OVERVIEW

ESG and the Sustainable Economy Handbook

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CURRENT TOPICS IN ESG AND THE SUSTAINABLE ECONOMY

THE ETHICAL SUPPLY CHAIN

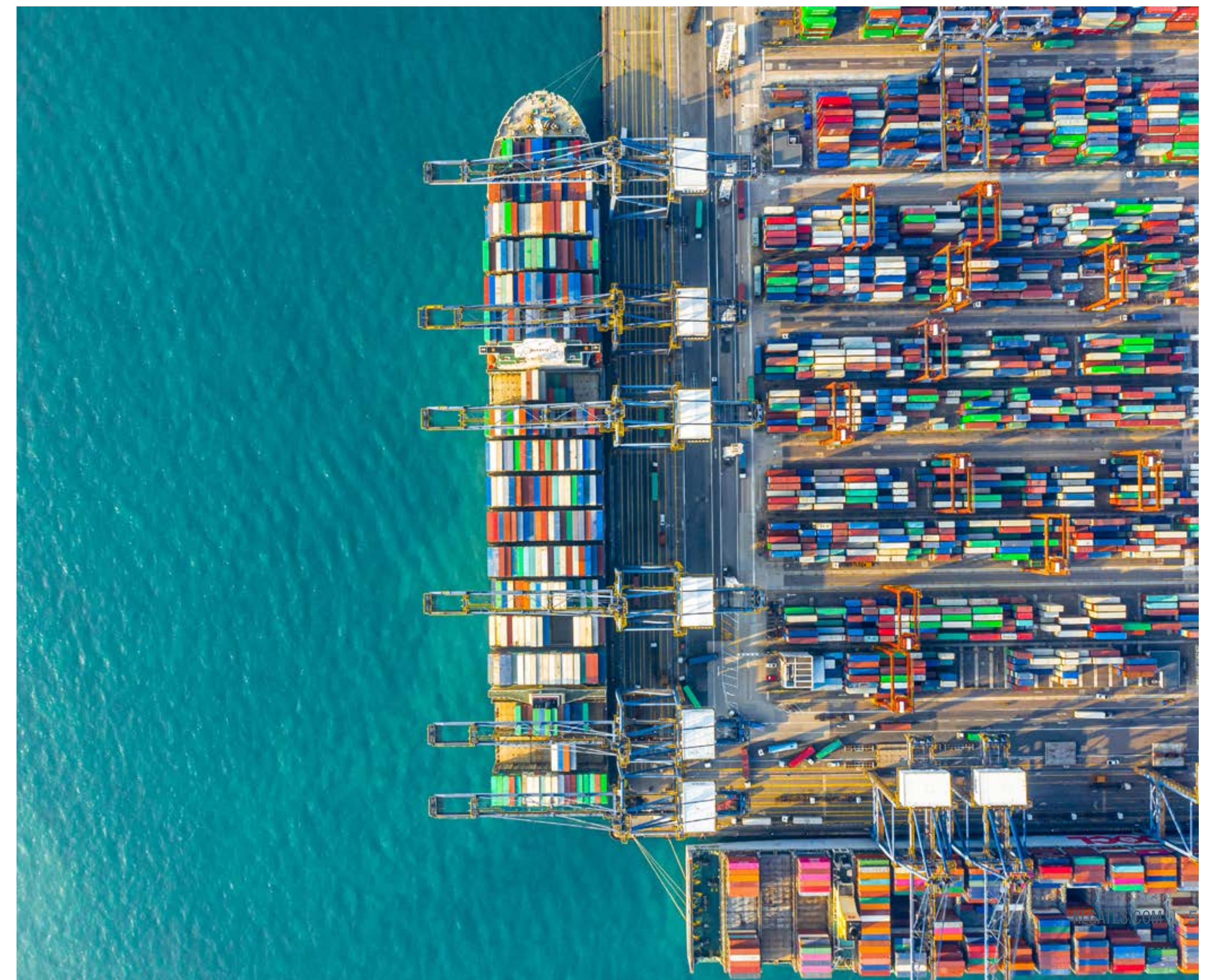
In recent years, supply chain risk management has received more attention in the context of investing with a focus on ESG and the sustainable economy. Specifically, efforts to address social issues, such as modern slavery and human rights abuses, in global supply chains have been prominent, both as a means of mitigating risk and as a proactive way to enhance brand reputation. Driving forces behind these efforts include consumers, shareholders, nongovernmental organizations, and other advocacy groups calling for action.

Jurisdictions around the world have enacted or proposed legislation requiring companies to disclose their risks, policies, and proactive steps relating to modern slavery, such as forced labor and child labor, in their supply chains. Two types of legislation are emerging. The first type is disclosure-based requirements, essentially requiring companies to publish statements identifying what actions, if any, they are taking to address modern slavery in their supply chains. Examples of this type of legislation include the California Transparency in Supply Chains Act and the United Kingdom's Modern Slavery Act. The second type of legislation goes further and imposes an obligation on companies to engage in human rights diligence in their supply chains. France's duty of vigilance law and the Netherlands' child labor diligence law are good examples.

However, legislation is only as good as the enforcement mechanisms that uphold it. While earlier laws lacked meaningful enforcement mechanisms, relying largely on naming-and-shaming lists and public image-related motivation as incentives for companies to take action, more recent legislation has included stronger penalty provisions, including the potential for civil fines, criminal sanctions, and disqualification of directors.

Litigation is also a business risk for companies that fail to meet established standards. Consumer class actions, human rights litigation by victims, and suits to enforce compliance with modern slavery and disclosure laws have become increasingly common. Higher insurance premiums, supply chain disruption, and related business continuity issues are additional tools to exert pressure that may be available in some jurisdictions. In the United States, goods produced with child labor or without payment of minimum wages can be enjoined from shipment under the Fair Labor Standards Act, and goods being imported to the country can be held at the border if they were produced with forced or child labor. These real business risks can have a meaningful financial impact on a noncompliant company when enforcement measures are taken.

It is challenging to determine how to assess these risks and the adequacy of measures companies are taking to prevent them. Without a uniform standard or set of criteria to consider, companies, investors, and fund managers are left to create their own policies and investment criteria relating to ESG matters and the sustainable economy. While the consequences of failing to meet any one stakeholder's criteria may result in reputational and some commercial damage to a company, one stakeholder's requirements are generally not enough to persuade a critical mass of supply chain participants to open up their activities for scrutiny, let alone change their operations. Thus, reliable, broadly applicable metrics for detecting and reporting supply chain risks are necessary to have a material impact. Corporate pressure in this area has been building, and we anticipate that it will increase in coming years, particularly as technology solutions, such as blockchain for tracking supply chain actions, become more broadly available.



