Corporate Counsel
Business Journal

March ▪ April 2021
CCBJournal.com

CCBJ

The Next Generation of ESG Disclosure Consumers

▶ Investors are increasingly applying environmental, social and governance factors in analyzing risk and growth opportunities. In this interview, McGuireWoods partners Aaron Flynn, Allison Wood and Katherine DeLuca discuss the growing demand for ESG disclosure and how disclosure requirements could change in the Biden administration.

CCBJ: In a recent report, the CFA Institute noted that we are entering "a true mainstreaming phase of ESG investing" and that the COVID-19 pandemic has intensified discussions around sustainability. The credit rating industries are now issuing ESG scores. How is the growing demand for ESG disclosure changing reporting practices and expectations for public companies?

Aaron Flynn: When we first started talking about ESG and the companies that were making disclosures, we were talking about industrial sectors like oil and gas, coal, electric utilities – companies that had a lot of experience dealing with emissions reporting and environmental issues in general. As the scope of ESG expanded to include not just environmental impacts, but also social issues and activities that affect your supply chains, more and more companies have been pulled into this space. So it is not just energy companies that are doing ESG reporting. It's retailers, grocery stores, banks – every company is being touched by this issue now, one way or another.

And because ESG funds have performed much better than traditional funds and investments – especially during the pandemic – companies want to be candidates for inclusion in an ESG fund.

Allison Wood: If you went back 10 years when the Carbon Disclosure Project first came out, you could just ignore it if you were a company and not complete the questionnaire. You can't ignore ESG now. Failing to report or to say anything is bad for your company. This is something that a company now has to grapple with and needs to give real thought to regarding what they are disclosing – not just environmental issues, but also the social and governance aspects. What are they thinking about how climate change is going to impact their business in the future? What are they doing around diversity and inclusion? What is their carbon footprint, and what are they doing to try to minimize it? Those are the types of questions that companies now have to answer.

Katie DeLuca: Public companies are getting a lot of pressure from institutional investors who are starting to demand ESG disclosure, and this pressure is no longer just coming from investors. They also are getting these questions from their customers, for example. So you see a lot more companies doing ESG reports, which are separate documents that are not filed with the SEC-required documents. I have seen a lot more public companies and even non-public companies that have ESG reports posted on their websites. That is in response to a variety of different constituencies; it is not just shareholders anymore.

Different constituencies want different types of ESG information. Without uniform reporting requirements, companies are using voluntary reporting structures to disclose sustainability information to investors. What are some key considerations for companies in striking a balance between disclosing ESG information and minimizing risk?

DeLuca: I talk about this a lot with my clients. If a company is going to publish ESG information, anything from carbon emissions to workplace diversity, it is very

important that they clearly describe how the numbers are calculated, what is included, what is excluded and any important exceptions or exclusions they make in a given period. It is important that the statistics are calculated consistently across periods, and if there are any special, one-time adjustments, they need to identify them. You don't want an investor or any other constituent to characterize the numbers as false and misleading. Even if a public company is making disclosures on its website or outside of its SEC filings, those statements are also subject to liability under the security laws, so you can't be materially false and misleading.

Also, it is important that companies keep backup for these numbers and that appropriate procedures are put into place to make sure that they are accurate and consistent and that the backup is preserved in case there is ever a question about the accuracy of the numbers or how they were calculated. The last thing a company wants to do is to be accused of "cherry-picking" their numbers or somehow tinkering with them to make themselves look good.

Wood: There is a cautionary tale that exists about making sure you are consistent in terms of how you are characterizing ESG information. The company in question had used one metric for evaluating the social cost of carbon – putting a price on carbon in their public ESG reports – but used a different, much higher number internally when they were assessing their climate risk. This was disclosed and was obviously not a good situation for that company. It highlights the importance of being consistent and making sure that everything you are doing within the company works together, and that you can't be accused of "cherry-picking," as Katie said.

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And the other thing you need to know when you are doing your ESG reporting – even beyond your formal reporting on SEC documents – any types of statements that you make on your company website are going to be scrutinized. You can’t make certain pledges on your website or commitments and not be backing them up with some action.

The SEC’s Investor Advisory Committee recommended last year that the SEC amend its reporting requirements to include ESG factors. Is the SEC likely to require more rigorous reporting under the Biden Administration?

