Feature

KEY POINTS

- Assets under management in Environmental, Social and Corporate Governance (ESG) funds is rising rapidly.
- Market demand has led to the creation of new funds.
- Regulation and metrics governing ESG funds have not kept pace with the growth of the sector.
- The resulting uncertainty opens funds to risks of mis-selling.
- Some issues will need time to reach a settled consensus.
- The question of whether ESG funds can short or lend their shares can be resolved immediately.

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A contradiction of terms: is stock-lending compliant with the ethos of an ESG fund?

The market share of ESG funds is rising rapidly and by some estimates is set to become a third of the total market as measured by assets under management. Many questions around ESG funds have yet to be resolved. There is active debate about the issues between, amongst others, asset managers, investors, regulators, lawmakers, scientists and pressure groups. However, some questions can be answered immediately. An ESG fund which shorts a stock which it would deem to be environmentally sound, or, more likely, lends it to another fund to short is acting against the principles of the ESG ethos which attracted its investors in the first place. This is because there is a tension between portfolio returns and environmental concerns. There is a risk of accusation of mis-selling resulting in litigation and censure by the regulator unless the fund's *modus operandi* and their rationale are explicit.

INTRODUCTION

Over the last few years there has been enormous interest from investors to invest in companies with superior Environmental, Social and Corporate Governance (ESG) ratings. This has led to a rapid increase in global assets under management in funds with a plethora of names; "carbon neutral", "net zero", "sustainable", "green", "responsible", "ethical", etc (ESG funds). The global ESG funds' assets under management have been forecast to reach US$53trn by 2025, around a third of the global total.[1] Whilst forecasts vary, it is clear that ESG funds will form a substantial pool of assets.

The regulations and ESG metrics governing such funds have not kept pace with the speed of growth of the sector. The Financial Conduct Authority, the UK's financial regulator, published its concerns in a letter to asset managers in July 2021.[2] Many of the points of debate will no doubt settle over time. This article discusses only the issues of stock-lending and short-selling.

Consider two companies which are identical in every respect other than that one is "clean" (CleanCo) and the other is "dirty" (DirtyCo). CleanCo manufactures its widgets whilst ensuring that its processes minimise greenhouse gas emissions. Consequently, its costs are higher than that of DirtyCo leading directly to lower profitability.

Whilst there is much debate about how to measure environmental damage, everyone can agree that DirtyCo is worse than CleanCo even if the extent is undetermined (perhaps even indeterminable).

Presumably, an ESG fund interested in investing in a widget manufacturer will choose CleanCo over DirtyCo despite its lower profitability. In other words, the investors in the ESG fund are willing purposefully to accept stock under-performance for the sake of the environment. On the other hand, a non-ESG fund with a sole focus on maximising performance will rationally choose to invest in DirtyCo.

A non-ESG fund might go one step further and short the shares of CleanCo. Shorting shares is the process of selling shares a fund does not own with a view of buying them back later at a lower price once the share price has fallen thereby making a profit. Selling shares requires delivery of the shares to the buyer which can only be done if the short seller *borrows* the shares from a current owner. The short-seller (or stock-borrower) returns the shares to the owner (stock-lender) once they have been bought back. The stock-borrower pays the stock-lender a fee for the privilege of borrowing the shares. In this example, the ESG fund is the stock-lender and lends CleanCo shares to the non-ESG fund which is the stock-borrower.

The fee payable to the stock-lender makes lending shares an efficient and low-risk[3] method to increase the return of a portfolio. The increase in fund performance is the main reason to lend shares.[4] There are other consequences of stock-lending that need to be considered: voting rights and ESG credentials.

VOTING RIGHTS

Lending stock transfers the shares' voting rights to the stock-borrower (and ultimately to the buyer of the shorted shares) for the period of the transaction. It follows that the stock-lender can no longer have influence over the management of the company during this period, including the inability to vote at AGMs. In 2019, the Japanese government required that those who manage its US$1.6trn[5] assets (in the Government Pension Investment Fund) suspend their stock-lending activities. They considered stock-lending to be "inconsistent with the fulfilment of the stewardship responsibilities of a long-term investor".[6] The consequences of this logic when applied to CleanCo's management is clear – it deters the management from reneging on its environmental commitments in the face of competition from a more profitable DirtyCo.

A nascent group of financial institutions have devised a new set of standards applicable to stock-lending of ESG companies – the Global Principles for Sustainable Securities Lending.[7] Yet none of its nine principles addresses the problem head-on. Its Principle 7 states:

Biog box

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"Global PSSL emphasises the need to weigh voting and corporate engagement alongside stakeholder values."

