NOTE

WAR, CACOPHONY & BEYOND: REEXAMINING AND ADDING SECURITY TO ENVIRONMENTAL, SOCIAL & CORPORATE GOVERNANCE INVESTING

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ABSTRACT

Russia's invasion of Ukraine has exposed the current ESG approach's weakness in many ways, most noticeably in the form of real-world consequences of negative screening strategies against defense and energy sectors. This Note attributes this weakness to a cacophony of risk and impact—a conceptual conflation between the two concepts in the relatively nascent ESG space. However, this Note finds that, even after resolving this cacophony, ESG investing still has significant problems that challenge its efficacy: (1) insufficient fairness and reasonableness of ESG ratings; (2) its uncertain future viability as an effective investment methodology under unfavorable economic conditions; and (3) its decay into a public relations and marketing tool. Eschewing ESG investing and promoting impact investing instead is a solution worth considering, but implementation issues prevent it from becoming a large-scale alternative in the short-term. This Note argues that a better solution, albeit far from perfect, is the inclusion of security—defined as elements that support the United States and its allies' security against adversarial forces—as a component of ESG's ambiguous "S." It could not only address ESG's lack of responsiveness to geopolitical risks exposed by the Russo-Ukrainian War, but also accelerate the market and the public's new and accurate understanding of ESG as a risk framework.

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I. INTRODUCTION

The business and financial world has adopted the Environmental, Social, and Corporate Governance ("ESG") framework—a set of standards that environmentally and socially conscious investors can use to evaluate a company's operations[1]—at a rapid rate over the past two decades, even prompting regulators to promote its incorporation.[2] However, the unilateral Russian invasion of Ukraine on February 24, 2022, and its repercussions have exposed numerous problems associated with the present ESG application. Among other things, pervasive, stigmatizing negative screening practices against defense and conventional energy sectors have shown that ESG is being

1. For a more in-depth explanation, *see* discussion *infra* Sections II.A, II.D.
2. *See* discussion *infra* Section II.A.

implemented in a manner far too unresponsive to non-climate, geopolitical risks. Moreover, ESG application has generated real-world phenomena that contradict ESG's purported values, including inflationary pressures on energy costs affecting the most vulnerable segment of society whilst enriching the oil-producing autocrats. Statistics also show that ESG-friendly businesses are not necessarily less exposed to or more active about pulling out of Russia than the ESG-resistant ones.[3]

This Note finds that such ESG approach is due to a significant cacophony of risk and impact—a conceptual conflation between the two concepts. It finds that this cacophony carries over to the public and even financial professionals' conflation of ESG investing—a risk framework in its origin—with impact investing,[4] thereby precipitating many of the supposed vices of ESG that have drawn considerable attention since the outbreak of the war.[5] The Note then questions the efficacy of ESG investing by pointing out the issues that remain after resolving the cacophony. These lingering issues concerning ESG investing are: (1) insufficient fairness and reasonableness of ESG ratings; (2) its uncertain future viability as an effective investment methodology under unfavorable economic conditions; and (3) its decay into a public relations and marketing tool.[6]

Based on these findings, the Note briefly contemplates completely abandoning ESG and promoting impact investing as an alternative form of sustainable and responsible finance, but concludes that serious implementation issues prevent impact investing from becoming a suitable large-scale alternative in the short-term.[7] Instead, this Note advocates for the inclusion of security—which the Note defines as elements that support the United States and its allies' security against adversarial forces—as a component of ESG's ambiguous "S." The Note explains that, albeit far from perfect, the proposal is a quickly actionable temporary remedy to both the cacophony-associated ESG weaknesses

3. *See* discussion *infra* Section II.C.

4. Impact investing refers to an investment method under which an investor builds the portfolio with the intent of generating measurable, positive impacts. For a more in-depth explanation, *see* discussion *infra* Section II.D.

5. *See* discussion *infra* Section II.D.

6. *See* discussion *infra* Part III.

7. *See* discussion *infra* Section IV.A.

exposed by the Russian invasion and the other non-cacophony-related problems that challenge ESG investing's fundamental efficacy. In making this proposal, the Note stresses the utmost importance of preserving the US-led global order in mitigating the social risks and maintaining global stability that goes far beyond ESG.[8]

II. UNPACKING ESG IN LIGHT OF THE 2022 RUSSO-UKRAINIAN WAR

This Part explores the implications of ESG in the context of the Russo-Ukrainian War by first laying out ESG's origins and rise in Section II.A. In Section II.B, it discusses the growing prevalence of ESG-based negative screening strategies against defense and conventional energy sectors leading up to the outbreak of the war. Section II.C then examines the numerous problems associated with ESG application exposed by the war through the lens of negative screening strategies discussed in Section II.B. Finally, Section II.D analyzes the potential reasons behind these problems discussed in Section II.C by focusing on the major conceptual conflation, a cacophony of risk and impact with respect to ESG.

A. ESG's Origins and Rise

Since its inception in December 2004,[9] ESG has risen rapidly as an important and ostensibly indispensable concept linking the business and financial world to nonpecuniary, social issues.[10] Though initially met with resistance from institutional investors who were reluctant to embrace the concept beyond their

8. *See* discussion *infra* Section IV.B.

9. The origin of the term ESG could be traced to then-UN Secretary General Kofi Annan's 2004 invitation to over fifty CEOs of financial institutions to UN Global Compact. This initiative issued a landmark report regarding the implementation of environmental, social, and governance factors in capital markets. *See* Georg Kell, *The Remarkable Rise of ESG*, FORBES (July 11, 2018), https://www.forbes.com/sites/georgkell/2018/07/11/the-remarkable-rise-of-esg/?sh=2c01cd651695 [https://perma.cc/78TD-YGZB]; *see also* THE GLOBAL IMPACT, WHO CARES WINS: CONNECTING FINANCIAL MARKETS TO A CHANGING WORLD 1–2 (2004) ("Throughout this report we have refrained from using terms such as sustainability, corporate citizenship, etc., in order to avoid misunderstandings deriving from different interpretations of these terms. We have preferred to spell out the environmental, social[,] and governance issues which are the topic of this report.").

10. For the purposes of this Note, the exact nature of ESG in its origin is discussed later in greater depth. *See* discussion *infra* Section II.D.

traditional fiduciary duties,[11] findings of positive correlation between the incorporation of ESG factors into investment strategies and higher financial performance around the mid-2010s[12] have increased its acceptance by investors and industry leaders.[13] Over US$649 billion were invested in ESG-focused funds globally in 2021, accounting for roughly ten percent of worldwide fund assets, compared to US$285 billion and US$542 billion in 2019 and 2020 respectively.[14] The COVID-19 pandemic was probably partially responsible for this surge over the past two years; according to one survey, ninety percent of surveyed investors responded that they attach greater importance to corporates' ESG performance when making decisions in light of the pandemic.[15]

These growing inflows into ESG funds and public attention have even pressured governments around the world to update their policies to promote ESG. The US Department of Labor, for instance, proposed rules in October 2021 that would allow retirement plan fiduciaries to consider ESG when making investment and shareholder voting decisions.[16] The US Securities and Exchange Commission ("SEC") has also pushed for greater ESG-related disclosures, most notably proposing a rule in April 2022 that would require SEC registrants to disclose their greenhouse gas emissions and climate-related risks that are "reasonably likely to have a material impact on [their] business,

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11. *See* Kell, *supra* note 9.

12. *See, e.g.*, GORDON L. CLARK ET AL., FROM THE STOCKHOLDERS TO THE STAKEHOLDER: HOW SUSTAINABILITY CAN DRIVE FINANCIAL OUTPERFORMANCE 9 (2015) (finding that companies with superior sustainability standards tend to have lower cost of capital, better operational performance, and higher stock prices).

13. *See* Kell, *supra* note 9.

14. Ross Kerber & Simon Jessop, *Analysis: How 2021 Became the Year of ESG Investing*, REUTERS (Dec. 23, 2021), https://www.reuters.com/markets/us/how-2021-became-year-esg-investing-2021-12-23/ [https://perma.cc/59LM-XD8Y].

15. *Is Your ESG Data Unlocking Long-term Value?: Why Nonfinancial Information, Data Analytics, and Better Performance Insight Can Be Key To Enhancing the ESG Premium*, EY GLOBAL (Nov. 2021), https://assets.ey.com/content/dam/ey-sites/ey-com/en_gl/topics/assurance/assurance-pdfs/ey-institutional-investor-survey.pdf [https://perma.cc/BRE4-T7KN].

16. *See* Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, 86 Fed. Reg. 57272 (proposed Oct. 14, 2021) (to be filed at 29 C.F.R. pt. 2550).

results of operations, or financial condition."[17] Meanwhile in the United Kingdom, new secondary legislations requiring certain companies and limited liability partnerships to disclose material climate-related financial information aligned with Task Force on Climate-Related Financial Disclosures ("TCFD") recommendations[18] went into effect in January 2022.[19]

B. Pre-Invasion Prevalence of Negative Screening Against Defense and Energy Sectors

However, the rise of ESG has negatively impacted defense contractors' access to their capital. While many funds that present themselves as ESG-driven still contain as much as US$7.3 billion exposure to military weapons,[20] data suggests that investors have been moving away from defense companies in general and that ESG funds have been more aggressive in reducing their exposure to military weapons.[21] This trend has been especially pronounced in the European market, where negative screening—the exclusion or blacklisting of certain companies and sectors from the investment portfolio—is much more prevalent than in other regions.[22] More than sixty percent of European investment institutions employ some form of negative screening strategies

17. The Enhancement and Standardization of Climate-Related Disclosures for Investors, 87 Fed. Reg. 21334 (proposed Apr. 11, 2022) (to be filed at 17 C.F.R. pts. 210, 229, 232, 239, 249).

18. TCFD is an organization established by Financial Stability Board ("FSB") in 2015 to "develop recommendations on the types of information that companies should disclose to support investors, lenders, and insurance underwriters in appropriately assessing and pricing . . . risks related to climate change." The four thematic areas that these recommendations focus on are governance, strategy, risk management, and metrics and targets. *About*, TASK FORCE ON CLIMATE-RELATED FIN. DISCLOSURES, https://www.fsb-tcfd.org/about/ [https://perma.cc/4MHC-NV3S] (last visited Apr. 20, 2022).

19. *See* UK DEP'T FOR BUS., ENERGY, & INDUS. STRATEGY, MANDATORY CLIMATE-RELATED FINANCIAL DISCLOSURES BY PUBLICLY QUOTED COMPANIES, LARGE PRIVATE COMPANIES, AND LLPS 5–7 (2022).

20. Polly Bindman, *Why ESG Funds are Full of Weapons*, CAP. MONITOR (Mar. 17, 2022), https://capitalmonitor.ai/strategy/responsilbe/how-exposed-are-esg-funds-to-weapons/ [https://perma.cc/8B7U-A3A9].

21. *See id.* (showing that non-ESG funds' percentage exposure to weapons manufacturers decreased from 2 percent in 2020 to 1.5 percent in February 2022 while ESG funds' percentage exposure dropped from 1.8 percent in 2020 to 0.8 percent in February 2022).

22. *See* Sylvia Pfeifer, *Rise of ESG Adds to Pressure on European Defense Companies*, FIN. TIMES (Nov. 30, 2021), https://www.ft.com/content/e14ea515-a6f3-4763-9def-7bc40d3b2e4a [https://perma.cc/TD3F-HVPV].

compared to less than twenty-five percent in the United States and less than ten percent in Japan and Canada.[23] Though no longer a EU member, the United Kingdom also shows high and rapidly surging adoption rate of negative screening practices. The percentage of UK wealth managers offering ESG-driven negative screening services increased from fifty-nine percent in 2019 to eighty-one percent in 2021.[24]

The most notable examples of screening include the Stockholm-based Skandinaviska Enskilda Banken AB ("SEB") policy that directs funds to exclude "companies that manufacture, develop[,] or sell weapons that violate international conventions and companies that participate in the development of nuclear weapons programs or produce nuclear weapons."[25] However, it did partially reverse its policy by allowing six of its more than one hundred funds to invest in the defense sector following the outbreak of the Russo-Ukrainian War in February 2022.[26] Whereas this directive only targets controversial weapons—including anti-personnel mines, biological and chemical weapons, cluster weapons, and depleted uranium ammunition[27]—some of SEB's funds also exclude investment in companies that derive more than five percent of their revenues from the "development, production[,] and service of weapons comprising combat equipment, or certain other military equipment."[28] This has resulted in the exclusion of 363 military and defense industry players that do not necessarily involve themselves in the controversial weapons business from SEB's portfolio as of

23. *Id.* (citing Barclays data).

