Fisher Broyles

CLIENT ALERT
March 31, 2021

Beyond Disclosure - The Emergence of ESG as a C-Suite Risk Factor

Part I: Looking Ahead to NDC and Net Zero

The global impacts of the COVID-19 pandemic and the Black Lives Matter movement in 2020 continue to be felt in 2021 as a renewed focus on integrating Environmental Social and Governance ("ESG") issues into investment decisions has been pushed by investors and other stakeholders. Following the election of President Biden, the United States has rejoined the Paris Agreement[1], and Congress has proposed sweeping ESG legislation.[2] Meanwhile, growth in ESG funds has soared,[3] led by large institutional investors and millennial retail investors for whom ESG issues such as income inequality, diversity and inclusion, social injustice, employee welfare, and climate change are core issues of import.

In 2021 the U.S. Securities and Exchange Commission (the "SEC") has reversed course from its prior posture that existing regulations provided a sufficient disclosure framework for assessing ESG risk and has responded with an "all agency" approach including not only disclosure, but also including climate-related risks as an examination priority, announcing the creation of an Enforcement Task Force on Climate and ESG issues and taking steps to educate investors on mutual funds and exchange-traded funds ("ETFs") that focus on environmental, social and governance principles.[4] In recognition of the growing awareness both in the boardroom and among investors that systemic risk—be it climate change, poverty, or social injustice—requires significant change in how business is done, and that stakeholders

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[1] The Paris Agreement was adopted by 197 countries on December 12, 2015 at the 21st Conference of Parties (COP21) in Paris, France.

[2] *See* discussion on the CLEAN Future Act *infra.*

[3] "US SIF, an organization that has tracked socially responsible investing since 1995, reported in November that 33% of total U.S.-domiciled assets under management (AUM) now use sustainable investing strategies…. Sustainable-debt issuance—including green and social bonds—reached a record $530 billion in 2020, according to Environmental Finance, up 63% from 2019." ESG A Growing Phenomenon | ETF.com. "According to Deloitte, the percentage of investors who applied ESG principles to at least a quarter of their portfolios grew from 48% in 2017 to 75% in 2019." 15 Best ESG Funds for Responsible Investors | Kiplinger. "Today, ESG investing is estimated at over $20 trillion in AUM or around a quarter of all professionally managed assets around the world,…" The Remarkable Rise Of ESG (forbes.com)

[4] *See* the SEC Response to Climate and ESG Risks and Opportunities https://www.sec.gov/sec-response-climate-and-esg-risks-and-opportunities

want the means by which to adequately monitor and judge the extent to which such risk is lurking, FisherBroyles is providing this alert as part of a series on ESG and its emergence as a risk factor for the C-Suite and legal, compliance, and risk professionals. This part of the series focuses on the steps the U.S. generally and the SEC, in particular, is taking on instituting an ESG disclosure regime. Future alerts will focus on other stakeholders, including market participants, investors, and credit rating agencies as well as legislative initiatives.

The Paris Agreement and Net Zero

The Biden Administration signaled to the world its prioritization of talking climate change when it moved to reinstate the U.S. to the Paris Agreement just hours after taking office. The mission of the Paris Agreement is to limit 21st century average temperature increase to no more than 2 degrees Celsius (3.6 degrees Fahrenheit) above pre-industrial levels (1850 – 1900). The Agreement also states a more aspirational goal of limiting temperature increase to 1.5 C (2.7 F) above pre-industrial levels, which is more likely to significantly reduce climate impacts.[5]

The Paris Agreement establishes two five-year processes for each signatory. The First is the submission every five years of "successive nationally determined contributions" ("NDC") to cutting greenhouse gas ("GHG") emissions, which must represent "a progression beyond the Party's then current nationally determined contribution and reflect its highest possible ambition…."[6] The second is a "global stocktake" to assess and measure progress towards the Agreement's long term goals every five years.[7]

On March 10, 2021, U.S. climate envoy John Kerry confirmed that the United States would issue its NDC by April 22, 2021. The United States is by far the world's largest emitter of GHG.

In 2018, the Intergovernmental Panel on Climate Change ("IPCC") warned of intensifying natural disasters if we exceed 1.5 C of global warming. Limiting global warming to 1.5 C would require curbing GHG emissions to 55% of 2010 levels by 2030 and to "net zero" by 2050—i.e. any remaining emissions must be balanced by removing an equivalent amount of CO_2 from the air.[8] As of 2021, approximately

[5] Scientists believe achieving this level will prevent the disappearance of certain island nations due to sea level rise.
[6] Paris Agreement, Article 4.
[7] Paris Agreement, Article 14.
[8] Global Warming of 1.5 ºC — (ipcc.ch) The IPCC is the leading world body on the science of climate change.

