Vinson&Elkins

Supporting Your Board’s Oversight of ESG

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Polling Questions

- ***How focused do you think investors and the public are on ESG practices in your industry?***
  - Investors and the public aren't paying much attention to our industry
  - Investors and the public are moderately interested in our industry
  - Investors and the public are very interested in our industry
- ***How does your board oversee ESG risks, opportunities and initiatives?***
  - The full board
  - An existing board committee or a combination of existing board committees (i.e., audit, compensation, nominating and governance, risk or safety)
  - A new board committee focused on ESG/sustainability
  - Our board does not currently exercise oversight over ESG risks, opportunities and initiatives
- ***What is the biggest ESG challenge you think your industry faces?***
  - Explaining or addressing supply chain considerations (i.e., labor considerations, manufacturing and source of goods)
  - Explaining or addressing matters regarding how goods are consumed (i.e., single-use plastics, disposable fashion)
  - Explaining or addressing our greenhouse gas emissions generally
  - Avoiding greenwashing

ESG: Where We Are Today

Standards and frameworks are converging

Calls for integrated reporting in the U.S. are growing stronger

The lines between voluntary and required disclosure are blurring

Greenwashing is in the spotlight

The intersections of the "E," the "S" and the "G" are emerging as key areas for consideration

ESG litigation and government enforcement efforts are picking up

Significant regulatory changes in the U.S., U.K. and Europe are being considered or coming into effect

ESG "hard" activism is emerging

Understanding Your Board's Fiduciary Duties in the ESG Context

ESG and the Board's Fiduciary Duties

	ESG Implications
Duty of Care	▪ The duty of care is the duty to be curious – to continue to pursue understanding ▪ From an ESG perspective, this means being willing to promote "***risk creativity***" and "***strategic creativity***" throughout the organization
Duty of Loyalty	▪ The duty of loyalty is the duty to act in the best interest of the company and its investors ▪ From an ESG perspective, directors should also consider how they can ***act in the best interest of all stakeholders***, provided they do not deprioritize investors' interests
Duty of Oversight	▪ From an ESG perspective, directors should consider how their company is ***building effective controls, systems and reporting structures*** around material ESG goals and initiatives
Business Judgment Rule	▪ Consideration of material ESG matters can provide the board with ***a balanced approach that supports its business judgement*** ▪ Decisions should be ***guided by fiduciary duties***, but can be informed by ESG concepts

Using The Five Lenses of Materiality

- What is "material" to the company's ***specific stakeholders*** (i.e., investors, employees, customers and business partners)?
- What is "material" to the company, including with respect to how it wants to be ***viewed in the marketplace*** and ***compared to its peers and competitors***?
- What ***external standards of materiality*** should apply to the specific area of disclosure (i.e., EU Sustainable Finance Disclosure Regulation, SASB, GRI, Joint Statement)?
- How does the ***U.S. federal securities law definition*** of "Materiality" apply to the company's business, operations and financial statements and what does that definition require in terms of disclosure?
- With respect to each of the foregoing, how does Point A compare to Point B, in other words, ***how is materiality moving*** and ***what will it mean tomorrow***?

The Five Lenses of Materiality

- ***The company's specific stakeholders***: The "reasonable investor" standard under the federal securities laws does not require companies to assume that the positions or areas of interest of their specific investors, on average, rise to that level of materiality. However, it is practical for companies to consider their specific investors' interests and voting priorities in assessing what and how to disclose information. Major investors, including Blackrock, State Street and Vanguard, all have climate change positions, as do many other investors.
- ***Marketplace/peer and competitor considerations***: While the actions of a company's peers, competitors, and other stakeholders do not necessarily rise to the level of the federal securities law definition of materiality, they can still give rise to liability if stakeholders view a company's actions as inappropriately risky or unethical or a company's statements as incomplete or inaccurate.
- ***External third-party standards of materiality***: In the voluntary disclosure space, materiality is a battleground. Each of the following organizations has developed a concept of materiality: The Global Reporting Initiative ("GRI"), the International Integrated Reporting Council ("IIRC"), the Sustainability Accounting Standards Board ("SASB"), and the Task Force on Climate-related Financial Disclosures ("TCFD").
- ***U.S. federal securities law definition***: When assessing the materiality of voluntary disclosures under the federal securities laws, we are still in a reality where companies are unlikely to be found liable for omissions, unless statements made are materially incomplete rising to the level of a misstatement.
- ***The movement of materiality***: Ultimately, materiality, regardless of which lens of materiality we are discussing, is not static.

