February 18, 2020

The Coming Impact of ESG on M&A

Recent months have seen institutional investors and other stakeholders, notably BlackRock and State Street, stressing the importance of comparable and decision-useful ESG disclosures by their portfolio companies. Such calls follow in the wake of growing interest among investors and other stakeholders in understanding and assessing the performance of companies based on ESG metrics. While the exact system by which companies will report on ESG issues remains to be determined by the market, it is clear that beginning in 2020, and in the years to follow, companies will be disclosing significant amounts of quantifiable information on a basis that will permit comparisons within and across industries. This information will be used by companies, investors, asset managers and other stakeholders in making real-world business decisions, including decisions relating to M&A.

The impact of the growth in ESG disclosures on M&A cannot be underestimated. In the near-term, ESG performance will be incorporated into company valuations and risk assessments, and acquirers and targets will be expected to factor in ESG performance when evaluating the impact of potential transactions. All aspects of M&A will be affected; a few are highlighted below:

Selection of Targets and Business Partners. ESG factors can be expected to increasingly influence how companies select potential targets and business partners. There is growing recognition of new business opportunities across industries and that partnering with companies with strong ESG profiles, such as businesses focused on renewables or which have a strong record of innovation, can enhance a company's ability to deliver long-term sustainable value to its stakeholders. It is expected that Fiat Chrysler's pending merger with Peugeot will help the company avoid a potential $2 billion in European carbon emissions fines. Meanwhile, Mitsubishi and Japanese utility provider Chubu Electric Power Co., Inc. beat out Royal Dutch Shell to acquire sustainable energy utility company Eneco last year. Similarly, and perhaps as a harbinger for other industries, several mainstream asset managers have acquired ESG funds in recent years in order to expand their scope, capacity and expertise in the field.

As ESG disclosure practices become more ingrained in public company practice, those companies able to showcase their capabilities in this regard stand to gain a competitive advantage and potentially demonstrate attractiveness to acquirers looking to develop or supplement their own capabilities. Similarly, consolidation to achieve or enhance scale can be expected to continue within sustainability-focused industries. In some industries, new sub-industries will be created, such as those catering to managing assets with specific impact goals tied to ESG or monitoring and indexing ESG performance. Boards will need to consider, in addition to the pro forma earnings impact of potential transactions, the pro forma ESG impact of potential transactions. To the extent that higher ESG scores remain consistent with higher stock prices, larger, more efficient companies, and those that have been at the forefront of ESG practice, may be able to utilize their ESG expertise to acquire a "lower" performer as part of a transaction.

Due Diligence. ESG will continue to be an increasing concern in transaction due diligence. Certain key ESG risks—notably, risks related to corrupt business practices, privacy and data security, climate change, greenhouse gas emissions, diversity and labor practices—are already being evaluated in the context of M&A due diligence, as is the more general consideration of the potential impact of an acquisition on the reputation, culture and integration of the combined company. The addition of so-called "Weinstein Clauses" requiring targets to disclose allegations of sexual misconduct among senior executives further reflects this growing consciousness.

Governance and Integration. In the M&A context, the consideration of ESG factors and related metrics and the broader concepts of stakeholder governance and corporate purpose are entirely consistent with traditional conceptions of directors' duties. A company's broad positioning on ESG matters, including its policies and approaches and its quantifiable successes and failures in managing sustainability, human capital and other ESG concerns, will prove insightful into a company's culture, and an important determinant of whether it is a suitable target or partner. Similarly, companies with noticeable differences in their ESG performance will need to consider whether such differences would hinder their ability to fully realize expected synergies from a potential combination, or otherwise increase integration challenges.

Reactions of Shareholders/Stakeholders. Investors, shareholders and other stakeholders are increasingly scrutinizing a company's ESG performance. Major asset managers such as BlackRock and State Street have already indicated that their investment decisions will be driven by ESG performance, and have gone so far as to design products and offerings that exclude investments in certain industries. Investors' drive to obtain actionable comparative data will also underpin future efforts to tie voting decisions to management of ESG issues. Going forward, companies will need to consider how to address the concerns of their stakeholders in transaction rollouts, investor presentations, press releases and at analyst meetings. Boards and management will need to demonstrate how ESG concerns have been handled in connection with M&A decisions, and be prepared to engage proactively with stakeholders on such matters.

