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ESG & Web3 –
synergy of the next decade?

Introduction

In recent decades, there is a strong cultural shift when it comes to role that corporations play in the society. With increasing tensions around globalization and environment, generational equity and income inequality, two major global trends have materialized in the last decade – especially following the 2008 global financial crisis. Both trends address the same cultural challenge, but they approach it from different angles.

One of the trends is commonly known as ESG - it deals with environmental, social and governance aspects of doing business. In many ways this is a peer pressure driven, cultural update to conventional businesses (some might call it corporate virtue signalling). The other trend promises a complete uprooting of economic, social and even political institutions – by scaling of decentralized services and technologies based on block-chain (some call it the revolution that never happened).

So far, these two trends have been developing in parallel and without many points of intersection. But as global businesses and political institutions start to adapt, and adopt blockchain technologies, this combination might emerge as a megatrend. This paper deals with their intersection, how and where they may converge or diverge in coming years.

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ESG

In its broadest sense, the term ESG refers to a set of non-financial factors based on which it can be assessed whether, and to what extent, a company operates in line with the recognised environmental, social and governance standards.

By focusing on ESG factors, the company's stakeholders (shareholders, employees, customers, etc.) can assess the impact of company's business on environment (climate change, pollution etc.) the social aspects of its business activities (e.g. whether the company operates in line with labour, human rights, workplace health and safety standards) as well as relevant aspects of the internal governance system of the company (board structure, shareholders' involvement, executive pay etc.).

1 Keeping up with the ESG wave

Some industries, like the financial services industry, have been focusing on ESG more than others and the reason for this is twofold. First, financial institutions operating in certain major regions (like in the European Union) have become subject to new regulations that inevitably brought ESG part of their investment activities to their focus. On the other side, the rising investors' interest, led by a new generation of environmentally oriented investors such as millennials, has incentivised financial institutions to come up with more investment opportunities that would meet expectations of this ever-larger investor community.

Due to its capabilities to support the development of almost every other industry through financing, the financial services industry has soon made all other industries, including the emerging ones like the crypto-industry, to pay closer attention to ESG as well.

2 ESG Regulation

In the western hemisphere (in the United States and the European Union in particular) the ESG has become a key priority for almost all investors and companies that seek financing recently and the reason for this was the increasing level of regulatory involvement in this area. By starting in 2018 with its ambitious Action Plan on Sustainable Finance, the EU Commission has started a wave of ESG related regulations aimed to create a designated regulatory framework on sustainability related reporting, disclosures and management of sustainability risks. In this process, the EU lawmakers have especially focused on the financial services industry by seeing it as an essential intermediary that can channel the funds from investors towards environmentally sustainable projects. The Taxonomy Regulation[1], which has created a set of criteria based on which the companies can assess whether, and to what extent, an economic activity can be deemed as environmentally sustainable together with the Sustainable Finance Disclosure Regulation[2], which imposed rigorous disclosure obligations on the great number of financial institutions (with the special focus on asset and wealth managers) are putting financial institutions across the EU in front of unprecedented challenges.

3 Market reaction

In addition to the rising regulatory burden, the global financial services industry was also experiencing the rising investors' interest in investment opportunities that are able to meet expectations of the ever-greater number of environmentally oriented investors. This led to a rapid increase in the number of investment products (especially units in investment funds and structured products) with the ESG term in their names that have soon flooded the market.

[1] Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088

[2] Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088

4 Greenwashing

Yet the future may not be as green as some might hope. This year only, several eye-catching scandals have shaken up the financial services industry and left the experts and market participants questioning whether ESG wave is indeed as promising as it may appear to be at first glance. First, in May 2022 S&P decided to delist Tesla from its ESG index[3]. Even though we as authors have no technical expertise in the field of ESG, the booting of Tesla was quite possibly completely justified. But a decision as controversial as this one, that sparked huge debate about ESG ratings in general, requires a great deal of education of the public. The decision itself was primarily justified by work conditions at Tesla; yet Amazon, the company that experiences even greater level of criticism in this area, holds the no. 3 position on the list of the aforementioned S&P's ESG index.

