ESG might have different return characteristics. For example, investments in human capital might increase employee productivity and satisfaction, thereby leading to higher economic returns. On the other hand, investments in "green" securities or the avoidance of sin stocks might require accepting lowering returns. Pedersen, Fitzgibbons, and Pomorski (2021) show that ESG can affect performance through different channels (e.g., cash flows versus non-pecuniary preferences), which may predict performance in opposite directions. See Lasse Heje Pedersen, Shaun Fitzgibbons, and Lukasz Pomorski, "Responsible Investing: The ESG-Efficient Frontier," *Journal of Financial Economics* (2021).

[21] The authors argue that investors interested in improving the ESG characteristics of so-called "dirty" companies would achieve better outcomes if they instead retained their investments and used their voting rights to encourage improvements in ESG policies. See Jonathan Berk and Jules H. van Binsbergen, "The Impact of Impact Investing," *Social Science Research Network* (2021), available at: https://ssrn.com/abstract=3909166.

[22] This finding contradicts the standard narrative that companies do not invest in ESG activities because they are unwilling to incur a temporary hit to profitability.

[23] Rock Center for Corporate Governance at Stanford University, "2019 Survey on Shareholder versus Stakeholder Interests," (June 2019). See also David F. Larcker, Brian Tayan, Vinay Trivedi, and Owen Wurzbacher, "Stakeholders and Shareholders: Are Executives Really 'Penny Wise and Pound Foolish' about ESG?" Stanford Closer Look Series (July 2, 2019).

[24] It is almost certainly the case that companies promote their positive ESG attributes while burying their negative attributes. ESG ratings developed by third-party rating agencies rely heavily on this selective disclosure.

[25] The Coca-Cola Company, "The Coca-Cola Company Introduces Bottles Made from 100% Recycled Materials in the United States," press release (February 9, 2021).

[26] Break Free From Plastic, "Branded, Vol. III: Demanding Corporate Accountability for Plastic Pollution," (2020).

[27] Bartow J. Elmore, "The American Beverage Industry and the Development of Curbside Recycling Programs, 1950–2000," *Business History Review* (November 30, 2012); The Coca-Cola Company, "The Coca-Cola Company Announces New Global Vision to Help Create a World Without Waste," *Business Wire* (January 19, 2018).

[28] Bank of America, "Bank of America Increases Commitment to Advance Racial Equality and Economic Opportunity to $1.25 Billion," press release (March 30, 2021).

[29] Office of the Comptroller of the Currency, "Community Reinvestment Act: Fact Sheet," (March 2014), available at: https://www.occ.gov/publications-and-resources/publications/community-affairs/community-developments-fact-sheets/pub-fact-sheet-cra-reinvestment-act-mar-2014.pdf.

[30] For a corporate perspective on overstating ESG claims, see Kenneth P. Pucker, "Overselling Sustainability Reporting," *Harvard Business Review* (May-June 2021).

[31] For example, Starbucks was accused of greenwashing when it introduced a more environmentally straw-less lid that actually used more plastic than the combined straw and lid that it was designed to replace. See Deena Robinson, "10 Companies and Corporations Called out for Greenwashing," Earth.org (August 2, 2021).

[32] For example, U.S. investigators are investigating Deutsche Bank for overstating the ESG criteria of its sustainability funds. Europe has been advancing rules to rein in greenwashing in the investment management industry. See Patricia Kowsmann, Corinne Ramey and Dave Michaels, "U.S. Authorities Probing Deutsche Bank's DWS Over Sustainability Claims," *The Wall Street Journal* (August 25, 2021); and Attracta Mooney, "Greenwashing in Finance: Europe's Push to Police ESG Investing," *The*

Financial Times (March 10, 2021).

[33] See Söhnke M. Bartram, Kewei Hou, and Sehoon Kim, "Real Effects of Climate Policy: Financial Constraints and Spillovers," *Journal of Financial Economics* (2021); Itzhak Ben-David, Yeejin Jang, Stefanie Kleimeier, and Michael Viehs, "Exporting Pollution: Where Do Multinational Firms Emit CO2?" *Social Science Research Network* (November 2020).