24. Sarah Culpan, *Negative Screening Options Grow as Main ESG Approach from Wealth Managers*, SAVANTA, https://savanta.com/view/negative-screening-options-grow-as-main-esg-approach-from-wealth-managers/ [https://perma.cc/266X-JCN6] (last visited Oct. 20, 2022).

25. *Our Sustainability Approach: Exclude*, SEB GRP, https://sebgroup.com/about-us/our-business/our-divisions/seb-investment-management/our-sustainability-approach/exclude [https://perma.cc/7FRV-5QH5] (last visited Apr. 23, 2022) [hereinafter *Exclude*].

26. *See* Peggy Hollinger, *Ukraine War Prompts Investor Rethink of ESG and the Defense Sector*, FIN. TIMES (Mar. 9, 2022), https://www.ft.com/content/c4dafe6a-2c95-4352-ab88-c4e3cdb60bba [https://perma.cc/864H-VYNL].

27. SEB GRP., SECTOR POLICY ON ARMS AND DEFENSE FOR SKANDINAVISKA ENSKILDA BANKEN AB 3 (2022).

28. *Exclude, supra* note 25.

September 2022.[29] The Norwegian pension group KLP has taken a similar approach against companies engaged in controversial weapons.[30] But applying relatively broader scope of exclusions,[31] it has completely withdrawn its investments from at least fourteen defense contractors—including some of the largest industry players such as Babcock International, Dassault Aviation, General Dynamics, Raytheon Technologies, Rolls-Royce plc, and Thales—since November 2021.[32] European defense companies are certainly feeling the heat from these negative screening strategies. The Paris-based Thales Group's share of equity held by European investors outside of France, for instance, has halved since 2016.[33] Meanwhile, it was revealed in January 2022 that German banks BayernLB and LBBW had cut their credit lines for the German arms manufacturer Rheinmetall AG.[34]

The negative impact of ESG on conventional energy sector's access to capital is comparatively less pronounced. Thirty-three of the sixty largest global banks, most of which are based in Asia, increased their fossil fuel financing between 2016 and 2020.[35] In particular, the Postal Savings Bank of China increased its financing of conventional energy companies by twelve times, followed by China Minsheng Bank, Standard Chartered, and Sumitomo Mitsui

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29. SEB INV. MGMT. AB, SEB INVESTMENT MANAGEMENT EXCLUSIONS AND TRANSITION 2 (Sept. 2022) [hereinafter EXCLUSIONS AND TRANSITION].

30. *See* KLP, DECISION TO EXCLUDE COMPANIES THAT PRODUCE CONTROVERSIAL WEAPONS 2 (Nov. 2021).

31. KLP's categories of involvement in controversial weapons go beyond the manufacturing of actual controversial weapons and encompass the following categories: (1) the production of nuclear weapon components; (2) production or storage of fissile materials intended for use in weapons; (3) nuclear weapons systems including ballistic missiles that can be equipped with nuclear warheads; (4) support services for controversial weapons such as maintenance, repair, upgrading and modernization, storage, and testing and simulation; and (5) production of exclusive delivery platforms and their components. *See id.* at 5–6.

32. *See id.* at 17.

33. *See* Hollinger, *supra* note 26.

34. *See* Steven Arons & John Ainger, *Banks Change Course on Weapons Finance as Defense Spending Soars*, BLOOMBERG (Mar. 3, 2022), https://www.bloomberg.com/news/articles/2022-03-03/banks-change-tack-on-weapons-finance-as-defense-spending-soars?leadSource=uverify%20wall [https://perma.cc/P62D-JQU3].

35. *See* Catherine Clifford, *These are the World's Largest Banks that are Increasing and Decreasing Their Fossil Fuel Financing*, CNBC (Apr. 22, 2021), https://www.cnbc.com/2021/04/22/which-banks-are-increasing-decreasing-fossil-fuel-financing-.html [https://perma.cc/9SEZ-W92A].

Banking Corporation.[36] At the same time, many ESG investment leaders have been rather timid in excluding the oil and gas ("O&G") sector. Eight of the ten largest US sustainable funds invest in O&G companies,[37] and BlackRock CEO Larry Fink—who has been one of the leading advocates of stakeholder capitalism and ESG investing—even pushed back against divesting from O&G sectors entirely in January 2022 and argued that such an act "will not get the world to net zero [carbon emissions]."[38] He cautioned that businesses taking on the "climate police" role "will not be a good outcome for society," and proposed instead that governments need to provide "clear pathways and a consistent taxonomy for sustainability policy, regulation, and disclosure across markets."[39]

Nonetheless, negative screening strategies have still affected the conventional energy sector even though it is faring slightly better than the defense sector. This is particularly true in Europe. SEB currently excludes: (1) companies "engaged in developing, processing[,] and exploiting coal, oil[,] or natural gas resources"; (2) companies "generating energy from fossil fuels"; (3) companies whose distribution linked to fossil fuels is greater than five percent of total revenues; and (4) companies whose services linked to fossil fuels are greater than fifty percent of total revenues.[40] Applying this directive, SEB has excluded 1,403 fossil fuel producers, 1,136 fossil fuel distribution and services providers, and other 416 companies on the grounds of unconventional extraction and significant fossil fuels-related revenues as of September 2022.[41] KLP did not institute a similar level of blanket screening against the fossil fuels sector, but implemented

36. *See id.*

37. *See* Akane Otani, *ESG Funds Enjoy Record Inflows, Still Back Big Oil and Gas*, WALL ST. J. (Nov. 11, 2019), https://www.wsj.com/articles/top-esg-funds-are-all-still-invested-in-oil-and-gas-companies-11573468200 [https://perma.cc/76F8-LPRP].

38. Steven Mufson & Douglas MacMillan, *BlackRock's Larry Fink Tells Fellow CEOs that Businesses are not 'Climate Police'*, WASH. POST (Jan. 18, 2022), https://www.washingtonpost.com/climate-environment/2022/01/18/blackrock-larry-fink-letter-climate/ [https://perma.cc/5NFK-WZKX].

39. *Id.*

40. EXCLUSIONS AND TRANSITION, *supra* note 29.

41. *Id.*

exclusions against oil sands[42] and coal businesses.[43] Moreover, the aforementioned increase in Asian banks' fossil fuel financing has been partially offset by sizeable reductions in O&G financing from twenty-seven of the sixty largest global banks, most of which are based in Europe.[44] The Strasbourg-based Crédit Mutuel led this trend by halting fossil fuel financing altogether, followed by UBS, Sberbank, State Bank of India, Intesa Sanpaolo, Deutsche Bank, Credit Suisse, and Rabobank—all of which reduced their fossil fuel financing by at least fifty percent between 2016 and 2020.[45]

C. Post-Invasion: Waking Up from Negative Screening and Perhaps ESG in General

The outbreak of the 2022 Russo-Ukrainian War changed this dynamic. Russia's unilateral invasion of Ukraine prompted many, especially those in Europe, to realize that ESG may have been overly unresponsive to other non-climate risks, such as geopolitical risks.[46] As of April 2022, SEB's relaxation of its negative screening directive against defense companies[47] remains the only conspicuous case of major institutional investors adjusting its ESG-driven investment strategy in response to the war.[48] But European policymakers have shown stronger signs of a changing attitude towards defense and conventional energy sectors, such as the German government's unusual decision to support arms exports to Ukraine and invest EU€100 billion to

42. *See* Filipe Albuquerque, *KLP Blacklists Oil Sands*, NORDSIP (Oct. 10, 2019), https://nordsip.com/2019/10/10/klp-blacklists-oil-sands/ [https://perma.cc/7EV6-NKTB].

43. *See KLP Goes Coal Free*, KLP (May 8, 2019), https://www.klp.no/en/press-room/klp-goes-coal-free [https://perma.cc/YH34-4TAS].

44. *See* Clifford, *supra* note 35.

45. *See id.*

46. *See* Merryn Somerset Webb, *Are Defense Stocks Now ESG?*, FIN. TIMES (Mar. 4, 2022), https://www.ft.com/content/9073a69f-bc90-4944-b9d9-d2a0a2ff1f15 [https://perma.cc/2SMN-KXZU] ("ESG investors . . . tend to focus so much on the environment that they forget the social—the wellbeing of our communities and the maintenance of our living standard.").

47. *See* Hollinger, *supra* note 26.

48. Only fourteen percent of investors surveyed by HYCM responded that they were thinking about making changes to their investment strategies in relation to the war. Giles Coghlan, *Two Months into the Russia-Ukraine Conflict, How are Investors Reacting?*, INV. MONITOR (Apr. 25, 2022), https://www.investmentmonitor.ai/special-focus/ukraine-crisis/two-months-russia-ukraine-conflict-investors-reacting [https://perma.cc/3Y43-RGSW].

modernize its military.[49] The EU Platform on Sustainable Finance made a similar move by declining to label the entire defense industry as socially harmful in its final report on social taxonomy,[50] in contrast to an earlier leaked version which proposed deeming even the production of non-controversial armaments as socially harmful.[51] It is quite likely that these European policymakers' evolving perspectives will influence the region's investors and banks to view defense and conventional energy industries more favorably.

The war in Ukraine has also highlighted a more serious problem of numerous "inconsistencies that bankrupt a lot of [ESG's] underlying theses."[52] The war is indeed raising doubts about the social goods and noble qualities that ESG purportedly embodies, including ESG's pressure on the O&G industry. During the early months of the pandemic, the O&G industry's steep decline even caused some to hastily declare that "the beginning of the end of oil . . . may already be in the rearview mirror."[53] But renewables are still unable to replace petroleum on a large scale, and the global O&G demand is currently back to above record levels.[54] At the

49. *See* Hollinger, *supra* note 26.

50. The final report only labeled controversial weapons violating international conventions and treaties as socially harmful. *See* EU PLATFORM ON SUSTAINABLE FIN., FINAL REPORT ON SOCIAL TAXONOMY 70–71 (Feb. 2022).

51. *See* Gina Gambetta, *Armaments 'Cannot be Classified as Social' in Taxonomy, Says Entrepreneur*, RESPONSIBLE INV. (Mar. 1, 2022), https://www.responsible-investor.com/armaments-cannot-be-classified-as-social-in-taxonomy-says-rapporteur/ [https://perma.cc/B7KM-MDAC] (stating that the leaked version included the following paragraph: "Investment in other armaments, which for example can easily be used by child soldiers or which is exported to conflict zones, might be deemed socially harmful just as the development of lethal autonomous weapons without the possibility for meaningful human control.").

52. Bérengère Sim, *Ukraine War 'Bankrupts' ESG Case, Says BlackRock's Former Sustainable Investing Boss*, FIN. NEWS (Mar. 14, 2022), https://www.fnlondon.com/articles/ex-blackrock-boss-says-ukraine-bankrupts-esg-case-20220314 [https://perma.cc/9YT3-5FEC] (quoting Tariq Fancy, former Sustainable Investing CIO of BlackRock).

53. Editorial, *On the Horizon: The End of Oil and the Beginnings of a Low-Carbon Planet*, GUARDIAN (Nov. 1, 2020), https://www.theguardian.com/business/2020/nov/01/end-of-oil-and-beginnings-of-a-low-carbon-planet [https://perma.cc/L7EK-3UPQ] (suggesting that global market forces are tipping in favor of decreasing oil production).

