ESG Considerations for Public Companies

Public Company Advisory Practice (PCAP)

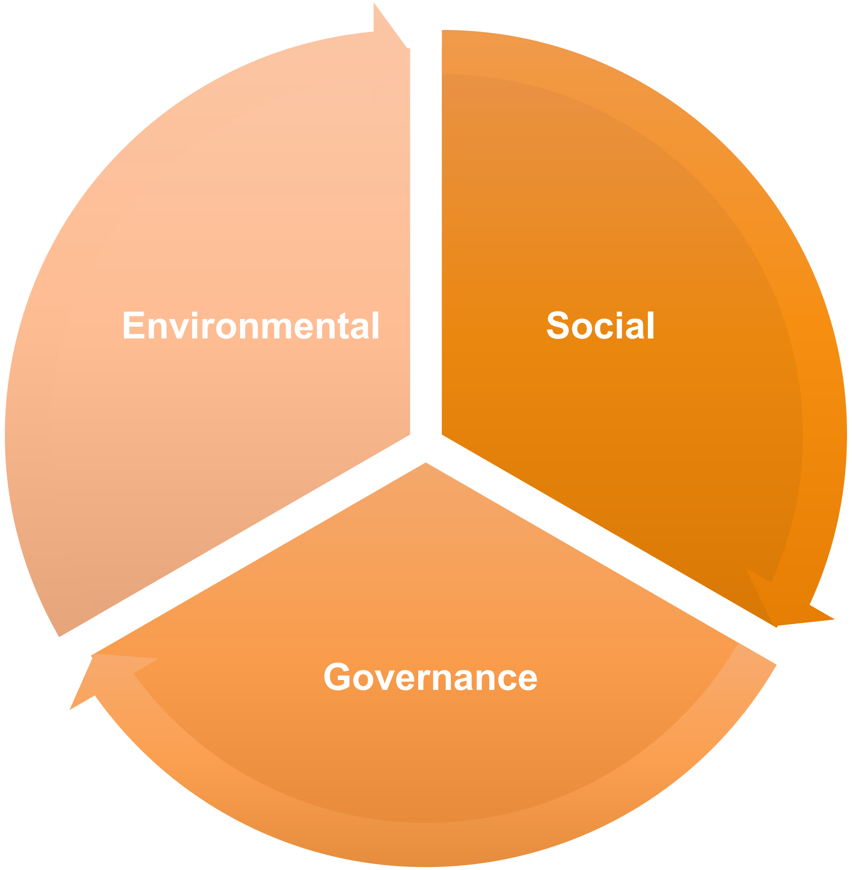
Sean M. Donahue
August 2022

GOODWIN

Topics Covered

- ESG Overview
- Who is Driving the Emphasis on ESG?
- Notable Aspects of the Current ESG Landscape
- Legal and Regulatory Developments
- Fiduciary Duties
- ESG Disclosures
- 2022 Proxy Season Highlights
- Investor Perspectives
- ISS/Glass Lewis Perspectives
- ESG and Executive Compensation
- What To Do Now

ESG Overview - What is ESG?



- Environmental, social, and governance factors help investors measure the sustainability and social impact of a business
- ESG is being used as a measure to predict a company's future financial performance
  - "Doing good while doing well": a higher ESG score has been linked to profitability
- Asset managers are increasingly focused on ESG, which has become an important factor in their investment decisions
- Companies are increasingly providing disclosure of ESG metrics

ESG Overview - Breaking Down ESG

Environmental:

- What impact (positive or negative) does the Company have on the environment?
- Considerations include environmental risks and opportunities, reducing the Company's and its partners' carbon footprint, greenhouse gas emissions and clean energy

Social:

- What impact does the Company have on the company's stakeholders and society generally?
- Considerations include labor relations, human rights, safety, product integrity and employee morale & turnover

Corporate Governance:

- How is the company run?
- Considerations include diversity, board independence, executive compensation, and policies for reporting & disclosing information

Who is Driving the Emphasis on ESG?