140 countries have committed to a net zero GHG emissions target and to producing no more emissions than they can offset by 2050 ("Net Zero"). [9]

The United States and Canada committed on February 23, 2021 to work towards Net Zero.

<u>The CLEAN Future Act</u>

On March 2, 2021, the U.S. House of Representatives Energy and Commerce Committee introduced H.R. 1512, the "Climate Leadership and Environmental Action for our Nation's Future Act" or "CLEAN Future Act."[10] The bill probably represents the most comprehensive and aggressive agenda ever proposed by the U.S. government to address climate change. While the bill is likely to undergo several amendments if it is to become law, it nonetheless represents an important indication of what is perhaps on the horizon in terms of regulations, opportunities, and risks on a company, industry, and macro-economic level.

The CLEAN Future Act proposes to cut greenhouse gas emissions by 50% from 2005 levels no later than 2030 and a 100% clean economy (Net Zero) by 2050, in accordance with the IPCC targets. It would impose both sector-specific and general cuts that would profoundly transform the U.S. economy. Among its numerous far-reaching initiatives, the bill proposes to:

- Require all retail electricity suppliers to reach 80% clean electricity by 2030 and 100% by 2035;
- Require prevailing wages for workers building participating new electricity generation and allow unions for such workers;
- Set new energy efficiency targets and standards for buildings and establish a benchmarking program to track energy and water consumption in buildings;
- Invest in transportation electrification and clean transportation infrastructure and establish a United States Environmental Protection Agency ("EPA") grant program to reduce GHG emissions and air pollution at ports;

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[9] The race to zero emissions, and why the world depends on it | | UN News China has set a target of 2060 to reach net zero emissions.
[10] Text - H.R.1512 - 117th Congress (2021-2022): To build a clean and prosperous future by addressing the climate crisis, protecting the health and welfare of all Americans, and putting the Nation on the path to a net-zero greenhouse gas economy by 2050, and for other purposes. | Congress.gov | Library of Congress.

- Require the establishment of a Buy Clean Program to reduce emissions from materials and products used in federally funded projects;
- Adopt numerous "environmental justice" initiatives and programs to address the disproportionate impacts of climate change, pollution, and environmental hazards on underserved or disadvantaged communities, including *inter alia* the replacement of lead service lines and a ten-year deadline for the cleanup of all EPA Superfund sites (hazardous waste sites) that are vulnerable to climate effects. The bill requires 40% of all funds made available to benefit environmental justice communities;
- Direct EPA to cut methane pollution by the oil and gas industry by 65% below 2012 levels by 2025 and 90% below 2012 levels by 2030 and progressively phase out routine flaring by 2028;
- Direct EPA to cut black carbon emissions 70% below 2013 levels by 2025;
- Encourage and empower states to complete the transition to Net Zero according to their own policy preferences, priorities and circumstances, based on the federalism model in the Clean Air Act;
- Introduce measures to reduce the generation of waste and improve recycling and waste management, including measures affecting the production of plastic, the use of landfills, and the reuse of batteries; and
- Invest in worker training and assistance with the transition to Net Zero.[11]

When one considers the CLEAN Future Act in conjunction with the new ESG disclosure regime being contemplated by the SEC (discussed below), the urgency of, and commitment by the United States to, the Paris Agreement and IPCC targets is manifest. If enacted, the bill will affect every major aspect of life and business in the United States, from energy, transportation, food, and education to urban planning, manufacturing, and inevitably banking, finance and capital markets.

<u>SEC Initiatives</u>

So far, the year 2021 has been notable for the SEC's rapid shift towards instituting an ESG disclosure regime for registered companies, which is in contrast to the laissez-faire approach previously followed.[12] It is also more in line with the proactive approach of European regulatory bodies, which have led on ESG

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[11] *See* CLEAN Future Act Fact Sheet FINAL.pdf (house.gov)
[12] *See* "Seeking alignment on ESG Reporting: the EU advances while the SEC steps aside." Datamaran_Regulatory_Snapshot_SEP2020.pdf

initiatives over the past five years.[13] Since President Biden's inauguration, the SEC has taken several incremental steps towards building a comprehensive and mandatory ESG disclosure regime, including:

(i) On February 24, 2021, SEC Acting Chair Allison Herren Lee instructed the Division of Corporate Finance to augment its focus on climate-related disclosures in public company filings and to begin updating its 2010 Guidance Regarding Disclosure Related to Climate Change (the "2010 Guidance").[14]

