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Three Key Developments in ESG and Sustainable Investing

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Capital owners and managers are increasingly leveraging environmental, social and governance ("ESG") factors to pursue sustainable investment. For those fundraising, operating or investing in the U.S., three significant trends in ESG and sustainable investment are growingly shaping that practice. First, certain leading states are using their fiscal footprints and regulatory reach to influence and drive sustainable investing. Second, the U.S. federal government, which has been relatively reluctant to regulate in the space, now has a Congress that appears to be preparing a new playbook on ESG in the U.S. And third, private efforts continue to elevate the importance of climate-related financial risk within the context of ESG. We evaluate each trend below.

States Starting to Lead on ESG

Certain leading states are advancing sustainable investment through a combination of procedural and substantive regulation. These states are leaning into the market's growing focus on managing capital using ESG factors and, in turn, elevating ESG to an even more important consideration for those raising and managing funds across the liquidity spectrum.

Pensions

A number of states are leveraging regulation of their pension systems to advance sustainable investment, including California, Connecticut, Illinois, New Jersey, New York, Oregon and Washington. In fact, certain city-managed pension systems have also taken up this approach, including Boston, Chicago, New York and Seattle.

- **California:** For over a decade, California has been integrating ESG factors into the way it manages the California Public Employees' Retirement System ("CalPERS") and

California State Teachers' Retirement System ("CalSTRS"), and, in more recent years, has become increasingly specific about how it considers ESG. This approach has shaped not only the funds in which California invests (e.g., through demands on investor agreements and in side letters), but also the broader market.

- **Illinois:** Illinois took significant new legislative action recently that could serve as a national model. Signed into law last month, the Sustainable Investing Act, also known as HB 2460, becomes effective in January 2020. The new law requires all public or government agencies involved in managing public funds to “develop, publish, and implement sustainable investment policies applicable to the management of all public funds under its control.” The coming months will show how exactly each Illinois agency implements this mandate.

Estates

- **Delaware:** Delaware passed a law in its last legislative session clarifying that ESG consideration could be appropriate in the management of an estate’s funds. Specifically, Delaware added the following to its Code: “when considering the needs of the beneficiaries, the fiduciary may take into account the financial needs of the beneficiaries as well as the beneficiaries’ personal values, including the beneficiaries’ desire to engage in sustainable investing strategies that align with the beneficiaries’ social, environmental, governance or other values or beliefs of the beneficiaries.”

Divestment

Legislation pending in Massachusetts, Minnesota, New Jersey, New York and Vermont seeks to restrict investment of publicly managed funds in fossil fuels. These legislative efforts build on what several dozen cities have already done — the largest among them being Denver, Minneapolis, New York and San Francisco.

Board Diversity

Led by California’s groundbreaking legislation mandating gender diversity on corporate boards, which has an initial deadline at the end of this year, a number of other states are working to scale up this approach to advancing sustainable investment.

- **Substantive Mandates:** In Michigan, SB 115 would impose requirements mandating one female director by the end of 2021 and scaling that requirement up by 2023 based on the size of the corporation. In New Jersey, S3469, and its counterpart A4726, seek to establish requirements that are substantially the same as California and Michigan.

- **Softer Requirements:** Other states are pursuing softer signaling, such as Pennsylvania's proposed resolution to "encourage" increased gender diversity, and Illinois, Maryland and New York's proposed bills that would merely push for greater data collection and transparency.

Congress Readies a Federal Approach

The proliferation of potential ESG approaches has not been paired by a concurrent national government-level push to drive consistency in the marketplace. Recent activity in Congress suggests, however, that the status quo may not persist much longer, particularly for public companies.

Reluctant Regulator

To date, the U.S. Securities and Exchange Commission ("SEC"), seen as the most natural national regulator of ESG, has been reluctant to regulate in this space. After issuing guidance on climate-related risk disclosure in 2010, the SEC has avoided providing formal ESG guidance or rules, choosing instead to focus issuers on their more general obligations to disclose material information under existing SEC rules. The SEC has maintained this posture in the face of mounting pressure, including demands from the regulated community. Nearly a year ago, the SEC was presented with a petition calling for rulemaking by investors representing more than $5 trillion in assets under management. However, the SEC chose not to act.

New Congressional Agenda

A set of new bills have been introduced in Congress relating to ESG disclosure, each focused on replacing aspects of the SEC's discretion with new, clear mandates. Although these bills are still being debated in Congress, they represent a potentially signi cant and step-wise change in the status quo with regard to federal regulation on ESG. Together, they show the readying of a new playbook on ESG in the U.S.

- ESG Disclosure Simplification Act of 2019 has essentially three aims. The bill:

    1. Establishes a process by which to define key ESG metrics through SEC rulemaking and the creation of a Sustainable Finance Advisory Committee.
    2. Clarifies Congress' sense that ESG disclosures are material and mandates annual disclosure of ESG metrics, as defined through rulemaking by the SEC.