Financing. Lenders have already seen the potential impact of significant ESG risks (both long term, such as the coal industry, and acute, such as PG&E) on the creditworthiness of businesses and industries. Over time, companies may find their cost and access to capital increasingly tied to their ESG performance. There is recognition that not all ESG metrics will have the same or even any impact on rates, but widespread availability of comparable data will allow lenders to determine over time which metric is most likely to be material.

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The full ramifications of the global push for ESG disclosures are still to be fully seen, particularly as companies and their investors and other stakeholders, as well as regulators, continue to assess and revise their approach. Disclosure practices and frameworks are actively evolving, and as the market standardizes we expect new datasets will impact capital allocation and operational decisions. We will continue to monitor ongoing developments in this field.

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Mark F. Veblen
Sabastian V. Niles
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March 2, 2020

ESG Disclosures — Considerations for Companies

Recent months have seen institutional investors, multinational organizations and the private sector emphasize the lack of (and importance of) comparable and decision-useful ESG disclosures. Some of the key issues in considering ESG disclosures are:

Choice of Framework and Content. Despite the growing recognition of the need for standardized reporting metrics, companies continue to face a myriad of choices as to how and where to present ESG disclosures. To date, the largest US public companies that disclose this information often report against some portion or combination of the Global Reporting Initiative (GRI), the Sustainability Accounting Standards Board (SASB), and the Task Force on Climate-Related Financial Disclosures (TCFD) standards. Other significant frameworks include those developed by the International Integrated Reporting Council (IIRC), the UN Global Compact and related Reporting on the Sustainable Development Goals (SDGs), the CDP (formerly the Carbon Disclosure Project) and the Climate Disclosure Standards Board. Some or all of the common metrics proposed in the World Economic Forum's (WEF) consultation draft will also likely become part of this landscape.

Materiality Standards. While each of the frameworks recognizes that specific ESG topics have varying impact on companies, the frameworks have significant differences in determining which topics should be covered. SASB, for example, references *financial materiality* with 77 industry guides outlining the material issues in any particular industry, while GRI requires disclosure against topics that affect a company's *stakeholders* and that reflect a company's "significant economic, environmental, and social impacts" or "substantially influence the assessments and decisions of stakeholders." GRI contemplates that an organization will determine the issues that are material to it in consultation with stakeholders, and provides corresponding detailed issue-by-issue guidance. The TCFD keys off the standard used in financial filings, and the WEF draft contemplates a "comply or explain" standard. In making disclosures, companies should be clear if references to materiality differ from (or are more expansive than) historical securities law constructs.

Disclosure Formats. The frameworks accommodate disclosure in a variety of documents. SASB's standards are designed to be "used in core communications to investors" but it requests companies to "assess the pros and cons" of each channel, taking into consideration input received from shareholders and consultation with auditors. GRI disclosures can be made in "a variety of locations and formats" as long as they reference the GRI standard they are reporting on, and are cross-referenced into a central index. The TCFD contemplates disclosure in mainstream filings, but recognizes that at least some disclosures may be in supplemental reports.

Many companies disclose the most material elements of their ESG governance and strategy in their SEC reports, focusing on qualitative discussions of items that are material to management and strategic planning of the business in accordance with the SEC's guidelines concerning climate change information and non-financial disclosures, and include more detailed metrics in separate sustainability reports, which often include an index demonstrating compliance with one or more of the major disclosure frameworks. Within the past year, several major companies have also issued inaugural human capital management reports. Other reporting avenues include integrated reports that combine financial data with ESG disclosures and sustainability-related information as well as more general investor relations websites, proxy statements, presentations during earnings calls, investor days and non-deal road shows (NDRs) and sustainability-specific forums, as well as regulatory filings.

Foreign Disclosures. Outside of the US, certain ESG disclosures have become mandatory. Under the EU Commission's Non-Financial Reporting Directive, certain large EU companies are required to report on environmental protection, social responsibility and treatment of employees, human rights, anti-corruption and bribery, and board diversity. This disclosure is required where necessary to understand the company's financial performance *or* the impact of its activity.