(ii) On March 2, 2021, during his Senate confirmation hearing as the next Chair of the SEC, Gary Gensler stated that disclosures, including ESG disclosures, should be based on materiality, which he explained as "what reasonable investors are seeking to have to make their decisions either to invest or not to invest." He pointed to last year's proxy season in which over 40% of investors indicated that such disclosures would be material to them. He further explained that materiality ought to be viewed in the context of the "total mix of information" that reasonable investors would want when making their investment decisions. When asked if companies should be able to hide their climate risks from investors, Mr. Gensler responded, "No, they should not…" With regard to a rule proposed by Nasdaq requiring all Nasdaq-listed companies to publicly disclose diversity statistics regarding their board of directors, Mr. Gensler answered that he thinks "human capital is a very important part of the value proposition in so many companies… We'll look at… what information investors want in this broad arena about the human capital, including diversity, at their companies they're investing in."[15]

(iii) On March 3, 2021, the SEC's Division of Examinations identified climate-related risks as a 2021 examination priority. The Division will "enhance its focus on climate and ESG-related risks by examining proxy voting policies and practices to ensure voting aligns with investors' best interests and expectations, as well as firms' business continuity plans in light of intensifying physical risks associated with climate change."[16]

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[13] Id.
[14] SEC Release No. 33-9106.
[15] *See* SEC Chair and CFPB Director Confirmation Hearing | C-SPAN.org (c-span.org)
[16] SEC Press Release 2021-39, SEC.gov | SEC Division of Examinations Announces 2021 Examination Priorities.

(iv) On March 4, 2021, the SEC announced the creation of a Climate and ESG Task Force in Division of Enforcement. The Task Force will "develop initiatives to proactively identify ESG-related misconduct" and "coordinate the use of Division resources including the use of sophisticated data analysis to mine and assess information across registrants." [17] Its initial focus will be to (i) "identify materials gaps or misstatements in issuers' disclosure of climate risks under existing rules" and (ii) "analyze disclosure and compliance issues relating to investment advisers' and funds' ESG strategies."[18]

(v) On March 11, 2021, the newly appointed Acting Director of the Division of Corporate Finance John Coates made public statements about the need for "the creation of an effective ESG disclosure system so companies can provide investors with information they need in a cost effective manner." [19] Mr. Coates expressed the belief that SEC policy on ESG disclosures be "both adaptive and innovative… to the realities of climate risk… and the fact that investors are increasingly asking for ESG information to help them make informed investment and voting decisions."[20] He cited asbestos as an analogy to ESG, explaining that "[f]or years, asbestos-related risks were invisible, and information about asbestos would likely have been called 'non-financial'."[21] As the risks of asbestos became clearer, disclosure increased. On the issue of costs, Mr. Coates suggested that disclosure requirements might reduce costs for some reporting companies rather than increase them, in terms of reducing redundant investor requests for information, lost investments and higher costs of capital due to the absence of such information.

[17] SEC Press Release 2021-42, SEC.gov | SEC Announces Enforcement Task Force Focused on Climate and ESG Issues.
[18] Id.
[19] SEC Public Statement, ESG Disclosure—Keeping Pace with Developments Affecting Investors, Public Companies and the Capital Markets, SEC.gov | ESG Disclosure – Keeping Pace with Developments Affecting Investors, Public Companies and the Capital Markets.
[20] Id.
[21] Id.

(vi) On March 15, 2021, SEC Acting Chair Lee requested public input on climate change disclosure in the context of upgrading the 2010 Guidance.[22] Acting Chair Lee listed 15 questions for public input, including:

- how to best regulate disclosures to provide consistent, comparable and reliable information while providing greater clarity to reporting companies;
- what information related to climate risks can be quantified and measured, including GHG emissions;
- what are the advantages and disadvantages of drawing on existing frameworks such as the TCFD[23], SASB[24] or CDSB[25]; and
- whether disclosure requirements should be incorporated into existing rules or new regulations.