ENVIRONMENTAL AND ENERGY JUSTICE

The concept of environmental justice is one of the ways in which environmental action and social justice come together. More specifically, environmental justice is typically concerned with the fair and equal treatment and meaningful involvement of all people, regardless of race, ethnicity, national origin, income, or other factors, with respect to the development, implementation, and enforcement of environmental laws, regulations, and policies.

These concerns typically arise from the lack of environmental protections for socioeconomically or culturally disadvantaged populations or a failure to enforce environmental laws that exist. For example, in the United States, environmental justice principles typically reflect injustices in Black and other communities of color, and the harms that people are typically concerned with include contamination of drinking water and soil, as well as proximity to operations and activities that emit carcinogens and toxic particulates into the air, such as mining and highways. Discussions around siting of electric generation and natural resource processing facilities also arise in this context, and these discussions may function to bridge environmental and energy justice concerns.

Energy justice is a similar concept that focuses on the equal treatment and involvement of all people—again, regardless of race, ethnicity, national origin, income, or other factors—in decisions regarding how energy is generated, distributed, and used. Energy justice concerns have become especially pronounced in recent years as more and more data shows that communities disproportionately impacted by climate change are typically communities of socioeconomically or culturally disadvantaged people. Some of the topics discussed in this context include a lack of access to electric vehicles due to the inability to afford a new car, off-street parking, or housing in neighborhoods where electric vehicle charging stations are most likely to be installed. Similarly, people in these disadvantaged communities often rent rather than own their homes, so they cannot simply install rooftop solar panels, energy-efficient appliances, and climate control units. Furthermore, they may not be able to participate in green power programs offered by local utilities if their landlords choose not to participate.

As a concept, neither environmental justice nor energy justice is new. Many jurisdictions, including the United States, have had laws and government regulations enshrining environmental justice principles for many years. These laws often concern public access to decision-making processes and equal protection of disadvantaged groups with respect to enforcement of environmental laws. Laws and regulations related to energy justice are also on the rise.

What is new is the increased focus of customers and investors in environmental and energy justice beyond compliance with applicable law, particularly in those jurisdictions where environmental laws are spotty, nonexistent, or enforced inconsistently. For instance, it is becoming increasingly popular for investors to probe how and to what extent a developer has engaged with the community when planning a renewable energy facility. In addition, as investors scrutinize their investments more, the companies in which they invest are increasingly attentive to the environmental and energy justice implications of their own operations and the practices of participants in their supply chain.

More and more, companies are setting goals that treat their relationships with employees, suppliers, customers, communities, and the world with an ESG and sustainable economy focus. These goals, and the actions taken to implement them, can encompass a broad range of considerations, including product and services sourcing, greenhouse gas output, waste handling, pollution mitigation, employee transit, and operational impacts to natural resources. In addition, corporate impact investing is on the rise, including direct investment in renewable energy facilities with specific social indicia (e.g., Microsoft's investment in solar facilities developed by Sol Systems), workforce housing with rooftop solar, and public-private partnerships to help fund publicly accessible electric vehicle charging stations throughout a metropolitan area.

CARBON

Global emissions of greenhouse gases have long been a key interest for some investors, but they are quickly becoming a topic of interest for many more. While there are a number of greenhouse gases, carbon dioxide—referenced simply as carbon—tends to capture much of the public's attention, particularly in the context of ESG and the sustainable economy. Conversations about carbon typically revolve around five major concepts:

- **Decarbonization** is a broad term that generally refers to efforts to reduce carbon emissions resulting from various processes, for example, product manufacturing, natural resource utilization, agriculture, and residential activities such as heating and cooking.
- **Low carbon** is a somewhat subjective phrase that refers to products or processes that have a lower carbon footprint than others. It is often used in conversations about the low-carbon economy, i.e., an economy powered by low-carbon energy sources.
- **Carbon reduction** describes activities and processes that are comparatively less carbon intensive than similar activities and processes.
- **Carbon neutral** can refer to an activity or product that is produced without emitting carbon, or it can refer to a person's actions to offset carbon emissions attributable to their current activities. A number of businesses and some investment firms have announced goals to become carbon neutral.
- **Carbon negative** can refer to an activity that consumes, rather than emits, carbon on a net basis. It also can refer to a person's actions to go beyond carbon neutral, including methods to offset more carbon emissions than those for which they are responsible over a defined time period. For example, a few large multinational corporations have announced goals to offset all carbon they have produced throughout the life of the corporation.

Decarbonization clearly fits within the environmental category of the ESG and sustainable economy frameworks, but it is also inherently tied to environmental justice because of the impact on socioeconomically and culturally disadvantaged groups of both climate change and many of the processes associated with sequestering carbon.

Investors utilizing an investment strategy informed by ESG and sustainable economy considerations can achieve investment goals centered on decarbonization concepts by investing in physical assets, such as carbon-capture or removal facilities. However, while carbon-capture equipment is becoming more common in certain industries, e.g., natural gas processing and electricity generation facilities, it is very expensive. Direct air capture technologies that remove carbon from the ambient air are also available and on the cusp of achieving the scale necessary to have a material impact on the climate. However, they remain difficult to finance. Carbon-capture and technology-driven carbon removal activities and sequestration also inherently present physical asset, environmental, and offtake risk. For example, the gold standard for carbon reduction is currently secure sequestration in a geologic formation. However, pumping carbon dioxide into the ground can affect groundwater, and there is always a chance of leakage. In addition, geologic formations suitable for carbon sequestration are not available in all regions. Some of these risks can be reduced by utilizing captured or removed carbon while, in some cases, still storing the carbon such that it will not easily be emitted, e.g., manufacturing of high-carbon steel and concrete. Many other utilization technologies are also available or in development, but they have not yet become commercially viable, e.g., fuels made from algae grown using captured carbon.

Investors with no appetite for physical asset risk or the business risk inherent in investing in technology with an uncertain offtake market can still participate in the low-carbon economy. These investors may prefer more established asset classes, such as sustainable forestry and agriculture, where carbon is removed and stored through intentionally deployed natural processes, such as photosynthesis and biochar application. Alternatively, investors may purchase carbon credits or offsets to meet their carbon reduction goals. These methods have been available for some time in certain jurisdictions, and they are becoming increasingly common worldwide. In addition, markets in these carbon instruments and their derivatives are evolving quickly, which should help to bring more carbon-capture and removal facilities online in the near future.

THE ENERGY TRANSITION

Charles Fritts is credited with installing the first solar panel in 1884; nearly 140 years later, we have arrived at the energy transition.

