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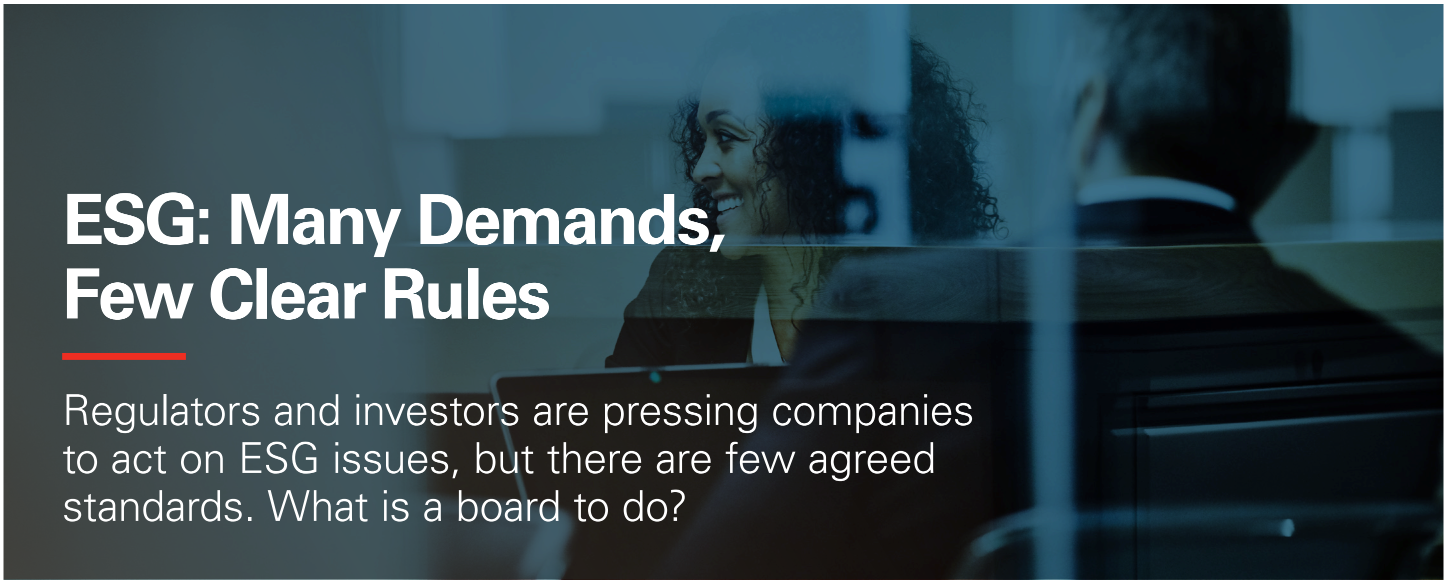

ESG: Many Demands, Few Clear Rules

Regulators and investors are pressing companies to act on ESG issues, but there are few agreed standards. What is a board to do?

- Boards can expect investors and regulators to demand increased disclosure of ESG metrics.
- With no uniform set of ESG standards, companies with global operations may face a hodgepodge of disclosure requirements.
- Investors will push for ESG to play a role in executive compensation.
- Directors need to be fluent in these topics when engaging with shareholders.

Environmental, social and governance issues (ESG) rose to the top of many agendas in 2020. Long-standing concerns about environmental issues continued to be important, but the "S" in ESG came to the fore as the world faced COVID-19 and the issues raised by the Black Lives Matters movement.

A focus on customers, employees, communities and other stakeholders will continue in 2021. We also expect environmental issues to remain a significant topic with the Biden administration's recommitment to the Paris Agreement and the upcoming U.N. Climate Change Conference of the Parties (COP26) in November.

For example, on January 26, asset manager BlackRock announced that it will ask "companies to disclose a plan for how their business model will be compatible with a net zero economy — that is, one where global warming is limited to well below 2°C," and to disclose how those plans are "incorporated into … long-term strategy and reviewed by your board of directors."

Growing demand for disclosure and a lack of uniform reporting standards. The continuing growth of ESG-focused investing, as well as the increased emphasis that asset managers and institutional investors are placing on ESG issues, is driving demand for ESG metrics. Nonprofit groups, governments and regulators have drafted or endorsed varying approaches. But the proposed disclosure regimes have varied by region and there is a lack of consensus as to which metrics are most relevant or useful. With asset managers such as BlackRock putting their weight behind a move toward common global standards, a core set of reporting standards is likely to emerge in the coming years.