(vii) On March 19, 2021, the SEC Asset Management Advisory Committee held a meeting to discuss potential recommendations to the SEC, including potential recommendations made on December 1, 2020 by the ESG subcommittee.[26] Those recommendations included:

- Requiring the adoption of standards by which corporate issuers disclose material ESG risks. While the subcommittee did not see the need to change existing disclosure laws to improve the quality and comparability of ESG for investors, it recommended the adoption of mandatory standards for those disclosures. However, the subcommittee did not recommend the "highly prescriptive" European approach, which it felt could result in superfluous metrics and unnecessary costs.
- Utilizing standard setters' frameworks to require disclosure of material ESG risks, focusing on limited material metrics, tailored by industry and overseen by independent entities such as the Sustainability Accounting Standards Board (SASB);

[22] SEC Public Statement, Public Input Welcomed on Climate Change Disclosures, SEC.gov | Public Input Welcomed on Climate Change Disclosures.
[23] Task Force on Climate-Related Financial Disclosures (fsb-tcfd.org)
[24] SASB (Sustainability Accounting Standards Board)
[25] Homepage | Climate Disclosure Standards Board (cdsb.net)
[26] Potential Recommendations of the ESG Subcommittee (sec.gov)

- Suggesting best practices (rather than mandate specific approaches) to enhance ESG investment product disclosure about their objectives and how they prioritize them (e.g., are the risk/return objectives a higher or lower priority than any non-risk/return objectives, such as religious rule adherence or social benefits).

The meeting generated divergent comments from commissioners and company representatives on whether or not the current voluntary disclosure regime should be enhanced, but the dissenting views are unlikely to halt the SEC's development of new ESG disclosure requirements and standards. Given the United States' rejoining of the Paris Agreement and Congress's proposal of the CLEAN Future Act, not to mention the heightened attention by funds and investors to ESG, the SEC appears to have a clear mandate to reform its ESG disclosure regime. It is therefore a matter of how much, not if, reform will occur.

Materiality Revisited

The ESG disclosure debate within the SEC centers around the issue of materiality. Information concerning a security is material if there is a substantial likelihood that a reasonable investor would consider it important in deciding how to vote or invest.[27] While the SEC under the previous administration favored a principles-based approach to determining materiality, the current administration appears likely to institute more of a rules-based approach, which requires more specific details and allows investors to compare similar types of information across companies and sectors. In-coming Chair Gensler appeared to hold the rules-based line during his Senate confirmation hearing, in which he expressed a willingness to be guided by what investors—as opposed to issuers—consider material to their decision-making.[28]

Even in the ESG context, both approaches have positive and negative aspects. Principles-based materiality favors issuer judgment, convenience and efficiency, while rules-based materiality favors measurability and reliability of investor knowledge. The underlying argument is that misleading or

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[27] *See* TSC Industries, Inc. v. Northway Inc., 426 U.S. 438, 449 (1976) (holding that a fact is material if there is "a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote… Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."); Basic Inc. v. Levinson, 485 U.S. 224 (1988)(upholding TSC Industries and holding that materiality "will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity." Id. at 238).
[28] *Supra* n. 16.

asymmetrical information is antithetical to reliable pricing and that transparent disclosure is required for efficient markets. However, the degree of investor demand for greater disclosure of climate change impacts since the 2010 Guidance might not merely exist as a byproduct of greater awareness of the threat of global warming and the need for greater diversity and inclusion in society. It could also exist as a reaction to the historical lack of transparency and attention paid to ESG disclosures. Had the principles-based materiality approach in fact yielded the qualitative and quantitative information promised, we might not have the level of investor activism around ESG that we have seen in recent years. Inevitably, increased ESG disclosures may put pressure on issuers to pay greater attention to ESG issues in their corporate strategy, policies and procedures. In some cases, greater disclosure or the lack thereof could cause a change in investor sentiment towards an issuer for better or for worse.

Net Zero, Not Zero Sum

Historically, the ESG disclosure debate has centered around a legal and economic cost-benefit analysis that one could view as a "zero sum game" where environmental or social development can only come at the expense of corporate profitability or growth. Essentially, the view is that addressing ESG issues in general and increasing ESG disclosures in particular will be cumbersome, expensive and may lead to litigation against reporting issuers. Also, the potential benefits of such actions are in principle intangible and nonquantitative, because they are not conducive to inclusion in financial statements. Under this perspective taking the "greater good" into account inevitably results in failure to maximize shareholder profit, i.e., a "zero sum game." Based on the sole interest of shareholder value maximization, management should decide what is material, what constitutes "value" for investors, and how that value should be achieved.

