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The Fundamentals of ESG

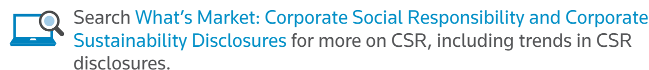
Public companies are facing increased pressure from numerous sources, including shareholders, regulators, and other stakeholders, to focus on environmental, social, and governance (ESG) issues. Practical Law asked *Helene R. Banks* of *Cahill Gordon & Reindel LLP* to explain ESG and its impact on companies, as well as provide some guidance on effectively incorporating ESG factors into corporate strategies and operations.

HELENE R. BANKS
PARTNER
CAHILL GORDON & REINDEL LLP

Helene advises public and privately held companies on significant corporate and finance matters, with a particular emphasis on mergers and acquisitions and capital markets transactions. She has represented sellers, acquirers, targets, financial institutions, shareholders, and investors in M&A transactions, spin-offs, joint ventures, private and public equity and debt offerings, and tender offers.

Companies seem to have comfortably embraced the concept of corporate social responsibility (CSR), but are now faced with the demand for ESG. What is ESG and how does it differ from CSR?

CSR refers to the policies a company adopts to be a good corporate citizen. The general belief is that being a good corporate citizen will drive business and create shareholder value in the process. The investor focus on CSR began over a decade ago. This has led to large public companies releasing annual CSR reports to explain what they are doing to benefit customers, suppliers, the community, the environment, and the greater good. These reports have become so common that, according to the Governance & Accountability Institute, in 2018 over 85% of companies in the S&P 500 prepared and distributed CSR reports.



Search What's Market: Corporate Social Responsibility and Corporate Sustainability Disclosures for more on CSR, including trends in CSR disclosures.

ESG is related to CSR, but views these issues from the perspective of the investing community. Large institutional investors began

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using the term when referring to matters that they want to track to determine value. Specifically, ESG matters relate to:

- **Environmental sustainability.** This component of ESG relates to how a company obtains, uses, and disposes of natural resources. Topics covered may include water usage, water disposal, emissions, climate change pollutants, scarce resources, and impact on natural habitats.
- **Social issues.** This component of ESG relates to how a company interacts with or affects individuals or groups of people, communities, and humanity. Topics covered may include labor relations, workforce diversity, safe working conditions, product safety, employee health, and community development.
- **Governance issues.** This component of ESG relates to how a company conducts business in an ethical manner. Topics covered may include board and management diversity, pay equity, supply chain engagement, shareholder access, and political contributions.

In many ways ESG is similar to CSR, but seeks to order the initiatives into three buckets in an attempt to conduct comparative assessments.

However, because ESG is not clearly defined, changes over time, and there is no single set of metrics, comparative assessment of ESG is an elusive goal. While the market and investors are clamoring for transparency, it is hard to attain when there are no clear guidelines.

The general view is that companies are supposed to work to drive shareholder value. How does ESG fit into that paradigm?

Companies must realize that building long-term shareholder value is not in opposition to ESG-related goals, and that pursuing ESG goals allows a company to thrive and build long-term value. Companies do not need to wade into the debate that pits profits against social good. The reduced downside risk resulting from an ESG strategy should be enough of a motivator. Companies are increasingly becoming aware of the need to address ESG factors due to a heightened focus on risk management and increased interest in ESG matters from all stakeholders. These stakeholders include:

- **Employees.** Employees want a living wage, a safe and healthy work environment, an inclusive work force, and an employer that is concerned about its impact on employees and society. Given the current low unemployment rate, employee retention is an important goal and, therefore, companies cannot afford to ignore these issues.
- **Customers.** Customers are increasingly interested in purchasing goods and services from companies that can demonstrate that they are more conscious of these issues. E-commerce and the internet have made it especially easy to transact with companies that satisfy the customer's ESG preferences.
- **Institutional investors.** Large institutional investors have adopted policies that require responsible investing. They seek to invest in companies that are sensitive to ESG issues and are incorporating them into their business strategies at all levels.

In response to increasing activism on ESG issues, regulators also are encouraging companies to pay attention to ESG factors and consider new policies and disclosures. In an environment that is characterized by an emphasis on deregulation, companies are now expected to monitor themselves and become more purpose-driven and responsible to society. Companies must respond to these pressures or face certain risks and other consequences, such as:

- Employee attrition and decreases in productivity.
- Loss of customers and revenue.
- Reputational harm.
- Reduced access to capital and lower market valuation.
- Missed opportunities for growth.

What are ESG ratings and how do they work?

Companies are increasingly being ranked, rated, and assessed for their ESG commitment, including by investors, stock exchanges, and independent rating organizations, among others. In 2019, all three major credit rating agencies (Moody's, Standard & Poor's, and Fitch) announced initiatives to add an ESG score to their traditional assessments of creditworthiness. Institutional Shareholder Services Inc., one of the most prominent proxy advisory firms, provides its customers with access to its ESG Corporate Ratings, which analyze ESG issues using up to 100 sector-specific criteria. Glass, Lewis & Co. also incorporates ESG factors in its voting recommendations. These rankings and ratings, in turn, are increasingly being used by institutional investors to make voting and investment decisions.

