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Introduction to ESG

Key Takeaways

- “ESG” describes a set of environmental, social and governance factors used to evaluate investment and company impacts beyond traditional financial measures. ESG topics are now the subject of significant focus by asset managers, asset owners such as pension funds and insurance companies, and other investors, as well as by proxy advisory firms, index providers, regulators and rating agencies.

- ESG disclosures and commitments that are inconsistent with company actions or industry standards have legal, regulatory and reputational consequences and require in-house legal teams (working closely with other corporate function leads) to take a leading role in monitoring ESG actions and statements.

Overview

Interest on the part of investors and other corporate stakeholders in environmental, social and governance (“ESG”) matters has surged in recent years, and the current economic, public health and social justice crises have only intensified this focus. ESG, at its core, is a means by which companies can be evaluated with respect to a broad range of socially desirable ends. ESG describes a set of factors used to measure the non-financial impacts of particular investments and companies. At the same time, ESG also provides a range of business and investment opportunities.

Net flows into ESG funds available to U.S. investors have skyrocketed, totalling $20.6 billion in 2019, nearly four times the previous annual record set in 2018,1 while ESG funds in Europe also attracted record inflows of $132 billion in 2019.2 More than 70% of funds focused on ESG investments outperformed their counterparts in the first four months of 2020,3 and nearly 60% of ESG funds outperformed the wider market over the past decade.4 Consumers and investors are placing a growing value on ESG, and industry leaders have responded in a number of ways, including issuing comprehensive sustainability reports and expanding ESG disclosures in their annual reports, providing information to ESG rating agencies and publicly communicating ESG commitments.

This client alert, the first in a series focused on ESG disclosure and regulatory developments, provides an introduction to ESG and identifies several critical issues for companies and their in-house counsel to keep in mind in evaluating and monitoring ESG actions and statements.
The Fundamentals of ESG

ESG grew out of investment philosophies clustered around sustainability and, thereafter, socially responsible investing. Early efforts focused on “screening out” (that is, excluding) companies from portfolios largely due to environmental, social or governance concerns, while more recently ESG has favorably distinguished companies that are making positive contributions to the elements of ESG, premised on treating environmental and social issues as core elements of strategic positioning. While climate figures prominently in ESG discussions, there is no single list of ESG goals or examples, and ESG concepts often overlap. That being said, the three categories of ESG are increasingly integrated into investment analysis, processes and decision-making.

- The “E” captures energy efficiencies, carbon footprints, greenhouse gas emissions, deforestation, biodiversity, climate change and pollution mitigation, waste management and water usage.

- The “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.

- The “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 metrics have evolved in recent years to measure risk as well as opportunity. In his “Dear CEO” letter in 2018, BlackRock Chairman and CEO Larry Fink wrote that:

[s]ociety is demanding that companies, both public and private, serve a social purpose. To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate.

He goes on to say that:

Companies must ask themselves: What role do we play in the community? How are we managing our impact on the environment? Are we working to create a diverse workforce? Are we adapting to technological change? Are we providing the retraining and opportunities that our employees and our business will need to adjust to an increasingly automated world? Are we using behavioral finance and other tools to prepare workers for retirement, so that they invest in a way that will help them achieve their goals?

Other leading business leaders have also supported more expansive views regarding the purpose of a corporation. In August 2019, the Business Roundtable, a non-profit organization comprised of corporate
CEOs, released a new Statement on the Purpose of a Corporation (the “BRT Statement”). The BRT Statement was signed by the CEOs of nearly 200 leading U.S. companies and identified shareholders as one of five key stakeholders – along with customers, workers, suppliers and communities. The BRT Statement supersedes prior statements that endorsed shareholder primacy (the idea that corporations exist principally to serve shareholders), and “outlines a modern standard for corporate responsibility.”

**ESG in Practice**

Under the current disclosure regime applicable to public companies listed in the United States, there is no affirmative duty to provide disclosures on ESG matters. As a practical matter, however, it can be anticipated that important stakeholders, such as investors, insurance companies, lenders, regulators and others, will increasingly look to companies’ disclosures to allow them to evaluate whether those companies have embraced ESG agendas. And, even in the absence of an affirmative duty to disclose, the substance of the information that companies do elect to report regarding their actions to identify and manage ESG risks and opportunities will be subject to the securities laws.

As we will discuss in future alerts in this series, the ESG regulatory landscape regarding disclosure is rapidly evolving. While there is a general recognition of the value of, and the imperative for, consistent and decision-critical information to more easily evaluate how companies are overseeing and managing ESG-related risks and opportunities, most companies have yet to achieve that level of consistency. Moreover, ESG factors cover a broad range of activities that may or may not be relevant to particular businesses and their performance, or their potential positive effect on communities, or more broadly, societies. These metrics need to be refined. Accordingly, a prudent public company will find it desirable to establish its own criteria for determining the scope and content of its ESG disclosures, both to mitigate legal risk and identify future opportunities that ESG presents in terms of growth and differentiation.

