
Dinsmôre
Credits & môre
2021
CONTINUING LEGAL EDUCATION SEMINAR

Dinsmôre

ESG 101:
An Introduction to ESG

Credits & môre 2021

Accomplish more.

Today's
Presenters

Richik Sarkar
Partner

Michael Bronson
Partner

Tammy Bennett
Partner

David Lavan
Partner

What is ESG?

- ESG stands for Environmental Social and Governance and refers to a subset of non-financial performance indicators that include ethical, sustainable, and corporate governance issues, such as ensuring there are systems to ensure accountability and manage the corporation’s carbon footprint.

E

"E" captures energy efficiencies, carbon footprints, greenhouse gas emissions, deforestation, biodiversity, climate change and pollution mitigation, waste management, and water usage

.

S

"S" covers labor standards, wages and benefits, workplace and board diversity, racial justice, pay equity, human rights, talent management, community relations, privacy and data protection, health and safety, supply-chain management, and other human capital and social justice issues

G

"G" covers the governing of the "E" and the "S" categories—corporate board composition and structure, strategic sustainability oversight and compliance, executive compensation, political contributions and lobbying, and bribery and corruption.

ESG Areas of Focus		
Environmental	**Social**	**Governance**
Energy Use	Leadership Diversity	Board Diversity
Water Use	Employee Engagement	Ethics/Compliance
Carbon Reduction	Employee Health/Safety	Metrics/Evaluation
Climate Change	Community Development	Shareholder Rights
Green Investment	Inclusion	Cybersecurity

The increasing importance of ESG issues and policies stems from the convergence of many overlapping factors, including:

- The rise in public concern for the environment and social equity
- A better understanding of investment risks related to ESG issues: direct risks from climate change-related flooding or droughts, increasing/decreasing demand for products by consumers based on the ESG profile of the product
- An increased legal and regulatory burden on organizations; presenting significant operational and logistical challenges.
- Consumers, investors, and companies becoming self-motivated to "do the right thing."

How is ESG success measured?

- Environmental success is measured by an organization's impact on the natural environment by looking at metrics such as its carbon footprint, its effects on biodiversity, and its production of waste and pollution.
- Social success is measured by how an organization treats the people it comes into contact with, including its employees, customers, and communities.
- Governance success is measured by how an organization operates, as demonstrated through audits, board diversity, internal controls, cybersecurity, tax compliance, and shareholder rights.

Five Leading Indicators of Increased ESG Risk

1. Regulatory Requirements

Economic and global crises are typically followed by a heightened regulator and legislative oversight, particularly for financial institutions.

UDAAP (Unfair, Deceptive, or Abusive Acts and Practices) enforcement actions may be an area of focus as companies introduce new products and innovations in a business environment made increasingly competitive by COVID-19 and fintech-driven digital transformation.

Five Leading Indicators of Increased ESG Risk

2. Voluntary Guidelines

Many companies adopt voluntary guidelines (the Equator Principles, UN Principles for Responsible Banking, and the Task Force's recommendations on Climate-Related Financial Disclosures (TCFD)) to keep up with evolving regulations.

Five Leading Indicators of Increased ESG Risk

3. Environmental Issues

Activists, consumers, and institutional investors like BlackRock use proliferating standards to examine businesses' environmental impacts with additional scrutiny.

The World Economic Forum and United Nations Sustainable Development Goals guidelines could lead to standardized environmental benchmarks for each industry. Changing policies increases the need for boards to oversee their bank's operations, from green bonds to mortgage loans for energy-efficient homes.

Accomplish more.

Five Leading Indicators of Increased ESG Risk

4. Climate Change and Disaster Risks

Recognizing the sweeping business impact, the UN Office for Disaster Risk Reduction calls upon companies to explicitly integrate sustainability factors into their assessments.

It also calls institutional investors, asset managers, and company directors to integrate disaster risk reduction, climate change adaptation, and resilience into their decisions.