54. *See* Jude Clemente, *ESG and the Dangerous Structural Increase in the Price of Oil*, FORBES (Feb. 13, 2022), https://www.forbes.com/sites/judeclemente/2022/02/13/esg-and-the-dangerous-structural-increase-in-the-price-of-oil/?sh=6a68c00f757b [https://perma.cc/KLX5-BSEW]. Global oil demand before the COVID-19 pandemic stood

same time, however, the global oil supply remains below the optimal level. Not only does ESG curb the O&G industry's access to capital, as discussed earlier,[55] but also induces Western oil companies in particular to invest more in renewables than in oil production capacity by driving up market uncertainties[56] and inflicting them with "[d]efeats in the courtroom and boardroom [to climate-activist shareholders]."[57] These burdens, combined with the war, have contributed to the highest oil prices since 2014,[58] causing low-income and minority populations to suffer the most[59] while enriching and empowering the autocrats of oil-producing countries that operate with far less ESG constraints than their Western competitors.[60] These outcomes certainly stand in contrast to the purported goals of ESG, and a senior executive of Russia's state-owned energy corporation Gazprom even reportedly commented in 2021 that "the West will have to rely more on what it calls 'hostile regimes' for its [oil] supply."[61] This prediction has unfortunately been corroborated by the Biden administration's

at 100 million barrels a day, which Clemente refers as "record levels." Javier Blas & Laura Hurst, *BP Says Oil Demand is Back Above 100 Million Barrels a Day*, BLOOMBERG (Nov. 2, 2021), https://www.bloomberg.com/news/articles/2021-11-02/bp-says-oil-demand-is-back-above-100-million-barrels-a-day [https://perma.cc/N9SV-G4S3].

55. *See* discussion *supra* Section II.B.

56. *See* Clemente, *supra* note 54.

57. Dmitry Zhdannikov, *OPEC, Russia Seen Gaining from Climate Activist Wins*, REUTERS (June 1, 2021), https://www.reuters.com/business/sustainable-business/opec-russia-seen-gaining-more-power-with-shell-dutch-ruling-2021-06-01/ [https://perma.cc/S5CK-6JC9] (reporting on Royal Dutch Shell's climate lawsuit defeat and Chevron shareholders' vote to cut carbon emissions generated by the use of the company's products); *see also Shell Directors Sued for 'Failing to Prepare for Net Zero' in Groundbreaking ESG Claim*, STEWARTS (Mar. 24, 2022), https://www.stewartslaw.com/news/shell-directors-sued-for-failing-to-prepare-for-net-zero-in-groundbreaking-esg-claim/ [https://perma.cc/5E22-MRSJ] (reporting that Royal Dutch Shell shareholders brought an ESG lawsuit against the company's directors under a claim that they failed to meet their duties outlined by sections 172 and 174 of the Companies Act of 2006 by putting the company at long-term risk through their strategies that are inconsistent with the goal of the Paris Agreement).

58. The average annual OPEC crude oil price per barrel was US$96.29 in 2014 and plummeted to US$49.49 in 2015. It did not return to the US$90-range until it reached US$97.70 in March 2022. N. Sönnichsen, *Average Annual OPEC Crude Oil Price from 1960 to 2022*, STATISTA (Apr. 11, 2022), https://www.statista.com/statistics/262858/change-in-opec-crude-oil-prices-since-1960/ [https://perma.cc/3W8E-AACX].

59. *See* Clemente, *supra* note 54.

60. *See* Zhdannikov, *supra* note 57.

61. *See id.*

contemplation of lifting US sanctions on Venezuelan oil imports in order to substitute the now-banned imported Russian oil.[62]

In addition to ESG's contradictory effects observed in the O&G space, a statistical examination of ESG shortly after the war's outbreak has further revealed ESG's questionable and inconsistent nature concerning Russia. In theory, Russia—as a nation riddled with deep environmental problems,[63] political oppression, disrespect for individual freedom and human rights,[64] corruption,[65] and corporate governance abnormalities stemming from the oligarchic economic system[66]—should be one of the least likely places where ESG-associated capital and business operations are comfortable. On the contrary, a study showed that large

62. Although the White House pushed back against speculation, experts generally agree that the nonpublic meeting in Caracas on March 5, 2022 between the US delegation and the Venezuelan President Nicolás Maduro included the discussion of Venezuelan oil imports. *See* Mary Anastasia O'Grady, *Biden Eyes Venezuelan Oil*, WALL ST. J. (Mar. 13, 2022), https://www.wsj.com/articles/biden-eyes-venezuelan-oil-russia-ukraine-gas-prices-maduro-national-imports-11647195311 [https://perma.cc/8MBU-ZCX8].

63. Whereas environmental awareness and activism has been growing in Russia as a response to worsening industrial and urban water pollution, illegal logging, coal mines expansions, and mismanaged landfills, the Russian government has brutally suppressed environmental activists with arrests, physical threats, and other forms of abuse. *See* Angelina Davydova, *Environmental Activism in Russia: Strategies and Prospects*, CTR. FOR STRATEGIC & INT'L STUD. (2021), https://www.csis.org/analysis/environmental-activism-russia-strategies-and-prospects [https://perma.cc/UCS3-E6VH].

64. *See* AMNESTY INT'L, AMNESTY INTERNATIONAL REPORT 2021/22: THE STATE OF WORLD'S HUMAN RIGHTS 309 (2022) ("The rights to freedom of expression, association, and peaceful assembly were routinely violated. Public assemblies organized by the political opposition were almost completely prohibited. Legislation on 'foreign agents' and 'undesirable organizations,' together with trumped-up charges and other forms of pressure, were widely used to suppress dissent. Threats and attacks against journalists, human rights defenders, and other activists were perpetrated with impunity, . . . Torture and other ill-treatment in places of detention remained endemic and prosecutions of perpetrators rare. Enforced disappearance were reported in Chechnya.").

65. Tracked by Transparency International, Russia ranked forty-fifth for most corrupt country out of 180 countries, scoring a mere twenty-nine points out of hundred points available on the Corruption Perceptions Index. *See Center for Anti-Corruption Research and Initiative Transparency International Russia: Country Data*, TRANSPARENCY INT'L, https://www.transparency.org/en/countries/russia [https://perma.cc/X33R-F7NY] (last visited May 3, 2022).

66. *See* Joe Nocera, *Russian Corporate Governance Plays by Its Own Grim Rules*, BLOOMBERG QUINT (May 14, 2018), https://www.bloombergquint.com/business/russian-corporate-governance-plays-by-its-own-grim-rules [https://perma.cc/R9LY-LXHE] (describing how Paul Ostling's, former Ernst & Young executive, attempt to implement American-style corporate governance and transparency in the Moscow-based Brunswick Rail LLC was thwarted by other board members who resorted to the "ways of Russian business," including fraud against creditors and certain shareholders).

nonfinancial European companies with substantial Russia-related activities—those with Russian subsidiaries that generate more than US$100 million in sales and that have more than US$100 million in total assets—have meaningfully higher average Refinitiv ESG scores[67] than similar-sized nonfinancial European companies without substantial Russia-related activities.[68] Furthermore, the same study discovered that there was no statistical association between the companies' ESG scores and the timeliness of a meaningful corporate response to the Russian invasion.[69] Some of the most ESG-resistant oil giants, such as BP, Shell, and Exxon Mobil, were the earliest corporations to announce major divestments in Russia, despite the staggering loss projections associated with these decisions.[70]

Ultimately, there is now a considerable view [71] that ESG has become a "regressive and never-ending endeavor" instead of tight controls exerted by "responsible investors who engage thoughtfully with the boards."[72] This is a crucial recognition that

67. An ESG score is a measurement of a given organization's operational performance against several ESG criteria. Financial services entities including MSCI, Sustainalytics, and S&P TruCost, described as "rating agencies" in this Note, generate these scores by reviewing company or fund disclosures, conducting management interviews, and comparing results and metrics to other organizations in the industry. *See* Noah Miller, *ESG Score*, CORP. FIN. INST. (Oct. 10, 2022), https://corporatefinanceinstitute.com/resources/esg/esg-score/ [https://perma.cc/NK6F-A52T]. Refinitiv is a provider of financial market data and the company states that it "provide[s] standardized ESG data points analytics for [eighty percent] of global market cap based on publicly reported company data." *Sustainable Finance*, REFINITIV, https://www.refinitiv.com/en/sustainable-finance [https://perma.cc/DAN3-XTNC] (last visited May 3, 2022).

68. Jurian Hendrikse et al., *The False Promise of ESG*, HAVR. L. SCH. F. ON CORP. GOVERNANCE (Mar. 16, 2022), https://corpgov.law.harvard.edu/2022/03/16/the-false-promise-of-esg/ [https://perma.cc/N86E-U5UM] (stating that firms with substantial Russia-related activities scored seventy-eight out of one hundred on average whereas firms without such activities scored sixty-eight on average).

69. *See id.*

70. *See* Ellen Meyers, *Rapid Corporate Exodus from Russia is Seen as a Lesson for ESG Investors, Regulators*, ROLL CALL (Mar. 17, 2022), https://rollcall.com/2022/03/17/rapid-corporate-exodus-from-russia-is-seen-as-a-lesson-for-esg-investors-regulators/ [https://perma.cc/LL25-ADUZ].

71. *See* Sim, *supra* note 52 (presenting several leading ESG investors' views that hostile perceptions and attitudes against defense and energy sectors are simply not practical and that such ESG investment approaches need to be addressed along with other ESG inconsistencies that the war has revealed).

72. Ed Moisson, *ESG Investors Accused of 'Failing' Over Russia*, FIN. TIMES (Mar. 11, 2022), https://www.ft.com/content/fad3e241-08fa-47fc-bdbd-32dd5b72403d

could guide ESG investors and banks in a positive direction, inducing them to "reconsider [their] black[-]and[-]white approach" of eschewing certain business activities simply because of the stigma or unethical image attached to them.[73] But the fact that the public and industry trust in ESG and its exclusionary investment practices have eroded so quickly following the outbreak of the war is an important consideration. It cautiously indicates that many instances of real-world ESG application may have been faultily driven more by simplistic, exclusionary narrative than by meaningful and substantive rationale.

D. Cacophony of Risk and Impact in ESG and ESG Investing

This influential, black-and-white narrative[74] has probably come about because ESG and ESG investing remain murky, often-misunderstood concepts. Similar to how there are several operating ESG rating agencies that each apply drastically different scoring conventions,[75] different people and organizations in different countries can interpret ESG differently.[76] A November 2019 *Wall Street Journal* article suggested that there are at least four ways an average retail investor could use ESG: (1) make money by pricing externalities associated with each company and "identifying which ones will lead to government, consumer[,] or worker action"; (2) reduce risk by paying a small premium for lower-carbon company stocks that "provide some insulation against new carbon rules or taxes"; (3) do good by selling stocks of companies with low ESG ratings to pressure their management and

[https://perma.cc/4ZKZ-MZK6] (quoting George Stewart, CEO of Tumelo, a responsible investment technology company).

73. Sim, *supra* note 52 (quoting Baroness Helena Morrissey, chair at AJ Bell).

74. *See* discussion *supra* Section II.C.

75. *See* Kevin Prall, *ESG Ratings: Navigating Through the Haze*, CFA INST. BLOG (Aug. 10, 2021), https://blogs.cfainstitute.org/investor/2021/08/10/esg-ratings-navigating-through-the-haze/ [https://perma.cc/AT7H-4NJW] (identifying MSCI, S&P Global, Sustainalytics Industry Bank, Carbon Disclosure Project, Institutional Shareholder Services, and Bloomberg as major ESG rating agencies with drastically different scoring systems).

76. *See* Willem Schramade, *The Land of ESG Confusion*, LINKEDIN (Feb. 23, 2015), https://www.linkedin.com/pulse/land-esg-confusion-willem-schramade [https://perma.cc/V7XX-7GJJ].

raise the valuation of more ESG-compliant companies;[77] and (4) use it as a propaganda tool to "make oil companies [and other ESG-resistant businesses] pariahs"[78] and thereby induce government action.