Search Credit Ratings and Credit Rating Agencies for more on credit ratings and the operations of the nationally recognized statistical rating organizations.

Search Developing Relationships with Proxy Advisory Firms for more on the role of proxy advisory firms and engagement processes.

Currently, the most potentially significant ESG rating rubric is the State Street Global Advisors R-Factor™, which is based on the standards issued in November 2018 by the Sustainability Accounting Standards Board (SASB) and is incorporated into the Bloomberg SASB ESG Indices. The SASB sustainability topics are organized under five dimensions (environment, social capital, human capital, business model and innovation, and leadership and governance) and into 26 broad issues within these five dimensions. These are then distilled by industry using a materiality lens that is familiar to public company executives and investors (see SASB Conceptual Framework (Feb. 2017), available at *sasb.org*).

The SASB is a nonprofit organization whose goal is to formulate standards by which investors can assess the ESG commitment of public companies in comparison to other companies in the same industry. The SASB standards are voluntary. However, with many of the largest institutional investors involved in creating the SASB standards, which focus on ESG from a material financial perspective, they may become the standard-bearer.

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Search ESG Disclosures & Sustainability Reporting Frameworks for more on ESG reporting frameworks and the methodologies used by ESG reporting and ratings firms.

What are the primary sources of the increasing pressure on companies to address ESG issues and what methods are being used to apply this pressure?

Companies currently face pressure on ESG issues from numerous sources, including:

- Shareholders.
- Regulators.
- Courts.

Shareholder Pressure

Shareholders continue to use shareholder proposals and activist pressure to effect change in the ESG areas that matter to them. Rule 14a-8 under the Securities Exchange Act of 1934 provides a process for shareholders to submit proposals for inclusion in a company's proxy materials under certain circumstances.

Search How to Handle Shareholder Proposals and Rule 14a-8 Shareholder Proposal Process Flowchart for more on shareholder proposals.

In 2019, approximately 64% of shareholder proposals that reached a shareholder vote were related to corporate governance. The number of environmental and social proposals introduced increased by 20% compared to 2018, with more proposals focused on social issues than in the past. However, the number of those proposals that were put to a vote increased only slightly. (See ICR, 2019 Proxy Season Recap & 2020 Trends to Watch (Sept. 4, 2019), available at *icrinc.com*.) This trend toward withdrawn shareholder proposals could indicate that shareholder pressure is working, as companies more often respond to shareholders' demands, rather than fight a shareholder proposal through the proxy process.

Shareholder pressure has been particularly successful in improving board gender diversity. It was recently reported that there are no longer any S&P 500 companies with an all-male board (Vanessa Fuhrmans, The Last All-Male Board on the S&P 500 Is No Longer, The Wall Street Journal (July 24, 2019), available at *wsj.com*). Institutional investors, such as State Street Global Advisors and BlackRock, have continued to implement policies that require a "no" vote for boards that do not have any female representation, focusing now on companies in the Russell 3000 Index, where approximately 500 companies still have all-male boards.

Search Board Diversity: Steering the Ship Under the Watchful Eyes of Shareholders, Lawmakers, and Regulators for more on board diversity, including how boards can improve their approach to diversity.

Regulatory Pressure

Regulators have only begun to weigh in on ESG matters and are doing so slowly. Other than in a few narrow areas, the Securities and Exchange Commission (SEC) does not require public companies to make specific disclosures about ESG-related matters. Examples of ESG matters on which the SEC does require specific disclosures include:

- Board diversity policies, if they are used to recruit board members.
- Conflict minerals usage.
- The impact of climate change, if material to investors.

The securities laws otherwise take a principled approach that only requires disclosure of material information.

Under pressure from climate change disclosure proponents, in 2010 the SEC issued interpretive guidance on what materiality means in the climate change context, but stopped short of issuing any rule changes. Since then, the pressure for specific disclosure requirements has increased as ESG has become an important factor for investors. With no clear requirements and a lack of comparability of information, investors have continued to complain that assessing a company's ESG efforts from its periodic reports is problematic.

In 2018, investors with more than $5 trillion in assets under management petitioned the SEC for a rulemaking, given changing business norms and investor needs. The petition argues that in response to investor demand, companies are disclosing more about ESG initiatives and impacts, but there is no framework for consistent, clear, complete, and comparable information. (See Request for Rulemaking on Environmental, Social, and Governance (ESG) Disclosure (Oct. 1, 2018), available at *sec.gov*.) However, recent comments from SEC Chairman Jay Clayton to the SEC Investor Advisory Committee (see Remarks to the SEC Investor Advisory Committee (Nov. 7, 2019), available at *sec.gov*) indicate that he believes the current approach, which is largely principles based with certain industry specific requirements, works best for ESG disclosures, so more uniform mandatory disclosure requirements are not likely to be adopted by the SEC any time soon.