ESG Ratings. The primary direct consumers of ESG information now include ratings agencies and investors, with ESG metrics affecting investment decisions and availability of capital. Sustainalytics, one of the largest ESG ratings agencies, evaluates companies on a sector-specific basis focusing on ESG risk management. State Street has developed its own proprietary ESG ratings system called R-Factor™, which draws on ESG data from the ratings agencies Sustainalytics, ISS-ESG, Vigeo-EIRIS and ISS-Governance, and is focused on financial materiality. There are many other providers of ESG ratings; as companies provide more uniform and comparable data and metrics, the utility and impact of third-party rankings will increase.

Strategic Opportunities. In addition to direct effects on investment decisions, ESG disclosures present an opportunity for companies to highlight the integration of ESG factors into longer-term business strategies. Such disclosures can be made alongside specific metrics and may prove useful for companies seeking to demonstrate plans to change or improve their business, including new business opportunities, as well as actual or intended improvement in areas where they lag behind peers and industry leaders. In making such disclosures, it is important to consider the time horizons of the company's key stakeholders and provide information that tie disclosed metrics with long-term business resilience and sustainability.

Risks. As noted in our prior memoranda, ESG-related statements and failures to disclose material trends can become the basis for securities litigation and enforcement action. Companies should ensure that appropriate controls are in place and consider whether external assurance, validation or review is necessary or appropriate as to specific ESG disclosures.

Targets and Goals vs. Descriptive Data. Currently, ESG disclosures primarily focus on expanding transparency regarding current (and historical) ESG performance against various metrics. However, providing forward-looking ESG performance-related information, both qualitative and quantitative, will become increasingly common. How a company conveys aspirations and shows progress in ESG areas, whether a company selects specific targets or goals to achieve and when and whether a company publicly discloses any ESG-related targets, goals or forecasts will become important strategic decisions with significant legal and practical implications in this new era.

The ESG disclosure and performance landscape is evolving rapidly, and we are monitoring that evolution. Companies would also do well to monitor disclosure trends and evaluate if they have the internal capacity to meet emerging reporting demands and requirements.

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February 19, 2020

ESG Disclosures and Litigation Risk

The past several years have seen a significant increase in the number of companies making public disclosures concerning environmental, social, and governance ("ESG") issues. Reflecting this trend, the World Economic Forum ("WEF") recently released a Consultation Draft of proposed common ESG metrics for companies to consider including in investor communications. While such ESG disclosures can provide substantial benefits for companies, including with respect to shareholder support and engagement, customer loyalty, and employee morale, they can also give rise to litigation and regulatory risk. As ESG-related issues have gained importance with investors and consumers, we have seen an increase in litigation and regulatory interest centered on such disclosures—a trend that we expect to continue.

Like any corporate disclosures, ESG-related statements that are later alleged to be materially inaccurate or misleading can become the basis for securities litigation. While such claims have often been dismissed on the grounds that general statements concerning a company's commitment to ethical conduct or social values are merely "aspirational" or corporate "puffery," some claims based on more specific or concrete statements have survived motions to dismiss, such as in the recent CBS case. Furthermore, to the extent that such ESG-related disclosures become more standardized and are made pursuant to a specific disclosure regime, it is less likely that courts would find such disclosures to be mere puffery.

Climate change-related disclosures have already provided one example of the heightened regulatory risk related to ESG-type disclosures. For many years, several state attorneys general have investigated the sufficiency of such disclosures, in some cases, reaching settlements that required changes to climate change-related disclosures, and in others, commencing litigation. Notably, the SEC, the principal federal regulator of corporate disclosures, was not involved in many of these cases. A widely adopted disclosure framework with standardized ESG-related disclosures could lead to increased SEC interest and enforcement activity.

One particular example in the WEF Consultation Draft highlights the potential litigation and regulatory risk from adoption of ESG-related disclosures. The Consultation Draft suggests that companies should disclose information about the percentage of employees and business partners who have received anti-corruption training along with the "Total number and nature of incidents of corruption confirmed during the current year." Needless to say, requiring companies to disclose the number of corruption incidents discovered during any particular year would have significant consequences on both the regulatory and civil litigation fronts.

Recognizing that there is growing momentum towards the development of a common framework for ESG disclosures, companies should evaluate the potential litigation and regulatory risks of proposed metrics and how they would adapt to a regime in which such metrics became a widely accepted standard.