Delisting of Tesla from the leading ESG index was by no means the only story that drew public's attention when it comes to ESG in 2022. Throughout the year, financial supervisory authorities were raiding offices of leading financial institutions that showed the tendency to over-green their financial products and services by leveraging the ESG wave that was hitting shores of their major customers around the world.[4] These events incentivised regulators in major jurisdictions, primarily in the European Union and the United Kingdom, to start paying closer attention to the topic of greenwashing.

First, in October 2022, Financial Conduct Authority (FCA) in the UK, has proposed a package of new rules that shall prevent greenwashing, including investment product sustainability labels and restrictions on how terms like 'ESG', 'green' or 'sustainable' can be used by financial products.[5]

Only a month after FCA's announcement, European Supervisory Authorities (ESAs) have issued a call for evidence looking for feedback on potential greenwashing practices across the EU financial sector. The call for evidence comes as a response to EU Commission's mandate given to ESAs on 23 May 2022 in which the EU Commission asked them to give their input on the trend of greenwashing practices within the EU and develop recommendations to address related issues (the Greenwashing Mandate).

[3] https://www.bloomberg.com/news/articles/2022-05-19/tesla-s-removal-from-s-p-index-sparks-debate-about-esg-ratings#:~:text=S%26P%20Dow%20Jones%20Indices%2C%20which,ranks%20against%20improving%20global%20peers

[4] https://www.wsj.com/articles/sec-fines-bny-mellon-over-esg-claims-11653323966#:~:text=The%20Securities%20and%20Exchange%20Commission,BNY%20Mellon%20Investment%20Adviser%20Inc.

[5] https://www.fca.org.uk/news/press-releases/fca-proposes-new-rules-tackle-greenwashing

Few days after this, European Securities and Markets Authority (ESMA) launched a consultation on guidelines for the use of ESG or sustainability related terms in funds' names, that goes pretty much in a similar direction like the aforementioned initiative of the FCA in the UK.

While regulators around the world are still in the process of finding right approach to regulation of ESG in the financial industry and while ESG seems as a laudable aspiration, it can be concluded that it is still lacking a 'consensus mechanism'. Enter Web3.

Web3

Web3 is not an ideal term since frankly speaking there is no Web3 yet. It is intended to mean the next iteration in how people will interact with the World Wide Web. It started with Bitcoin, the world's first cryptocurrency in 2009. Around 2015, it switched gears with the release of Ethereum, which was meant to operate as a decentralized smart contract platform.

Few could have guessed that by 2022 the combined market cap of Bitcoin and Ethereum would surpass USD 1 trillion, putting it ahead the likes of Visa, MasterCard, JP Morgan Chase, Walmart, and many other giants.