- Large investors, such as BlackRock and State Street
- Directors – want their companies to be identified as leaders in this area
- Business customers (particularly in Europe) increasingly link purchasing decisions to ESG matters
- Consumers want to spend money with companies that share their values
- Employees – in technology and other areas, employees are feeling increasingly empowered to insist that their companies pursue and achieve ESG; this, in turn, becomes an employee retention and attraction matter
- Government regulators – both in the EU and the SEC in the United States

Notable Aspects of the Current ESG Landscape

- Companies find themselves forced to expend dedicated resources to address a proliferation of ESG assessments, issued by organizations such as SASB, GRI and TCFD
  – Driven by customer requirements and public perception goals
- Companies are increasingly including ESG factors in their executive compensation programs to incentivize the achievement of ESG goals and manage ESG risks
  – Compensation Committees wanting to drive ESG-centric behavior
- Companies continue to issue green bonds and other sustainable finance bonds ($417.8 billion issued in first half of 2022 according to Climate Bonds Initiative)
  – There is a growing desire for these types of investments among individuals and some institutional investors

Notable Aspects of the Current ESG Landscape (cont.)

- The amount of ESG-related litigation has increased and continues to grow
  - In particular, there has been a rise in the number of suits “alleging greenwashing” – where plaintiffs allege that companies have made misrepresentations about their environmental practices, achievements and commitments
- ESG-driven activist campaigns
  - Climate-focused activist shareholder won three seats on ExxonMobil’s board in a proxy fight using ESG themes to argue for needed changes in board composition (2021)
  - More traditional activists have been raising ESG issues as a platform to gain support for campaigns

Legal and Regulatory Developments

Expanding focus by government agencies on ESG matters – across many different aspects

- Heightened SEC emphasis on ESG matters (discussed in detail below)
- SEC enforcement actions brought against investment funds for misleading investors about ESG-based products; also introducing new disclosure rules for funds that consider ESG matters as part of one or more investment strategies
- EU enforcement actions -- Netherlands court ordered Royal Dutch Shell to reduce its carbon emissions in first case in which a court imposed a legal obligation on a private company to reduce carbon emissions (2021)

- Initiatives by NYSE and Nasdaq:
  - In August 2021, the SEC approved Nasdaq's Board Diversity Rules:
    - The rules require Nasdaq-listed companies to have or explain why they do not have at least two diverse directors; companies are also required to annually disclose statistical information on board diversity using a standardized board diversity matrix
  - In September 2021, the NYSE and Intrinsic Exchange Group announced joint development of a new class of publicly-traded assets called Natural Asset Companies (NACs), subject to SEC approval
    - NACs will be sustainable enterprises that hold the rights to ecosystem services produced by natural, working or hybrid lands

Regulatory Developments – SEC

- In September 2021, the SEC's Division of Corporation Finance issued a sample comment letter to companies on climate change disclosure – articulating its expectations about the quality of that disclosure
- In November 2021, the SEC's Division of Corporation Finance published Staff Legal Bulletin No. 14L, which makes it more difficult for companies to exclude shareholder proposals involving ESG matters from proxy statements; 2022 proxy season saw an increase of as much as 20% in such proposals
- In March 2022, the SEC released proposed new climate-related disclosure rules for public companies (see discussion below)
- The SEC's current Regulatory Flex Agenda, issued in June 2022, indicates that the Commission is also going to propose new rules regarding Corporate Board Diversity and Human Capital Management Disclosure
- SEC focus is not just on corporate issuers but on investment advisors and firms offering vehicles touting connections with ESG (discussion below)
- Increase in enforcement actions (see discussion below)

Regulatory Developments – SEC (cont.)

- The SEC's March 2022 proposed climate disclosure rules are rooted in the Commission's statement that many investors—including shareholders, investment advisers, and investment management companies—currently seek information about climate-related risks from companies to inform their investment decision-making
- Broadly speaking, the proposed amendments differ from current disclosure requirements in two respects:
  - First, the proposed amendments are heavily prescriptive, and will require companies to address disclosure items whether or not material to the company
  - Second, the proposed amendments include several types of significant new disclosures. One of the most significant new disclosures would be disclosure of Scope 1, Scope 2 and, for some companies, Scope 3 greenhouse gas (GHG) emissions, including attestation by independent experts for Scope 1 and Scope 2 disclosures by large accelerated filers and accelerated filers
  - Another significant new disclosure requirement would be disaggregation of existing line items in footnotes to audited financial statements for certain climate-related expenditures and impacts, triggered at a 1% level
- It is unclear when, and in what final form, the proposed rules will be adopted. The public comment period on the proposed rulemaking ended on June 17, 2022. Litigation is expected.

Regulatory Developments – SEC (cont.)