[34] For example, in 2021 the Securities and Exchange Commission convened a task force to investigate "ESG-related misconduct, including "material gaps or misstatements" by companies and "disclosure and compliance issues" related to investment advisers' published strategies. As an example of shareholder litigation, Facebook was sued by shareholders in 2018 for making false and misleading statements about its diversity efforts. The plaintiff alleged the company's public statements about its diversity programs were not consistent with its internal policies and practices for hiring and promotion. Although the lawsuit was dismissed, it is likely that companies will continue to be pressured to demonstrate that their internal policies and actions are consistent with public statements about ESG. See U.S. Securities and Exchange Commission, "SEC Announces Enforcement Task Force Focused on Climate and ESG Issues," press release (March 4, 2021); and "Facebook Defeats Shareholder Suit Challenging Alleged Failures in Its Diversity and Inclusion Practices," *The National Law Review* (April 9, 2021).

[35] PricewaterhouseCoopers, "2021 Annual Corporate Directors Survey," (2021).

[36] OECG and Diligent, "ESG Planning and Performance Survey," (2021).

[37] Furthermore, ESG metrics in the annual incentive program tend to be ones that have long been in use (such as employee safety, employee development, customer service, etc.). Even though researchers categorize them as ESG, it is not clear that they were added explicitly with ESG objectives in mind. See Robert Newbury and Don Delves, "New Research Finds Progress on the Use of ESG Incentive Metrics," Willis Towers Watson (March 27, 2020).

[38] Michael J. Callahan, David F. Larcker, and Brian Tayan, "The General Counsel View of ESG Risk," Stanford Closer Look Series (September 14, 2021).

[39] An example of a company with a narrowly defined ESG agenda is Coinbase. An example of a company with a broad but well-defined ESG framework is Australian mining company BHP. See Stephen A. Miles, David F. Larcker, and Brian Tayan, "Protests from Within: Engaging with Employee Activists," Stanford Closer Look Series (March 8, 2021).

[40] For a thorough review of corporate governance, see David F. Larcker and Brian Tayan, *Corporate Governance Matters: A Closer Look at Organizational Choices and Their Consequences*, 3rd Edition (New York: Pearson, 2020).

[41] MSCI Key Issue Framework (as of October 18, 2021), available at: https://www.msci.com/our-solutions/esg-investing/esg-ratings/esg-ratings-key-issue-framework.

[42] Companies also advertise their placement on prominent media lists that rank the "best" companies in various social and environmental categories. Examples include *Bloomberg* Gender-Equality Index, *Corporate Responsibility* Best Corporate Citizens, *Fortune* Best Workplaces for Diversity, and *Newsweek* Green. Although perhaps moderately informative among subsets of companies, reliable media indices are likely to be less important for the functioning of markets.

[43] For example, the major credit rating agencies—Moody's, Standard & Poor's, and Fitch—rely on similar methodologies to produce credit ratings that are correlated and generally predictive of credit quality.

[44] Aaron K. Chatterji, Rodolphe Durand, David I. Levine, and Samuel Touboul, "Do Ratings of Firms Converge? Implications for Managers, Investors and Strategy Researchers," *Strategic Management* (August 2016).

[45] Florian Berg, Julian F. Koelbel, and Roberto Rigobon, "Aggregate Confusion: The Divergence of ESG Ratings," *Social Science Research Network* (August 17, 2019), available at: https://ssrn.com/abstract=3438533.

[46] Elroy Dimson, Paul Marsh, and Mike Staunton, "Divergent ESG Ratings," *The Journal of Portfolio Management* (November 2020).

[47] MSCI Key Issue Framework, op. cit.

