Who's Down with ESG? The U.S. Midterm Elections & The Future of ESG Investing

November 18, 2022

Introduction

With the 2022 midterm elections nearly in the rearview mirror, has the momentum towards ESG shifted, or is the backlash that was growing around ESG still gaining ground? The meteoric rise of ESG over the past several years was predicted to receive pushback at the hands of a Republican Congress. Now that is less certain. Almost all large investors have embraced ESG as a means to protect and enhance long-term shareholder value. But the honeymoon appears to be over. With the U.S. midterm elections and increasing fears of a global economic slowdown, certain members of the Republican party launched a robust campaign earlier this year linking ESG with everything from cultural "wokeism" to high gas prices to national security concerns. While the merits of these arguments can be debated, one thing seems clear – companies face the very thorny task of communicating their ESG initiatives to both pro- and anti-ESG investors and regulators.

State and Federal ESG Initiatives

As Congress shifts hands at the start of the new year, Republican control of the House will put the Congressional agenda at odds with the objectives of the Biden administration, especially on ESG regulation. This means that there will likely be little room for agreement on federal ESG-related legislation in the 118th Congress, and rhetorical debate will dominate the Congressional landscape. However, in the vacuum created by lack of legislative progress, look for states and federal agencies to step into an outsized policymaking role on ESG (see *Appendix*).

Agency rulemaking

We expect the Biden administration to continue its focus on enhancing ESG disclosures through rulemaking and oversight at federal agencies, most notably the Securities and Exchange Commission (SEC). The SEC has taken a significant interest in ESG, establishing a new Climate and ESG Task Force within the SEC's Division of Enforcement, whose mission is "to develop initiatives to proactively identify ESG-related misconduct." It has also promulgated new ESG rules on both company climate disclosures and ESG funds while signaling more ESG disclosure requirements to come. And, of course, the U.S. political environment has little bearing on the evolving ESG disclosure regulations in Europe.

Congressional action

While federal legislation is not likely to be passed in this new Congress, expect the debate over ESG to continue. As the SEC's ESG initiatives have already sparked significant criticism from Republicans in Congress, we expect that this trend will only continue under new Republican control. While a Republican-led House cannot block SEC rules, it can seek to slow its rulemaking through inquiries and investigations – which may include compelling corporations who have invested strongly in ESG initiatives to testify before Congressional committees. We have already seen hints of this as, just days before the midterm elections, a group of Republican Senators sent letters to 51 large corporate law firms warning them that they will be taking action "to scrutinize the institutionalized antitrust violations being committed in the name of ESG" by the firms' corporate clients.

Second, expect current ESG legislation to be reintroduced as the two parties seek to promote their messaging on ESG – even if the legislation does not have a strong chance of passage. Democrats will continue to push for legislation such as the Corporate Governance Improvement and Investor Protection Act, which passed the House in 2021 and would require enhanced disclosures for publicly traded companies on a variety of ESG-related topics. On the Republican side, legislation such as the Investor Democracy is Expected (INDEX) Act (which would restrict the voting power of large asset managers like BlackRock) and the No ESG at TSP Act (which would prohibit investments under the Thrift Savings Plan in mutual funds that make investment decisions based primarily on environmental, social or governance criteria) will likely be given further consideration under a Republican majority.

State-level initiatives

Finally, states will continue to engage on ESG policy, and in some cases expand on existing initiatives, primarily focusing on ESG disclosure requirements for state pension funds. In recent sessions, Texas, Oklahoma, Kentucky and West Virginia have passed legislation that would prohibit or significantly restrict investments in (and business with) financial institutions that boycott energy companies. Other states such as Florida have enacted rules to ban ESG considerations in pension fund investments. However, as the pro-ESG movement responds and gains political capital, expect Democratic-run states to not only enhance ESG disclosure requirements but also seek to divest from certain sectors. We can look to recently introduced legislation for signposts about what this may look like. For example, California, Massachusetts and New Jersey are currently considering legislation that would prohibit investment in fossil fuel or firearm manufacturing corporations and require investment in companies that are aligned with the goals of the Paris Climate Agreement. At the same time, Republican-run states are primarily looking to limit the proliferation of ESG investment practices in their state pension funds. Expect both pro- and anti-ESG state regulatory trends to continue in 2023.