There is, however, a clear dichotomy among the four ways presented by the article; ways (1) and (2) focus on using ESG factors as an investment risk mitigation tool in contrast to ways (3) and (4) that concentrate on generating impacts grounded on ESG factors. Moreover, this dichotomy vividly illustrates the contentious coexistence of risk and impact in the popular perception of ESG investing. Although the two are often conflated,[79] ESG risk and ESG impact are completely different concepts. Whereas the former is "like any other business risk" measured as part of an assessment or valuation metrics aimed at financial gains, the latter is about "improving ESG issues for society's benefit . . . [and is] centered on nonfinancial outcomes."[80] Since impact is value-oriented, unlike the valuation-oriented risk,[81] the stigmatizing narrative that has spawned negative screening strategies was very likely a result of ESG impact gaining an upper hand over ESG risk in the populace's ESG perception.

Making this distinction between risk and impact is critical because ESG investing—at least in its origin and assuming against post-inception changes—is not an impact framework but a risk framework. When the United Nations Global Compact laid down a set of recommendations that evolved into what is now ESG,[82] it made those recommendations by stressing the usefulness of ESG factors on company and investment value.[83] In particular, the report unambiguously concentrated on persuading that keeping ESG factors in mind is better for "managing risks related to

77. James Mackintosh, *A User's Guide to the ESG Confusion*, WALL ST. J. (Nov. 12, 2019), https://www.wsj.com/articles/a-users-guide-to-the-esg-confusion-11573563604 [https://perma.cc/YRK6-XFG3].

78. *Id.* (quoting Jeremy Grantham, founder of Boston-based fund managing firm Grantham, Mayo, Van Otterloo & Co.).

79. *See* Kristoffer Inton, *ESG Risk Management Makes Sense, But ESG Impact is Less Straightforward*, MORNINGSTAR (Jan. 27, 2022), https://www.morningstar.com/articles/1076450/esg-risk-management-makes-sense-but-esg-impact-is-less-straightforward [https://perma.cc/C3FY-3GX5].

80. *Id.*

81. *See id.*

82. *See* Kell, *supra* note 9.

83. *See, e.g.*, THE GLOBAL IMPACT, *supra* note 9, at 9.

emerging ESG issues, . . . anticipating regulatory changes or consumer trends, . . . accessing new markets or reducing costs[,] . . . [and generating] strong impact on reputation and brands," thereby resulting in greater company competitiveness and financial performance.[84] The Global Compact's report did mention creating positive ESG impacts and bringing general good to society and the world in a couple of places.[85] Their function within the report was strictly limited to reassuring the readers in 2004 that incorporating ESG would not hurt their operations, but rather be in their long-term self-interest in the grand scheme of things.[86]

Yet ESG investing is frequently conflated with impact investing,[87] which is also growing rapidly. Impact investment assets under management globally reached US$715 billion in 2020[88] from US$502 billion in 2018,[89] according to one estimate, and the fact that both ESG investing and impact investing are rising so quickly in tandem is probably one of the reasons behind the conflation. Even financial experts and professionals often unwittingly mix the two, such as the former Ukrainian finance minister whose *Financial Times* article made both risk-[90] and impact-oriented arguments in pointing out that Western

84. *Id.*

85. *See id.* at 3.

86. *See id.* ("Ultimately, successful investment depends on a healthy civil society, which is ultimately dependent on a sustainable planet. In the long-term, therefore, investment markets have a clear self-interest in contributing to better management of environmental and social impacts in a way that contributes to the sustainable development of global society. A better inclusion of [ESG] factors in investment decisions will ultimately contribute to more stable and predictable markets, which is in the interest of all market actors.").

87. *See* Stephanie Kater et al., *Why the World Needs Both ESG and Impact Investing*, BRIDGESPAN GRP. (Apr. 21, 2021), https://www.bridgespan.org/insights/library/impact-investing/why-the-world-needs-both-esg-and-impact-investing [https://perma.cc/4N9X-6E3C]; *see also* Véronique Chapplow, *Impact Isn't ESG*, M&G INV. (Mar. 13, 2019), https://www.mandg.com/investments/professional-investor/en-gb/insights/mandg-insights/latest-insights/2019/03/impact-isnt-esg [https://perma.cc/H6XQ-JY6Z].

88. DEAN HAND ET AL., ANNUAL IMPACT INVESTOR SURVEY 2020, GLOB. IMPACT INV. NETWORK 43 (2020).

89. ABHILASH MUDALIAR ET AL., ANNUAL IMPACT INVESTOR SURVEY 2019, GLOB. IMPACT INV. NETWORK 14 (2019).

90. *See* Natalie Jaresko, *Russia's Invasion of Ukraine Must Prompt an ESG Reckoning*, FIN. TIMES (Mar. 3, 2022), https://www.ft.com/content/cfbb1598-5d69-4649-8c19-6c7c56e30664 [https://perma.cc/D5KR-EHES] ("Without a strong defense of our democratic system based on rule of law and respect for one another's international rights, our entire system of business (and profit) could collapse.").

companies are not executing their "ESG responsibility" to fight for freedom and democracy.[91] Larry Fink's famous statement in his 2019 letter to CEOs that "profits and purpose are inextricably linked"[92] has also raised questions and criticisms due to the use of the impact-insinuating word "purpose,"[93] even though the rest of the letter emphasized the risk-based idea that ESG is a way for businesses to remain functional and profitable against the ascendance of new generations that care more about "improving society" than "generating profit."[94]

But except for their concern for ESG factors and similar speed at which the market is adopting them, ESG investing and impact investing lack common denominators. ESG investing, as a risk framework, "has nothing to do with morals . . . [as its promise] is to manage the down and upside of risks and opportunities associated with the investments."[95] Accordingly, even the ESG rating agencies themselves do not look at a company's actual corporate responsibility and their net impact on external stakeholders, but on "the degree to which [its] economic value is at risk due to ESG factors."[96] MSCI gives oil giants such as Exxon Mobil and BP an average ("BBB") aggregate score,[97] as MSCI does not regard these O&G companies' emissions and pollution levels to be serious

91. *Id.* ("The global business community must understand that nurturing, upholding, and protecting freedom and democracy is part of their ESG responsibility.").

92. Larry Fink, *Larry Fink's 2019 Letter to CEOs: Profit & Purpose*, BLACKROCK, https://www.blackrock.com/americas-offshore/en/2019-larry-fink-ceo-letter [https://perma.cc/CR5N-VH8T] (last visited May 5, 2022).

93. *See, e.g.*, Adrian Wooldridge, *Business Doesn't Need a 'Social Purpose' Revolution*, BLOOMBERG (Jan. 18, 2022), https://www.bloomberg.com/opinion/articles/2022-01-18/larry-fink-is-wrong-business-doesn-t-need-a-social-purpose [https://perma.cc/4VV5-B8FY] (criticizing Fink and other stakeholder capitalism advocates' focus on "purpose" on the grounds that it is: (1) "much more than stakeholder capitalism in new clothes" with the intention of "undo[ing] the liberal revolution of the 1850s" and (2) "at best . . . a recipe for [business] paralysis.").

94. Fink, *supra* note 92.

95. Moisson, *supra* note 72 (quoting Sasja Beslik, a Swedish financial sustainability expert).

96. Hans Taparia, *The World May be Better Off Without ESG Investing*, STAN. SOC. INNOVATION REV. (July 14, 2021), https://ssir.org/articles/entry/the_world_may_be_better_off_without_esg_investing# [https://perma.cc/Q7PE-LRCQ].

97. MSCI ESG Ratings range from Leader (AAA, AA), Average (A, BBB, BB), and Laggard (B, CCC) in descending order. *ESG Ratings*, MSCI, https://www.msci.com/our-solutions/esg-investing/esg-ratings [https://perma.cc/BAD8-V2P2] (last visited Oct. 20, 2022).

enough to jeopardize their profits and financial value for investors.[98]

Impact investing, on the other hand, may use ESG factors and ratings to make investment decisions, but by its very nature, goes beyond ESG investing. Unlike ESG investing, impact investing entails that an investor: (1) intends a particular impact, (2) contributes to the impact, and (3) measures the impact to connect the investor's intent and contribution to actual social and environmental improvements.[99] Fulfilling the intentionality component of impact investing requires investors to actively pick stocks that deliver specific positive impacts instead of passively screening out risky companies or selecting the least bad from each sector like ESG investors.[100] Ensuring that this intention leads to actual contribution, additionality and materiality must be considered to ascertain whether the investment would create a meaningful difference in social or environmental conditions, compared to conditions without that investment.[101] Measurability is closely tied to the additionality and materiality standards, and is a critical element of impact investing because its ultimate aim is to derive social and environmental advancements, not just financial returns as in ESG investing.[102]

Given these stark differences between ESG investing and impact investing, one could possibly conclude that ESG itself is not to blame for the problems and inconsistencies revealed by the Russian invasion.[103] Rather, the public and industry's misguided interpretation of ESG investing as an impact framework is to blame. As an example, if ESG investing is practiced strictly as a risk framework as it should be, then the defense sector "[should not be] an automatic no-go from an ESG perspective,"[104] similar to oil giants that can receive an average aggregate ESG score as previously mentioned. The corporate and financial world could in

98. *See* Taparia*, supra* note 96.
99. *See* Kater et al., *supra* note 87.
100. *See* Chapplow, *supra* note 87.
101. *See id.*
102. *See id.*
103. *See* discussion *supra* Section II.C.
104. Brooke Sutherland, *Defense Stocks Search for Their Place in the ESG Universe*, BLOOMBERG (Mar. 25, 2022), https://www.bloomberg.com/opinion/articles/2022-03-25/industrial-strength-defense-stocks-search-for-their-place-in-the-esg-universe-l16s9bcq [https://perma.cc/L4Y8-6BVE].

fact treat the ills from the conflation between risk and impact by halting and phasing out the moral narrative-driven negative screening practices, especially the most vicious practices that impose blanket bans and no-go labels on an entire sector.

III. BEYOND THE CACOPHONY: CONTINUING TO QUESTION THE EFFICACY OF ESG INVESTING

Is the strict adherence to the risk-oriented origins and nature of ESG investing, if it is even possible, going to be the panacea for all the ESG issues that have been raised so far? Unlikely so, as there will still be several unresolved issues that could arguably unsubstantiate the efficacy of ESG investing. These include: (1) the likely insufficient fairness and reasonableness of ESG ratings; (2) its uncertain future viability as an effective investment methodology under unfavorable economic conditions; (3) and its decay into a public relations and marketing medium.

A. Insufficient Fairness and Reasonableness of ESG Ratings

The first lingering issue, even when ESG investing is practiced as a risk framework, is ESG ratings' questionable fairness and reasonableness. This issue cannot be ignored as these ratings exert a sizeable influence over investors' decisions. Nothing better highlights these unfair ratings than the tobacco industry's cozy yet seemingly hypocritical spot in the age of ESG. As a case in point, a leading ratings company Sustainalytics gives Philip Morris International Inc. ("PMI")—one of the largest tobacco companies in the world[105]—an ESG Risk Ratings score[106] of 23.9 in the

105. In 2021, PMI's global net revenue stood at approximately US$82.2 billion with its most-recognized cigarette brand Marlboro recording a sale of nearly 239.9 billion units equal to US$36 billion in value alone. PMI's share of the global cigarette market stood at about fourteen percent the same year. Koen van Gelder, *Philip Morris International—Statistics & Facts*, STATISTA (May 10, 2022), https://www.statista.com/topics/4633/philip-morris/#topicHeader__wrapper [https://perma.cc/XS8J-2DWW].

106. Sustainalytics' ESG Risk Ratings scores range from zero representing "negligible" risk to forty and above representing "severe" risk. *See ESG Risk Ratings,* SUSTAINALYTICS, https://www.sustainalytics.com/corporate-solutions/esg-risk-ratings [https://perma.cc/SG3P-JFXR] (last visited May 6, 2022).