- In April 2022, the SEC's Division of Examinations indicated that ESG would be its #2 examination priority based on its view that there is a risk that disclosures regarding portfolio management practices could involve materially false and misleading statements or omissions, which can result in misinformed investors. This risk may be compounded by:
  - lack of standardization in ESG investing terminology (e.g., strategies that are referred to as sustainable, socially responsible, impact investing, and environmental, social, and governance conscious, which incorporate ESG criteria);
  - the variety of approaches to ESG investing (e.g., a portfolio may be labeled as ESG because of the consideration of ESG factors alongside traditional financial, industry-related, and macroeconomic indicators, among others; other portfolios may use ESG factors as the driving or main consideration in selecting investments; or some portfolios engage in impact investing seeking to achieve measurable ESG impact goals); and
  - the failure to effectively address legal and compliance issues with new lines of business and products
- While this discussion is focused on investment advisors and companies and broker dealers, it underscores the scrutiny the SEC is giving to ESG disclosure more broadly

Regulatory Developments – SEC (cont.)

Recent Enforcement Actions

- In January 2022, the SEC's Enforcement staff in Texas sent letters to banks that have acted as underwriters in Texas asking about potential inconsistencies between disclosures to investors versus responses to Texas regulators about the banks' policies on doing business with gunmakers and fossil fuel companies
- In April 2022, the SEC's Climate & ESG Task Force announced that it had charged Brazilian mining company Vale with making false and misleading claims about dam safety, leading to environmental and social harm. In January 2019, a dam operated by the company (which has ADRs listed on the NYSE) collapsed, killing 270 people and spreading toxic waste across the countryside. The complaint alleges, among other things, that Vale manipulated multiple dam safety audits and misled local governments and investors about the safety of the dam through its ESG disclosures
- In May 2022, the SEC announced a settlement with BNY Mellon Investment Adviser stemming from representations made by the firm from July 2018 to September 2021 that all investments in its funds had undergone an ESG quality review (which was not the case). BNY Mellon consented to the entry of the SEC's order finding that it violated federal securities laws and agreed to a cease-and-desist order, a censure, and to pay a $1.5 million penalty
- In June 2022, a variety of news outlets reported that the SEC is investigating at least four mutual funds offered by Goldman Sachs that have ESG or clean energy in their names

Fiduciary Duty Issues in ESG Context (Delaware)

- Directors are obligated to take into account ESG factors when they implicate material legal compliance issues or when they present material risks or opportunities
- In circumstances where attention to a specific ESG factor, or set of ESG factors, is clearly in the long-term financial interests of shareholders, directors need to take it into account
- Management should present to directors ESG factors that represent material risks or opportunities, and if the directors are not receiving such information, they should ask for such information
- Directors are permitted to take into account ESG factors as long as they are rationally related to shareholder interests
- Directors may take into account the welfare of other constituencies, such as customers, employees, and the communities in which the corporation operates, but only if that consideration is rationally related to shareholder interests
- Directors should also be mindful of their fiduciary duty of disclosure under Delaware law, which would apply to the disclosure of ESG matters when the board is seeking stockholder action, including when there is a stockholder vote on an equity plan

Fiduciary Duties - Duty of Care in ESG Context (Delaware)

- Duty of care means that directors must act on an informed basis after reasonable inquiry, with such skill and diligence as a person of ordinary prudence would use under similar circumstances
  - If ESG factors present material risks or opportunities to the company, directors have an obligation to take them into account when making decisions
  - Directors have substantial latitude in determining what they consider to be material to the corporation as well as in selecting the time horizon for the achievement of corporate goals (but considering long-term interests of stockholders is the default time horizon)
  - Directors could decide that the long-term implications of climate change pose a threat to the corporation even if the director perceived no immediate threat or risk to the corporation
  - Conversely, directors could also decide that the risk was remote in likelihood or time and thus did not require action by the corporation

Fiduciary Duties - Duty of Loyalty in ESG Context (Delaware)

- Duty of loyalty means directors must act without self-interest, in good faith, and motivated solely by what they believe is in the best interests of the company's shareholders
  - In most instances, a director's consideration of ESG factors does not implicate the duty of loyalty unless the director has a conflict of interest related to the matter
  - Without a conflict, a director would have liability under the duty of loyalty if he or she acted in bad faith - an intentional dereliction of duty or a conscious disregard for one's responsibilities
- In most cases, directors have broad latitude to take into account ESG factors in making decisions without risking a judicial finding that they breached their duty of loyalty

Fiduciary Duties - Duty of Oversight in ESG Context (Delaware)