At its most basic, the energy transition is the movement away from fossil-based energy sources to low- or zero-carbon energy fuels and electricity. But what does that mean for consumers and investors?

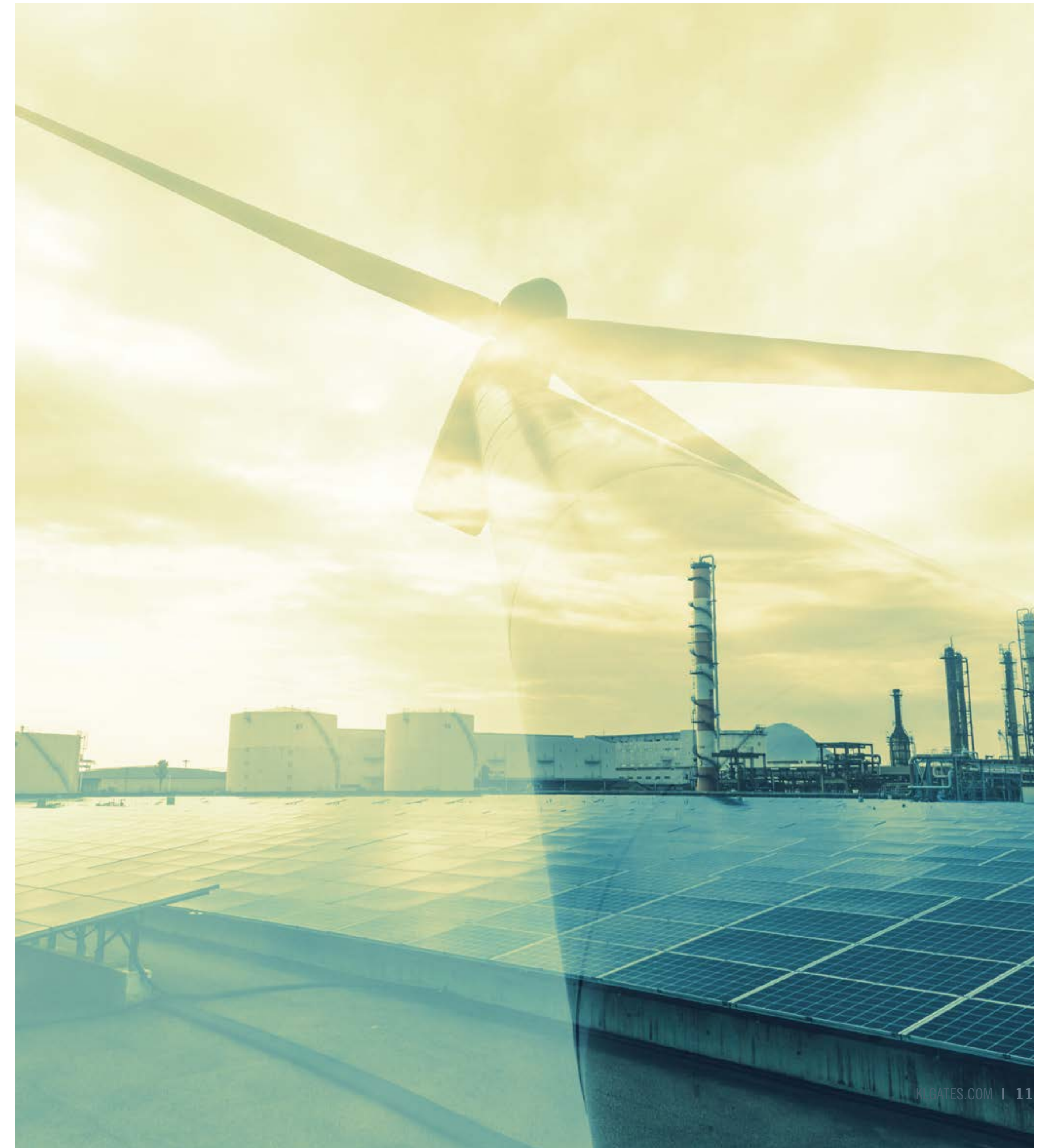
The energy transition is not merely a process of turning off coal-fired power plants and powering up wind and solar farms. Rather, it is a technology-intensive process of coordinating a variety of renewable resources to ensure that consumers and businesses can obtain the power and fuels they need to operate while generating the lowest possible carbon footprint, both before and after the energy is consumed. While the nongovernmental sector has frequently advocated for this transition, it has been driven largely by governmental policy choices, such as renewable generation requirements, tax incentives, and other subsidies, as well as government spending on research and development and infrastructure development. In recent years, the private sector has also become heavily involved in the push toward zero-carbon energy by entering into a variety of contracts to incentivize the production of electricity using renewable resources as well as investing in renewable generation facilities and, recently, in carbon capture and removal.

The steps needed to accomplish the near-term energy transition goals set by many local and national governments and a growing number of corporations are daunting but achievable. These include not only building more renewable electricity generation facilities and long-term storage facilities, but also developing robust manufacturing and transportation infrastructure for renewable fuels, such as renewable natural gas and hydrogen. Transmission and distribution grids also must be reconfigured to account for much more widely distributed generation and storage assets. In addition, because the energy transition will not happen overnight, it is essential to dramatically reduce the carbon footprint of those resources needed to maintain energy reliability and stability in the interim. As the European Union noted in its July 2020 “Strategy for Energy System Integration,” it is necessary to move away from silos and vertical energy value chains to an integrated and more circular energy system. In addition, the transition from carbon-based energy to carbon-free energy presents opportunities for the workforce, but it may also require that certain personnel be retrained or relocated.

How can so much change be accomplished so quickly? Luckily, many of the key innovations needed to accomplish the energy transition are already commercially available or approaching commercial viability. Many regions in the United States and several countries already have sufficient renewable energy resources to power their grids using entirely renewable resources for significant periods of time. Offshore wind turbines have been instrumental in accomplishing that in Northern Europe and will help many more regions accomplish long-term, reliable renewable generation as government permissions processes adapt. Long-duration energy storage is also here, both in the form of pumped hydro facilities (which are enjoying a recent resurgence) and long-duration chemical batteries. In addition, large-scale production of renewable hydrogen is increasingly viable, both technologically and commercially.

Many players in the traditional fossil fuel sector are both recognizing and creating these opportunities by drawing from their long history of technological innovation in challenging environments.

ESG- and sustainable economy-minded investors can and are making a difference in the energy transition. In fact, there is currently more money in the renewable energy sector than projects. Many of the investors in this space are strategic investors; for example, many of the major oil and gas players have diversified into renewable energy and carbon-capture technologies and projects. Others are traditional project finance and private equity participants. Some are corporations that want to directly (or indirectly through derivatives) access renewable energy for their operations. Still more are retail and other private investors seeking a return for themselves and the planet through mutual funds and direct investment.