In other words, before deciding against stock-lending, the investor should be mindful of the financial returns of the stock-lending fee. This gives rise to a key question: for an investor in an ESG fund, does financial return trump environmental concerns? If it does then presumably there would be no need to label the fund as "ESG". The asset manager's fund prospectus and sales materials have to be transparent on this point if mis-selling claims are to be avoided.

Blackrock's policy is to have the right to recall shares that have been lent to enable them to vote.[8] This solves part of the problem.

ESG CREDENTIALS: PLENTY OF ROOM FOR DOUBLE COUNTING

Establishing the ESG rating of a company – its business's effect on the environment – is a hot topic with many diverse views. For the purpose of the following example, DirtyCo has a score of -75 (a negative figure denotes a net polluter) and CleanCo has a score of +25. The figures themselves do not relate to any particular scale, but are used merely as illustrations.

The change in score for a fund which replaces DirtyCo with CleanCo in its portfolio is +100 (an increase of 25 for buying CleanCo plus an increase of 75 for selling DirtyCo).

What should the net score for the fund be if it shorts CleanCo?

If buying environmentally friendly stocks is deemed good for the planet, then it follows that shorting the same stock must be bad for the planet. It is simply the opposite effect and so the score should be -25. Buying a company's shares allows it to raise valuable capital to fund its business. Buying pressure tends to increase a company's share price and reduces the cost of the capital. That is in the future the company would need to issue fewer shares to raise the capital it needs. Conversely, selling a company's shares tends to decrease its share price and increases the cost of capital. Indeed, the pressure on the share price can be such that further issuance may not be possible.

This is not an argument about the fair value of a company. Nor is it about whether shorting shares is *per se* desirable in a market: the basis on which Blackrock justifies its own stock-lending operation for ESG shares. Referring to independent research, Blackrock states:

"Each of these papers similarly concluded that short selling contributes to efficient price discovery and liquidity in markets, reducing volatility and costs for investors and is not contrary to long term sustainable value creation."[9]

This misses the point and may be misleading. The key question is whether investing with an ESG ethos and shorting shares are compatible.

Looked at another way it becomes clear that ESG ethos and shorting are incompatible. Consider a fund that buys CleanCo. Its ESG score increases by 25. Now, consider the change in its ESG score if it were to sell the share – it must decrease by 25 to bring its overall score back down to zero. Selling shares has the opposite effect of buying them.

What should the net score for the fund be if it lends its CleanCo stock?

Lending stock enables a third-party to short it. Assuming the third-party is not an ESG fund, the ESG score for shorting the share is not accounted for. Yet, the net score has to be zero. It follows that the ESG score for stock-lending is, in this example of CleanCo, -25. Viewed through an ESG lens, stock-lending should be treated in the same way as shorting.

CONCLUSION

An ESG fund's investors are likely to view sub-optimal performance when compared to a non-ESG fund as an acceptable price (subject to limits) to pay to improve the environment. As such, a fund which seeks to increase returns by lending the portfolio to allow shorting for a fee may be seen as contrary to the investors' objectives. Unless the stock-lending is explicitly allowed for, an ESG fund could be accused of mis-selling. ■

Disclaimer: this article is not advice and the author accepts no liability for reliance upon any of the facts or matters stated. Financial and legal advice on the issues discussed should be sought in the ordinary way.

1 https://www.bloomberg.com/professional/blog/esg-assets-may-hit-53-trillion-by-2025-a-third-of-global-aum/
2 https://www.fca.org.uk/publication/correspondence/dear-chair-letter-authorised-esg-sustainable-investment-funds.pdf
3 The risk to the stock-lender is that the share price increases and the stock-borrower defaults on its obligation to return the borrowed shares at the prescribed time. However, this risk is mitigated by the obligation of the stock-borrower to post margin.
4 Short-selling also increases market liquidity and reduces transaction costs as a result of greater transaction volumes.
5 ¥201trn as at December 2021 converted at an exchange rate of 127, p 3, https://www.gpif.go.jp/en/performance/2021_3Q_0214_eg.pdf
6 https://www.gpif.go.jp/en/topics/Suspension_of_Stock_Lending_Activities.pdf
7 https://gpssl.org/wp-content/uploads/2021/09/Global-PSSL-2021-supported-by-opening-signatories.pdf
8 "While most voting items are routine, our global commitment to constructive and continuing dialogue with companies is particularly relevant in contested votes that could lead to an internal process of recalling shares for voting purposes.", p 5, https://www.blackrock.com/corporate/literature/publication/securities-lending-viewed-through-the-sustainability-lens.pdf
9 Page 3, *Ibid.*

Further Reading:

- Seeing the world differently: litigation arising from ESG-related disclosure (2022) 3 JIBFL 150.
- Claims against ESG rating agencies: A hopeless task? (2021) 10 JIBFL 681.
- LexisPSL: Corporate: Practice Note: Investor group guidance on environmental, social and governance (ESG) issues.