David B. Anders
Lauren M. Kofke
Karen Wong

February 20, 2020

ESG Metrics and Compensation

Investors, regulators, and companies have become increasingly focused on environmental, social and governance ("ESG") issues, with the recent release by the World Economic Forum of a Consultation Draft of common ESG metrics for investor communications highlighting the growing pressure for disclosure of ESG metrics. As the ESG movement continues to gain momentum, companies are grappling with the relationship between ESG and compensation, with focus both on various prominent ESG factors that relate to human capital and on utilization of ESG goals in incentive compensation design.

ESG Human Capital Factors. Several frequently cited ESG factors relate to compensation or to human capital more generally. The World Economic Forum discussion of common metrics identifies "People" as one of four core areas, including within that rubric standards related to gender pay equality, diversity and inclusion, wage level, and various worker safety and training metrics. Individual companies will grapple with each metric uniquely, but the trend towards a common set of factors reflects an emerging consensus that a successful human capital framework that values employee welfare will improve productivity, motivation, and morale, ultimately resulting in better outcomes for all stakeholders and contributing to long-term profitability.

ESG Incentive Compensation Metrics. According to a recent Willis Towers Watson study, 51% of S&P 500 companies already incorporate ESG-related metrics in their incentive programs, although such metrics are often included within qualitative or individual performance components of the programs and are frequently of limited weight. We expect the prevalence of ESG measures to grow in the years to come. Any attempt to implement ESG goals must begin with an assessment of which ESG issues are most relevant to the individual company and an evaluation of whether all constituents will likely be in directional agreement as to appropriate goals. The largest challenge for many companies will be devising objective criteria for measurement, although movement towards disclosure of common metrics may facilitate establishment of such criteria by standardizing measurements and making peer data more readily available. While, historically, ESG goals have been employed primarily in annual bonus programs, the necessarily long-term view appropriate to sustainability may potentially make them suitable for long-term incentive programs.

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As investors continue to deeply engage in ESG issues, companies should monitor developments and prepare for more widespread use of ESG metrics in compensation programs. With the continued emergence of ESG standards, companies will need to be positioned to educate all constituencies regarding the relevance of ESG issues and how the achievement of related goals will benefit not only executives in their compensation packages but all stakeholders.

David E. Kahan
Erica E. Bonnett

February 21, 2020

Tax and ESG

Proponents of enhanced environmental, social and governance ("ESG") disclosure have identified corporate income tax as a relevant metric. While it is premature to predict how ESG standards in this regard will evolve, a key area of focus is tax arbitrage, including profit-shifting among jurisdictions. Boards should be aware of the possibility of detailed country-by-country public disclosure intended to reveal scenarios involving high profits in jurisdictions with little economic activity and low profits in jurisdictions where a company has a significant presence.

Inspired by the Action Plan on Base Erosion and Profit Shifting of the Organisation for Economic Co-operation and Development, the standards put forth by the Global Reporting Initiative ("GRI") in 2019 (GRI 207: Tax 2019) and the Consultation Draft of the World Economic Forum in 2020 would require (effective January 1, 2021, in the case of the GRI standards) public disclosure, by jurisdiction, of, among other things, third-party sales revenue, number of employees, profit or loss, corporate income tax paid on a cash basis and revenue from intercompany transactions. ESG initiatives also contemplate disclosure of a company's tax policy or "approach" to tax, as well as governance and risk management processes relating to tax.

Arguments cited in support of greater engagement include that aggressive tax planning can create corporate governance risk, lead to material fines, damage corporate and brand reputation and, alone or in combination with competition among jurisdictions to attract businesses through tax incentives or holidays, deprive governments of funding needed to provide services to communities. Indeed, enhanced corporate income tax disclosure could itself lead to changes in tax laws, perhaps as a result of governments gaining insight into tax practices or public reactions to ESG disclosures. The public reaction to corporate "inversions" cannot be discounted as a factor that led to increasingly strict Internal Revenue Service rules relating to such transactions.

We are monitoring these developments, and Boards should consider whether to seek a proactive role in shaping the standards, whether their organization should (if voluntary) or could (if mandatory) meet such standards with respect to corporate income taxes, and whether the possibility of such disclosures should inform the organization's current policies, risk controls and strategies with respect to corporate income tax matters.

Apart from disclosure, the possibility of carbon taxes, and carbon tariffs on imports from countries with less stringent carbon-related regulation, remains of interest to ESG-minded governments and constituencies. We are monitoring these developments as well.