Five Leading Indicators of Increased ESG Risk

5. Social Risks

Consumers and investors alike are watching what companies do with their money and where they invest their money, what they prioritize in terms of diversity, equity, and inclusion, how they treat their customers and employees, and more.

Corporate governance intelligence tools can help boards stay current with both evolving frameworks and public opinion on being a good corporate citizen and ensure their company's actions keep pace with both.

Federal securities laws currently do not yet broadly require the disclosure of ESG data, but liability can arise from voluntary disclosures that are misleading or false.

- Attorneys General have sued companies for allegedly misleading shareholders by not appropriately disclosing the companies' understanding of climate change risks.
- The Federal Trade Commission challenges misleading green statements about products being biodegradable or otherwise sustainable.
- Greenwashing claims also trigger state laws and the federal Lanham Act, which prohibits companies from using advertising that misrepresents "the nature, characteristics, qualities or geographic origin" of goods and services sold.

Federal securities laws currently do not yet broadly require the disclosure of ESG data, but liability can arise from voluntary disclosures that are misleading or false.

- Following the Deepwater Horizon accident, BP was sued under Section 10(b) of the Securities Exchange Act for making false statements in press releases, its annual reports, and sustainability reports about its safety program following several industrial accidents that had occurred years earlier.
- Massey Energy Co. Securities Litigation, the court permitted an investor suit against Massey Energy, claiming that the company had committed securities fraud by misleading the market about its safety and compliance record and its commitment to safety following a 2010 mine explosion.
- At least ten suits have been filed against public companies for failing to maintain diverse boards; despite their proclaimed commitment to diversity.

ESG Investigations

- Investigations ensure: (1) vigilance consistent with ESG values; and (2) ESG disclosures are accurate and timely.
- Internal investigation can be triggered by internal or external events.
  - These events sometimes require disclosure to shareholders.
- Investigations are part of robust corporate ethics and compliance programs and enable business leaders to make informed and socially responsible decisions.
- Investigations often involve issues of statutory or regulatory compliance, financial and consumer requirements, internal corporate controls, and data privacy and security.
  - An investigation can touch on any ESG category.

Triggers for an Investigation

- Grand jury subpoena
- Government agency administrative subpoena
- Informal document requests by the Government
- Government agents contacting employees
- Civil Investigative Demands ("CIDs")
- Whistleblower/hotline complaints
- Employee complaints to HR/Ethics/Legal
- Issues flagged by internal quality controls
- Cybersecurity or data breach
- Shareholder demand letter

Encourage Internal Reporting

- Strong compliance and internal reporting systems support governance
    - Also strengthen environmental and social policies
- Develop organizational code of ethics
    - Incorporate in performance reviews
- Develop clear reporting pathways
    - E.g., Ombudsman, Hotline, Separate Compliance/Legal group
- Publicize all ways to report internally and anti-retaliation policy
    - Training for new employees; refresher training for management and all employees
- Consider publicizing (and, if appropriate, rewarding) internal reporting “wins”

Benefits of Internal Reporting

- Creates a culture of increased employee engagement and allows organization leaders to understand the issues that are important at all levels of the company
- Opportunity to evaluate and address concerns:
  - Address and correct legitimate concerns
  - Document and explain why complaints are unfounded
- May not be able to stop conspiracy theorists' frivolous allegations, so document response and explanation
  - Government and good plaintiffs' lawyers focus on substance
  - Shareholders may appreciate thorough documentation of concerns and response
  - Independent investigation and documentation can head off shareholder claims of inadequate governance

When Does an Investigation Require Outside Counsel?

