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ALERT

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Observations from the Second House Oversight Committee Hearing on ESG

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The House Committee on Oversight and Accountability recently held its second hearing on ESG, styled as "ESG Part II: The Cascading Impact of ESG Compliance." The hearing was a joint session of the Economic Growth, Energy Policy, and Regulatory Affairs and the Health Care and Financial Services subcommittees. In this Alert, we provide observations and possible takeaways from the second hearing. We also preview the key priorities and issues published last Friday by the ESG Working Group of the House Committee on Financial Services, which are expected to be part of future House ESG hearings.

The first hearing – "ESG Part I: An Examination of Environmental, Social, and Governance Practices with Attorneys General" – was discussed in our earlier Alert here.

At the second hearing, four witnesses appeared before the Committee: Mandy Gunasekara, Director at the Independent Women's Forum's Center for Energy & Conservation; Jason Isaac, Director of Life:Powered, an initiative of the Texas Public Policy Foundation; Stephen Moore, a Distinguished Fellow in Economics at The Heritage Foundation; and Shivaram Rajgopal, the Kester and Byrnes Professor of Accounting and Auditing at Columbia Business School. A relatively modest amount of time at the hearing involved remarks by the witnesses. More of the time was taken up by statements and remarks by Committee members.

ESG and Fiduciary Duties

As at the first hearing, alignment of ESG with fiduciary duties was a topic of discussion. As a threshold matter, there appeared to be common ground in the second hearing, at least among some of the Republican Committee members and their Democratic colleagues, that there is a role for ESG in investment decisions and portfolios.

In his remarks, Mr. Moore, one of the witnesses, noted that "ESG funds are fine, if people want to invest their money in ESG funds." He continued, stating that "I don't think anybody in this room is against ESG investing," but instead "just saying that you can't force people or have them in ESG funds when they don't even know about it." Representative Lisa McClain (R-Michigan) appeared to agree with this premise: "[I]f you want to invest in ESG companies, by all means you have every right to do so, but let's just be honest and transparent."

On the Democratic side, Representative Katie Porter (D-California) noted, "I'm with Miss McClain." She continued, stating that "I think companies should be free to decide for themselves whether ESG practices are beneficial to their bottom line" and that "asset managers should be free to decide that ESG data helps them make good valuation decisions and good investment decisions and if they don't, they should be able to ignore it."

Transparency

Although there appeared to be at least some consensus regarding the general premise of ESG integration, the same could not be said about its current implementation. An area of focus at the hearing was transparency relating to ESG practices and whether investors are receiving adequate disclosures concerning how ESG is being integrated into investment decisions. In particular, Representative McClain expressed skepticism was skeptical that this is occurring.

As was discussed by our colleagues Samer Mussallem, Chong Park, Amy Roy and Rob Skinner in a recent Ropes & Gray podcast (see Treacherous Shoals—Navigating Growing Anti-ESG Sentiment: Recent Developments Impacting

Asset Managers), several Republican attorneys general have launched investigations into investment managers' ESG practices, to date largely focusing on fiduciary duty and antitrust grounds. The second committee hearing may foreshadow a greater focus by Republican AGs on ESG-related disclosures.

In their remarks, Democratic members of the Committee, such as Representative Shontel Brown (D-Ohio), focused on the transparency afforded by ESG data and its use in decision-making. This was consistent with remarks made by Dr. Rajgopal, who noted in his opening statement that "to me, ESG is really about material factors that affect future cash flows and the cost of capital of a firm. So I think of ESG as a term that covers data that's not adequately disclosed by our financial reporting model and by our mandated disclosure rules."

Are Proxy Advisors and Rating Firms Next?

At the first hearing, the role of proxy advisory firms was discussed. At that hearing, Republicans contended that proxy advisory firms aligned their recommendations based on the ESG goals of groups like Climate Action 100+ rather than shareholders' best interests. Among other things, they criticized the lack of transparency in these recommendations and raised concerns about "racial quotas" violating anti-discrimination laws. Republican state attorneys general also have been critical. Earlier this year, they sent a letter to the two primary proxy advisory firms criticizing their actions and positions relating to climate change and diversity topics, contending that such commitments may interfere with their legal and contractual obligations.

Although not a focus of the second hearing, at various points, Republican Committee members were critical of proxy advisory firms. They also were critical of ratings firms, noting, in particular, inconsistencies among ratings and highlighting the ESG ratings of some companies that later exhibited financial performance issues.

We would not be surprised to see ESG ratings, in particular, emerge as a bigger theme in a future Committee hearing. Ratings agencies are among the priorities and issues that have been identified by the ESG Working Group, as noted below. ESG ratings are a focus of regulators in many jurisdictions. For example, earlier this month, the European Commission published a proposed Regulation relating to ESG ratings.

What Comes Next?

While no concrete plans for future hearings were discussed, at least some Republican Committee members expressed that desire. In her closing remarks, Representative McClain indicated that "this Committee will continue to investigate this matter."

Those Democratic members who expressed an opinion were unanimous in their view that neither the current hearing nor additional hearings were needed. As succinctly put by Representative Porter, "Please God, let there not be a Part III."

On Friday, the ESG Working Group of the House Committee on Financial Services sent to the Republican members of that committee a memorandum discussing eight key priorities and issues that the Working Group has identified to date and that it intends to continue to focus on during the current Congressional term (the framing below is the Working Group's):

- Reforming the proxy voting system to safeguard the interests of retail investors.
- Promoting transparency, accountability and accuracy in the proxy advisory system.
- Enhancing accountability in shareholder voting by aligning voting decisions with the economic interests of shareholders.

- Increasing transparency and oversight of large asset managers to ensure their practices reflect the pecuniary interests of retail investors.
- Improving ESG rating agency accountability and transparency to safeguard retail shareholders.
- Strengthening oversight and conducting thorough investigations into federal regulatory efforts that would contort our financial system into a vehicle to implement climate policy.
- Demanding transparency, responsibility and adherence to statutory limits from financial and consumer regulatory agencies.
- Protecting U.S. companies from burdensome EU regulations, safeguarding American interests in global markets.

Some of these topics were discussed at the second (and first) hearing. They are likely to be part of future House ESG hearings as well.

In any event, it is a certainty that the politicization and polarization of ESG – at the federal, state and international level – will continue. The themes discussed and arguments made at the hearing – on the left and on the right – will continue to be reflected in position papers, political commentary, litigation and enforcement proceedings and in proposed legislation.

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