[48] For example, a decade ago commercial governance ratings firms invested significant dollars into developing indices to measure governance quality—one of the three pillars in ESG. Many of these firms left the market because their ratings failed to predict outcomes of interest, such as performance, likelihood of failure, and adverse outcomes including lawsuits, fraud, or bankruptcy. Combining a reliable governance rating (which does not currently exist) with reliable environmental and social ratings would be a monumental challenge. For an analysis of the predictive quality of governance ratings, see Robert Daines, Ian D. Gow, and David F. Larcker, "Rating the Ratings: How Good Are Commercial Governance Ratings?" *Journal of Financial Economics* (2010).

[49] One study finds that increased ESG disclosure actually increases the ESG ratings problems and leads to a wider, rather than smaller, disparity across ratings providers. See Dane M. Christensen, George Serafeim, and Anywhere (Siko) Sikochi, "Why is Corporate Virtue in the Eye of the Beholder? The Case of ESG Ratings," *Social Science Research Network* (August 19, 2021), available at: https://ssrn.com/abstract=3793804.

[50] For a look at the challenging issue of human capital management disclosure, just one aspect of ESG, see Amit Batish, Andrew Gordon, John D. Kepler, David F. Larcker, Brian Tayan, and Courtney Yu, "Human Capital Disclosure: What Do Companies Say about Their 'Most Important Asset'?" Stanford Closer Look Series (May 2021).

[51] Maher and Weiss (2010) find the median cost of compliance with the new provisions of Sarbanes Oxley was between $1.3 million and $3.0 million annually in the four years following enactment, compared with an original estimate of $91,000 by the SEC. Bernile, Lee, and Marietta-Westberg (2013) find that, while many corporate insiders believe the act improved reporting quality, internal controls, and fraud detection, a majority do not believe the benefits outweigh the costs of compliance. Coates and Srinivasan (2014) conduct a literature review and find that the direct costs of compliance fall disproportionately on small firms. They note several indirect costs beyond these, such as decreased listings of small firms in public equity market and a decline in corporate investment. They conclude that the cost-benefit trade-off is unclear. See Michael D. Maher and Dan Weiss, "Costs of Complying with SOX—Measurement, Variation, and Investors' Anticipation," *Social Science Research Network* (October 25, 2010), available at: https://ssrn.com/abstract=1699828; Cindy R. Alexander, Scott W. Bauguess, Gennaro Bernile, Yoon-Ho Alex Lee, and Jennifer Marietta-Westberg, "Economic Effects of SOX Section 404 Compliance: A Corporate Insider Perspective," *Journal of Accounting and Economics* (2013); and John C. Coates and Suraj Srinivasan, "SOX after Ten Years: A Multidisciplinary Review," *Accounting Horizons* (2014).

[52] SEC Commissioner Elad Roisman explains, "Some of the data that has been requested is inherently imprecise, relies on underlying assumptions that continually evolve, and can be reasonably calculated in different ways. And ultimately, unless this information can meaningfully inform an investment decision, it is at best not useful and at worst misleading." See Elad L. Roisman, "Putting the Electric Cart before the Horse: Addressing Inevitable Costs of a New ESG Disclosure Regime," (June 3, 2021), available at: https://www.sec.gov/news/speech/roisman-esg-2021-06-03.

[53] The profit potential to outside providers, including investment bankers,

consultants, auditors, and ESG rating agencies is enormous. See Tim Quinson, "Banks Are Really Cashing in on ESG Bond Underwriting," *Bloomberg* (September 29, 2021); Michael O'Dwyer and Andrew Edgecliffe-Johnson, "Big Four Accounting Firms Rush to Join the ESG Bandwagon," *Financial Times* (August 30, 2021).

[54] Hans B. Christensen, Luzi Hail, and Christian Leuz, "Mandatory CSR and Sustainability Reporting: Economic Analysis and Literature Review," *Review of Accounting Studies* (2021).

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The Stanford Closer Look Series is dedicated to the memory of our colleague Nicholas Donatiello and to the retirement of our colleague Michelle E. Gutman.