- Presentation to some audiences, including government agencies, may be more credible coming from outside counsel
- Will witnesses feel more comfortable talking to an outsider?
    - Reinforces a message that a company is taking complaints seriously and may help protect anonymity
- Do individuals require their own counsel?
- Accurately assess internal capabilities and appearance of independence

Post-Investigation Engagement with Enforcement Entities

- Seek an audience with decision-makers from the enforcement entity to advocate for the appropriate outcome
  - Best-case scenario: Investigation shows that government concerns relied on incomplete or inaccurate information
- If there is a problem, decide how to position the company
  - Are we victims of employee wrongdoing, to our own detriment?
  - Did we buy someone else's problem?
  - Whatever the starting point, must demonstrate to enforcement agency that the company can be trusted to move forward on its own
- Implement remedial and curative actions designed to work in the real world
  - Firewalls within approval processes
  - Ethics and compliance consultants
  - Consider shareholder disclosure
- Negotiate appropriate resolution: e.g., "walkaway," non-prosecution/deferred prosecution agreement, no admission civil settlement, regulatory oversight agreement, plea agreement

Potential Post-Investigation Actions

- Disclosing the existence of an investigation or compliance win can bolster the success of an organization's governance and enhance credibility with shareholders/enforcement agencies
- In some instances, an investigation may uncover information that *requires* disclosure to shareholders
  - Conducting a thorough investigation and identifying findings can be essential not only to reinforce ESG principles and socially responsible governance, but also to comply with SEC requirements
- Ultimately, proper and thorough investigations provide company leaders with assurance that they are accurately and appropriately identifying, accounting for, and disclosing facts relevant to ESG principles