DIVERSE AND INCLUSIVE BUSINESSES

While governance in the context of ESG considerations is generally focused on how a company is managed by its executives, directors, and management team, investors more focused on governance often look beyond the tone-setting thought leadership and dissect the internal system of practices, controls, and procedures companies adopt in order to govern themselves, make effective and conscious decisions, comply with the law, and meet the needs of internal and external stakeholders from the broader sustainable economy perspective. In essence, to excel in governance requires corporate behavior and leadership to master not only the letter of the law, but also the spirit of it.

Driving forces behind blue-ribbon corporate governance and behavior now stem from the companies' employees, service providers, vendors, consumers, shareholders, nongovernmental organizations, and other advocacy groups, all of which are increasingly questioning the C-suite about ESG- and sustainable economy-related issues. For example: How is the company giving back to the communities where it is located? How is the company holding itself accountable for full and honest corporate, financial, and sustainability reporting? Are the board members acting in a genuine fiduciary relationship with shareholders? Are there corporate responsibility, sustainability, or governance committees responsible for board-level accountability? Is executive compensation appropriately tied to increasing the long-term value, viability, and profitability of the business? What about ESG and sustainable economy targets? How is the company working to fix pay-equity issues based on gender, race, or other demographic factors? How does the company manage its human capital? Is health and wellness embedded into the workplace?

One of the hottest topics around governance during the last several years has been equity, diversity, and inclusion, particularly at the board level. Many businesses have embraced serious efforts to create more inclusive hiring and promotion systems, in part because of a greater agreement that equal pay is a key part of fair employment practices, which are not only essential for avoiding costly litigation, but also for recruiting and retaining a high-performing and innovative workforce. Proactive approaches taken by some companies include conducting equal pay audits, promoting salary transparency, standardizing compensation setting, and eliminating salary negotiation. The move toward equity, diversity, and inclusion increases in speed as businesses see organizations that matter to them joining the effort. For example, in December 2020, Nasdaq, Inc., which governs the Nasdaq stock exchange, proposed to the U.S. Securities and Exchange Commission (SEC) that Nasdaq be permitted to require that listed companies have at least one female board member and at least one board member who is a racial minority or self-identifies as lesbian, gay, bisexual, transgender, or queer.

In addition, many laws concerning diversity and inclusion have been enacted around the world, though these laws vary significantly depending on the enacting jurisdiction and its cultural and racial composition. For example, Sweden has required companies to promote gender equality since 2009 and has had laws otherwise seeking to combat gender discrimination for much longer, it has placed less emphasis on creating laws to combat racial and ethnic inequality. At the other end of the northern hemisphere, in 2018, the state of California passed a law mandating that public companies headquartered in California have at least one woman on their boards of directors by the end of 2019, with higher requirements of representation depending on board size. More recently, on 30 September 2020, California enacted a law requiring that, by the end of 2021, publicly held companies headquartered in the state must include members of underrepresented communities, defined as "an individual who self-identifies as Black, African American, Hispanic, Latino, Asian, Pacific Islander, Native American, Native Hawaiian, or Alaska Native, or who self-identifies as gay, lesbian, bisexual or transgender," on their boards of directors.

CREATING A SUSTAINABILITY POLICY

ESG and the sustainable economy are about more than talk. They are also about action. To begin the journey of acting on ESG and sustainable economy principles, many organizations first create an internal policy in support of ESG and the sustainable economy, i.e., a sustainability policy.

There are many approaches to creating a sustainability policy, and each policy is likely to be different because of variations in the business and operations of different organizations, as well as in its reasons for creating a policy. Moreover, in some cases, the same organization may have different policies, for example, one for gauging investments and one for managing its own operations. In addition, depending on how a business is structured and its size, it could have separate policies for each of the main topical categories in the realm of ESG and the sustainable economy. For example, a large corporation with extensive supply chain operations may have a robust policy around social criteria that is used within its logistics department and a completely separate approach and policy around its carbon footprint, each of which are managed by different personnel. Much of this variation is driven by historic functions within a business, as well as historic practice and regulation in a particular industry.

Whatever the reason for, or focus of, a sustainability policy, there are broad commonalities in the process of formulating it. The suggested processes that follow are based on the guidelines published by the Principles for Responsible Investing, which has been widely adopted by organizations all over the world, as well as our experience working with organizations that have formulated and implemented sustainability policies.

Suggested First Steps

1. Learn more about the concepts behind ESG and the sustainable economy and how thought leaders view them. Consider the extensive academic and popular literature on the topic.
2. Gather intelligence about what other organizations in the same and related industries are doing.
3. Review any core beliefs, principles statements, or internal initiatives that your organization is already using.
4. Review laws and regulations relating to ESG and the sustainable economy that apply to your organization, such as environmental regulations, labor standards, or contracting requirements.
5. Consider ESG- and sustainable economy-related standards that are available in your country or region and that pertain to your organization's business. Also consider any standards that are more broadly available and that pertain to your organization. For example, Leading Harvest's Farmland Management Standard pertains to an array of ESG and sustainable economy criteria and can apply to many geographies and crops. On the other hand, the Fair Wear Code of Labour Standards relates to labor standards in the apparel industry. For investment management companies, the United Nations' Principles for Responsible Investment represent a consensus view—of over 3,500 asset owners, asset managers, and service providers—on how to integrate concepts relating to ESG and the sustainable economy into investment decisions and portfolio manager selection decisions.
6. Discuss the topic with stakeholders in your organization, assemble a diverse working group, and formulate a timetable for creating a policy and goals.

Brainstorming Your Organization's Sustainability Policy

1. Consider your goals. What impact do you want the policy to have? Is one aspect of sustainability more important in this policy than the others? What activities in your organization do you want the policy to impact? What activities do you not want the policy to impact?
2. Consider your audience. Will the policy apply to specific groups or everyone in your organization? Will it apply to your organization's goods and services providers? What role do the users of the policy play in your organization, and how will their daily activities be shaped by the policy?
3. Consider how the policy will be implemented. How should the policy impact the daily activities of your organization's workforce? What about your organization's contracting standards and procurement guidelines? Will derivatives or other financial instruments be used to synthetically offset negative exposures relating to ESG or sustainable economy principles? How will implementation affect your organization's risk profile and profitability?
4. Consider how the policy should be discussed. Will your organization discuss its initiative or policy publicly? With shareholders? As a recruiting tactic? In the context of business negotiations? Will those discussions have regulatory implications, e.g., under securities or consumer protection laws?
5. For investors, consider how the policy should be reflected in proxy voting decisions.
6. Consider how you will know when you have achieved your goals. How will you measure progress? Will you use a standards accreditation process, or will you develop a measurement tool and process internally? Who will measure progress?
7. Consider what should be the consequence of noncompliance with the policy. Will executive compensation be impacted? Should compliance be considered in employee evaluations?