- The duty of oversight (Caremark duty) requires directors to oversee the company's operations and exposure to risk and implement reasonable legal compliance and monitoring systems
  - ESG topics involving legal obligations, such as environmental compliance, worker safety, anti-bribery laws, and supply chain integrity, require directors to ensure that reasonable compliance and monitoring systems are in place
  - Liability for failure to monitor risk can only be imposed where: (a) the directors utterly failed to implement reporting or information system or controls or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus preventing themselves from being informed of risks or problems requiring their attention
- Historically, lawsuits alleging Caremark violations rarely survived a motion to dismiss, but the Delaware courts have been more willing to allow Caremark claims to proceed the last few years

Claims for Breaches of Fiduciary Duty (Delaware)

- Even in circumstances in which directors are obligated to take ESG factors into account, there are meaningful obstacles to shareholders who wish to bring a claim for breaches of fiduciary duty
- A large number of Delaware corporations have a provision in their charter exculpating directors from monetary liability for breach of the duty of care so long as their acts are in good faith, meaning that a potential plaintiff would need to show that the directors' actions were in bad faith
- The business judgment rule creates a presumption that directors comply with their fiduciary duties of care and loyalty, placing the burden of proof on any potential plaintiff

ESG Disclosures - Overview

- Companies are increasingly making ESG disclosures on company websites, in sustainability and corporate responsibility reports, in investor presentations, and in SEC filings
- These disclosures are often being made due to increased demand from institutional investors and other stakeholders for such disclosures rather than pursuant to SEC disclosure requirements
- The SEC has instituted disclosure requirements for ESG matters related to human capital, board diversity policies, and environmental regulations and approved Nasdaq rules on board diversity-related disclosure. With the exception of the new proposed climate-related disclosure rules, ESG disclosures in SEC filings are typically made voluntarily, according to general principles of materiality, or pursuant to existing disclosure requirements that do not directly reference ESG matters
- The SEC Regulatory Flex Agenda issued in June 2022 indicates that the SEC is going to propose rules regarding Corporate Board Diversity and Human Capital Management Disclosure (in addition to the aforementioned proposed climate-related disclosure rules)
-

ESG Disclosures – Legal Liability

- ESG disclosures, regardless of whether or not they are made in an SEC filing, create potential liability for false and misleading statements under Section 10(b) and Rule 10b-5 of the Exchange Act (but this requires a showing of scienter – intent to defraud)
- ESG disclosures in SEC filings that are made or incorporated by reference into an SEC registration statement create potential liability under Section 11 (imposes strict liability for false and misleading statements) and Section 12 of the Securities Act
  - This potential for liability makes it crucial that companies have robust disclosure controls and procedures in place for reviewing ESG disclosures, especially those contained in SEC filings
- ESG disclosures in proxy statements create potential liability under Section 14(a) and Rule 14a-9 of the Exchange Act (requires a showing of negligence for false and misleading statements)
- CEOs/CFOs could also face “control-person” liability under Section 20(a) of the Exchange Act for false and misleading statements in Forms 10-K and 10-Q

GOODWIN

ESG Disclosures - Metrics, Ratings, and Standards

- There are several third-parties that have established ESG metrics by which a company's performance regarding various ESG factors is measured
- Several ESG data providers aggregate the data provided by these ESG metrics to produce ESG ratings for individual companies
- There are also several ESG standards and frameworks that set forth various principles and metrics regarding ESG, many of which are industry specific
- While there has been consolidation of data providers and convergence of ESG standards and frameworks, there are still numerous data providers and standards and frameworks in place
- Companies disclosing ESG metrics may satisfy the ESG criteria of a specific data provider or rater or that of a particular ESG standard or framework, but such disclosure may not necessarily satisfy the criteria of other data providers/raters or standards/frameworks
- Companies wishing to satisfy the ESG criteria set by third-parties should ensure that any disclosures that they prepare satisfy the criteria of such third-party and that the company clearly identifies the criteria to which it refers
- Such companies should also carefully consider whether the information they are releasing to these firms is material nonpublic information, either individually or in the aggregate; if so, they should determine whether selective disclosure to these firms is advisable

2022 Proxy Season Highlights

- As indicated above, in late 2021, the SEC Division of Corporation Finance staff changed its approach to “ordinary business” and “economic relevance” exclusions used by corporate issuers to exclude many ESG-related shareholder proposals from proxy statements. As a result, ESG matters that could be deemed to raise significant social or ethical issues with broad societal impact became more difficult to exclude.
- 2022 saw an uptick in ESG-related shareholder proposals
- 924 ESG-related proposals in the 2022 season as compared to 837 in 2021 and 754 in 2020 (through May 16, 2022).
- However, of 286 proposals voted on through May 16, 2022, the passage rate remained relatively low and declined as compared to 2021:
  - 20% for environment-related proposals
  - 19% for governance-related proposals
  - 9% for social-related proposals