Diversifying Corporate Boards

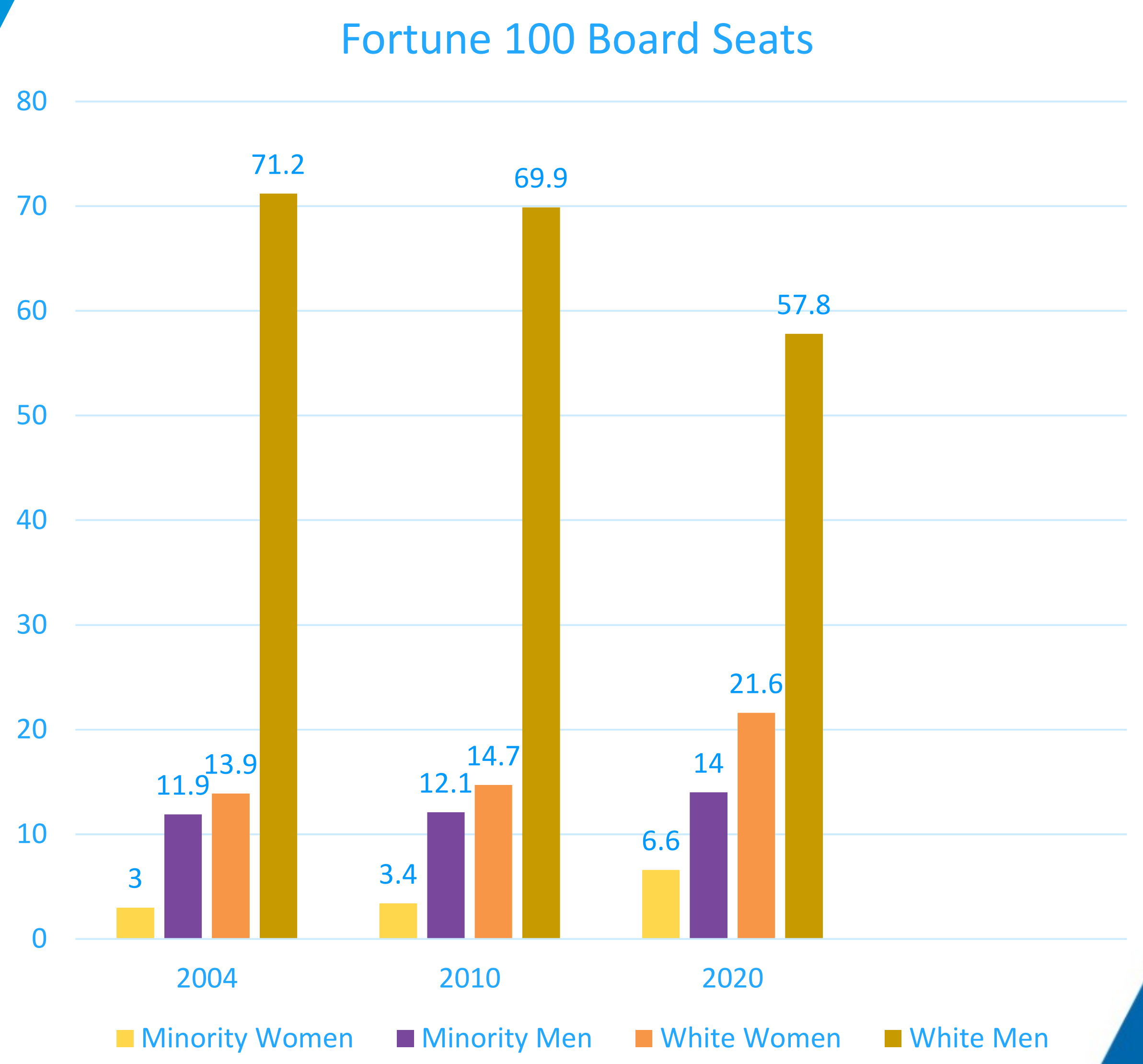
TRENDS

→ Women and minorities have made gains in board representation for the Fortune 500, Fortune 100 and Russell 3000 companies.

→ The pace of progress has been painfully slow.

→ Achieving equitable gender and minority board representation may take decades for some demographics or social groups.

TRENDS: FORTUNE 100



KEY DRIVER: Improves Performance

→ Research shows a strong association between diverse boards and company performance.

→ Boards comprised of directors with different lived experiences, cultures and backgrounds benefit from a multi-perspective analysis of problems, which leads to higher quality decision-making.

→ Board diversity can mitigate groupthink

KEY DRIVER: Societal Events

- **Increased Focus on Culture Risk and ESG (“S” Factor) as Governance Concerns**
  - Societal Acumen (“EQ”) of Board Directors
- **Confluence of Societal Events**
  - #MeToo Movement
  - Health Pandemic
  - Racial Justice Movement

KEY DRIVER: Moral Imperative

→ **It's the right thing to do**

- → Equality for Equality's Sake
- → "I could never buy into the view that some 40% of the population (if we're talking about minorities) or 50% of the population (if we're talking about women) must rationalize their inclusion in corporate boardrooms and elsewhere in economic terms instead of the reverse."

Commissioner Allison Herren Lee

Accomplish more.

KEY DRIVER: Stakeholder & Shareholder Demands

- Investor Activism
- Employee Activism
- Shareholder Activism
- SEC – Regulatory Trends

Corporate Governance Diversity Rules & Regulations

In 2019, California was the first state to require headquartered public companies to have a minimum number of female directors or face sanctions, with the minimum to be increased in 2021.

In 2020, California has mandated such public companies elect at least one director from an underrepresented community by December 2021 or face up to $300,000 in fines. For boards with between four and nine directors, two such directors must be in place by December 2022, and companies with more than nine directors must have three.

On August 6, the SEC adopted a Nasdaq proposal that will require most listed companies to elect at least one woman director and one director from an underrepresented minority or who identified as LGBTQ+.

When effective, the tiered requirements will force non-compliant companies to disclose such failures in the company's annual meeting proxy statement or website. The SEC has solicited public comment on this proposal.

CHALLENGES

- **Court scrutiny of new rules and regulations**
- **Belongingness in Boardrooms**
  - The challenge of creating an inclusive environment.
    - Is it safe to be me?

Why are Companies Making Voluntary Disclosures?

Consumer Perception

Major companies often face changing consumer attitudes. Consumer sentiment regarding a company can change rapidly in response to business practices, corporate culture, or isolated incidents. Due to the voluntary nature of ESG disclosure, companies generally have the opportunity to help shape the narrative and tell their story about their efforts to improve workplace culture, have a positive impact in their community, and address public controversies.

Green Investing and Shareholder Activism

The rapid rise in voluntary ESG disclosure has largely been driven by demand from investors and other stakeholders. While "green" investing, and other sustainability-driven investment strategies are not new, shareholders, institutional investors, and asset managers are integrating sustainability into their overall investment strategies at an increasing rate. This is also driving investors to push for increased ESG disclosures from companies, allowing for better analysis of a company's performance over time and against their peers.