Drafting Your Organization's Sustainability Policy

Like other organizational policies, a sustainability policy should be drafted with some specificity but broadly enough to capture the range of activities that the organization intends to impact and efficiently adapt to changing circumstances. For example, organizations that set net-zero emissions goals pursuant to an environmental or comprehensive sustainability policy typically set a date by which they plan to achieve net-zero emissions and how

they will measure emissions. In the investment context, investors that use an ESG scoring tool, such as MSCI's ESG Ratings, may create a policy that they will only invest in companies with a particular minimum rating or will never invest in certain asset classes.

While sustainability policies can follow any format that you and your colleagues can imagine, in addition to the policy statement itself, many organizations include some combination of the following:

1. A description of what ESG and sustainable economy principles mean to the organization and in its primary industry.
2. An explanation of why the organization has created a policy. This may discuss the organization's beliefs, goals, and desired outcomes.
3. A description of how the policy was developed, what was considered during the process, who was consulted during the process, how widely supported is the policy by stakeholders, and who approved it.
4. How the policy fits into your organization's other policies, for example, for financial transactions, investment, hiring, or procurement.
5. The scope of the policy, including who and what activities it applies to with as much specificity as possible.
6. The risks associated with the policy and when those risks may outweigh compliance with the policy.
7. How progress under the policy will be measured and by whom. Describe any external accreditation process that will be utilized.
8. The consequences to applicable personnel for failing to adhere to the policy.
9. When and how the policy will be reviewed and by whom.
10. Personnel who are responsible for the policy and its implementation.

Ancillary Documents

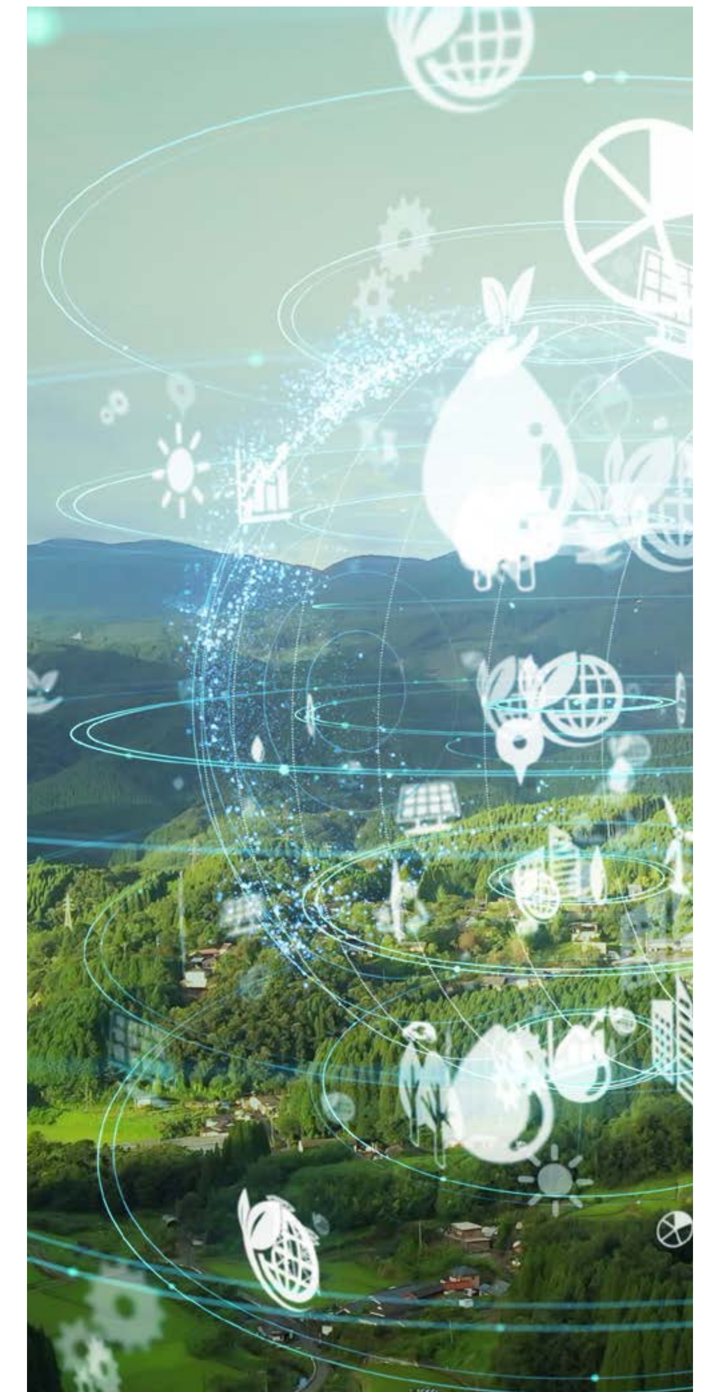
Like so many things in the organizational context, a sustainability policy is only as good as its implementation. Thus, organizations that create such policies typically also craft a variety of ancillary documents, including:

1. Guidelines for evaluating investment or business opportunities.
2. Reporting methodologies so that business units can track and compare their progress.
3. Decision-making guidelines. These are likely to vary significantly based on the type of operation and how its policy is intended to impact the organization's activities. For example:
    a. An investor may need additional guidelines for personnel voting the investor's board seats or shares.
    b. An operating business may benefit from guidelines for energy sourcing or scoring suppliers to account for fair labor practices, how inclusive and diverse a supplier's workforce is, or a supplier's environmental impact.
4. Guidelines for public communication about the organization's policy and its implementation. As discussed elsewhere in this handbook, these communications will vary based on whether the organization is publicly or privately held, is part of a government, the legal jurisdictions in which it operates, and other criteria.
5. Budgeting requirements.

PUBLIC POLICY CENTERING ON ESG AND THE SUSTAINABLE ECONOMY

The public policy issues relating to ESG and the creation of a sustainable economy center on evolving notions of corporate responsibility as well as ongoing developments in modern portfolio theory.