In an August 2019 request for rulemaking in this area, the petitioner, an energy and environmental think tank, explained that rulemaking is needed not to add disclosure, but to stop what it views as the false and misleading disclosures being made by companies that provide information, but with insufficient context within which to assess its impact (see Petition for Action Regarding Misleading Climate Disclosures (Aug. 13, 2019), available at *sec.gov*).

While the SEC has declined to take action for now, some states have used the power of their state pension funds to effect change. For example, in:

- California, CalPERS has issued specific requirements for ESG investing.
- Illinois, the legislature recently passed the Sustainable Investing Act, effective January 1, 2020, which requires all public agencies that manage public funds in that state to develop, publish, and implement sustainable investment policies (2019 Ill. Legis. Serv. P.A. 101-473 (H.B. 2460)).

In promoting board gender diversity, California has adopted a law that requires every company headquartered in California to have at least one woman on its board by the end of 2019 (Cal. Corp. Code § 301.3).

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Additionally, several bills introduced in the US Congress in 2019 would, if passed, require public companies to assess, address, and disclose certain ESG issues, such as political expenditures (H.R. 1053) and climate change (H.R. 3623), as well as ESG disclosures in general (H.R. 4329).

Pressure to make ESG factors a priority is also coming from the United Nations (UN). The UN Principles for Responsible Investment (PRI), available at *unpri.org*, are a set of voluntary principles that provide a global standard for investors to assess ESG factors. The PRI were launched in 2006, and currently over 1,500 investment institutions have signed on, with approximately $62 trillion in assets under management. The UN also spearheaded the Sustainable Stock Exchanges Initiative. Member exchanges, including the NYSE and NASDAQ, commit to promote the improvement of ESG disclosure and performance of their listed companies.

Judicial Pressure

Several cases have touched on ESG-related matters. Two recent Delaware cases have allowed claims to proceed against directors for failure to oversee important safety or regulatory measures at their companies, finding that the plaintiffs satisfied the heavy pleading burden needed to withstand a motion to dismiss. Specifically, in:

- *Marchand v. Barnhill*, the Delaware Supreme Court denied a motion to dismiss the claims against the directors who failed to provide oversight of food safety matters (2019 WL 2509617 (Del. June 18, 2019)).
- *In re Clovis Oncology*, the Delaware Court of Chancery denied a motion to dismiss claims against directors for failure to provide oversight of the conduct of clinical drug trials (2019 WL 4850188 (Del. Ch. Oct. 1, 2019)).

These cases demonstrate that directors must focus on ESG not only to add value, but also in exercising their duty of loyalty, because the line between a "nice-to-have" ESG factor can blur into a "must-have" oversight failure.

Search Fiduciary Duties of the Board of Directors for more on the fiduciary duties of the board, including the core duties of care and loyalty.

Additionally, a recent case against Exxon Mobil in New York Supreme Court may impact ESG from a different angle. *The People of the State of New York v. Exxon Mobil Corp.* involves a claim that Exxon failed to properly disclose in its proxy materials certain climate change risk-related information (No. 0452044/2018 (N.Y. Sup. Ct.)). As of press time, the case has not been decided. The outcome of this case could have a significant impact on ESG-related disclosures in the energy industry and potentially more widely.

How should companies approach incorporating ESG factors into their strategies?

If a company wishes to develop ESG policies, the most important things for the company to do are to identify the key ESG factors for the company, determine how to measure and assess them, and communicate these factors to the company's shareholders. While there are no mandated requirements that standardize the process, several sources provide helpful guidance, including:

- The SASB guidelines.
- The UN PRI.
- Guidelines issued by the company's major institutional investors.

The company should consider what the most important ESG factors are for the company. For example, the company should determine whether its:

- Operations rely on labor in emerging markets.
- Production processes depend on energy or water.
- Employees are a key resource and not easily replaceable.
- Board and executive suite are sufficiently diverse to make effective decisions.

The most important ESG factors for each company will vary, and these factors may change over time. There is no off-the-shelf assessment tool that will provide the right answer. The best results will come from gathering information specific to the company from managers across all departments and the company's board.

Once the key ESG factors are identified, the company must determine how to address the ESG factors. For example, steps the company could take include:

- Seeking to maintain or improve employee retention rates.
- Offering employee sick days.
- Redirecting waste.
- Increasing diversity.

It is important to include ESG factors at all company levels that tie into meaningful performance indicators. Stakeholders will be monitoring these assessments to see if the company is effectively implementing ESG factors into the business.

Additionally, while most large public companies have been issuing CSR reports for years, these reports need to be reassessed and updated for effectiveness. Companies in the middle market and below should consider preparing a regular ESG report. Currently, public companies have very limited disclosure obligations in the ESG area. While failure to fully communicate ESG efforts and risks may not expose the company to legal risks, it may represent a missed business opportunity. Companies should avoid boilerplate disclosures, be sure to provide context, and include straightforward explanations for their various constituents on their website and in their annual reports, public filings, and employee and customer communications. Having a clear understanding at all levels of the company of the most important ESG factors and related metrics will make communication easy and allow the company to avoid the risks and reap the benefits in this area.

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