Institutional Investor Stewardship

Many institutional investors have dramatically shifted their stewardship practices to engage with companies directly on ESG-related issues and disclosure. In his 2021 annual letter to CEOs, BlackRock CEO Larry Fink asked companies to disclose a plan for how their business will be compatible with a net-zero economy, including how the plan is being incorporated into their long-term strategy and reviewed by the board.

Data Providers and Frameworks

ESG Data Providers

Bloomberg

- Constantly updated data on nearly 12,000 companies worldwide
- Fully integrated into and accessible via the ubiquitous Bloomberg Terminal
- Relays scores from third-party rating agencies (RobecoSam, Sustainalytics, ISS Quality Score, and CDP Climate Disclosure Score)
- The ESG Disclosure Score (a single number from 1-100) measures a company's transparency in disclosing ESG-related metrics, such as payroll, energy, GHGs, water, waste, employee turnover, and injury rate

MORNINGSTAR®

- The Morningstar Sustainability Rating ranks companies' ESG risk management relative to their peers
- Allows for comparisons between companies across industries.
- Powered by third-party Sustainanalytics' ESG Risk Rating

JUST capital

- An influential nonprofit pioneer of proprietary ranking with unique survey-based methodology
- Conducts annual focus groups with samples of American public to assess issues that represent "just" corporate behavior
- In "as fair, unbiased, and rigorous way as possible," collects and assesses data on how companies in the Russell 1000 Index perform across issues
- Companies are afforded opportunity to review their data and submit suggestions for revisions
- Companies are scored and ranked (both overall and by industry)

JUST 2020 Top 10 Companies

NVIDIA

intel

salesforce

Alphabet

Anthem

PayPal

P&G

vm

ESG Data Providers

ISS

- Produces QualityScore, ranging from QS:1 (best governance practices) to QS:10 (worst), that evaluates a company's governance risk
- Over 220 factors are analyzed and weighted
- Companies receive an overall QS and subscores for each of (1) Board Structure, (2) Compensation / Remuneration, (3) Shareholder Rights, and (4) Audit & Risk Oversight
- The Governance QS evaluates the qualitative aspects of governance, including global governance standards and ISS voting policy in each region

GLASS LEWIS

- Each company's ESG Profile is derived from Sustainalytics' ESG data without manual adjustment by Glass-Lewis
- ESG ratings may influence Glass-Lewis's research and analyses of companies and voting recommendations, but they are not determinative
- Sustainalytics' research and ratings do not influence the creation or updating of Glass Lewis' policy guidelines

STATE STREET

- Developer of the proprietary R-Factor Scoring System, a complex meta-data statistical framework that
  - draws on multiple data sources (Sustainanalytics, Vigeo EIRIS, ISS ESG)
  - leverages recognized guidance such as the SASB frameworks and the ISS governance data, and
  - focuses only on "material" ESG considerations

"[ESG] is no longer an option for long-term strategy… [T]his year we are prepared to use our proxy voting power to ensure companies are identifying material ESG issues and incorporating the implications into their long-term strategy[…] Beginning this proxy season, we will take appropriate voting action against board members at companies[…] that are laggards based on their R-Factor scores and that cannot articulate how they plan to improve their score."

Cyrus Taraporevala, State Street Global Advisors

Accomplish more.