Understanding ESG Activism, Litigation and Enforcement

ESG Activism: How ESG Can Reinforce Economic Activism

Public ESG Activism Campaign Drivers

- ***Failure to Engage***. A company's poor record of engaging with investors around ESG concerns can provide an activist with an opportunity to argue that the company does not do an effective job of engaging with investors generally.
- ***Failure to Prepare***. An activist can use a poor or disorganized ESG record to argue that the company is not prepared to address material risks or strategic changes in the future, including those relating to ESG matters.
- ***Failure to Deliver***. A story around strategic or financial difficulties or failures can also be further enhanced by a failure to deliver on ESG promises, goals or targets.

Private ESG Activism Campaign Drivers

- ***Passing the Buck***. Investors and capital providers are increasingly pledging significant amounts of capital to "green" or sustainable efforts and making promises to reduce emissions in their portfolios. This may include engaging in activism in order to force the issue.
- ***Being the "Good Guy."*** Activists may also criticize a company's ESG efforts, even where those efforts have been robust and appropriate, as a form of virtue-signaling and greenwashing.

ESG Litigation

Reputation-related litigation

Operations-related litigation

Disclosure-related litigation

Governance / fiduciary duty-related litigation

ESG Litigation

- To date, ESG litigation has largely focused on climate change litigation or catastrophic environmental events; however, recent developments, including the COVID-19 pandemic and a heightened awareness among many companies of social justice-related matters, are highlighting other types of ESG litigation as well.
- Given the litigation trends and developments, we generally recommend that companies:

▪ Provide the board and management with periodic updates on ESG litigation in your industry	▪ Understand what meaningful ESG data collection and integration mean for your organization
▪ At least once a year, assess how your operations and business influence ESG factors and are influenced by ESG factors	▪ Expand your enterprise risk management program to more thoroughly consider non-material risks and exercise risk creativity
▪ Have your ESG disclosures reviewed by securities counsel sophisticated in ESG matters	▪ Form a more nuanced approach to materiality
▪ Build board and management knowledge on key ESG matters	▪ Understand the intersections between regulation, your litigation efforts and ESG strategy
▪ Build ESG considerations into your internal controls and disclosure processes	▪ Be honest about whether your targets and commitments are achievable, and consider whether/when updates are necessary

Recent US ESG Enforcement Developments

- In March 2021, the SEC Division of Examinations announced that one of its 2021 examination priorities is climate and ESG-related risks, with the press release indicating that the Division will continue to review the compliance programs of registered investment advisers, including with respect to the offering of ESG-related investment strategies. In April, the Division issued a risk alert on some of its early findings.

- In March 2021, the SEC announced the creation of a Climate and ESG Task Force in the Division of Enforcement, stating that "[t]he initial focus will be to identify any material gaps or misstatements in issuers' disclosure of climate risks under existing rules," and "evaluate and pursue tips, referrals, and whistleblower complaints on ESG-related issues, and provide expertise and insight to teams working on ESG-related matters across the Division."

- In August and September 2021, the SEC launched an investigation into Deutsche Bank's asset manager DWS over its sustainable investing labels and sent letters to other fund managers regarding potential "greenwashing."

- In September 2021, the SEC's Division of Corporation Finance issued a sample comment letter regarding climate change disclosures. The sample comment letter highlights what the SEC is thinking about: (i) the degree to which SEC filings should reflect the contents of voluntary ESG disclosures; (ii) the importance of effective and sophisticated climate risk disclosure; (iii) the impact of climate change-related litigation, legislation, and regulation; (iv) the costs associated with climate change-related expenditures and compliance; (v) the degree to which disclosures honestly reflect ESG trends and developments; and (vi) the broad implications of physical climate change risk.

Effective ESG Goal Setting

What Are Effective ESG Goals

- ***Clear***. Effective ESG goals need to be sufficiently developed that one can specify what will be achieved, by when, the responsible part(y/ies), and at least a rough idea of how the goal will be met.
- ***Deliverable***. While ambitious goals are not inherently bad, the "arms race" of ESG promises runs the risk of companies coming up short when the time to demonstrate achievement comes due. It is better for a company to "under-promise" and "over-deliver" in the ESG space. ESG targets can always be expanded upon in future, but it is harder for ESG targets to be walked back without any legal or reputational backlash.
- ***Informed***.
  - ESG goals require company introspection and will likely require the collection, compilation and verification of information from across company operations.
  - Effective ESG goals may require engagement with various stakeholder groups to more fully understand impacts and opportunities.
  - Effective goals make use of existing expertise; ESG frameworks continue to proliferate and, while not all are created equal, consideration of highly respected frameworks (e.g., TCFD, UNGPs, etc.) can help companies to effectively develop and contextualize their goals.