The Stanford Closer Look Series is a collection of short case studies that explore topics, issues, and controversies in corporate governance and leadership. It is published by the Corporate Governance Research Initiative at the Stanford Graduate School of Business and the Rock Center for Corporate Governance at Stanford University. For more information, visit: http:/www.gsb.stanford.edu/cgri.

EXHIBIT 1 — BUSINESS ROUNDTABLE, STATEMENT ON THE PURPOSE OF THE CORPORATION (AS OF 2021)

Americans deserve an economy that allows each person to succeed through hard work and creativity and to lead a life of meaning and dignity. We believe the free-market system is the best means of generating good jobs, a strong and sustainable economy, innovation, a healthy environment and economic opportunity for all.

Businesses play a vital role in the economy by creating jobs, fostering innovation and providing essential goods and services. Businesses make and sell consumer products; manufacture equipment and vehicles; support the national defense; grow and produce food; provide health care; generate and deliver energy; and offer financial, communications and other services that underpin economic growth.

While each of our individual companies serves its own corporate purpose, we share a fundamental commitment to all of our stakeholders. We commit to:

- Delivering value to our customers. We will further the tradition of American companies leading the way in meeting or exceeding customer expectations.
- Investing in our employees. This starts with compensating them fairly and providing important benefits. It also includes supporting them through training and education that help develop new skills for a rapidly changing world. We foster diversity and inclusion, dignity and respect.
- Dealing fairly and ethically with our suppliers. We are dedicated to serving as good partners to the other companies, large and small, that help us meet our missions.
- Supporting the communities in which we work. We respect the people in our communities and protect the environment by embracing sustainable practices across our businesses.
- Generating long-term value for shareholders, who provide the capital that allows companies to invest, grow and innovate.

We are committed to transparency and effective engagement with shareholders. Each of our stakeholders is essential. We commit to deliver value to all of them, for the future success of our companies, our communities and our country.

Source: Business Roundtable, "Our Commitment," (2021). See https://opportunity.businessroundtable.org/ourcommitment/.

EXHIBIT 2 — CORPORATE MANAGER VIEWS OF THE COSTS AND BENEFITS OF ESG

WHAT IS THE FINANCIAL IMPACT TO YOUR COMPANY OF MEETING THE INTERESTS OF STAKEHOLDERS?*

		Long-term impact		
		High or moderate cost	**Little or no cost or benefit**	**High or moderate benefit**
Short-term impact	**High or moderate cost**	37%	4%	12%
	Little or no cost or benefit	5%	10%	5%
	High or moderate benefit	0%	0%	28%

* Respondents were requested to select one answer for the short-term impact and one answer for the long-term impact.

Source: Rock Center for Corporate Governance at Stanford University, "2019 Survey on Shareholders versus Stakeholder Interests," (June 2019).

EXHIBIT 3 — EXAMPLES OF ESG INITIATIVES RELATED TO CORE BUSINESS (SELECTED)

THE FOLLOWING PROGRAMS ARE INCLUDED IN EACH COMPANY'S SUSTAINABILITY REPORTS. ARE THEY "ESG"?

American Express
BUILD FINANCIAL CONFIDENCE Provide responsible, secure, and transparent products and services to help people and businesses build financial resilience. STRATEGIC OBJECTIVES • Empower individuals to build and maintain their financial well-being through products, services, tools, and education, while providing robust account security • Strengthen the financial security and money management capacity of small businesses through products, services, campaigns, and initiatives • Help build resilient communities through grants, programs, and initiatives that support economic empowerment and equity
Amgen
ACCESS TO MEDICINE AMBITION Amgen's medicines make a difference for those facing serious illnesses and we believe patients should have access to them. Together with partners and stakeholders, we are working to overcome access challenges and barriers through a multifaceted Access to Medicine approach tailored to the unique aspects of biologic medicines. STRATEGY & OBJECTIVES Our approach to access begins years before a product is approved. During all stages of drug development, a cross-functional team representing research, clinical development, commercial, medical affairs, and manufacturing works to define the potential new medicine's target profile. [...] Once a medicine is approved, we use a variety of approaches to expand and evolve our efforts to increase access to our medicines globally and assist more patients. Our approach includes responsible pricing, patient-support programs and donations, and health systems strengthening.
Nike
COMMUNITY IMPACT Quantitative Target: Invest a minimum of 1.5% of pre-tax income to drive positive impact in our communities. Community has always been at the core of who NIKE is and what we do. Our history is rooted on the trails, courts, fields, and tracks of communities all around the globe. In both flourishing and challenging times, NIKE has been a committed and active participant in the communities where we live, work, and play. FY20 was no exception. By harnessing the power of our brands, together with employee talents and passions, NIKE invested $89.8 million to drive positive changes for kids and communities around the world.