The public policy issues relating to ESG and the creation of a sustainable economy center on evolving notions of corporate responsibility as well as ongoing developments in modern portfolio theory. In contrast to the historical practice of defining corporate responsibility by reference to shareholder returns, emerging viewpoints have increasingly focused on a larger pool of stakeholders, including customers, employees, suppliers, and communities, in evaluating questions of corporate responsibility. This paradigm shift is at the core of the debate over recent United States rulemaking with respect to fiduciary duties, the role of proxy advisors, and disclosures, as well as the European Union Sustainable Finance Action Plan. A key element in this debate is the question of materiality, i.e., what information an investor would consider to be material in the analysis of a potential investment. Often overlooked in the debate about materiality is the temporal dimension to ESG and sustainable economy considerations. Which of these considerations would be deemed material could change substantially based on the investment time frame, as ESG and sustainable economy considerations tend to become increasingly material over time, particularly for institutional investors with very long-term obligations to beneficiaries.



SEC and Sustainability Disclosures

For over a decade, disclosure requirements relating to climate risks have been at the forefront of discussions relating to ESG and sustainability disclosures. In 2010, the SEC issued interpretive guidance requiring public companies to disclose the material impact that climate change has on their businesses, including the costs of complying with climate-related laws. This guidance is widely considered to be incomplete, as the SEC has not proposed any rules to specify what climate risks are material, the threshold that would trigger disclosure obligations, nor has it provided any system or guidelines for measuring and reporting climate-related risks. In its review of the effects of SEC's climate-related risks disclosure requirements, the U.S. Government Accountability Office found that, while public companies disclose climate risks to a certain extent, such disclosure is often inconsistent and thus does not allow investors to make accurate comparisons among different companies with respect to these risks.

Prior to his election, President Biden pledged to require public companies to disclose climate-related risks applicable to their operations, along with their greenhouse gas emissions. While a number of bills have been introduced in Congress to mandate this type of disclosure, the SEC is authorized to mandate the disclosure of climate-related risks independently of any congressional action. During the confirmation hearing for Gary Gensler, President Biden's candidate for SEC Chair and former Chair of the Commodity Futures Trading Commission (CFTC) during the Obama administration, Democrats on the Senate Banking Committee encouraged now-Chair Gensler to require a more comprehensive disclosure of climate-related risks without delay.

All indications suggest that the SEC will eventually mandate climate-related risk disclosure for public companies. The timing of this decision is unclear. SEC Commissioner Caroline A. Crenshaw and its new chair, Gensler, both support more rigorous disclosures relating to climate risks than are currently required. Commissioner Hester M. Peirce and Commissioner Elad L. Roisman appear skeptical that updates to current disclosure guidelines are needed. Following Gensler's confirmation, the SEC appears to favor requiring additional climate risk disclosures by a 3-2 majority, which is sufficient for the SEC to take action to enact new climate disclosure requirements. Chair Gensler was sworn into office on 17 April 2021, so we anticipate that the SEC will quickly launch a formal rulemaking process to develop mandatory climate disclosure rules, including public comment periods and other significant actions.

In addition to mandating a more robust disclosure procedure around climate-related risks, the Biden administration is expected to require public companies to disclose more information than is currently required around social and governance issues. Commissioner Allison Herren Lee, who held the position of Acting Chair of the SEC from January 2021 until Chair Gensler's arrival, had already indicated these matters to be a priority for the SEC by seeking public comment on an ESG disclosure framework, reorienting various divisions' focus on ESG and sustainability issues, and exploring revisions to rules and guidance regulating shareholder proposals and proxy voting to facilitate ESG shareholder proposals. We believe that Commissioner Lee's actions as Acting Chair also reflect the priorities of Gensler and are supported by the Biden administration. These reforms are relatively partisan in nature, as the Democratic-appointed SEC Commissioners favor advancing such proposals, while the Republican-appointed SEC Commissioners have voiced opposition.

SEC Division of Corporation Finance Acting Director John Coates has also been supportive of a robust ESG disclosure framework. In a speech on 11 March, he argued that "[t]he SEC should help lead the creation of an effective ESG disclosure system so companies can provide investors with information they need in a cost effective manner."[1] To be effective, the disclosure system will need to reflect a consensus among investors and companies, be flexible, blend voluntary and mandatory disclosures, and provide specific guidance about key questions, such as what information is most useful and how to verify the accuracy of disclosures. Acting Director Coates expressed concern about the costs investors bear because of a "lack of consistent, comparable, and reliable ESG information" and increasing costs to public companies by virtue of "numerous, conflicting and frequently redundant requests for different information about the same topics."

Increasing Focus on ESG Across the SEC's Divisions

The SEC is also reorienting its various divisions' focus toward ESG and sustainability concerns. According to the SEC Division of Examinations, among its 2021 priorities are an "enhanced focus on climate-related risks."[2] This focus will include "examining proxy voting policies and practices to ensure voting aligns with investors' best interests and expectations, as well as firms' business continuity plans in light of intensifying physical risks associated with climate change." Former Acting Chair Lee has stated that "through these and other efforts, we are integrating climate and ESG considerations into the agency's broader regulatory framework." Division of Examinations Director Peter Driscoll noted that "our priorities reflect the complicated, diverse, and evolving nature of the risks to investors and the markets, including climate and ESG" and that these priorities include review of investment advisors' disclosures regarding strategies relating to ESG and sustainability matters.

The SEC Division of Enforcement is also prioritizing ESG issues. As Acting Chair, Commissioner Lee created a 22-member Climate and ESG Task Force within the Division of Enforcement.[3] The Acting Deputy Director of Enforcement will lead the Task Force, whose members will be drawn from the SEC's headquarters, regional offices, and specialized units within the Division of Enforcement. The Task Force "will develop initiatives to proactively identify ESG-related misconduct," particularly "any material gaps or misstatements in issuers' disclosure of climate risks under existing rules." It also will review "disclosure and compliance issues relating to investment advisers' and funds' ESG strategies."

Republican-appointed Commissioner Peirce and Commissioner Roisman issued a joint statement that "these new climate-related announcements raise more questions than they answer, [but] we look forward to working with SEC staff in the relevant divisions as they review disclosures, assess the adequacy of our guidance and rules, examine for compliance with our rules, and pursue securities law violations."[4] They further cautioned former Acting Chair Lee against imposing new obligations outside of the rulemaking process.

Lee also appointed the SEC's first senior policy advisor for climate and ESG, thereby cementing the importance of ESG issues to the current SEC.[5] Satyam Khanna serves in this role. Previously, he served as a counsel to former SEC Commissioner Robert Jackson and as a member of the SEC's Investor Advisory Committee.