"Medium Risk" category as of November 2022.[107] This may seem unimpressive at first glance. But when comparing PMI to other companies in the "Food Products" industry group—under which PMI and other giant tobacco manufacturers strangely falls—one would find it shocking that PMI ranks fifty-six out of 591 and is rated as Tier 1 leader representing the lowest risk within the industry group.[108]

Sustainalytics explains that PMI's high ratings performance is thanks to the company's strong ESG material risk management.[109] Indeed, PMI's strategic ambitions involve raising its smoke-free nicotine products' share of the company's net revenues from twenty-nine percent in the third quarter of 2021 to more than fifty percent by 2025,[110] as well as achieving carbon neutrality of PMI's direct operations by the same year and reaching net zero emissions throughout PMI's entire supply chain by 2040.[111] Additionally, PMI advertised itself as a responsible corporate entity by promoting the ESG recognitions it had earned from Sustainalytics and other ESG rating agencies.[112] As discussed previously, ESG ratings only account for the degree to which ESG risks and the management's poor mitigation of those risks jeopardize a company's profitability and financial value to investors.[113] Hence, it is not ostensibly outlandish for PMI to have such favorable ratings, given that the company is taking proactive measures to address its ESG risks.

Nevertheless, PMI's ESG ratings start to raise eyebrows when one compares them to the scores in the defense and conventional

107. *Company ESG Risk Ratings: Philip Morris International Inc.*, SUSTAINALYTICS, https://www.sustainalytics.com/esg-rating/philip-morris-international-inc/1014447427 [https://perma.cc/4YJX-9ACQ] (last visited Nov. 6, 2022).

108. *Id.*

109. *See id.*

110. Press Release, Philip Morris Int'l, Dow Jones Sustainability Index North America Recognizes, Once Again, PMI's Sustainability Performance (Nov. 26, 2021), https://www.pmi.com/sustainability/sustainability-news/dow-jones-sustainability-index-north-america-recognizes-pmi-s-sustainability-performance [https://perma.cc/PCP5-JL2T] [hereinafter Dow Jones Recognizes PMI].

111. *See Philip Morris International Announces Low-Carbon Transition Plan to Accelerate Its Journey to Carbon Neutrality,* PHILIP MORRIS INT'L (Oct. 27, 2021), https://www.pmi.com/sustainability/low-carbon-transition-plan/philip-morris-international-announces-low-carbon-transition-plan [https://perma.cc/6JPP-4EHW].

112. *See id.*; *see also* Dow Jones Recognizes PMI, *supra* note 110.

113. *See* discussion *supra* Section II.D.

energy sectors. Among defense companies, major players all score worse than PMI's 23.9 under the Sustainalytics system. As of November 2022, Airbus and Northrop Grumman are in the "Medium Risk" category with scores of 25.8 and 26.9, respectively.[114] On the other hand, Lockheed Martin, Boeing, and Raytheon Technologies are in the "High Risk" category with scores of 30.3, 34.6 and 36, respectively.[115] Companies in Sustainalytics's "Oil & Gas Producers" industry group are rated even worse; Exxon Mobil, Royal Dutch Shell, and Chevron are in the "High Risk" category with scores of 36.5, 37.6, and 38.3, respectively, while non-Western O&G companies like Saudi Aramco and PetroChina Co. Ltd are in the "Severe" category.[116]

These worse scores are largely because O&G and defense sectors are inherently handicapped compared to the tobacco industry regarding the "E" and "S" components of ESG. For the "E" component, no matter how much effort these companies expend, existing technology limits carbon emissions reductions from their jet fuel-guzzling aircrafts, gas-pumping oilfields, and distillation equipment.[117] As for the "S" component, tobacco companies can move away from traditional tobacco products like cigarettes to purportedly "better" smoke-free products.[118] But it is much more challenging for defense and conventional energy sectors to manage the intrinsic "S"-related risks unless they suspend their weapons production and O&G operations.[119] Furthermore, although its connection to PMI's ESG score is not exactly clear here, the major ESG rating agencies' practice of calculating a company's composite ESG score by assigning each ESG factor a weight for aggregation

114. *Company ESG Risk Ratings: Lockheed Martin Corp.*, SUSTAINALYTICS, https://www.sustainalytics.com/esg-rating/lockheed-martin-corp/1008164073 [https://perma.cc/85DH-XKKW] (last visited Nov. 6, 2022).

115. *Id.*

116. *Id.*

117. Large all-electric commercial aircraft and fighter jets are unlikely to become viable until mid- to late- century. *See, e.g.*, AMY SCHWAB, ELECTRIFICATION OF AIRCRAFT: CHALLENGES, BARRIERS, AND POTENTIAL IMPACTS, NAT'L RENEWABLE ENERGY LAB'Y (Oct. 2021).

118. *See, e.g.*, *ESG Evaluation: Philip Morris International*, S&P GLOBAL, https://www.spglobal.com/ratings/en/research/pdf-articles/210513-esg-evaluation-philip-morris-international-100081210 [https://perma.cc/JN9P-AYZE] (last visited Nov. 6, 2022) ("We see PMI's move into [smokeless reduced-risk products] . . . as positively differentiating it from its tobacco peers.").

119. Investors are excluding defense companies regardless of the types of weapons they produce. *See* discussion *supra* Section II.B.

enables companies to receive high composite scores by focusing its efforts on the more heavily weighted factor(s) despite scoring poorly on the less weighted one(s).[120] For instance, Amazon is far from an ideal corporate citizen, with notoriety for its deplorable labor practices[121] and possible anticompetitive behaviors.[122] It therefore rightfully scores low on MSCI's labor management and corporate behavior factors, but its high scores on corporate governance and privacy/data security factors put Amazon's composite score in the BBB range.[123]

The sheer paradox of ESG rating agencies assessing defense and conventional energy companies as riskier—hence less desirable for responsible investment than tobacco companies—begs the question as to whether ESG ratings are sufficiently fair and reasonable for use in making investment decisions. All sectors and business activities generate some level of negative externalities. But there is no doubt that tobacco companies are collectively responsible for more deaths each year than defense and O&G companies. Smoking causes over seven million preventable deaths worldwide each year[124] compared to about 53,000 conflict fatalities in 2018,[125] 250,000 projected annual excess deaths caused by climate change,[126] and 3.6 million excess deaths caused

120. *See* Taparia, *supra* note 96.

121. *See* Jodi Kantor et al., *Inside Amazon's Worse Human Resources Problem*, N.Y. TIMES (Oct. 24, 2021), https://www.nytimes.com/2021/10/24/technology/amazon-employee-leave-errors.html [https://perma.cc/W8S8-JAP7] (describing Amazon's rogue ways of handling paid and unpaid leaves, unsafe workplace environment, lack of support for employees, and retaliation against employees that file complaints or protest).

122. *See* Enrique Dans, *If Amazon is Guilty of Anticompetitive Practices, Who Did It Learn Them From?*, FORBES (June 13, 2020), https://www.forbes.com/sites/enriquedans/2020/06/13/if-amazon-is-guilty-of-anti-competitive-practices-who-did-it-learn-themfrom/?sh=165f2c4f3223 [https://perma.cc/KBR5-PCCL] (reporting on the European Union's antitrust charges against Amazon).

123. *See* Catherine Brock, *What is an ESG Rating?*, MOTLEY FOOL (Mar. 4, 2022), https://www.fool.com/investing/stock-market/types-of-stocks/esg-investing/esg-rating/ [https://perma.cc/D975-FM5Y].

124. *Smoking & Tobacco Use: Diseases and Death,* CTR. FOR DISEASE CONTROL & PREVENTION, https://www.cdc.gov/tobacco/data_statistics/fact_sheets/fast_facts/diseases-and-death.html [https://perma.cc/WQV3-QPPZ] (last visited Nov. 6, 2022).

125. HÅVARD STRAND ET AL., TRENDS IN ARMED CONFLICTS, 1946-2018 2 (2019).

126. The WHO expects climate change to cause approximately 250,000 additional deaths between 2030 and 2050 in the form of malnutrition, malaria, diarrhea, and heat stress. *Climate Change and Health*, WORLD HEALTH ORGANIZATION (Oct. 30, 2021),

by broadly defined "fossil fuel air pollution."[127] This does not even account for the enormity of other health and socioeconomic impacts that smoking causes[128] without offering any discernable benefits to smokers or the wider society. On the contrary, the war has underscored the defense and O&G industries' social importance and necessity[129] as well as their societal merits, which later Sections discuss in greater detail.[130] The ratings' inconsistency only becomes more apparent when recognizing that PMI's score-boosting move towards smoke-free nicotine products is nothing more than pretending to reduce the regulatory and other ESG risks associated with tobacco; these smoke-free replacements are as addictive[131] and harmful as tobacco products.[132]

To these points, one might again play devil's advocate and note how ESG investing is not about moral impact.[133] One may even make a case that PMI simply happens to be a superior ESG risk manager regardless of whether their risk mitigation is truly genuine or a mere rebranding of risks. Such rebranding is

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https://www.who.int/news-room/fact-sheets/detail/climate-change-and-health [https://perma.cc/K5EA-TBGF].

127. The article's fossil fuel air pollution includes not only "emissions from power generation, industry, traffic, and residential energy use" but also "small-scale burning of biomass . . . and coal, particularly in residences in some parts of the world for cooking and heating." Roger Pielke, *Every Day 10,000 People Die Due to Air Pollution from Fossil Fuels*, FORBES (Mar. 10, 2020), https://www.forbes.com/sites/rogerpielke/2020/03/10/every-day-10000-people-die-due-to-air-pollution-from-fossil-fuels/?sh=3d1c542b2b6a [https://perma.cc/RAV7-AR2P].

128. *See Economic Trends in Tobacco*, CTR. FOR DISEASE CONTROL & PREVENTION, https://www.cdc.gov/tobacco/data_statistics/fact_sheets/economics/econ_facts/index.htm#economic-costs [https://perma.cc/5QKX-R6BY] (last visited Nov. 6, 2022)(presenting that more than sixteen million people in the United States alone are suffering from smoking-caused diseases and disabilities, and that smoking costs the United States over US$300 billion each year in direct medical costs and lost productivity).

129. *See* discussion *supra* Section II.C.

130. *See* discussion *infra* Section IV.B.

131. *See Top 15 Myths About Smoke-Free Alternatives: Frequently Asked Questions,* PHILIP MORRIS INT'L, https://www.pmi.com/smoke-free-life/busting-common-myth-around-smoke-free-alternatives [https://perma.cc/QQZ6-98BT] (last visited May 6, 2022) (admitting that both e-cigarettes and smoke-free heated tobacco products contain addictive nicotine).

132. *See* Tom Miles, *WHO Says E-cigarettes, 'Smoke-Free' Products Do Not Help Reduce Cancer*, REUTERS (July 26, 2019), https://www.reuters.com/article/us-health-tobacco/who-says-e-cigarettes-smoke-free-products-do-not-help-reduce-cancer-idUSKCN1UL29C [https://perma.cc/8FL6-ATGG].

133. *See* discussion *supra* Section II.D.

nonetheless an effective business decision that ameliorates public criticisms and prepares the company for a long-term transition at the same time.

However, ESG investing's identity as a risk framework does not and must not mean its complete detachment from social values. If one could rely on the risk-orientated nature of ESG to support and finance objectively horrid and socially destructive activities for financial gains, then would there be any difference between ESG investing and other types of business risk-cognizant conventional investing? How could anyone justify the existence of ESG and ESG investing as a separate investment concept in such case? After all, ESG risks are not just any business risks, but risks pertaining to stakeholders.[134] Thus, ignoring the defense and conventional energy sector's inherent characteristics—which can be socially constructive but prevent the sectors from exploiting and adapting to ESG ratings' technicalities as conveniently as the tobacco sector does—and assuming PMI as a more ESG-compliant risk mitigator than a company like Lockheed Martin or Exxon Mobil is highly unfair and unreasonable. And if this finding is a valid indicator of ESG ratings' accuracy and efficacy, then it spells trouble for ESG investing that relies on these ratings.