The SASB Framework

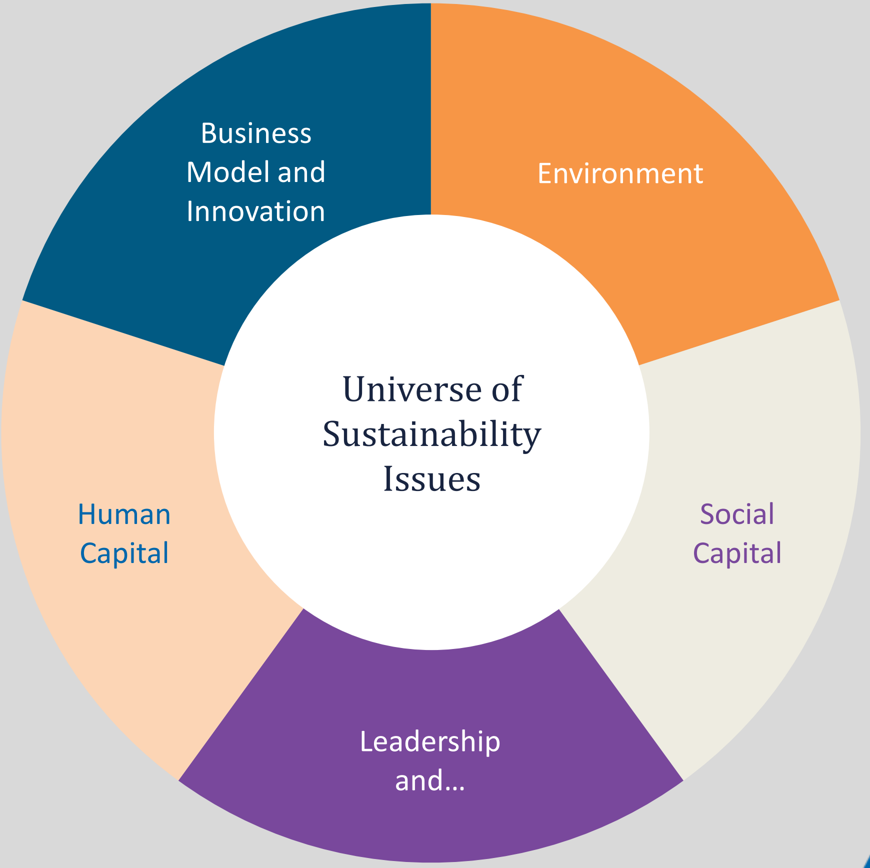
Environment
- GHG Emissions
- Air Quality
- Energy Management
- Fuel Management
- Water and Wastewater Management
- Waste and Hazardous Materials Management

Social Capital
- Human Rights and Community Relations
- Access and Affordability
- Customer Welfare
- Data Security and Customer Privacy
- Fair Disclosure and Labeling
- Fair Marketing and Advertising

Human Capital
- Labor Relations
- Fair Labor Practices
- Diversity and Inclusion
- Employee, Health, Safety, and Wellbeing
- Recruitment, Development, and Retention

Business Model and Innovation
- Lifecycle Impacts of Products and Services
- Environmental and Social Impacts on Assets and Operations
- Product Packaging
- Product Quality and Safety

Leadership and Governance
- Systemic Risk Management
- Accident and Safety Management
- Business Ethics and Transparency of Payments
- Competitive Behavior
- Regulatory Capture and Political Influence
- Materials Sourcing
- Supply Chain Management



Credits & more 2021

The TCFD Framework

Four Core Elements of the TCFD Recommendations

World Economic Forum Paper

*"**A company is more than an economic unit generating wealth.** It fulfils human and societal aspirations as part of the broader social system. Performance must be measured not only on the return to shareholders, but also on how it achieves its environmental, social and good governance objectives."*

World Economic Forum's Davos Manifesto 1973: "A Code of Ethics for Business Leaders"

Principles of Governance

The definition of governance is evolving as organizations are increasingly expected to define and embed their purpose at the centre of their business. But the principles of agency, accountability and stewardship continue to be vital for truly "good governance''.

Planet

An ambition to protect the planet from degradation, including through sustainable consumption and production, sustainably managing its natural resources and taking urgent action on climate change, so that it can support the needs of the present and future generations.

People

An ambition to end poverty and hunger, in all their forms and dimensions, and to ensure that all human beings can fulfil their potential in dignity and equality and in a healthy environment.

Prosperity

An ambition to ensure that all human beings can enjoy prosperous and fulfilling lives and that economic, social and technological progress occurs in harmony with nature.