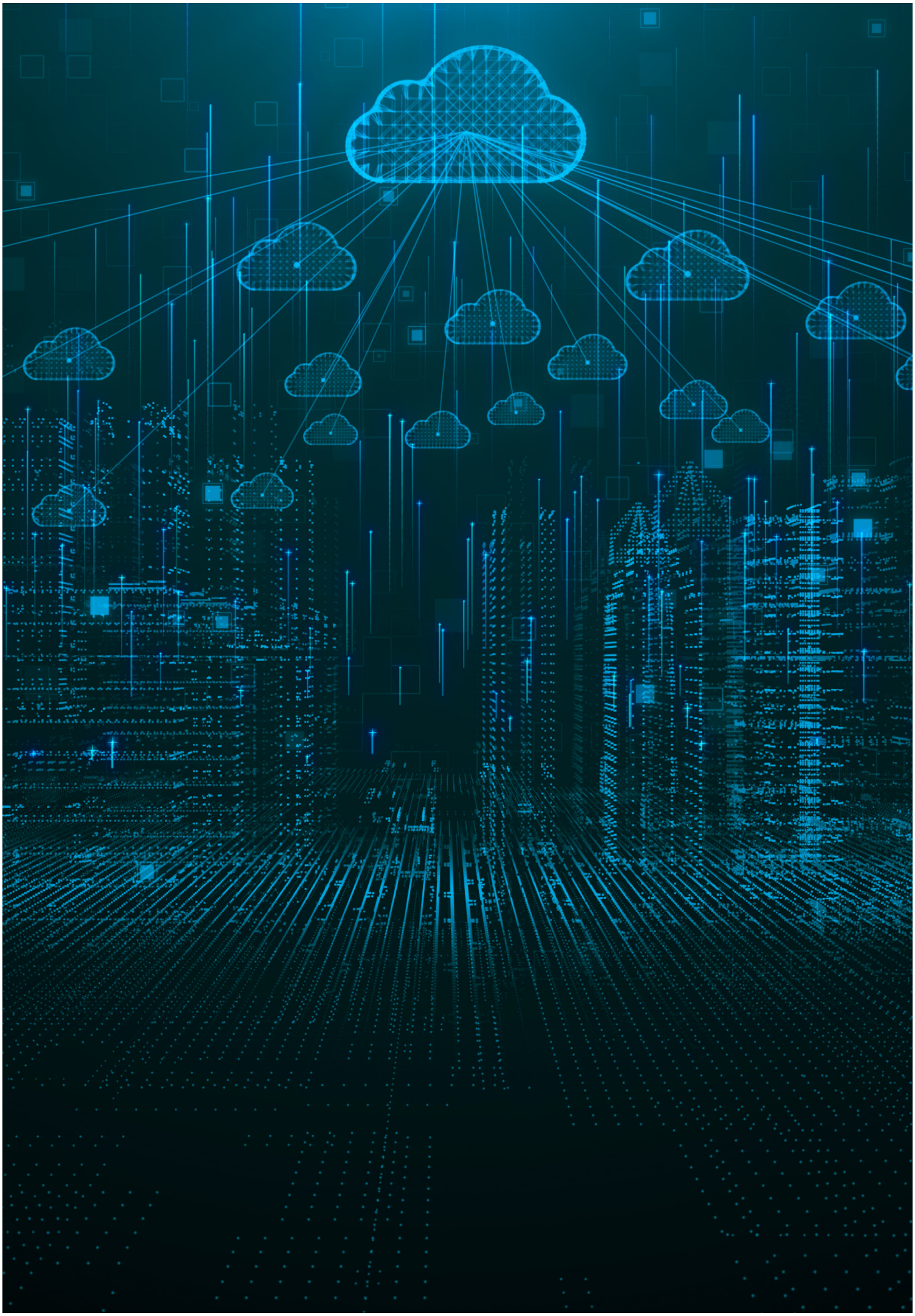
The popularity of blockchain technology has steadily grown year after year in several hype waves. Following the ICO bull-run in 2017, crypto assets have gained in popularity that has just continued to gain in size in the years to follow. Together with the blockchain technology underpinning their essence, crypto-assets have led to the emergence of various new products and solutions that innovative thinking individuals and companies from across the globe have managed to come up with. NFTs, crypto-based carbon credits, crypto-securities and blockchain based systems for information sharing and verification (that can be used across various industries like shipping, finance, international trade etc.) were just some solutions for the existence of which the global economy can thank blockchain technology and crypto-assets for.

The centrepiece of the blockchain technology is decentralization, which brings more control and transparency to market participants across various industries. Led by the idea of decentralization, the crypto-industry was exploring the ways in which higher level of decentralization can be achieved by existing centralized systems, including the backbone of the modern society, the internet. In this process, certain parts of the crypto-industry have started to work on something that was soon labelled as Web3.