Recognition of ESG factors began to change this traditional view of "value," as led by public pension funds and other institutional investors, many of which have sought to broaden the concept of "value" beyond financial profit and "stakeholder" beyond shareholders to employees, customers, and communities at large. To the extent that the American retail investor has shifted towards indexed-investing (ETFs), these institutional investors share similar interests with the average investor, which could further legitimize the activism of the fund asset managers.[29] "The Big Three of institutional investors—BlackRock, Inc., State Street Global Advisors, and Vanguard Group—now hold over 20% of

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[29] *See* generally Coffee, The Future of Disclosure: ESG, Common Ownership, and Systematic Risk by John C. Coffee :: SSRN.

the shares in S&P 500 companies (and vote approximately 25%) and are projected to vote over 40% by 2038."[30] Consequently, the increased activism of institutional investors may be seen not merely as increasing their focus on systemic risk—of which climate change is the greatest—but also as converging with the desires of retail investors that issuers pay more attention to planet and people as opposed to just profits. By many accounts, the activism is working: Following BlackRock CEO Larry Fink's 2020 letter to CEOs on climate change, several major companies pledged to achieve Net Zero, including Royal Dutch Shell, BP, JPMorgan Chase, Delta Air Lines, and Microsoft.[31] A recent survey shows that 400 of the world's 2,000 largest publicly listed companies have committed to Net Zero.[32]

A Time for Choosing

The core premise of the Paris Agreement is that the world is running out of time. The IPCC has said that if we achieve Net Zero by 2050, we can still keep warming below 1.5 C. However, we can expect to see worsening climate conditions well before then with predictably disruptive effects on capital markets and life in general. As we near 2050 and fall further behind our targets, required measures could be viewed as too draconian and austere for orderly implementation in modern society as we know it, whether through legislation or executive action. Any and all of these developments could constitute material risk factors that companies should begin planning for now. Integrating ESG into corporate strategy and planning will lead to more efficient and transparent disclosure.

One of the more immediate ways in which issuers may be called upon to change not only their disclosures but their policies and procedures is with regard to social issues. In particular, companies that broaden their view of stakeholders beyond shareholders might be better informed and able to measure the ESG impacts of their strategies by including outside perspectives not present in the board room. Such engagement can garner more buy-in, cooperation and trust, which can further legitimize the strategies adopted.

In anticipation of new SEC ESG disclosure rules, issuers should consider some of the following measures:

[30] Id. at p. 3
[31] Shell is latest to pledge net-zero greenhouse emissions by 2050 - Roll Call
[32] ECIU-Oxford_Taking_Stock.pdf (edcdn.com)

- Review and monitor proposed legislation, particularly the CLEAN Futures Act, and how it affects the company;
- Begin planning for a transition to a Net Zero economy and identify opportunities and costs of such a transition;
- Review current ESG disclosures and statements in SEC filings, social media, and marketing materials;
- Adopt standards and recommendations developed by TCFB or SASB;
- Consider engaging stakeholders in discussions around corporate ESG strategies, programs, and initiatives;
- Recruit board members with knowledge in various aspects of ESG planning;
- Make sure that ESG disclosures reflect actual measures taken;
- Where possible, assess and measure whether and how strategies and initiatives taken lower emissions or improve social conditions;
- Develop resiliency plans for physical damage or disruption caused by climate events.

Conclusion

Many of the steps being taken by the U.S. Government, and the SEC in particular, can be viewed as part of a larger effort to institute NDC in compliance with the United States' commitment to the Paris Agreement and Net Zero. Similarly in the aftermath of 9/11 when the U.S. Government enlisted the active participation of the financial industry in its fight against terror by instituting in the USA Patriot Act[33] sweeping new bank secrecy and anti-money laundering laws and regulations, the steps being taken by the U.S. Government and the SEC do not shy away from imposing compliance costs on certain sectors of the U.S. economy deemed critical to the fight at hand. The transition to Net Zero will have a far more profound impact on the way business is conducted than the USA Patriot Act if it is to have any chance of success. Accordingly, we must assume that further significant regulatory change is likely. If the CLEAN Future Act (or some portion of it) becomes law, ESG disclosures may become an afterthought for certain industries, as they may be required to radically change their business models in order to survive. Regardless of the U.S. regulatory landscape over the next five years, companies ought to begin re-examining and optimizing their missions, corporate strategy, policies and processes to incorporate ESG issues and transition to Net Zero. The cost of doing so now is likely to be less than the cost of not

[33] Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA Patriot Act) Act of 2001. https://www.congress.gov/107/plaws/publ56/PLAW-107publ56.pdf

managing the risks associated with not doing so. Conversely, the benefits of recognizing and managing ESG risks, and addressing them (e.g., developing resilience and sustainability) will outweigh the perceived cost saving of delaying action and reacting to events after they occur.

FisherBroyles attorneys are knowledgeable on ESG and SEC matters and are able to advise and assist you with SEC disclosure matters as well as both proactive efforts to build and maintain a risk and/or compliance program, as well as responding to regulatory inquiries and enforcement matters.

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