Navigating the ESG Landscape

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Investors and other stakeholders continue to focus on environmental, social and governance (ESG) issues at public companies, both as a driver of financial performance and as a factor of social importance.

The ESG landscape continues to evolve, both in the United States and in Europe, and boards should continue to consider ESG issues, particularly in connection with overall company strategy, and monitor new developments closely.

Investor Focus on ESG Matters

Much of the focus on ESG matters in recent years has been driven by large asset management firms and pension funds that have sought to influence corporate governance and strategy on ESG matters. Firms such as BlackRock have indicated their intention to act as leaders in this area by incorporating ESG criteria into their portfolio management strategies on an ongoing basis. This includes adjusting fund allocation based on ESG criteria, including downgrades or removals from ESG indices based on negative press or crises that are indicative of poor ESG governance.

In the UK, the concept of sustainability was included in recent changes to the definition of "stewardship" in the UK Stewardship Code (effective January 1, 2020),[1] which sets out certain expectations for those managing assets of UK investors. The code, developed by the UK Financial Reporting Council, requires firms wanting to become signatories to produce an annual Stewardship Report explaining how they have applied the code in the previous 12 months.

[1] Stewardship is now defined as the "responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society" In the UK Stewardship Code, available here.

ESG issues also continue to be topics of heightened shareholder activism and engagement. For the third year in a row, environmental and social (E&S) proposals were a majority of all shareholder proposals in the 2019 proxy season. Support for E&S proposals included in company proxy materials rose for the fourth consecutive year, with 48% of E&S proposals receiving above 30% support.

In particular, climate change proposal submissions in 2019 were at a record high, with requests shifting to the establishment of hard targets for reducing company emissions, rather than simply the production of a report. At Amazon, a group of 7,500 employees brought a climate change proposal, which received approximately 30% support, highlighting an increasing trend of engagement by employees, particularly in the technology industry, who are leveraging their equity compensation to promote change at their workplaces. In 2019, Institutional Shareholder Services (ISS) also issued a custom climate voting service, which provides a framework to help investors address climate issues in proxy voting and engagement policies proactively, including through climate disclosure indicators, climate performance signals, future performance signals, sector-specific materiality and norms violation analysis.

We expect investor focus on climate change to continue. A 2019 Morrow Sodali survey found that 85% of institutional investors surveyed consider climate change to be the most important engagement topic, compared to 31% last year; and CDP, an international nonprofit, analyzed the submissions from 215 of the world's largest 500 corporations and found that companies potentially face $1 trillion in costs related to climate change (a majority within the next five years) unless they take proactive steps to prepare.

Human rights proposals also exhibited a steady uptick, increasing by more than 25% in 2019 and dealing with topics including human trafficking, forced labor, prison labor and immigrant detention. Human capital management has been another area of significant shareholder engagement. Investors, employees and other stakeholders expect companies and boards to make further progress on issues such as employment and human resource practices (in light of #MeToo), gender pay equity, workplace diversity, employee retention and corporate culture. See Board Composition and Shareholder Proposal Highlights in this memo.

Other areas of significant shareholder engagement include social issues such as the opioid epidemic and immigration detention, as well as political spending and corporate lobbying. It is no coincidence that these issues reflect press headlines and social media hot topics: boards should make sure to monitor the latest trends relevant for their companies as a bellwether for future investor focus.

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Sustainability Reporting: A Move Toward Strategy

The proliferation of sustainability reporting has led to the growth of a variety of frameworks, each with its own standards and requirements, leading to considerable confusion about which ones (and how many) companies should follow and whether investors prefer particular types of disclosure. Recently, however, a more coherent approach seems to be emerging.

Companies and investors alike have been focusing increasingly on the tie between ESG issues and long-term company strategy, with many companies refining their sustainability reporting to focus on key metrics and issues related to their overall business strategy. The latest iteration of the Sustainability Accounting Standards Board's (SASB) 79 industry-specific sustainability accounting standards appears to be helpful in developing disclosure that is material, comparable and relevant for investors; with Glass Lewis' incorporation of SASB's standards into its proxy voting recommendations in 2019, use of these standards is likely to increase.

A number of sustainability advocates and companies have also continued to move toward integrated reporting—combining corporate financial disclosure and sustainability reporting into one report—and one key advocate, the Principles for Responsible Investment (PRI), now has large institutional investors with a total of $70 trillion of assets under management as signatories to its integrated reporting framework.

Whatever the format, companies should ensure their ESG disclosure is subject to good processes and controls, as with any US public disclosure.

A More Formal European Disclosure Approach

Despite a 2018 petition filed with the SEC requesting formal rulemaking requiring US companies to publish ESG disclosure, and continuing SEC guidance reminding companies to include disclosure about climate change risk, ESG reporting in the United States is largely voluntary. The European Union, by contrast, has taken several regulatory steps in rendering its ESG disclosure framework more comprehensive.

Since 2017, the EU has required listed companies and certain other entities to include in their public reports a "non-financial statement" on corporate social responsibility matters.[2] At a minimum, this disclosure must address considerations relating to environmental, social and employee matters; respect human rights, anti-corruption, bribery and diversity matters; and evaluate how the company is integrating these factors into its business model, policies and due diligence processes, risk management program and key performance indicators (or if it has not adopted policies covering these matters, why not).

In 2019, the European Union went a step further by issuing guidance on disclosure of climate-related information.[3] This guidance requires disclosure if climate-related information is necessary to understand either: the development, performance or position of the company (i.e., information typically of principal interest to investors); or the external impacts of the company (information typically of principal interest to other constituents such as consumers, employees and other interest groups). Board engagement on climate change is one of the factors that should be disclosed, including board oversight of climate-related risks and opportunities and whether the company has access, through internal and external sources, to expertise on climate-related issues.

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In addition to climate change matters, the European Union has also introduced new disclosure requirements on conflict minerals in supply chains (somewhat similar, although narrower in scope, to the conflict minerals disclosure requirement in the United States) and, in certain countries (e.g., the UK's Modern Slavery Act and France's Duty of Care Law), the overall human rights impact of companies' operations and procurement practices.

Any company with operations or securities listings in Europe or the UK should be sure to consider whether the EU and UK ESG disclosure requirements are applicable.

2 *See* European Union Directive 2014/95/EU of October 22, 2014, amending Directive 2013/34/EU as regards disclosure of nonfinancial and diversity information by certain large undertakings and groups, available here.

3 *See* Guidelines on non-financial reporting: Supplement on reporting climate-related information, C(2019) 4490 final, available here.