Statistics on this page are from Georgeson, An Early Look At The 2022 Proxy Season

2022 Proxy Season Highlights (cont.)

Key Topics Across 14a-8 Proposals for 2022

Environmental	Social	Governance	Business Practices	Executive Comp
• Emissions reduction • Cease financing new fossil fuel supplies • Reduce plastic use	• Animal welfare • Charitable donations disclosure • Civil rights audit • DEI audit • Racial equity audit • Lobbying practices • Human rights impact • Political spending • Public health	• Board diversity • Declassify board • Independent board chair • Majority voting for directors • Proxy access • Special meeting threshold percentage • Stockholder action through written consent	• Anti-competitive pricing strategies • Employment agreement concealment clauses • Pay equity	• Clawback provisions • Determining CEO pay • Shareholder approval of termination pay

Investor Perspectives

- Institutional investors are increasingly focused on ESG issues, including how ESG factors may impact the long-term performance of a company and its stock price
- BlackRock has stated that it will consider voting against committee members and/or individual directors where the board has failed to exercise sufficient oversight of material ESG risk factors. In addition, in 2022, it has enabled its large investors to vote on key proxy matters themselves (vs BlackRock making those decisions). BlackRock clients who feel strongly about different ESG issues will have a stronger say in proxy voting
- State Street is also very focused on ESG and has indicated that supporting the acceleration of systemic transformations, including climate change and a lack of diversity of boards and workforces are its main stewardship priorities
- Vanguard will consider oversight of governance failures and/or material or manifested risks, including social and environmental risks, when determining whether to vote against directors for governance or risk oversight failures
- Fidelity Investments specifically references ESG in its proxy voting guidelines indicating that, in addition to remaining focused on maximizing long-term shareholder value, it also considers potential ESG impacts that it believes are material to individual companies and the investing funds

ISS/Glass Lewis Perspectives

- ISS provides an Environmental and Social QualityScore in reports for annual shareholder meetings of most companies; ISS also separately provides ESG Corporate Ratings
- Glass Lewis includes in its reports for annual shareholder meetings of most companies an ESG Profile
- ISS takes the position that significant risk oversight failures related to environmental and social concerns may constitute material governance failures and thus may trigger vote recommendations against board members
- Glass Lewis has issued guidelines with respect to board-level oversight of environmental and social issues
  - Will generally recommend voting against the governance chair of a board of an S&P 500 company that fails to provide explicit disclosure concerning the board's role in overseeing environmental/social issues
- For companies that are on the Climate Action 100 Focus List, ISS will recommend voting against applicable committee chairs or full boards if they have not taken ISS's minimum steps to understand, assess and mitigate climate change risks

ESG and Executive Compensation

- Companies are increasingly including ESG factors in their executive compensation programs to incentivize the achievement of ESG goals and manage ESG risks
- In particular, companies are adding ESG metrics, such as those relating to the number of underrepresented employees in management and executive groupings, into their annual incentive plans and to a lesser extent into their long-term incentive plans
- Companies wishing to incorporate ESG metrics into their compensation plans should focus on the metrics that are most important to them as a company based on the industry in which they operate
- Since pay will be tied to these ESG factors, it is essential that standalone ESG metrics used for executive compensation be clearly measurable and controllable
- Alternatively, rather than using a standalone quantitative metric, a company may wish to use ESG measures in a discretionary evaluation of individual performance or use an ESG scorecard that contains multiple ESG priority areas and perhaps even qualitative goals

What To Do Now

- Ensure the board is receiving the information it needs to meet its fiduciary duties by providing the board with information about material ESG risks and opportunities
- Assess what systems and controls may be needed so that the appropriate legal and compliance monitoring systems are in place to manage ESG risks
- Tailor ESG disclosures to provide the information sought by investors and to align with investor-favored ESG rating and reporting frameworks
- Review disclosure controls and procedures to ensure ESG disclosures are subject to appropriate review, especially when such disclosures appear in SEC filings
- Consider whether ESG factors should be part of executive compensation measures in order to incentivize proper management of ESG risks and opportunities
- Update governance documents to reflect the board’s and its committees’ approach to ESG
- Consider creating an ESG or Corporate Responsibility committee focused on ESG issues
- Review the proposed new SEC rules on climate-related disclosures and assess whether they will present compliance challenges for the company

Thank You