Deborah L. Paul
T. Eiko Stange

February 25, 2020

ESG Factors and Antitrust

Recently, the World Economic Forum ("WEF") released a Consultation Draft of proposed common standards for corporate disclosure of environmental, social, and governance ("ESG") factors. The draft proposal highlights the need for a common framework from which to evaluate corporate actions and their impact on ESG factors. While it is unclear precisely which of the proposed standards will ultimately prevail, it is clear that we are poised to enter a new era of corporate governance and disclosure, and that there is an increasingly acute need to better understand how these standards may affect all aspects of corporate regulation, including antitrust.

It is not immediately apparent whether the adoption of these new standards will directly impact antitrust regulation of mergers, acquisitions or joint ventures, but there are some intriguing possibilities. Fundamentally, antitrust analysis is underpinned by the economic assumption that corporations are motivated by profit maximization. This bedrock principle drives the analysis of whether any given transaction will create or change incentives to raise price or reduce output, innovation, or quality in a way that is harmful to consumers.

An era in which corporations measure performance by factors other than profit could change this fundamental assumption with potentially interesting implications. For example, when evaluating the potential anticompetitive effects of a transaction, the U.S. antitrust authorities are expected to account for the transaction's procompetitive synergies—an analysis traditionally driven by effects on the combined firm's profit margins. However, environmental efficiencies (a factor identified by the proposed WEF standards) resulting from a transaction should perhaps be credited as a benefit to be weighed against any perceived harm to competition, even if such efficiencies are not captured by looking to profit margins alone.

These developments bear watching, and we will continue to monitor and report on these issues as they progress.

Damian G. Didden
Christina C. Ma

February 26, 2020

ESG Performance and the Credit Markets

The view that it is not only possible to do well by doing good, but that doing good is critical to doing well in the long run, has come to the fore in the investment community. Environmental, social and governance (ESG) issues are, as State Street says, "a matter of value, not values." In his much-publicized letter to CEOs, BlackRock founder Larry Fink augured "a profound reassessment of risk and asset values," noting "climate risk is investment risk." The statement can be generalized: ESG risk is credit risk. Recognizing this reality, investors have increasingly demanded from companies ESG disclosure alongside traditional financial metrics, with profound implications for corporate credit.

Over time, we expect companies to find their cost of capital more directly tied to their ESG risk, which firms are lining up to help investors evaluate. All of the major credit ratings agencies have signed onto the Principles for Responsible Investment statement that ESG factors can weigh on default probability, and consider such factors in their ratings. Some also offer stand-alone ESG products, as do independent specialist firms. As an indicator of the growing demand for ESG data and analysis, both Moody's and S&P made strategic acquisitions in the ESG-data space in 2019. Morningstar took a 40 percent stake in Sustainalytics in 2017.

Notwithstanding the plethora of firms, investors and analysts propounding their own views on which ESG metrics matter and to what degree, the vast potential of ESG-informed financing has yet to be tapped. Accelerating its growth depends on the availability of consistent and comparable data across firms. Universally acknowledged as lacking today, standardization is coming. The World Economic Forum, for example, recently released a Consultation Draft of proposed common standards for corporate disclosure of ESG factors. Companies will have little choice but to respond to investor, and in some cases regulatory, demand for useful information.

Widespread, comparable ESG disclosure portends more than just facilitation of risk assessment: financial innovation will follow. Unlike their equity cousins, ESG bond indexes are few, and non-existent in the high-yield realm. That will change. Borrowers, particularly in Europe, are already using "green bonds" (proceeds earmarked for environmentally friendly projects) and "sustainability-linked loans" (pricing tied to bespoke sustainability targets) to demonstrate commitment to ESG issues. While the actual pricing impact of ESG performance in such products is currently marginal, often only a few basis points, having an infrastructure that ties the cost of capital to ESG performance will enable rapid change as improved statistics increase transparency and diminish fears of "greenwashing" (*i.e.*, investor concerns about buying genuine ESG performance rather than public relations coups). Today these products operate as signaling devices to stakeholders with respect to ESG commitment; tomorrow they may materially affect debt service.

We encourage companies to be proactive in choosing their individual ESG disclosures, to stay abreast of the ESG-related financing trends in their industry and to work with rating agencies, trade groups and leading sustainability-measuring organizations, so that their voices are heard as the standard-setting process unfolds.