The United States: Asset managers BlackRock, State Street and Vanguard, among others, have encouraged companies to follow reporting standards set by the Sustainability Accounting Standards Board and the framework established by the Task Force on Climate-related Financial Disclosures (TCFD), which was formed under the Basel, Switzerland-based Financial Stability Board.

> *There is no company whose business model won't be profoundly affected by the transition to a net zero economy — one that emits no more carbon dioxide than it removes from the atmosphere by 2050 … As the transition accelerates, companies with a well-articulated long-term strategy, and a clear plan to address the transition to net zero, will distinguish themselves with their stakeholders — with customers, policymakers, employees and shareholders — by inspiring confidence that they can navigate this global transformation. But companies that are not quickly preparing themselves will see their businesses and valuations suffer … "*
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> – **Larry Fink** / Chairman and CEO, BlackRock / 2021 Letter to CEOs, January 2021

Many expect the Securities and Exchange Commission under the Biden administration to consider rules requiring ESG disclosures, potentially addressing climate change, workforce diversity and corporate political contributions, but no new rules are imminent. (Listen to a short interview about possible ESG initiatives by the SEC.)

Meanwhile, Nasdaq has proposed amending its listing standards to require companies to enhance their disclosures regarding director diversity. In addition, companies eventually would be required to have at least one female director and at least one director from a racially or ethnically diverse background or the LGBTQ community, or explain why their board lacks them.

The United Kingdom and European Union: A proposal pending in the U.K. would force more than 650 public companies, including all of those in the FTSE 100, to make the environmental disclosures in line with the TCFD recommendations by the end of 2022. The rules would be extended to all large private companies in the U.K. by 2023.

In the EU, new rules will require fund managers to demonstrate how ESG factors are being integrated into investment decisions. The European Commission has also produced guidelines for companies on reporting climate change information.

A patchwork of standards will make compliance challenging. For companies operating in multiple jurisdictions, the hodgepodge of rules and guidelines may impose extensive but differing disclosures.

The upshot: Companies need to begin preparing to comply with different reporting requirements around the world.

Some investors want executive compensation tied to ESG performance. Many investors subscribe to the view that you get the results that you measure and reward, and we expect some investors to continue to argue for ESG to play a part in setting executive compensation. The U.K. Investment Association, representing 250 asset managers, Norway's $1.3 trillion national oil fund and the $400 billion Dutch civil pension fund ABP have said that companies should consider whether their remuneration systems promote sustainable business practices and progress on ESG issues. BlackRock has adopted proxy voting guidelines for EMEA companies stating that ESG-driven metrics for remuneration should be specific and linked to the achievement of strategic objectives.

Expect increasing pressure on ESG issues. Boards can expect more demands for accountability on ESG matters in 2021, from investors and other stakeholders. For example, in 2020, major oil companies in the U.S. and Europe faced shareholder campaigns demanding reduced emissions, some spearheaded by new ESG-focused activist funds. (For a look at the new emphasis shareholder activists have placed on ESG issues, see "New Tactics and ESG Themes Take Shareholder Activism in New Directions.")

Diversity will likely feature prominently in 2021. Investors continue to advocate that new directors and executives better reflect the societies within which their companies operate. For example, the New York City Employees' Retirement System advocates policies to ensure that a diverse range of candidates are considered when directors and executives are named.

Proxy advisory services in the U.S. will continue to play a role on these issues. For example, starting in 2021, Institutional Shareholder Services will monitor the boards of companies in the Russell 3000 and S&P 1500 indices and flag those with no apparent racial or ethnic diversity. In 2022, ISS will recommend voting against nominating committee chairs of these companies where a board lacks diversity.

Already, Glass Lewis, another proxy advisor, generally votes against nominating committee chairs of all-male boards. Starting this year, it will point out boards with no more than one woman director, and in 2022 it will recommend against nominating committee chairs of boards with fewer than two female directors if the board has at least seven members.

Get ahead of ESG and communicate your progress. Boards and management teams need to understand the ESG changes that institutional investors, activists and regulators are seeking, and how the various disclosure mandates are shaping up so they can address shareholder concerns and respond to new disclosure guidelines and requirements.

Although disclosure may not be required, and guidelines vary across jurisdictions, waiting for mandatory or consistent disclosure regimes is not an option for most companies. Those that fail to tell their own ESG story will do so at their own peril. They are at risk of third parties painting a less flattering and less accurate picture.

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