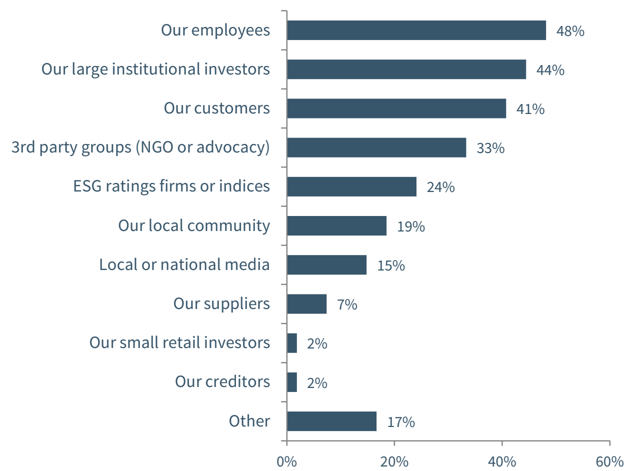
EXHIBIT 3 — CONTINUED

Verizon
INDUSTRY, INNOVATION AND INFRASTRUCTURE As a vital provider of critical network infrastructure, Verizon's primary goal has always been to keep our employees, customers and society connected to the people and resources that are important to them. The resilience of our networks reflects many years of significant investment so that we can continue to serve our customers even in times of crisis, whether it be from hurricanes, floods, wildfires or other unforeseeable events like the COVID-19 pandemic. Target 9.4: By 2030, upgrade infrastructure and retrofit industries to make them sustainable, with increased resource-use efficiency and greater adoption of clean and environmentally sound technologies and industrial processes, with all countries taking action in accordance with their respective capabilities.
The Walt Disney Company
CONTENT & PRODUCTS The Walt Disney Company and its subsidiaries are a family of creative brands and businesses, all working together to create high-quality, unparalleled stories that audiences of all ages can enjoy together. We work to create inclusive and positive content, products and experiences that are delivered in the ever-evolving ways that consumers request. [...] DIVERSITY IN CONTENT Disney's platforms and brands are united by the drive to tell powerful stories. We have the opportunity and responsibility to create authentic, unforgettable stories, experiences and products that reflect the diversity of cultures and backgrounds of our consumers and the world we live in. It's important that when people engage with Disney content and products, they see themselves and their experiences reflected in our stories. We believe purposefully championing a multitude of voices and perspectives is integral to the growth and viability of the Company and will forge an even stronger connection with our consumers.

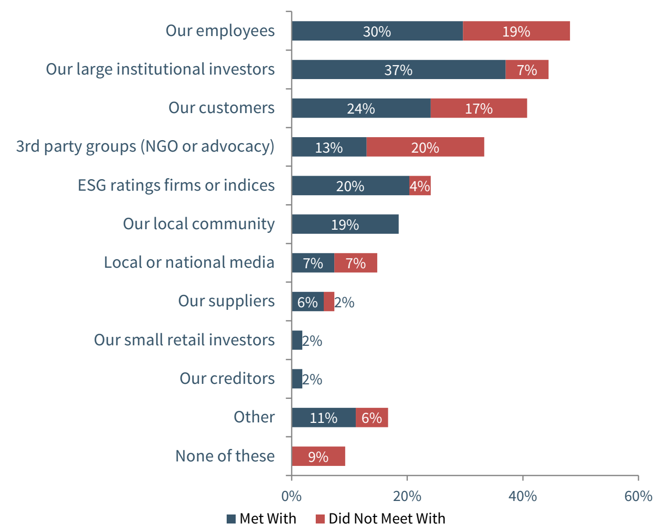
Source: Company Corporate Sustainability and ESG Reports, 2020/2021.