3. Pushes public companies to analyze the relationship between ESG and strategy, requiring annual disclosure of (a) "the views of the issuer about the link between ESG metrics and the long-term business strategy" and (b) "any process the issuer uses to determine the impact of ESG metrics on the long-term business strategy."

In addition to this broad, procedural ESG bill, Congress is also considering a series of more substantive bills focused on aspects of ESG.

- Shareholder Protection Act of 2019 takes aim at the "S" concern of public company spending on political activities. The bill:

    1. Requires that political expenditures be "authorized by a vote of the majority of the outstanding shares of the issuer." For specific expenditures over $50,000, the bill mandates a vote of the board of directors.
    2. Makes these votes subject to disclosure requirements, providing transparency around the actions of institutional investors and individual directors, who are also made subject to certain joint and several liability under the bill.

- Corporate Human Rights Risk Assessment, Prevention, and Mitigation Act of 2019 focuses on human rights issues as identified by the United Nations. The bill:

    1. Creates an annual requirement for public companies to assess their human rights risk, asking companies to look not only at their own operational footprint, but within their supply chains, which the bill calls "value chains."
    2. Mandates that companies identify approaches they have taken to prevent and mitigate violations and to justify instances where, despite being aware of an operational or supply chain vulnerability, the company has taken no action at all.

- Climate Risk Disclosure Act of 2019 seeks to take on the issue of climate change, which has gained particular prominence among investors focused on ESG. The bill:

    1. Calls for sectoral guidance regarding disclosure, identifying "finance, insurance, transportation, electric power, mining, and non-renewable energy" as some sectors that merit bespoke treatment by the regulator.
    2. Directs the SEC to establish guidance for greenhouse gas emissions disclosure and "establish a minimum social cost of carbon" that companies can use to consider their financial risk over "5-, 10-, and 20-year time frames."

3. Requires an accounting of the “physical impacts of climate change” to companies under various climate scenarios and spells out a unique and detailed set of requirements for companies involved in the production of fossil fuels.

Climate Gains ESG Prominence

In addition to the actions that state and federal governments are taking or evaluating, the private sector is leading its own market transformation. Nearly 2,500 institutions — who represent almost $90 trillion in assets under management — have signed onto the United Nations Principles for Responsible Investments (“UNPRI”). Through UNPRI, these institutions have thrown their weight behind six principles: (1) incorporating ESG into investment processes; (2) advancing ESG performance during ownership; (3) seeking ESG disclosure for assets owned; (4) promoting UNPRI across the investment industry; (5) working with other members on implementation; and (6) reporting on activities and progress. Now, this same group is growing more focused on climate change.

Climate Mandate

Starting January 2020, signatories to the UNPRI will be mandated to undertake certain climate-related analyses and reporting. Despite remaining a voluntary framework, the Task Force on Climate-related Financial Disclosures ("TCFD") framework — an effort launched by the G20’s Financial Stability Board and chaired by Michael Bloomberg — has already attracted robust adoption.

The elevation of climate-related risk (and TCFD) within UNPRI represents an elevation of the same within the universe of ESG. UNPRI’s TCFD mandate is circumscribed in two key ways. First, although members will have to collect the relevant climate-related risk data and report that data to UNPRI on an annual basis, members will not be required to publicly disclose that data. Second, UNPRI is focused on a few key TCFD-aligned indicators (rather than the entire framework).

Specifically, UNPRI has introduced the following areas for reporting:

- **SG 01 CC — Climate-related policy and coverage**, which focuses on (1) how a company integrates climate change and related issues into its investment policy, and (2) whether the company’s core products or investment strategy might be impacted by the transition to a lower-carbon economy. This thrust is really about understanding how and how much climate impacts the company's strategic and financial planning.

- **SG 07 CC — Climate-related roles and responsibilities**, which focuses on (1) board-level and (2) management-level roles as they relate to the management of climate-related financial risk. This thrust is really about deciphering how much organizational capacity is actually dedicated to and concentrating on climate and how that attention is organized within the company's highest levels of leadership.
- **SG 13 CC — Climate in asset allocation**, which focuses scenario analysis designed to surface the risk exposure of a company from the transition to a lower-carbon economy. This thrust is really about identifying how the assets and operations of a company would fare in a world where the goals of the Paris climate agreement are met and how the company's strategy reflects an understanding of that risk exposure.

Given the broad reach of UNPRI across the liquidity spectrum, the new TCFD mandate within UNPRI is likely to drive significant transformation in terms of what is "market" for both public and private companies. For many, this will spur a first look at governance practices related to climate change and demand significant attention to existing policies and practices, as well as to the need for the development of new approaches.

Looking Forward

ESG is gaining momentum on many different playing fields, and we can expect to see significantly more growth and interest in sustainable investing as a result of this shift in the market. However, there are legal considerations and liabilities that must be taken into account in all of these efforts. Public companies in particular should continue to stay apprised of developments relevant to the adequacy of disclosures made to investors.

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