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Emily D. Johnson

February 28, 2020

The Road to Glasgow: Integration of
Climate Change Metrics into Business Decisions

Yesterday, as part of a kickoff event for COP26, which will be held in Glasgow in November, Bank of England Governor Mark Carney outlined the role of finance in transitioning to a net zero economy. As much of the climate-related disclosure that is now being made by US companies was originally driven by Carney's seminal 2015 speech, yesterday's speech may be seen as a good guide to what will be expected from European, and eventually American, companies in terms of climate action.

His objective is clear: to "ensure that every financial decision takes climate change into account." Notably, the Bank of England will become the first regulator to stress test its major banks and insurers against different climate pathways, including the "catastrophic business-as-usual scenario"; a transition to net zero by 2050; and a "late policy action" scenario involving a sudden recognition of the scale of stranded assets and economy-wide disruption associated with a delayed and disorderly transition. The stress tests will be built on scenarios being developed by the Network for Greening the Financial System (NGFS); those scenarios will be made publicly available this spring so that any company can use them to assess strategic resilience.

Carney also intends to work with standard setters and national authorities to make climate reporting mandatory. In this regard, Carney noted that the framework proposed by the Task Force for Climate-Related Financial Disclosures (TCFD) has become the "go-to standard" for climate-related information, with widespread support from across the financial sector, including every major systemic bank, nine of the top ten asset managers, all of the credit rating agencies, all major accounting firms and shareholder advisory firms, and with TCFD compliance included within the framework recently proposed for discussion by the World Economic Forum's International Business Council (WEF).

Relatedly, Carney encouraged the private sector to commit to full TCFD reporting in the 2021/22 reporting round, and to demand TCFD-consistent disclosures (which he noted would include a strategy for managing down scope 1, 2 and 3 emissions with appropriate board-level governance structures and compensation linkage) from borrowers and portfolio companies. He also encouraged companies to contribute to the review of the current TCFD framework that Mary Schapiro is leading.

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Carney's "Breaking the Tragedy of the Horizon" speech in 2015 led to the creation of the TCFD and the promulgation of its – at this point voluntary – climate-related disclosure standards, which have now been adopted to some extent by over 1000 companies. As Governor of the Bank of England, and Boris Johnson's Finance Advisor for COP26, he is in a position to exert significant influence on the future of climate-related disclosure. Forward-looking US companies should be mindful of these views.

David M. Silk

January 15, 2020

Accelerating ESG Disclosure—
BlackRock Nudges Companies Toward a Common Standard (SASB + TCFD)

A common concern among companies, investors, asset managers and other stakeholders considering voluntary ESG-related disclosures is the lack of a uniform standard that would permit reliable and consistent comparability. In yesterday's annual letter to CEOs, BlackRock's Chairman and Chief Executive Officer Larry Fink advocated for standardized and accelerated sustainability disclosures and endorsed both the industry-specific standards developed by the Sustainability Accounting Standards Board (SASB) and the climate-specific framework developed by the Task Force on Climate-related Financial Disclosures (TCFD) as the benchmark frameworks.

Pointedly, and building on selected private engagements with companies, BlackRock will now request its investee companies to disclose in accordance with SASB's (or similar) and TCFD's guidelines by year-end. The request has teeth: BlackRock "will be increasingly disposed to vote against management and board directors when companies are not making sufficient progress on sustainability-related disclosures and […] plans underlying them." Going forward, formal Rule 14a-8 shareholder proposals seeking SASB- and TCFD-aligned sustainability reporting may receive greater investor support where companies have not committed to expanded disclosures.

At the same time, BlackRock published updated stewardship guidance about climate risk engagement and SASB- and TCFD-aligned reporting. While recognizing that other standards may be acceptable, the guidance adheres closely to guidance published by SASB and the Climate Disclosure Standards Board, including their joint TCFD Implementation Guide.

Whether or not BlackRock's efforts produce a consensus on a sustainability disclosure standard and accelerated voluntary reporting, it is clear that, going forward, investors will expect officers and directors of investee companies to demonstrate a strong understanding of company-specific sustainability and climate-related risks. Companies that have not yet disclosed against SASB and TCFD standards are well-advised to familiarize themselves with these frameworks and develop their rationales for not making those disclosures, deciding upon a reasonable time frame for making new disclosures or adhering to a different standard. The resources and primers prepared by the Society for Corporate Governance are useful for issuers seeking to understand this landscape, as are industry-specific resources.