Aaron Flynn: This rule is really all about what type of investments are permissible in plans governed by ERISA. The rule puts some guardrails around whether ESG funds and ESG investments can be a default investment for ERISA plans, or whether they can be included even just as an option. The emphasis of the rule revision was to put the primary focus of these investment decisions on pure, black-and-white financials and not on more qualitative environmental, social and governance-type considerations. This is a rule that was unpopular with the financial industry, because it places additional burdens on investment companies looking to promote or offer ESG funds to their customers, but there were other industry groups that did support aspects of the rule. It was also unpopular with environmental groups, because it was viewed as undermining efforts to raise the profile of ESG issues.

I think there is a chance this rule will be revoked through the Congressional Review Act or modified substantially through the regulatory process because most of the constituencies for the Democratic Party and this administration do not support it. The practical effect of repealing it will be to make ESG products even more appealing.

What other regulatory developments are you monitoring that could trigger major changes in ESG disclosure requirements?

Wood: To date, most reporting is strictly voluntary and has been done through a myriad different platforms. One of the things that we are seeing right now and that we are monitoring for clients is that a lot of the voluntary reporting platforms are coming together to try to come up with a uniform reporting structure. If that occurs, it may well be something that the Biden administration then endorses through some type of regulatory mechanism – be it through the SEC or another way to require that a uniform structure be used. This will be good for companies in a lot of ways because, right now, there are so many voluntary structures that a lot of companies end up reporting multiple times through multiple different voluntary platforms. When that happens, you run a risk that the ways in which the different platforms calculate emissions can end up with different figures. That’s problematic because of Katie’s earlier caution about making sure you’re being consistent in how you report your ESG information.

Flynn: We’re going to see a lot of new regulation related to climate and environmental justice coming out of this administration. It’s going to come from EPA, it’s going to come from the Department of Transportation, from

the Treasury Department – all over the place. We have this "whole-of-government" approach to climate and environmental issues coming our way, which means a lot of companies that have not had to deal with substantial regulations from EPA, that don't know what it's like to be targeted by some of these environmental rules, are going to experience this for maybe the first time. They are going to have to incorporate those new regulatory risks into their disclosures, either with the SEC or through these more voluntary ESG platforms.

Looking ahead, do you expect ESG disclosures to be driven more by investor demand or perhaps I should say market demands or by regulatory requirements?

Wood: To date, a lot of the disclosures have been driven more by investor demand. We've talked a lot about how increased regulatory requirements will drive more disclosure, but I don't think that will stop investor demand. You've seen a lot of large institutional investors requiring companies to produce more ESG information. You see where large institutional investors are forcing boards of directors to have more people on the board with more of an ESG focus.

DeLuca: It's going to be interesting to see how much of this will be driven by rulemaking or if the SEC will instead use the comment letter process and issue guidance indicating that issuers should be including more ESG disclosure in their filings. There's also already a private ordering occurring, similar to what happened with proxy access, which may mean that the SEC doesn't need to dictate disclosure by the rulemaking process. For example, you're seeing a lot of companies including human capital disclosure and social justice topics in their proxy statements – and it's not because the rules require it, it's because investors want to see it. ■

Aaron Flynn is a partner with McGuireWoods in their Washington D.C. office. He represents utilities, national trade associations, oil and gas companies, and manufacturers in environmental litigation and regulatory matters across the country. He focuses on reducing clients regulatory burdens under the Clean Air Act in particular. Reach him at aaronflynn@mcguirewoods.com.

Allison Wood is a partner with McGuireWoods in their Washington, D.C. office. She is nationally recognized as a leader in the field of environmental law, particular in the area of climate change. She assist clients with complex and politically charged precedent-setting cases before the U.S. Supreme Court and several Courts of Appeals. Reach her at awood@mcguirewoods.com.

Katherine DeLuca is a partner with McGuireWoods in their Richmond office. Her practice focuses on compliance with federal securities laws, mergers and acquisitions and corporate governance. She assists public companies with registered offerings of securities and collaborates with large and small public companies on their periodic reporting, proxy solicitations, shareholder communications. Reach her at kdeluca@mcguirewoods.com.