One of the first examples of Web3 that have become widely known is decentralised finance (DeFi) that consists of DLT based protocols that enable trading as well as lending and borrowing of crypto-assets on a bilateral basis between the network participants, without any intermediary in between. To that end, Web3 aims to achieve a paradigm shift from the existing data centric and centralized systems that dominate the internet that we know (largely dominated by large tech companies) to new decentralised DLT based models. Decentralised approach used in the process of development of Web3 projects has also resulted in the emergence of the so called decentralised autonomous organisations (DAOs), the term that basically refers to the community that participate in the development and functioning of the Web3 project. Having no centralised authority or system, DAOs function based on an internal decision-making process in which all participants have a voting right and thereby ability to directly influence the functioning of the project.

However, it is also fair to say that in many aspects, Web3 is falling short on its big promises – if we take NFTs as an example, it has become clear that this fad is quickly fading. Yet, it is becoming equally apparent that its trail of fading can serve as a good indication of their future use, and there is a growing consensus that NFTs tied with 'real life' applications results in a strong and appealing combination.

The objective underlying value of NFTs is negligible. Scarcity in digital media (exclusivity and inexhaustibility) can only exist in the context of government-enforced IP laws. But its subjective value can be disproportionally greater owing to the consensus mechanism which can (a) be based on a more widely accepted public consensus and (b) create artificial scarcity of digital assets. In other words, the problem which the NFTs solves appears very similar to the problem which the ESG needs to address.



When Web3 meets ESG

In comparison to other industries of the global economy, the crypto-industry did not stay immune to the rising public interest in ESG either. If we focus on the interplay between the ESG and Web3 for a moment, the question that needs to be answered would be, whether these two megatrends are mutually exclusive or combinable after all?

Environmental

One of the first issues that was raised when it comes to alignment of crypto-related business activities with ESG standards was the electricity consumption. The energy inefficiency of the network of the most well-known crypto-currency in the world, Bitcoin, was increasingly criticized in recent years due to the fact that it operates based on a quite energy inefficient proof-of-work consensus mechanism. Ethereum, the second largest blockchain network in the world, is criticized for energy consumption as well due to its transaction costs (the so called "gas-fees") and speed of transactions.

There are many competing solutions for the problem of energy consumption as well as transaction speed and costs. By sacrificing some security and decentralization of Ethereum and Bitcoin, several alternative consensus mechanisms like proof-of-stake or proof-of-authority have been developed. On 15 September 2022 Ethereum made a radical shift from the proof-of-work to the proof-of-stake by joining its original execution layer based on proof-of-work with its new proof-of-stake consensus layer, which aims to replace energy-costly mining process with staking (commonly known as "Ethereum Merge"). Staking refers to the process that allows users to become validators on a proof-of-stake blockchain by locking up an amount of native tokens (e.g. ETH) in a staking smart contract in order to get a chance to be selected by the protocol to propose new blocks of transactions and other data in exchange for interest payments.

Against the backdrop of the above-mentioned, it is fair to conclude that the environmental part of the ESG equation is solvable for crypto-businesses that develop Web3 projects

through the deployment of consensus mechanisms that provide for a better energy efficiency. Combination of an energy efficient consensus mechanism and the consumption of electricity from renewable energy sources (solar, wind, hydro etc.), can generally be seen as a universal solution for all crypto-businesses that aim to show commitment to development of environmental businesses.

There are also several examples in the market of how Web3 projects can support businesses from various industries that are looking for a way how to keep up with the ESG wave. Nowadays, there is a variety of methods that can be used by businesses for the purposes of reduction of their carbon footprint. One of the most convenient method that has become increasingly popular is recent years are carbon offsets. With this in mind, the UK based company DOVU[6] has developed an online marketplace where businesses can achieve carbon offsetting by utilizing blockchain technology and crypto-assets in full. The company's online marketplace enables real-time calculation of the user's carbon footprint (by reviewing user's wallet's transactions and gas fees) and provides the value of the carbon footprint of the wallet together with the recommendation which amount of carbon offsets is necessary for the complete carbon offsetting in a particular case. The company cooperates with Klima DAO[7], decentralized autonomous organization (DAO) standing behind another major Web3 project with the environmental focus.