Creating Effective ESG Goals

- ***Identify key areas of importance***. Companies' ESG profiles vary. Effective goals require knowing what matters are applicable given a specific company's unique situation.

- ***Establish an ESG "baseline***.***"*** Effective goals require understanding where a company is in its ESG journey and what tools and policies may already be in place that the company can build from.

- ***Consider available resources***. Related to the "deliverable" component of effective ESG goals, a company needs to assess what resources (internal time and expertise, financial expenditures for outside experts, etc.) it realistically can devote to its ESG goals in order to determine what goals are attainable.

- ***Develop checkpoints***. Dividing the goals into sub-tasks can help not only with clarity of the goal's scope, but also with building structure to achieve the goal. This is particularly important in areas like ESG where the company may not have pre-existing structures or controls, or substantial internal experience to rely upon.

- ***Expect change***. ESG is a dynamic area, with expectations evolving rapidly. If you keep this in mind in planning your ESG goals, such as by incorporating systemic or process-focused goals alongside any metrics-focused goals, you will likely have an easier time adapting to many such developments.

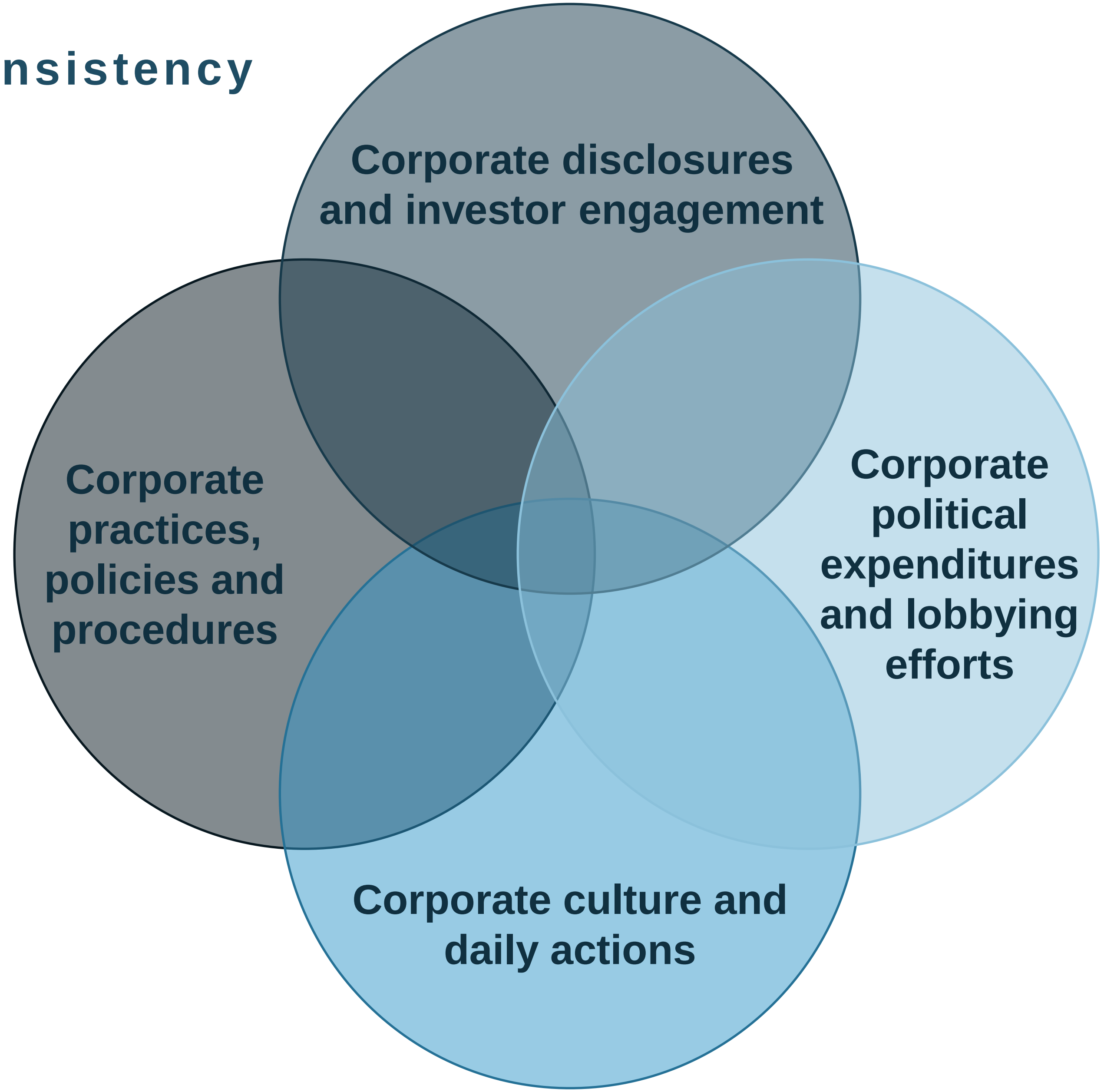
Learning From Other Areas of Law

- ***Learning from executive compensation***:
  - Make it measurable.
  - Connect authority and accountability.
  - Tie it to corporate strategy.
- ***Learning from compliance and ethics***:
  - Those with day-to-day oversight should report directly to the Board from time to time.
  - There should be auditing functions for effective practices.
  - There should be reporting mechanisms for reporting potential issues.
- ***Learning from environmental reporting considerations:***
  - Understand that regulation establishes the baseline, not the ceiling.
  - Be prepared for things to change quickly.

Immediate ESG To-Dos

One Word for the Future of ESG: Consistency

- The future of effective ESG lies in the consistency between a company's disclosures, practices, culture and supported values. This means having ESG as part of the company's:
  - Board oversight;
  - Strategic planning;
  - Enterprise risk management program;
  - Internal and disclosure controls;
  - Employee onboarding and training efforts;
  - Disclosures and investor engagement efforts;
  - Internal reporting and compliance considerations; and
  - Externally supported values.



Immediate ESG Action Items

1. ***Organize your data***. It is time to have conversations with your enterprise risk management team, traditional compliance function and operations to understand what ESG efforts and information may already exist, and what can be done to fill any gaps. Material ESG should be integrated into your ERM processes and procedures.