Reform of the Shareholder Proposal Process to Facilitate ESG Proposals

In addition to updating ESG disclosure guidance and potentially implementing new rules, the SEC is likely to revise rules issued under the Trump administration governing the shareholder proposal process and investment advisers' proxy voting obligations in order to facilitate more shareholder votes on ESG and sustainability issues. In her speech addressing ESG, Lee said that the SEC will consider taking the following steps:

- "Reversing last year's mistaken" shareholder proposal rule;
- Revising Rule 14a-8;

- Evaluating new proposals from SEC staff to revise SEC and staff guidance on the no-action process for shareholder proposals, particularly with respect to ESG proposals;
- Revising SEC guidance on proxy voting responsibilities of investment advisers. In particular, the SEC may explore rules regarding ESG-specific policies and procedures requirements; and
- Revising fund voting disclosures on Form N-PX to improve the standardization and clarity of description of ballot issues.

Lee cited "the soaring demand for opportunities to invest in vehicles with ESG strategies" as the basis for her desire to reform the proxy voting responsibilities of investment advisers.[6] Moreover, she is concerned about ensuring that investors' ESG preferences are furthered by the votes their advisers cast: "We know investors are demanding ESG investment strategies and opportunities, but funds may not always reflect those investor preferences in their voting."[7]

Senator Pat Toomey (R-PA), the ranking member of the Senate Banking Committee, has criticized all of these efforts, arguing that the SEC is engaging in "mission creep."[8] He is particularly concerned by the formation of the Task Force and the former Acting Chair's support for mandated political expenditure disclosures, arguing that the SEC is abusing its power and politicizing its mission by seeking to mandate disclosure of what he considers to be "non-material" information.

Notable Actions by Other Agencies and Executive Departments

Commodity Futures Trading Commission

The Commodity Futures Trading Commission (CFTC) has established a Climate Risk Unit (CRU). Acting Chair Rostin Behnam formed the unit because "climate change poses a major threat to U.S. financial stability, and I believe we must move urgently and assertively in utilizing our wide-ranging and flexible authorities to address emerging risks."[9] The CRU "is intended to accelerate early CFTC engagement in support of industry-led and market-driven processes in the climate—and the larger ESG—space critical to ensuring that new products and markets fairly facilitate hedging, price discovery, market transparency, and capital allocation." To do so, the CRU will meet with market participants to discuss climate-related risks and the impact of severe weather events on derivatives markets; review derivatives products that address climate-related risk; participate in interagency and international working groups; and consider whether to implement a regulatory sandbox for climate-related products, tools, and services.

The CRU was formed in response to the findings of a 2020 report from the Climate-Related Market Risk Subcommittee of the CFTC's Market Risk Advisory Committee about managing climate risk in the financial system.[10] Acting Chair Behnam praised the report as "exceed[ing] all expectations in tackling the challenges of how to safeguard the financial system in the face of the uniquely complex risks presented by climate change and how to facilitate the transition to a low-carbon, climate resilient economy."[11]

The U.S. Department of Labor

On 10 March 2021, the U.S. Department of Labor (DOL) announced that it will not enforce the "Financial Factors in Selecting Plan Investments"[12] or the "Fiduciary Duties Regarding Proxy Voting and Shareholder Rights"[13] final rules "until [the DOL] publishes further guidance."[14] The DOL "intends to revisit the rules" which they believe have "already had a chilling effect on appropriate integration of ESG factors in investment decisions." These rules were issued by the Trump administration in order to preclude ERISA plan fiduciaries from considering ESG factors as part of their investment selection process. Rather, the rules required fiduciaries to focus on "pecuniary interests"; ESG issues were to be considered only as a tie-breaker between investment opportunities. The DOL also indicated its interest in hearing from ESG advocates as it likely revises the rule: "Stakeholders have also questioned whether those rulemakings were rushed unnecessarily and failed to adequately consider and address the substantial evidence submitted by public commenters on the use of environmental, social, and governance (ESG) considerations in improving investment value and long-term investment returns for retirement investors."

Senators Toomey, Mike Crapo (R-ID), and Richard Burr (R-NC) issued a letter to the DOL, expressing concern that the decisions reflect "Wall Street asset managers'" preferences and will "harm Americans' retirement savings by allowing plan fiduciaries to sacrifice investment returns to promote non-pecuniary policy objectives."[15] The senators are the ranking members of the Banking, Finance, and Labor committees, respectively. Senators Toomey and Burr have announced their plans to retire at the end of 2022.

The Federal Reserve Board

The Federal Reserve Board of Governors is researching the need for financial institutions to provide climate-related risk disclosures to investors and how to examine financial institutions' resilience to climate-related risks. In a speech to the 2021 U.S. Climate Finance Summit hosted by the Institute of International Finance, Federal Reserve Board Governor Lael Brainard said that "current voluntary disclosure practices are an important first step, but they are prone to variable quality, incompleteness, and a lack of actionable data. Ultimately, moving toward standardized, reliable, and mandatory disclosures could provide better access to the data required to appropriately manage risks."[16] Her views align with former Acting Chair Lee's views on ESG and sustainability disclosures. Governor Brainard also stated that "robust risk management, scenario analysis, and forward planning can help ensure financial institutions are resilient to climate-related risks and well-positioned to support the transition to a more sustainable economy."

Predictably, these efforts will be met with some resistance. Senator Toomey and the Republican members of the Senate Banking Committee have sent a letter to the Federal Reserve Board of Governors to warn against implementation of any climate-related risk regulations. The senators stated that they "question both the purpose and efficacy of climate-related banking regulation and scenario analysis," asserting that the Federal Reserve "lacks jurisdiction over and expertise in environmental matters."[17]

ENDNOTES

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[3] Press Release, SEC, SEC Announces Enforcement Task Force Focused on Climate and ESG Issues (Mar. 4, 2021), https://www.sec.gov/news/press-release/2021-42.

[4] Press Release, Hester M. Pierce and Elad L. Roisman, SEC Commissioners, Enhancing Focus on the SEC's Enhanced Climate Change Efforts (Mar. 4, 2021), https://www.sec.gov/news/public-statement/roisman-peirce-sec-focus-climate-change.

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[6] Allison Herren Lee, Acting Chair, SEC, Address at the ICI Mutual Funds and Investment Management Conference: Every Vote Counts: The Importance of Fund Voting and Disclosure (Mar. 17, 2021), https://www.sec.gov/news/speech/lee-every-vote-counts.

[7] *Id.*

[8] Pat Toomey, Richard Shelby, Mike Crapo, Tim Scott, M. Michael Rounds, Thom Tillis, John Kennedy, Bill Hagerty, Cynthia Lummis, Jerry Moran, Kevin Cramer, Steve Daines, Senators, U.S. Sen. Comm. on Banking, Housing, and Urban Affairs, Toomey, GOP Banking Members Caution Federal Reserve Against Climate Regulations (Mar. 18, 2021), https://www.banking.senate.gov/newsroom/minority/toomey-gop-banking-members-caution-federal-reserve-against-climate-change-regulations.