Social

The Social (S) part of the ESG focuses generally on the social aspects of a particular business by analysing for example whether and how the company complies with health and safety standards at workplace, human rights and minimum labour standards (throughout the entire supply chain), questions related to diversity and inclusion in the workplace etc. Younger generations that are generally staff members and founders of crypto-companies are usually keen to operate in a socially oriented working environment that the aforementioned S factors are the essential part of. Further, even where certain changes must be made with the aim of company's further alignment with social standards, a relatively small size and flexibility of the great majority of crypto-firms that are active in Web3 space allows them to introduce necessary changes more easily than other more established businesses. It is therefore, fair to say that crypto-businesses could use their greater level of flexibility as a competitive advantage over more established industries (like oil, shipping,

[6] https://dovu.earth/en/solution/#carbon_marketplace

[7] https://www.klimadao.finance/de

aviation etc.) that are sometimes more reluctant to embrace such changes that rapidly.

There are also some good examples of Web3 projects that promote social goals, like for instance Big Green DAO.[8] Promoted as the first Non-Profit Led Philanthropic DAO, Big Green DAO pursues to open a new era in the field of philanthropy by leveraging Web3. It aims to enable both donors and grant recipients to cast votes within the DAO community and directly participate in the decision-making process regarding the allocation of group's funds for donation purposes. Besides donors that will receive governance tokens after pledging certain amount of funds for donation purposes, governance tokens will also be allocated to non-profit grant recipients that have successfully received donations via the platform. The project mainly aims to support socially oriented organisations that are advancing food and gardening, including food justice, school gardens, home gardens, urban gardens, food advocacy, and regenerative agriculture etc.

Governance

The analysis of governance aspects of the ESG term is usually performed based on factors that focus on internal decision-making process, appointment and the composition of the management board, (incl. by focusing on diversity and inclusion) their compensation, management of internal conflicts of interest etc. Whereas centralized systems in more established industries face sometimes significant challenges in solving this part of the ESG equation, one may argue that the blockchain technology has a potential to unlock new opportunities for more inclusive and diversified internal governance systems. For instance, DAOs are generally structured in a way to achieve high level of transparency and simplicity when it comes to decision making. DAOs allow people from all around the world to virtually gather, form virtual community and directly participate in the decision-making process that is featured by transparency and high level of inclusion of all participants involved in the network.

Against the backdrop of the aforementioned, it can be argued that Web3 projects in their essence, can provide good example to other industries of how internal governance systems can be structured in a transparent, easy to understand and inclusive way.

Conclusion

From today's perspective, both ESG and Web3 seem to be here to stay. Each one seems to be aggregating a great number of trends which have emerged in response to globalization and the 'end of history'. Each one is informing and influencing global business and politics in major ways the "Breitbart doctrine" states that culture is upstream from politics – and both ESG and Web3 (possibly as the articulation of the decentralization and deglobalization narrative) seem to be the integral part of today's culture. ESG is infiltrating the culture through institutions – from the UN through global financial institutions and media, to businesses and organizations around the world. Web3 is taking a different route.
The Balaji "doctrine" makes a point that technology is upstream of both culture and politics, and this seems to be accurate: ideas and solutions emerging from crypto and Web3 are infiltrating the culture and institutions from grassroot levels.

These are times when ESG seems to be on a vector where it will experience a major test of trust. On the other side, at its core, Web3 is nothing other than a solution to the trust problem. Synergies around this combination are likely already inspiring brilliant ideas. These are turbulent times - the global economy is experiencing unprecedent challenges on various fronts including global energy crisis, heavily disrupted supply chains, rising inflation and questionable future of globalisation in general. But crises are periods when world changing ideas emerge.

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