2. ***Regularly revisit your KPIs, metrics and targets***. ESG data, frameworks and standards are evolving quickly. Companies should regularly revisit their ESG KPIs, metrics and targets.

3. ***Confirm that you have a path to achieve your commitments***. Many companies have made significant ESG commitments with long time horizons. Some of these companies will achieve these commitments, others will not. It is critical for companies to create plans that can be flexible but also effective in identifying potential issues with achieving commitments on schedule.

4. ***Talk to internal controls***. To the extent that the SEC adopts final ESG disclosure rules, those rules may ultimately require companies to build out internal disclosure controls to address topics that existing controls may or may not be equipped to handle.

5. ***Address internal ESG reporting***. As ESG regulation and enforcement begins in earnest in the U.S., a question about ESG whistleblowers arises. Companies should consider what options employees have for reporting ESG issues internally.

Immediate ESG Action Items

6. ***Talk to your independent auditor and your internal accounting department***. Climate change risks will eventually be seen as material to many companies' financial reporting, and it is possible that any SEC climate change disclosure regulation will accelerate this reality.

7. ***Consider opportunities for industry collaboration but be aware of the risks***. Trade and industry associations and organizations present an opportunity for companies to collaborate on ESG considerations, however, companies should be aware of antitrust risks.

8. ***Find your ESG lawyers***. When compliance with an actual regulation is required, or if the SEC begins to bring enforcement actions against companies that have failed to live up to their voluntary disclosures and commitments, experienced lawyers become a necessity. It is important to investigate the credentials of any ESG lawyer you use, given the wide range of capabilities and experience in the space.

9. ***Compare what you've said to what you're doing***. Assuming that there will be increased transparency required with respect to all areas of ESG — will there be anything that could threaten your company's relationships with its regulators or its investors, its access to capital, or its social license to operate?

10. ***Consider your ESG culture***. Similar to the compliance space, in ESG having a policy is one thing, creating the culture is something else entirely. ESG efforts need to be fully integrated not only into the operations of the organization, but also into its culture for those efforts to be effective.

THANK YOU!

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