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January 29, 2020

State Street Global Advisors Sharpens Voting Push on Financially Material ESG Matters

In a letter to directors of public companies, State Street Global Advisors' President and CEO, Cyrus Taraporevala, reiterated SSgA's focus on "financially material" ESG issues as "a matter of value, not values." He also confirmed that SSgA will go beyond engagement and deploy its voting power in director elections to accelerate corporate action on ESG. In SSgA's view, "fewer than 25% of the companies we've evaluated have meaningfully identified, incorporated and disclosed material ESG issues into their strategies."

As shareholder proposals touching on ESG and sustainability matters proliferate, SSgA has also sounded a cautionary note, flagging that "some shareholder activists continue to focus on specific or narrow ESG issues in piecemeal fashion—often creating confusion for investors, boards and company leadership without fundamentally tackling the ESG issues material to long-term shareholder performance."

Leveraging SSgA's endorsement of the Sustainability Accounting Standards Board (SASB) standards, SSgA uses its proprietary "R-Factor" ESG scoring methodology to benchmark companies against peers and will make these scores and associated drivers available to companies. As to the specific voting plans (which could include abstain as well as "withhold" or "against" votes against directors):

"Beginning this proxy season, we will take appropriate voting action against board members at companies in the S&P 500, FTSE 350, ASX 100, TOPIX 100, DAX 30, and CAC 40 indices that are laggards based on their R-Factor scores and that cannot articulate how they plan to improve their score. Beginning in 2022, we will expand our voting action to include those companies who have been consistently underperforming their peers on their R-Factor scores for multiple years, unless we see meaningful change. We believe doing so is in the best interests of investors and companies alike."

In connection with the SSgA's CEO letter to directors, its stewardship team, led by Rakhi Kumar, published an ESG Oversight Framework for Directors – Demystifying ESG for Board Members, which informs engagements with companies. This update affirms SSgA's desire to have directors "acknowledge the importance of environmental, social and governance (ESG) issues to the business" and assess ESG materiality through strategic and operational lenses.

SSgA has previously pressed boards and management teams on a range of emerging and nuanced issues, including focusing on the long-term, resisting short-termism, corporate culture as a driver of long-term value, incorporating sustainability considerations into business strategies, structuring effective independent board leadership approaches without defaulting to who does or does not have the title of "chair," board gender diversity, climate change, protecting long-term shareholder interests in activist engagements and the Investor Stewardship Group's corporate governance principles. SSgA has also published various industry sector-specific insights informed by stewardship engagements with lead directors and management teams.

While it remains to be seen when and whether SSgA's prediction that "a company's ESG score will soon effectively be as important as its credit rating" will come to pass, SSgA's push on these issues will likely foster expanded corporate dialogue and disclosure, board focus and company-specific approaches on ESG-related matters.

SSgA's latest announcement underscores the growing global focus on ESG performance across companies and industries and BlackRock's own push for expanded disclosure. In what will also prove a significant development, the World Economic Forum ("WEF") recently released a consultation draft proposing a core set of ESG-related disclosure metrics aligned with the UN Sustainable Development Goals, drawing from existing frameworks. The draft WEF framework was prepared under the leadership of Brian Moynihan in collaboration with the four largest accounting firms—Deloitte, EY, KPMG and PwC—and members of the WEF's International Business Council. It marks a notable step towards achieving more universal disclosure standards on ESG matters that may be acceptable to companies.

The upcoming year will see continued efforts to consolidate the many different metric- and framework-related initiatives. If an agreed-upon set of ESG and sustainability-related long-term value metrics were to be widely adopted and embraced by public companies and institutional investors alike, that could have a profound impact on company business strategies and approaches to sustainable investment and growth.