Teneo

Investor Response to the Anti-ESG Sentiment

The "Big 3" react

Despite the anti-ESG sentiment from certain regulators, large institutional investors have shown no indication that they are de-prioritizing ESG issues. BlackRock's 2022 Annual Voting Spotlight published in September noted that *"it is imperative that we seek to understand and assess how [ESG] risks and opportunities will impact the companies in which we invest…"* State Street Global Advisors (SSGA) reiterated its focus on *"addressing all financially material issues – including ESG issues – through our proxy voting and company engagement…"* in its recent insights piece. Pension funds such as the NYC Comptroller have sent letters to their asset managers asking them to increase the pressure on companies to make progress on important ESG issues such as climate and diversity.

Proxy season data and market developments

While the 2022 proxy season results indicated a slight decrease in shareholder support for "E" and "S" shareholder proposals overall, they still far exceeded support levels from just two years ago – especially those related to climate, diversity and political contributions. In addition, proposals asking companies to not focus on ESG issues routinely received negligible support from shareholders. Looking ahead to the 2023 proxy season, results from the recent Institutional Shareholder Services annual survey indicated that a majority of investors are seeking more climate risk disclosure from companies – not less. New "universal ballot" requirements for proxy contests, new executive compensation disclosure requirements and initiatives that give asset manager clients the ability to vote themselves (e.g.; BlackRock's Voting Choice) will add to the increasing uncertainty of vote outcomes on ESG issues moving forward.

The looming recession

Companies are also facing tough decisions on ESG – not only from anti-ESG sentiment from some regulators, but also from the looming recession. How are companies reacting so far? The Environmental Sustainability Index published by Honeywell in October indicated that *"nearly nine out of ten organizations are planning to increase sustainability budgets for the coming twelve months."* A recent Nasdaq study indicated that of 2nd quarter earnings calls this year for Russell 300 companies, 78% discussed ESG topics, and 20% were asked ESG-related questions from sell-side analysts. Nonetheless, some companies may face difficult decisions when it comes to ESG.

Looking Ahead

With so much uncertainty facing both the market and the regulatory environment, what approach should companies and boards take on ESG? As we saw with the economic challenges of the pandemic, large investors are likely to remain firmly committed to their belief that some ESG issues can have a material impact on a company's long-term financial performance. In addition to focusing on good financial performance, companies and boards should continue to focus on the ESG issues that are most material to the business. Instead of speaking about ESG in the abstract, it may be beneficial to be more specific in deliberations. For example, is climate change still a risk to the business? Is diversity still important to the company's stakeholders? Is an independent and diverse board still important? The answer to these and other questions is likely still "yes," regardless of how politicized the term ESG becomes. Clearly communicating a company's focus on material ESG issues to stakeholders – which may now include "hidden" asset manager clients as well as regulators who are opposed to ESG – has never been more important.

© 2022 Teneo. All rights reserved. This material was produced by Teneo for use solely by the recipient. This communication is intended as general background research and is not intended to constitute advice on any particular commercial investment or trade matter or issue and should not be relied upon for such purposes. The views expressed here represent opinions as of this date and are subject to change without notice. The information has been obtained from sources believed to be reliable but no guarantees can be given as to its accuracy, completeness or reliability. No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic or otherwise, without the prior consent of Teneo.

Teneo refers to Teneo Holdings LLC and its affiliates.

Appendix

States that have introduced pro-ESG investing legislation

1. California
2. Hawaii
3. Indiana
4. Maryland
5. Massachusetts
6. New Jersey
7. Vermont
8. Virginia

States that have introduced anti-ESG investing legislation

1. Florida
2. Idaho
3. Indiana
4. Kentucky
5. Louisiana
6. Minnesota
7. Missouri
8. Oklahoma
9. Texas
10. Utah
11. West Virginia

Teneo

Authors

Dr. Martha Carter

Vice Chair & Head of Governance

Orson Porter

Senior Managing Director & Head of Government Affairs

Matt Filosa

Senior Managing Director, Governance

Nate Tamarin

Senior Managing Director, Government Affairs

Andrew Fitch

Associate, Government Affairs