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[11] Rostin Behnam, Acting Chairman, CFTC, Opening Statement of Acting Chairman Rostin Behnam before the CFTC Market Risk Advisory Committee (Feb. 23, 2021), HYPERLINK https://www.cftc.gov/PressRoom/SpeechesTestimony/behnamstatement022321https://www.cftc.gov/PressRoom/SpeechesTestimony/behnamstatement022321#_ftn7.

[12] Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 72,846 (Nov. 13, 2020) (to be codified at 29 C.F.R. pt. 2509, 2550).

[13] Fiduciary Duties Regarding Proxy Voting and Shareholder Rights, 85 Fed. Reg. 81,658 (Dec. 16, 2020) (to be codified at 29 C.F.R. pt. 2509, 2550).

[14] Statement, U.S. Department of Labor, U.S. Department of Labor Statement Regarding Enforcement of its Final Rules on ESG Investments and Proxy Voting by Employee Benefit Plans (Mar. 10, 2021), https://www.dol.gov/sites/dolgov/files/ebsa/laws-and-regulations/laws/erisa/statement-on-enforcement-of-final-rules-on-esg-investments-and-proxy-voting.pdf.

[15] Richard Burr, Mike Crapo, Pat Toomey, Senators, U.S. Sen. Comm. on Banking, Housing, and Urban Affairs, Toomey, Crapo, Burr Urge DOL to Put Americans' Retirement Savings Above ESG Objectives (Mar. 18, 2021), https://www.banking.senate.gov/newsroom/minority/toomey-crapo-burr-urge-dol-to-put-americans-retirement-savings-above-esg-objectives.

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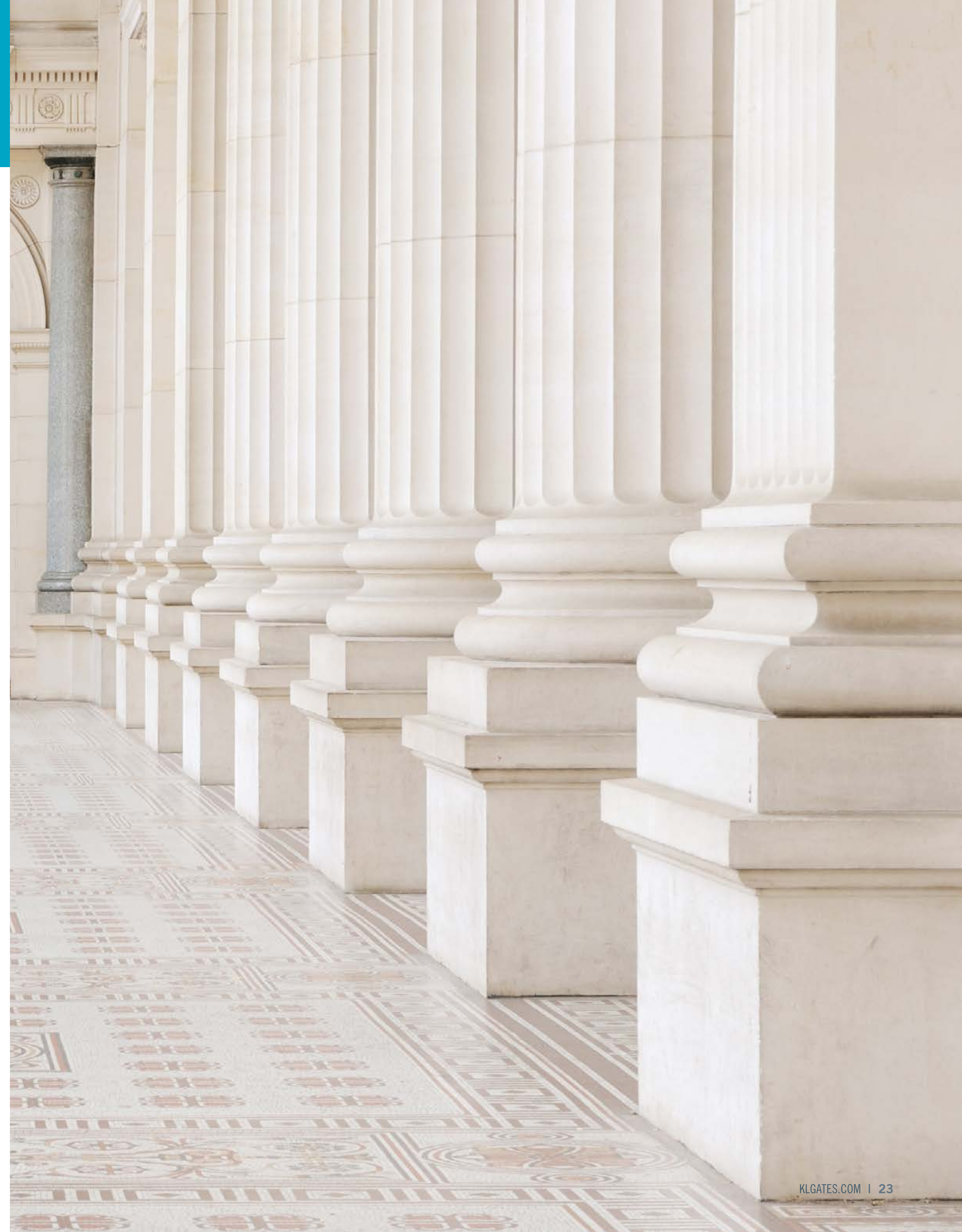

EDITORS AND AUTHORS

EDITORS

Elizabeth C. Crouse
Partner
+1.206.370.6793
elizabeth.crouse@klgates.com

Elisabeth Yandell McNeil
Partner
+1.206.370.7824
elisabeth.mcneil@klgates.com

AUTHORS

Molly K. Barker
Associate
+1.206.370.7653
molly.barker@klgates.com

Jeff M. Cohen
Partner
+1.202.778.9122
jeff.cohen@klgates.com

Caitlin C. Blanche
Partner
+1.949.623.3526
caitlin.blanche@klgates.com

Amy L. Groff
Partner
+1.717.231.5876
amy.groff@klgates.com

Daniel S. Cohen
Associate
+1.202.778.9020
dan.cohen@klgates.com

AUTHORS

Clare Kempkens
Partner
+44.(0)20.7360.8211
clare.kempkens@klgates.com

William D. Semins
Partner
+1.412.355.8973
william.semins@klgates.com

Anthony R.G. Nolan
Partner
+1.212.536.4843
anthony.nolan@klgates.com

Jonathan J. Tong
Associate
+1.415.882.8070
jonathan.tong@klgates.com

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