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February 3, 2020

Accelerating ESG Disclosure—
WEF Task Force Releases Preliminary Framework Centered on
Mainstream Reporting Aligned with UN Sustainable Development Goals

Reflecting the growing push among investors, asset managers, companies and other stakeholders for a standardized ESG disclosure framework, a task force sponsored by the International Business Council (IBC) of the World Economic Forum (WEF), has released a consultation draft proposing a set of common disclosures aligned with the UN Sustainable Development Goals for companies to consider. Entitled "Toward Common Metrics and Consistent Reporting of Sustainable Value Creation" and drawing from several existing standards and disclosure frameworks (notably, the Global Reporting Initiative (GRI), the Sustainability Accounting Standards Board (SASB) and the Task Force on Climate-related Financial Disclosures (TCFD)), the draft framework proposes a set of 22 "core" primarily quantitative metrics and disclosures believed to be readily reportable by companies and an additional set of "expanded" metrics and disclosures that serve as "a more advanced way of measuring and communicating sustainable value creation" and which could be made by companies for whom such disclosure is material and appropriate. The task force was chaired by Brian Moynihan, Chairman and CEO of Bank of America and Chairman of the IBC, and included experts from each of the Big Four accounting firms—Deloitte, EY, KPMG and PwC. Roughly 120 multinational companies and their CEOs are represented on the IBC, which launched this initiative to identify a core set of material ESG metrics and recommended disclosures with the objective that companies would begin reporting collectively on an aligned basis.

The proposed framework is driven by the growing belief that ESG and other sustainability factors are critical to long-term business viability and that a company's performance must be measured not only on the return to shareholders, but also on how a company achieves its environmental, social and good governance objectives. Accordingly, material metrics and disclosures set forth in the proposed framework would be provided by companies in their mainstream investment disclosures, such as annual reports and proxy statements, in addition to supplemental sustainability or social impact reports. The proposal contemplates that addressing ESG topics in the management discussion and analysis section of a company's annual report would ensure that consideration of these topics will be on the board's agenda, and thus integrated into core business strategy and governance.

The proposed ESG disclosures are organized into four pillars grounded in the UN Sustainable Development Goals: the Principles of Governance, Planet, People and Prosperity. Together, the pillars seek to measure the strength of a company's governance, its environmental impact and climate change risk management, labor practices and contribution to wider society.

Each of the pillars is further divided into themes, metrics and disclosures which were selected based on their adoption among existing frameworks and standards, materiality to long-term value creation, actionability, universality across industries and firms, and monitoring feasibility. The proposed framework aims to provide "a path for companies to report on core indicators, with the possibility to add more leading-edge disclosures to their reporting."

Companies will be expected to disclose in all pillars: the proposal notes that each of the pillars has "an important bearing on the capacity of a firm to generate shared and sustainable value" and that "performance in one pillar is highly interdependent with that in the others."

While many of the "core" metrics and disclosures are generally comparable with those that are currently being made by many companies in their voluntary ESG disclosures and sustainability reports, some of the "expanded" metrics are not currently in widespread use. For example, several of the "expanded" metrics relating to climate change and sustainability engage ISO 14008, a new standard issued last year by the International Organization for Standardization providing for a monetary valuation of environmental impacts from emissions and use of natural resources. The proposal would require this monetary valuation with respect to greenhouse gas emissions, use of land and conversion of ecosystems, water consumption, air and water pollution and solid waste disposal, where material. Moreover, for purposes of the "Planet" pillar, the proposed framework provides that materiality of impacts on society (rather than on the disclosing company) should be the key determinant of whether or not a metric should be quantified and reported. Other proposed metrics in the "expanded" category are totally new and do not track to any of the major disclosure frameworks, such as reporting on single-use plastics and the level of stakeholder buy-in on a company's stated purpose.

A key development in this latest push for a standardization of ESG disclosure metrics is the participation of the Big Four in the development of the proposal. The contributions and support of the Big Four, backed by members of the IBC and the WEF, will likely help pave a concrete pathway forward for not only the adoption of more standardized ESG disclosure metrics but also, potentially, future assessments of the accuracy and verifiability of disclosed ESG data.

Together with the recent letters from BlackRock's CEO, Larry Fink, and State Street's CEO, Cyrus Taraporevala (see our memos found here and here), WEF- and IBC-sponsored disclosure metrics would further accelerate the entry of ESG into mainstream business practice as a measured, disclosed and impactful aspect of corporate strategy and operations. The proposed set of agreed-upon metrics and disclosures are expected to be finalized over the coming months with the benefit of further consultation with and feedback from companies (including IBC members), investors and other stakeholders, with a view to implementation in 2021.

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