EXHIBIT 4 — SOURCES OF ESG PRESSURE AND CORPORATE RESPONSIVENESS

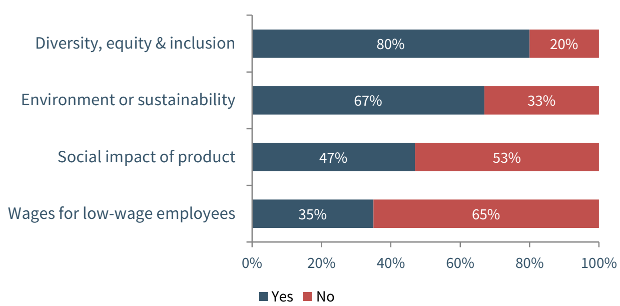
WHAT ARE YOUR PRIMARY SOURCES OF ESG PRESSURE? (SELECT ALL)



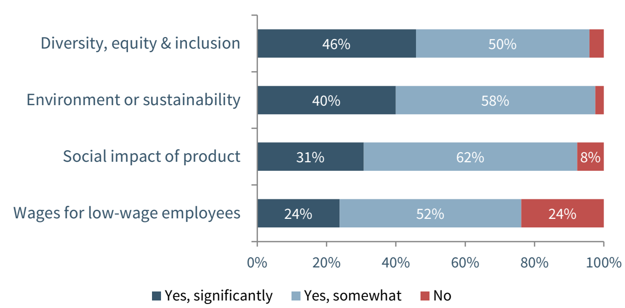
WHICH, IF ANY, OF THESE GROUPS DID SENIOR MANAGEMENT MEET WITH TO DISCUSS THEIR CONCERNS? (SELECT ALL)



IN THE PAST YEAR, DID YOU FACE PRESSURE TO INCREASE YOUR ORGANIZATIONAL OR FINANCIAL COMMITMENT TO THE FOLLOWING?



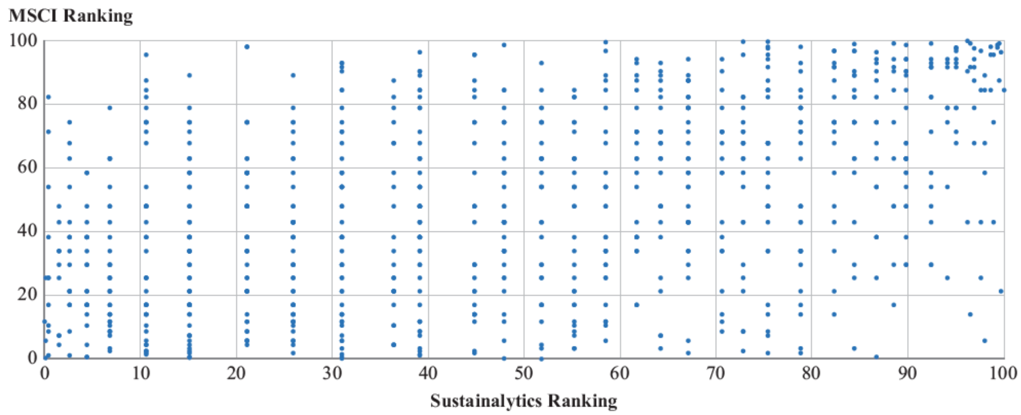
[IF YES] DID YOU?