In the absence of international consensus regarding ESG disclosures, a number of frameworks and indices have emerged to guide company disclosures and inform investors. Some of the leading international frameworks include the Global Reporting Initiative standards, the Sustainability Accounting Standards Board (SASB) standards, the United Nations Principles for Responsible Investment and the United Nations Sustainable Development Goals. Ratings have also proliferated over the last decade. Morgan Stanley Capital International (MSCI) and specialist firms such as Sustainalytics have recently been joined by traditional credit rating agencies such as Moody’s and S&P Global. A recent estimate suggests that the “global market for ESG ratings is currently worth about $200m and could grow to $500m within five years.” The influence of these frameworks and rating agencies is such that they may shape regulation to come.

ESG is also influenced by public opinion. ESG issues are inherently reputational, especially given recent societal events. As more companies provide ESG disclosures and commitments, and given the speed of social media responses and the news cycle, observations about a company’s ESG actions or inactions are
often published and sometimes go viral. Companies that are out of step with public opinion and market demands may face punishing reputational consequences.

**Matching Aspiration and Action**

We will describe in subsequent alerts the challenges faced by companies in developing a disclosure posture that satisfies the needs of a growing number of stakeholders, as well as the challenges faced by many of those stakeholders in obtaining information that is consistent and decision-critical. While ESG disclosures today are, from an SEC perspective, purely voluntary, over time that could change, and in the meantime there may be increasing pressure from a range of stakeholders to incorporate ESG statements. If a company’s ESG disclosures (for example, those in relation to compliance with legal, regulatory or voluntary standards or a particular commitment to achieve an ESG-positive outcome) later appear to be false or misleading, the company could face reputational backlash, shareholder lawsuits or possibly regulatory enforcement. Putting aside which disclosure standards they adopt, companies should ensure that they take a systematic approach to ESG reporting.

We highlight below considerations that should facilitate tying aspirations to actions and mitigating legal and reputational risks for commitments that cannot realistically be achieved:

- **Monitor internal ESG disclosures and commitments.** Management should appoint a team tasked with monitoring the company’s ESG disclosures and commitments, recognizing that these statements can appear in a variety of formal communications (e.g., SEC filings, or in documents incorporated by reference in SEC filings, sustainability reports and corporate responsibility reports) as well as informal communications (e.g., communications to employees, social media posts, media interviews and website postings). The team should identify existing ESG commitments to establish a baseline. Thereafter, the team should have a procedure in place to monitor ESG disclosures of the company as well as of peer firms.

- **Treat ESG statements like all other public statements.**
  - ESG statements made publicly should be vetted for factual accuracy and context in the same way as any other statement of fact.
  - Forward-looking commitments should be qualified as such, much as other forward-looking statements are (with aspirational qualifiers and appropriate disclaimers).
  - Management should consider extending the internal disclosure controls and procedures process to ESG statements, since some statements may well find their way into SEC filings.
  - Even though ESG disclosure standards are not mandatory, the SEC has noted that it will be comparing information that is voluntarily provided with disclosures made in SEC reports and
registration statements, which is consistent with its general approach of monitoring analyst and investor calls as well as other statements made outside of SEC filings (for example, to police the use of non-GAAP financial measures and selective disclosure rules).

• As with all material statements that are included in public disclosure, coordination among the relevant internal constituencies is critical and collaboration should be encouraged.

• *Educate employees on the risks associated with ESG disclosures.* Employees responsible for preparing and updating ESG disclosures should be sensitized to the risks associated with public disclosures and to the importance of ensuring that ESG statements are consistent with the company’s description of its business, its MD&A and its risk factors in annual and quarterly reports, even if those latter disclosures have no apparent ESG themes.

• *Measure ESG performance.* The ESG team should establish procedures 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 that the company has committed to – or is required to – follow. Doing so can help a company identify any vulnerabilities in order to mitigate potential legal and reputational risks.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Mark S. Bergman  
+44-20-7367-1601  
mbergman@paulweiss.com

Ariel J. Deckelbaum  
+1-212-373-3546  
ajdeckelbaum@paulweiss.com

Jeh C. Johnson  
+1-212-373-3093  
jjohnson@paulweiss.com

Brad S. Karp  
+1-212-373-3316  
bkarp@paulweiss.com

Loretta E. Lynch  
+1-212-373-3000

Counsel Frances F. Mi and associates Alexander T. Louis and Sofía D. Martos contributed to this Client Memorandum.

7. Id.