Source: World Economic Forum and Big Four Analysis. Definitions for Planet, People and Prosperity taken from the UN's 2030 Agenda for Sustainable Development of Governance*

"Toward Common Metrics and Consistent Reporting of Sustainable Value Creation"

Pillar	Theme	Sub-themes, Core Metrics and Disclosures	Sources
Principles of Governance	**Governing Purpose**	**Setting purpose** Whether the company has a stated purpose linked to societal benefit and their core business	GRI (102-26), EPIC, Colin Mayer and others
	Quality of Governing Body	**Board composition** Composition of the highest governance body and its committees by: executive or non-executive; independence; tenure on the governance body; number of each individual's other significant positions and commitments, and the nature of the commitments; gender; membership of under-represented social groups; competencies relating to economic, environmental and social topics; stakeholder representation	GRI (102-22), GRI (405-1 a)
	Stakeholder Engagement	**Impact of material issues on stakeholders** A list of the material topics identified in the process of defining report content and how they impact stakeholders	GRI 102-47
	Ethical Behaviour	**Anti-corruption** 1. Total percentage of governance body members, employees and business partners who have received training on the organization's anti-corruption policies and procedures, broken down by region 2. Total number and nature of incidents of corruption confirmed during the current year but related to previous years 3. Total number and nature of incidents of corruption confirmed during the current year, related to this year	Adapted from GRI (205-2) and GRI (205-3)
		Protected ethics advice and reporting mechanisms A description of internal and external mechanisms for: 1. seeking advice about ethical and lawful behaviour, and organizational integrity; 2. reporting concerns about unethical or unlawful behaviour, and organizational integrity	GRI (102-17)
	Risk and Opportunity Oversight	**Integrating risk and opportunity into business process** Company risk factor disclosures clearly identify the principal risks facing the company specifically (as opposed to generic sector risks), the Board appetite in respect of these risks, how these risks have moved over time and the response to those changes. These should include discussion of data security and other emerging principal risks and should disclose the number of data breaches in the reporting period	Combination of EPIC and SASB (230a. 1 and 2)

"Inclusion of a core set of global metrics for NFI [non-financial information] in mainstream reports and in a connected way with financial information would respond to stakeholders' concerns that these issues that are often material to business resilience are not reported with the same discipline and rigour as financial information. An approach to interconnected standard setting for corporate reporting is therefore needed that will standardise the qualitative characteristics of information and disclosure principles for mainstream reports, connecting NFI with financial reporting. Such an approach should also lead to high-quality information that can be used in other corporate reports intended for specific stakeholders."

Source: Interconnected Standard Setting for Corporate Reporting, Accountancy Europe, 2019

SEC Action is Coming – E is First

SEC Chairman Gensler has made ESG a priority, since taking over as Chair every Division has sent signals regarding ESG as a regulatory priority.

On July 28, 2021 SEC Chair Gary Gensler outlined rulemaking considerations aimed at promoting mandatory climate risk disclosures. He expects proposed rules to be published before the end of the year.

Final rules requiring the disclosures could follow in 2022.

Mandatory Climate Risk Disclosures Considerations

1. Location of Disclosure
2. Qualitative Disclosure
3. Quantitative Disclosure
4. Industry-Specific Disclosure
5. Scenario Analysis
6. Jurisdictional Requirements
7. External Standards

Best Practices Regarding ESG Disclosures and Commitments

ESG disclosures must be consistent as the SEC will be comparing information that is voluntarily provided with disclosures made in SEC reports and registration statements.

Educate employees on the risks associated with ESG disclosures.

Best Practices Regarding ESG Disclosures and Commitments

Measure ESG performance to determine whether the company's actions match its public ESG goals, the standards set by industry leaders, and the frameworks established by third parties.

Questions?

Richik Sarkar
Partner

Michael Bronson
Partner

Tammy Bennett
Partner

David Lavan
Partner

Accomplish more.℠

DINSMORE & SHOHL LLP / LEGAL COUNSEL