B. ESG's Uncertain Future as an Effective Investment Methodology

Adding to the problem of unfair and unreasonable ESG ratings is the uncertainty of ESG's future viability as an effective investment methodology under unfavorable economic conditions. The main driving forces behind ESG's meteoric rise over the past few years were the findings in the mid-2010s of a positive correlation between ESG and financial performance, which has led to massive capital inflows into ESG funds.[135] Yet the early months of 2022 were brutal to the ESG investing space. In January, both global and US ESG funds underperformed non-ESG funds by 120 basis points, while the European ESG funds underperformed by fifty basis points.[136] The iShares MSCI USA ESG Select ETF—one of

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134. *See id.*

135. *See* discussion *supra* Section II.A.

136. Lauren Foster, *ESG Funds are Having a Lousy Year. What to Do Now.*, BARRON'S (Mar. 27, 2022), https://www.barrons.com/articles/esg-funds-inflation-ukraine-war-51648245058 [https://perma.cc/R2NX-4D7F] (citing a report by Bernstein Private Wealth Management).

the leading ESG funds—was down nine percent in mid-February from the beginning of the year;[137] S&P 500 was down around eight percent.[138] Meanwhile, defense and conventional energy stocks have rallied thanks to the Russian invasion[139] and soaring oil prices, respectively.[140] This dynamic was reflected in the bond market as well, where the UK government had to double its green savings bond's annual interest rate in late February amid fears of insufficient investor demand for it.[141] Hence, notwithstanding some analysts' optimism that this trend is a temporary Big Tech-driven outlier because ESG has become too big to fail,[142] the realities are now challenging the widely accepted belief that ESG delivers meaningfully better financial performance.

The most obvious factor behind the challenge to this widely held belief is that the history of ESG's success is too short for the market to accept its continuing outperformance as an indisputable

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137. Taylor Tepper, *It's Not Easy Being Green: Why is ESG Underperforming in 2022?*, FORBES ADVISOR (Feb. 17, 2022), https://www.forbes.com/advisor/investing/why-is-esg-underperforming/ [https://perma.cc/HP7F-KMDK].

138. *S&P 500*, YAHOO FIN., https://finance.yahoo.com/quote/%5EGSPC/history?period1=1640995200&period2=1644710400&interval=1d&filter=history&frequency=1d&includeAdjustedClose=true [https://perma.cc/7ZVF-AX6Y] (last visited May 7, 2022) (calculating S&P 500's year-to-date performance as of February 11, 2022).

139. *See* Sweta Killa, *Aerospace and Defense ETFs Rallying on Russia-Ukraine War*, NASDAQ (Mar. 4, 2022), https://www.nasdaq.com/articles/aerospace-and-defense-etfs-rallying-on-russia-ukraine-war [https://perma.cc/3JX4-FU4L]; *see also* Joe Miller & Sylvia Pfeifer, *German Defense Shares Soar After €100bn Pledged for Armed Forces*, FIN. TIMES (Feb. 28, 2022), https://www.ft.com/content/df1cbca9-1f3f-4889-a626-8a36bdd43f65 [https://perma.cc/9B5M-VMQP].

140. *See* Jacob Sonenshine, *Oil Companies Have Crushed Earnings Expectations. Why Their Stocks Have Been Falling.*, BARRON'S (Apr. 27, 2022) https://www.barrons.com/articles/oil-stock-earnings-exxon-chevron-51651087968 [https://perma.cc/5TVB-G4XD] (explaining that, although oil giants' stocks fell after impressive Q1 earnings, energy stocks had already been flying high before the earnings).

141. *See* Joshua Oliver & Tommy Stubbington, *Green Savings Bond Interest Rates Doubled Following Demand Fears*, FIN. TIMES (Feb. 15, 2022), https://www.ft.com/content/d64e1f7b-c635-47da-8e28-4b6004f7260b [https://perma.cc/YR67-VKTU].

142. *See* Simon Jessop & Patturaja Murugaboopathy, *Analysis: Investors Back ESG Stock Funds Even as Tech Slide Hurts Returns*, REUTERS (Feb. 10, 2022), https://www.reuters.com/business/sustainable-business/investors-back-esg-stock-funds-even-tech-slide-hurts-returns-2022-02-10/ [https://perma.cc/D5VD-2SN2] (quoting Laith Khalaf, head of investment analysis at AJ Bell: "[t]he sheer number of funds which are assuming the ESG tag, combined with a huge amount of funds industry marketing, and a genuine groundswell of investor interest, are all likely to continue to prop up ESG fund sales irrespective of performance.").

fact. At most, only about seven years' worth of data are available since 2015 when ESG truly took off.[143] It is also important to recognize that these seven years coincided with the second half of "officially the longest expansion in American history"[144] during which the US stock market stayed buoyant,[145] and the global economy also grew at a steady rate of almost three percent despite a pandemic hiccup in 2020.[146] Therefore, ESG stocks and ESG funds' outperformance, if any, could have been a mere fortunate phenomenon occurring over a relatively short period of good economic times rather than a proof of ESG and ESG investing's desirable financial qualities. If this is true, then there is no guarantee of ESG investors faring better than non-ESG investors in a future economic downturn.

As such, there is a concern as to whether ESG investing could replicate its seeming market successes so far when favorable conditions—namely, the low interest rate—have disappeared. The period between 2015 and 2021 was defined not only by continued economic growth and stock market buoyancy, but also by historically low interest rates that drove the economic and market boom after the Great Recession.[147] Unfortunately, skyrocketing inflation compelled the Federal Reserve in May 2022 to make the biggest interest rate hike in two decades to suppress the inflationary pressure.[148] The Federal Reserve also indicated that it

143. *See* discussion *supra* Section II.A.

144. Ben Casselman, *A Recession is Coming (Eventually). Here's Where You'll See It First.*, N.Y. TIMES (July 28, 2019), https://www.nytimes.com/2019/07/28/business/economy/economy-recession.html [https://perma.cc/4KQG-9PB5].

145. The US30 index started at around 17,500 in January 2015 and is hovering above 32,000 as of early May 2022. *See, e.g.*, *United States Stock Market Index (US30)*, TRADING ECON., https://tradingeconomics.com/united-states/stock-market [https://perma.cc/3RL8-2WUG] (last visited May 9, 2022).

146. *See World GDP Growth Rate 1961–2022,* MACROTRENDS, https://www.macrotrends.net/countries/WLD/world/gdp-growth-rate [https://perma.cc/CD6V-A682] (last visited May 9, 2022) (using World Bank Group data).

147. *See* David Wessel et al., *What was the Big Story in Economics Over the Last Decade?*, BROOKINGS INST. (Dec. 16, 2019), https://www.brookings.edu/blog/up-front/2019/12/16/what-was-the-big-story-in-economics-over-the-last-decade/ [https://perma.cc/TW2D-MEGS].

148. *See* Jeff Cox, *Fed Raises Rates by Half a Percentage Point—the Biggest Hike in Two Decades—to Fight Inflation*, CNBC (May 4, 2022), https://www.cnbc.com/2022/05/04/fed-raises-rates-by-half-a-percentage-point-the-biggest-hike-in-two-decades-to-fight-inflation.html [https://perma.cc/3VH3-M293].

could raise the rates even further if necessary,[149] which it did with even bigger rate hikes in June, July, September,[150] and November 2022.[151] This will likely put an end to the boom of the "kinds of growth stocks that fit neatly into an ESG story . . . [without] mak[ing] much money yet"—such as renewable energy and tech stocks—a boom which was permitted by low interest rates that make "future profits worth more in industry valuation models."[152] Inflation is also likely to negatively affect ESG investing's performance given that ESG funds are underweight in conventional energy sectors that tend to outperform the market during periods of high inflation.[153]

Additionally, there is a contention that the notion of ESG investing's financial outperformance may have been a self-fulfilling prophecy. A European Corporate Governance Institute ("ECGI") study, for instance, found that institutional investors focus heavily on each stock's ESG ratings.[154] The study then predicted that such overwhelming attention from institutional investors may put these stocks at risk of overvaluation.[155] In other words, ESG investing's outperformance is not an outcome derived from ESG-friendly stocks' inherent superior qualities, but rather a bubble resulting from market hype and obsession.

Supporting all these contentions, a recent quantitative study by an independent index provider, Scientific Beta, suggested that ESG strategies "do not generate positive alpha."[156] Scientific Beta's

149. *See id.*

150. *See* Taylor Tepper, *Federal Funds Rate History 1990 to 2022*, FORBES ADVISOR (Sept. 21, 2022), https://www.forbes.com/advisor/investing/fed-funds-rate-history/ [https://perma.cc/TZ2M-QQN8].

151. *See* Nora Colomer, *Fed Delivers Fourth 75 Basis Point Hike, May Soon Slow Pace*, FOX BUS. (Nov. 3, 2022), https://www.foxbusiness.com/personal-finance/federal-reserve-interest-rate-hike-inflation-november-meeting [https://perma.cc/N88Q-USGK].

152. Merryn Somerset Webb, *Divesting Fossil Fuel Stocks? That's So Last Year*, FIN. TIMES (Feb. 18, 2022), https://www.ft.com/content/b159c919-ddef-420c-b63b-f90441e8c758 [https://perma.cc/3KFT-6436] [hereinafter *Divesting is So Last Year*].

153. *See* Foster, *supra* note 136.

154. *See* Florencio Lopez de Silanes et al., *Institutional Investors and ESG Preferences* 26 (Eur. Corp. Governance Inst. Law Working Paper No. 631, 2022).

155. *See id.*

156. GIOVANNI BRUNO ET AL., "HONEY, I SHRUNK THE ESG ALPHA.": RISK-ADJUSTING PORTFOLIO RETURNS, SCI. BETA 7–8 (2021), https://cdn.ihsmarkit.com/www/pdf/0521/Honey-I-Shrunk-the-ESG-Alpha.pdf [https://perma.cc/X38R-NLG7]; *but see* TENSIE WHELAN ET AL., ESG AND FINANCIAL PERFORMANCE: UNCOVERING THE RELATIONSHIP BY AGGREGATING EVIDENCE FROM 1,000 PLUS

study found the following: (1) there is no ESG outperformance when applying standard risk adjustments; (2) ESG strategies do not provide downside protection; and (3) growing ESG attention has inflated returns over part of the study's sample period.[157] The third finding pertaining to the relationship between attention to ESG and inflation of ESG investment returns, if accurate, quantitatively validates the ECGI's aforementioned prediction of the market's ESG overvaluation. Though this is the first and only study thus far indicating the absence of ESG's impact on financial performance, the argument that ESG investing has managed only to showcase a semblance of market outperformance could potentially disrupt the entire ESG framework, if verified. Perhaps that moment of truth will be the next global recession if Scientific Beta correctly predicted that ESG lacks downside protection. ESG's future viability as an effective investment methodology is thus uncertain.

C. ESG's Decay into a Public Relations Medium

The final non-cacophony-related issue concerning ESG is that ESG has largely decayed into a public relations medium. It is no secret that ESG has become an essential branding and marketing tool. High ESG ratings, particularly, are a major prize that companies want to achieve and advertise as evidenced by PMI's case. In fact, when the UN Global Compact introduced the concept of ESG in 2004, it presented ESG's important function as a branding and marketing tool as one of the reasons why it believed that the business and financial community would and should accept ESG.[158]

On the other hand, there is an undeniable and regrettable phenomenon of many companies and investors prioritizing ESG's public relations function over, or even at the expense of, its central function of risk management. This phenomenon is partially evidenced by BNP Paribas's 2021 survey in which fifty-nine

STUDIES PUBLISHED BETWEEN 2015–2020, N.Y.U. STERN SCH. CTR. FOR SUSTAINABLE BUS. 2–4 (2021), https://www.stern.nyu.edu/sites/default/files/assets/documents/ESG%20Paper%20Aug%202021.pdf [https://perma.cc/7PL7-HRYW] (concluding that there is positive correlation between ESG and financial performance, and that ESG offers downside protections in social or economic crises).