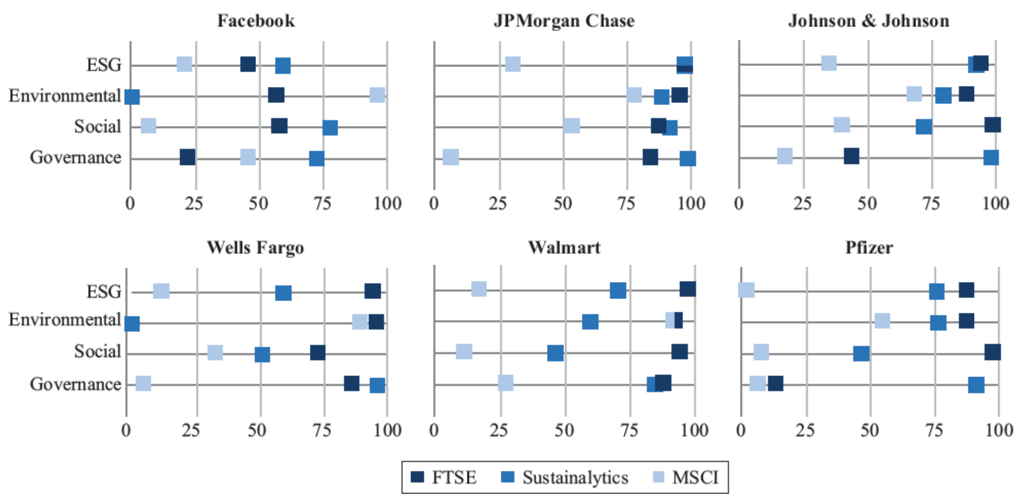
Source: Company Corporate Sustainability and ESG Reports, 2020/2021.

EXHIBIT 5 — ESG RATINGS: CORRELATIONS AND EXAMPLES ACROSS RATINGS PROVIDERS

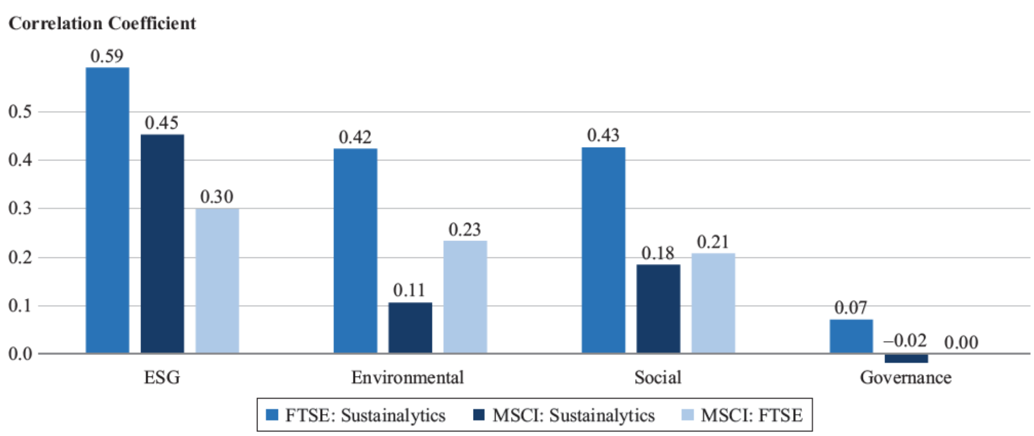
MSCI VERSUS SUSTAINALYTICS RANKINGS, 2019



DIVERGENCE IN RATINGS ACROSS SELECTED US COMPANIES, 2019



CORRELATIONS BETWEEN RATINGS PROVIDERS



Source: Elroy Dimson, Paul Marsh, and Mike Staunton, "Divergent ESG Ratings," *The Journal of Portfolio Management* (November 2020).

EXHIBIT 6 — MSCI ESG RATINGS: KEY ISSUE FRAMEWORK

Source: MSCI Key Issue Framework (as of October 18, 2021), available at: https://www.msci.com/our-solutions/esg-investing/esg-ratings/esg-ratings-key-issue-framework.