157. *See id.*

158. *See* discussion *supra* Section II.D.

percent of the respondents chose "brand and reputation" as one of their primary motivations for ESG investing compared to forty-six percent who chose "external stakeholder requirement," forty-five percent who chose "improved long-term returns," and thirty-nine percent who chose "decreased investment risk."[159] Comparing the 2019 survey to the more recent 2021 survey is particularly troubling. In the 2019 survey, "improved long-term returns" had the highest number of responses at fifty-two percent, while "brand and reputation," "external stakeholder requirement," and "decreased investment risk" each recorded forty-seven percent, thirty-two percent, and thirty-seven percent, respectively.[160] Making a cautious assumption that the "external stakeholder requirement" responses reflect, to some meaningful degree, a passive form of marketing carried out to avoid backlash from stakeholders, one could see that investment decisionmakers are increasingly approaching ESG as a means to furthering their public relations campaigns rather than enhancing their investment decisions.

The result of this trend is that the ESG space is "jammed with greenwashing, vague promises of purpose[,] and mission creep."[161] For example, a study commissioned by As You Sow—a non-profit shareholder advocacy organization—discovered that there is very little correlation between the mentioning of ESG in a given mutual fund's or ETF's prospectus and its actual level of ESG incorporation.[162] Among ninety-four ETFs with ESG in their prospectuses, sixty had miserable ESG ratings of earning a "D" or an "F" grade on at least one of the ESG factors.[163] Such prevalence of self-proclaimed ESG funds has even made some financial experts allege that "[m]ost ESG investing is little more than a marketing trick"[164] by those who understand the nonexistence of positive ESG

159. TREVOR ALLEN ET AL., THE ESG GLOBAL SURVEY 2021, BNP PARIBAS 7 (2021), https://securities.cib.bnpparibas/esg-global-survey-2021/ [https://perma.cc/4BDA-4YVQ].

160. *Id.*

161. *Divesting is So Last Year*, *supra* note 152.

162. *See* Kathie O'Donnell, *Low Correlation Between ESG in Fund Titles and Their Rating, Says Study,* PENSIONS & INV. (Jan. 13, 2022), https://www.pionline.com/esg/low-correlation-between-esg-fund-titles-and-their-rating-says-study [https://perma.cc/DQ4L-R9DY].

163. *Id.*

164. Steven Johnson, *ESG Outperformance Narrative 'is flawed', New Research Shows*, FIN. TIMES (May 3, 2021), https://www.ft.com/content/be140b1b-2249-4dd9-859c-

alpha "yet continue to present data in a way that deliberately ignores this to ride the wave of investor interest."[165] Therefore, even when the vices of the impact-driven narrative[166] are treated, and industry professionals correctly recognize ESG as a risk framework, ESG will likely remain nothing more than a must-have buzzword for those that control meaningful capital.

IV. ADDING SECURITY TO ESG

This Part examines two possible solutions to the ongoing problem: (1) replacing ESG investing with impact investing and (2) adding security as a component of ESG's ambiguous "S." Even though this Note finds several merits of the former, it ultimately rejects it due to implementation challenges in the short run. It then advocates for the inclusion of security as a new element of ESG by contending that this solution would not only address ESG's lack of responsiveness to geopolitical risks exposed by the Russo-Ukrainian War, but also accelerate the market and the public's new and accurate understanding of ESG as a risk framework.

A. Considering and Rejecting Impact Investing as an Alternative to ESG Investing

With these myriads of issues that challenge the fundamental efficacy of ESG, it is worth contemplating its complete abandonment and promoting impact investing instead, to foster sustainable and responsible finance. The preceding Sections show that ESG has been, in many respects, reduced to the idea of "doing good" and partially fused into impact investing either by unwitting conflation or its repurposed use as a public relations prop.[167] If the line has already been blurred, then why not encourage companies and investors to pursue actual social good as long as they remain profitable?

The preceding Sections' other revelations that ESG is likely deficient of the requisite evaluative metrics, substantive qualities, and genuinely interested practitioners and followers also support

3f8f12ce6036 [https://perma.cc/D7SX-48LZ] (quoting Sony Kapoor, managing director of the Nordic Institute for Finance, Technology, and Sustainability).

165. *Id.*

166. *See* discussion *supra* Sections II.C, II.D.

167. *See id.*

the case for pushing for impact investing instead. These deficiencies would make it hard for ESG to deliver the promises of risk management-based business profitability and financial outperformance under unfavorable economic conditions.[168] If ESG does not deliver real business profitability and financial outperformance, then the best approach for sustainable and responsible finance might be impact investing. Although impact investing may not necessarily produce better financial outcomes than ESG investing, it would at the very least produce some social impact, unlike ESG investing that may deliver neither financial outperformance nor social good. It would also conceivably be more efficient for the market if entities masquerading as ESG-friendly focus on profits and financial gains maximization, while those truly invested in sustainability focus on generating genuine social impacts.

On the other hand, impact investing presents implementation issues that curb its viability as a large-scale alternative to ESG investing in the short run. For one, satisfying measurability—a critical component of impact investing that distinguishes it from other investment methodologies[169]—is extremely challenging as a given investor needs to measure and assign quantitative values to intangible social outcomes.[170] There are already some impact measurement service providers in the market.[171] However, just as different ESG rating agencies have "little consensus among [themselves] over what areas to measure and how to measure them,"[172] there exists no standardized or harmonized industry-wide impact measurement metric and methodology. This likely raises the same problems associated with ununified ESG rating systems, such as confusing, misleading, and inconsistent evaluative information that often hinder an investor from making an

168. *See* discussion *supra* Part III.

169. *See* discussion *supra* Section II.D.

170. *See* Chapplow, *supra* note 87.

171. *See, e.g.*, *Future-Fit Business Benchmark: A Free Methodology to Help Business Build a Better World*, FUTURE-FIT BUS., https://futurefitbusiness.org/benchmark/ [https://perma.cc/US3P-8NZ4] (last visited May 12, 2022); *B Impact Assessment,* B LAB, https://www.bcorporation.net/en-us/programs-and-tools/b-impact-assessment [https://perma.cc/Q6FW-E3NK] (last visited May 12, 2022).

172. Ron Gordon et al., *Are ESG Ratings Actually Measuring How Responsible a Company Is?*, FAST CO. (Dec. 13, 2021), https://www.fastcompany.com/90705318/are-esg-ratings-actually-measuring-how-responsible-a-company-is [https://perma.cc/32KN-HD4M].

informed decision.[173] Considering the low statistical correlation among rating agencies' ESG ratings[174] and the fact that measuring impact is much more difficult than the "current focus on ESG measurement [which] is dangerously narrow,"[175] the divergence among ununified impact measurement systems and the problems stemming from such divergence will likely cause more confusion.

Furthermore, promoting impact investing could be problematic as it may indirectly deprive corporate entities and funds of their autonomy and freedom in the market. Whereas impact investing is principally about generating positive societal results through investments, with an underlying assumption that impact investors are philanthropically motivated, most businesses and investors are not philanthropists in their mission and purpose. At the same time, given that market players are practically forced to follow suit when others step up their sustainability branding and marketing campaigns,[176] promoting impact investing may leave no choice for uninterested, profit-oriented funds other than to participate in impact investing. Inadvertently or not, compelling companies and funds to proactively contribute to society and do good certainly conflicts with the spirit of autonomy and freedom in the market and has the potential to constrain them from operating at their most efficient levels.[177] This of course does not even account for the likelihood of companies and funds turning impact investing into yet another public relations tool without substance like ESG and ESG investing.[178]

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173. *See id.*

174. The correlation among a sample of prominent rating agencies' ESG ratings in a 2019 study by the University of Zurich team was 0.61, well below the correlation of 0.92 for Moody's and Standard & Poor's credit ratings. *Id.*

175. Present ESG assessments capture inputs but do not capture outputs and impacts because they incorrectly presume causality. Jennifer Howard-Grenville, *ESG Impact is Hard to Measure—But It's Not Impossible*, HARV. BUS. REV. (Jan. 22, 2021), https://hbr.org/2021/01/esg-impact-is-hard-to-measure-but-its-not-impossible [https://perma.cc/78DT-9BG3].

176. *See* Gideon Blaauw, LINKEDIN (Feb. 8, 2018), https://www.linkedin.com/pulse/using-sustainability-branding-finding-sweet-spot-gideon-blaauw?trk=portfolio_article-card_title [https://perma.cc/4XGJ-SUR5].

177. *See* Wooldridge, *supra* note 93 (criticizing Fink and other stakeholder capitalists' emphasis of "purpose" on grounds that it detracts businesses from their mission to generate profits and serves as a recipe for business paralysis).

178. *See* discussion *supra* Section III.C.

Considering these implementation limitations, promoting impact investing as a large-scale alternative to ESG investing is not a viable remedy in the short run. Impact investing may very well become the future norm in the market given the speed at which it is being adopted.[179] In the meantime, however, the business and financial world requires a more quickly actionable solution to the ESG issues exposed by Russia's invasion.

B. Case for Security as a Component of the "S"

Another approach worth considering and which this Note ultimately advocates is adding security—defined as elements that support the United States and its allies' security against adversarial forces such as Russia and China—as a component of ESG's "S." There exists a significant vagueness as to what the "S" of ESG exactly stands for. In contrast to the more clearly understood "E" and "G," the "S" is often "a bit of a hodge-podge"[180] as although the "[p]lanet [is not] necessarily more important than people, [it is] just easier to measure."[181] Such ambiguity detracts companies and investors from their sustainability and responsible finance initiatives, as reflected by BNP Paribas's 2021 survey in which fifty-one percent of the respondents picked social factors as the most difficult ESG element to grasp due to an "acute lack of standardization around social metrics."[182]

In addition to this ambiguity around the "S" providing a lot of wiggle room for security to fit into it, security has sufficient qualities that make it a valid social factor. For one, there is an understanding that insecurity and aggressions from non-Western, authoritarian forces are risks that seriously disrupt and endanger Western society and its values. This view has been more than validated by the Russian aggression against Ukraine. The former Ukrainian minister's *Financial Times* article mentioned before in Section II.D, in which she argued that "[w]ithout a strong defense of [the Western] democratic system based on rule of law and respect for one another's international rights, [the] entire system

179. *See* discussion *supra* Section II.D.

180. Jason Saul, *Fixing the S in ESG*, STAN. SOC. INNOVATION REV. (Feb. 22, 2022), https://ssir.org/articles/entry/fixing_the_s_in_esg [https://perma.cc/W98F-7ABY].

181. *Id.* (quoting an anonymous fund manager).

182. ALLEN ET AL., *supra* note 159, at 9.

of business (and profit) could collapse," crystalizes this idea.[183] Based on this understanding, defense contractors have argued even before the invasion that their sector needs to be regarded as sustainable because security is the precondition of sustainability.[184]

Another related quality of security is that, even when a given member nation of the US-led alliance is not under direct threat from an aggressor, security facilitates the development and integration of global capital markets and globalization in general that could alleviate the material social risks. Social factors that commonly fall under the "S" include but are not limited to labor standards, human rights, social dialogue, pay equity, workplace diversity, and access to health care.[185] Although far from perfect with winners and losers, global capitalism and its unleashing of capital have been a critical net positive force behind improving these social factors across the globe by uplifting innumerable people from absolute poverty and bringing prosperity.[186] These net positive changes are undoubtedly beneficial from both ESG risk and ESG impact perspectives. One could argue that the continued dominance of the US-led order and stability is vital to achieve this globalization, in light of the United States' pivotal role in the post-WWII growth of global capitalism.[187] Security's essential role in

183. Jaresko, *supra* note 90.

184. *See* Bindman, *supra* note 20 (quoting a BAE Systems spokesperson: "We've been making the case for quite a long time that well-regulated defense companies provide social value . . . It's tragic that it's taken a crisis such as this to make more people realize the value of well-regulated defense and the need to support the protection of nations and their citizens."); *see also* Pfeifer, *supra* note 22 (quoting the Leonardo CEO Alessandro Profumo's statement: "Without security we cannot have sustainability.").

185. *See* Saul, *supra* note 180.

186. *See, e.g.*, Indra de Soysa & Krishna Chaitanya Vadlammanati, *Do Pro-Market Economic Reforms Drive Human Rights Violations? An Empirical Assessment, 1981–2006*, 155 PUB. CHOICE 163 (2011); Gita Gopinath & Ceri Parker, *An Economist Explains the Pros and Cons of Globalization*, WORLD ECON. F. (Apr. 11, 2019), https://www.weforum.org/agenda/2019/04/an-economist-explains-the-pros-and-cons-of-globalization-b2f0f4ae76/ [https://perma.cc/ZRW2-G8B3]; Charles Kenny, *A Manifesto for Globalization*, CTR. FOR GLOB. DEV. (July 22, 2020), https://www.cgdev.org/publication/manifesto-globalization [https://perma.cc/44U4-UFGV].

187. *See* Robert E. Litan, *The "Globalization" Challenge: US Role in Shaping World Trade and Investment*, BROOKINGS (Mar. 1, 2000), https://www.brookings.edu/articles/the-globalization-challenge-the-u-s-role-in-shaping-world-trade-and-investment/ [https://perma.cc/FJ5J-XC9G] (stating that the United States helped create and lead the International Monetary Fund and the World Trade

ensuring this continuation of US leadership thus strongly supports security's value as a social factor.

Some may criticize this focus on security as an anti-globalist re-blocification of the global economy. But if the notion that unipolarity and hegemony foster stability[188] holds true, then strengthening security by making it a critical component of ESG considerations would arguably help the continued growth of global capitalism and accompanied social improvements. This contention is especially so when security, in the form of US military power, is a key element of continued US primacy.[189]

Coming back to the inclusion of security in ESG, this proposal, if implemented, would immediately cure the vices and detrimental effects of the moral impact-driven ESG narrative,[190] giving the stigmatized defense and conventional energy sectors a breathing room. The impact-driven narrative and related stigma against so-called non-ESG sectors could be resolved through widespread recognition of ESG's risk-oriented nature.[191] It would, however, require considerable time, resources, and campaigning for the business and financial world to eschew its pre-existing conceptions and reflect its revised understanding of ESG in its operational and investment decisions.

Organization, and that it has "help[ed] shape the future of both organizations and arguably the course of the global economy" since the end of World War II); *see also* UN DEP'T OF INT'L ECON. & SOC. AFFAIRS, WORLD ECONOMIC AND SOCIAL SURVEY 2017: REFLECTING ON SEVENTY YEARS OF DEVELOPMENT POLICY ANALYSIS, at 29–39, U.N. Doc. ST/ESA/365, U.N. Sales No. E.17.II.C.1 (2017) (suggesting that three US-led initiatives—the Marshall Plan, the creation of the Bretton Woods monetary system, and trade liberalizations—were central to the Golden Age of Capitalism between 1948 and 1971).

188. Unipolarity is a condition under which one state enjoys a preponderance of power and faces no competition from another competing state. Political scientist William C. Wohlforth argued that unipolarity results in a more peaceful world by eliminating the problem of hegemonic rivalry from world politics and reducing the salience and stakes of balance-of-power politics among the major states. *See generally* William C. Wohlforth, *The Stability of a Unipolar World*, 24 INT'L SEC. 5 (1999).

189. Political scientist Carla Norrlof contends that the United States will be able to maintain its dominance despite its diminishing share of the global economy due to three critical factors: (1) the largest domestic economy; (2) the US dollar's status as the world's dominant reserve currency; and (3) the strongest military. Norrlof then observes that the United States' global military presence reinforces the perceived stability of the US market and the dollar. *See generally* CARLA NORRLOF, AMERICA'S GLOBAL ADVANTAGE: US HEGEMONY AND INTERNATIONAL COOPERATION (2010).

190. *See* discussion *supra* Section Part II.

191. *See* discussion *supra* Section II.D.

There are right-minded funds and investment professionals who correctly understand ESG as a risk framework and view black-and-white approach to ESG investing unfavorably. But for many relatively small and less-diversified funds, carrying the stigmatized sector stocks in their portfolio is "just [not] worth the potential headache"[192] until the financial industry finds it acceptable. Security's inclusion in the ESG factors, on the other hand, would not only have an instant effect on how defense and O&G companies are rated, but also help the industry correct its misguided understanding of ESG's nature much faster. By doing so, it would allow defense and O&G companies to gain easier access to the much-needed capital and gradually relieve the struggling Western economy from skyrocketing oil prices.

The proposal would also help ameliorate some of the problems discussed in Part III that put the fundamental efficacy of ESG at risk beyond the cacophony of risk and impact. With respect to ESG ratings' inadequacy for use in making sound business and investment decisions,[193] security's addition to the metrics would not completely fix the arbitrary characteristics of rating mechanisms employed by numerous rating agencies, but it would balance out some of the ratings' underlying unfairness and unreasonableness. Revisiting the case of PMI's surprisingly high ratings and defense and O&G companies' significantly lower ratings,[194] the latter would very likely receive a huge boost from the accounting of security in the ratings metrics considering the importance of stable and self-sufficient energy supply to national security. Security's inclusion in ESG would also likely mitigate ESG's possible future ineffectiveness as an investment methodology under unfavorable economic conditions[195] by making it much more convenient for ESG funds to carry inflation- and recession-resistant defense and O&G stocks.

The proposal is by no means without issues. Security's inclusion in ESG will most likely be accompanied by some implementation challenges. But because security can simply be incorporated into the existing ESG ratings system and companies' internal, independent methodologies for assessing their

192. Sutherland, *supra* note 104.
193. *See* discussion *supra* Section III.A.
194. *See id.*
195. *See* discussion *supra* Section III.B.

operational risks,[196] there are probably going to be fewer practical hindrances than the measurability problems with impact investing.[197] There are also several well-studied indexes of countries that identify which ones present greater security and related social threats, such as TheGlobalEconomy's Security Threats Index[198] and the Fraser Institute's 165-country Human Freedom Index.[199]

Still, geopolitical complexities and fluctuating diplomatic relations among nations based on national interest could pose a challenge when it comes to some neutral or borderline case countries. With regards to the Russo-Ukrainian War specifically, many countries that have close military, economic, and other strategic ties with both the United States and Russia—namely

196. *See* Jack M. Mintz, *How to Put 'Security' into ESG*, FIN. POST (Mar. 17, 2022), https://financialpost.com/opinion/jack-m-mintz-how-to-put-security-into-esg [https://perma.cc/V2QJ-WQAC] ("As in the case of GHG emissions, concerns about security can be broken down into different types of risk. Companies with their own operations in dubious countries would have "Scope 1" security risks. Those purchasing inputs or selling directly to listed countries would have "Scope 2" risks. And those transacting with businesses operating in listed countries would have "Scope 3" risks. In principle, all security risks, like all GHG risks, would be disclosed to investors. It would be a huge data challenge, but Scope 1 and perhaps Scope 2 risks might not be too hard to calculate.").

197. *See* discussion *supra* Section IV.A.

198. TheGlobalEconomy's security apparatus indicator considers the security threats to a state, such as bombings, attacks and battle-related deaths, rebel movements, mutinies, coups, terrorism, other serious criminal activities, and perceived trust of citizens in domestic security. The higher the value of the indicator, the more the threats in the state. In 2021, a total of 173 countries were measured. Slovenia and Portugal were rated as most secure with a score of 0.5 while Afghanistan was rated as least secure with a score of 10. *Security Threats Index—Country Rankings*, THEGLOBALECONOMY.COM, https://www.theglobaleconomy.com/rankings/security_threats_index/ [https://perma.cc/RN8R-7NEA] (last visited May 14, 2022).

199. The Fraser Institute's Human Freedom Index used eighty-two distinct indicators of personal and economic freedom in areas such as rule of law, security and safety, freedom to trade internationally, and civil liberties to measure each country's degree of respect for human freedom on a scale of zero to ten. *See* Ian Vasquez et al., *The Human Freedom Index 2021*, FRASER INST. (Dec. 16, 2021), https://www.fraserinstitute.org/studies/human-freedom-index-2021 [https://perma.cc/P675-NCJJ].

India,[200] Hungary,[201] and Turkey[202]—have declined to comply with Washington's request to aid Ukraine or to condemn Moscow's unilateral invasion as well as its troops' human rights atrocities in Ukraine. It would be extremely tricky for ESG rating agencies and companies' internal risk assessment teams to determine the risk score and weight they should assign to these countries. Then there is also the ultrasensitive case of China. Beijing clearly poses a grave threat to the US-led global order and stability, yet so many Western companies and funds are dependent on China.[203] This could potentially render the inclusion of security in ESG a significant operational hardship for them. Hence, there will most likely be some implementation difficulties, albeit much smaller than those related to promoting impact investing on a large scale. For these reasons, adding security as a component of the "S" is a potent and more quickly actionable temporary remedy prior to ESG's replacement by a more viable framework for sustainable and responsible finance or the dominance of impact investing in the distant future.

200. India, despite being the world's biggest democracy, has refused to voice its opposition against the Russian aggression by abstaining from a series of United Nations resolutions condemning Moscow and Putin. The country has deep strategic and historical empathy towards Russia and is also dependent on Russian weapons for its defense. *See* Rajeswari Pillai Rajagopalan, *The Democracy Turning Its Back on Ukraine*, ATLANTIC (Mar. 13, 2022), https://www.theatlantic.com/ideas/archive/2022/03/india-military-support-russia-ukraine-war/627035/ [https://perma.cc/FH7P-D57K].

201. Hungary is currently led by the pro-Russian prime minister Viktor Orban. Unlike other Visegrad Group members, the country has vetoed EU sanctions against Russia and is refusing to let weapons bound for Ukraine pass through its borders. *See* Tim Gosling, *The War in Ukraine Undermines Orban's Illiberal Project*, FOREIGN POL'Y (May 10, 2022), https://foreignpolicy.com/2022/05/10/ukraine-conflict-visegrad-group-orban-hungary-illiberal/ [https://perma.cc/49K4-44YN].

202. Turkey has gotten closer to Russia in recent years under President Erdogan and is opposing Finland and Sweden's future NATO membership. *See* Illiya Kusa, *From Ally to Mediator: How's Russia's Invasion has Changed Ukraine-Turkey Relations*, CARNEGIE ENDOWMENT FOR INT'L PEACE (Oct. 7, 2022), https://carnegieendowment.org/politika/88097 [https://perma.cc/Q7V9-NT62] ("Since the start of Russia's invasion of Ukraine, Turkey has remained the friendliest of all the NATO countries toward Moscow.").

203. *See, e.g.*, Ryan Hass, *The "New Normal" in US-China Relations: Hardening Competition and Deep Interdependence*, BROOKINGS INST. (Aug. 12, 2021), https://www.brookings.edu/blog/order-from-chaos/2021/08/12/the-new-normal-in-us-china-relations-hardening-competition-and-deep-interdependence/ [https://perma.cc/6KU6-L6K5].

V. CONCLUSION

The recent outbreak of the Russo-Ukrainian war has cast several doubts on ESG by exposing the devastating and contradictory real-world outcomes brought on by pervasive exclusionary negative screening strategies against supposedly non-ESG sectors such as defense and conventional energy industries. The cacophony between risk and impact with respect to ESG largely drives the stigmatizing narrative behind these negative screening practices. Therefore, correcting the public and industry's recognition of ESG investing as a risk framework and thereby reducing its conflation with impact investing should resolve the problems that have permeated the business and investment space.

However, there are three issues besides the cacophony that raise questions regarding ESG investing's fundamental efficacy: (1) insufficient fairness and reasonableness of ESG ratings; (2) its uncertain future viability as an effective investment methodology under unfavorable economic conditions; and (3) its decay into a mere public relations medium. Given these lingering problems, abandoning ESG investing entirely and promoting impact investing instead as an alternative form of sustainable and responsible finance might be a desirable solution that would, at the very least, generate social utility. But implementation issues do not make impact investing a suitable large-scale alternative in the short-term. The inclusion of security—which furthers the stability of the US-led order—as a component of ESG's ambiguous "S" is therefore a more pragmatic and quickly actionable temporary remedy. Rooted in the principle that security is the prerequisite for sustainability and other societal advancements, the proposal would be able to address both the cacophony-related ESG weaknesses exposed by the Russian invasion and the other non-cacophony-related ESG problems that challenge ESG investing's fundamental efficacy.