ESG Investing: Searching for Clarity

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Introduction

This article addresses the growing importance and fundamentals of environmental, social and governance (ESG) investing. We believe the current explosion in ESG investing provides lawyers an opportunity to identify and help their clients understand ESG-related risks and bring clarity to current and future obligations.

The ESG acronym encompasses: **environmental** considerations covering "how companies manage their impact on the environment and how they mitigate environmental risks, such as climate change and resource shortages"; **social** considerations covering "the impact of company operations on labor, human rights, and other aspects of society"; and **governance** considerations covering "structures and processes that companies use to direct and manage their operations" including "relationships between management, directors, shareholders and other stakeholders."[1] Although seemingly new, ESG investing has an interesting history.

The application of various ESG factors to investment decisions can be traced back to socially responsible investing (SRI) in the 1980s. This investment approach was largely driven by negative screening (exclusion of "sin stocks") and activist "buy-side" demand.[2] Pioneers in this area included asset managers such as Trillium Investments and Domini Investments. This "do-no-harm" investment approach expanded over the decades to include performance edge investing that looks to enhance returns through positive screening ("doing well by doing good"). Leaders in this area included Innovest Strategic Value Advisors and Generation Investment Management. These practices have evolved to include systematic ESG analysis with the goal of producing a measurable positive impact. This approach is sometimes called Impact Investing.[3]

ESG investing, like all investing, involves a basic risk versus reward equation. The risks and rewards, however, can be different from typical investment practices that focus on only economic considerations. ESG investing also raises several legal and ethical considerations. For example, how does an ESG charter square with an asset manager's fiduciary responsibility to maximize returns while minimizing risks? Financial accounting to assess investment returns is well established and straightforward. Assessing and minimizing ESG related risks, especially those related to the broader public good, is quickly evolving and becoming more complicated.

Growing Importance of ESG Investing

The following statistics point to a major trend toward the growth of ESG investments:

- In 2019, growth in ESG investments by Swiss impact investors was up more than 200%, totaling about $52 billion.[4]
- In June 2020, total investments with the aim of generating positive social or environmental impact were estimated to be between $2.1 trillion and $3.5 trillion, according to the International Finance Corporation (IFC).[5]
- In early August 2020, "Alphabet sold $10 billion of bonds at record-low rates, including $5.75 billion of sustainability notes. Investors placed almost $40 billion in orders for the deal, which paid about $4 million in fees to minority-owned underwriters."[6]
- Issuance of ESG bonds had increased by 272% year-on-year in April 2020.[7]
- Swedish bank SEB AB forecasts that global issuance of debt that meet ESG criteria will exceed $1 trillion in 2021.[8]

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- U.S. investment bank JP Morgan has set a $2.5 trillion sustainable development financing target by the end of 2030.[9]

This global trend toward Responsible Investing has become so significant that almost every major credit, financial information or performance rating company has either created or acquired an ESG information company and/or assessment capabilities. Some examples:

- March 2018: U.S.-based proxy voting and advisory giant ISS bought German sustainability specialist Oekom.
- January 2019: Fitch Ratings launched ESG relevance scores to show impact of ESG on credit.
- February 2019: Thomson Reuters acquired ASSET4, a Swiss-based provider of ESG information and tools. Also, information giant Bloomberg acquired New Energy Finance, a provider of news, data and analysis on reviewable and alternative energy.
- April 2019: Moody's acquired a majority stake in Vigeo Eiris, specialists in ESG research, data and assessments.
- November 2019: S&P Global acquired the ESG ratings business from RobecoSAM.
- April 2020: Morningstar acquired Sustainalytics to expand access to ESG research, data and analytics.
- July 2021: Blackstone acquired ESG data provider Sphera to help integrate ESG into its global investment strategies.

In June 2020, the ESG data and services market stood at $2.2 billion and was estimated to more than double to over $5 billion by 2025.[10]

A 2018 study by BlackRock found that sustainable equity portfolios feature companies that offer the potential to match, if not outperform, the broader market over longer time periods.[11] A 2019 research study by Morgan Stanley Institute for Sustainable Funds found that there is "no financial trade-off in the returns of sustainable funds compared to traditional funds, and they demonstrate lower downside risk."[12] This study also found that during periods of extreme volatility (uncertainty) there is "strong statistical evidence that sustainable funds are more stable."[13] Put simply, ESG funds do better than typical investment funds during bear markets. But, how do ESG funds perform over the longer-term?

Bank of America Global Research published a report in late 2019 that presents even more positive results of ESG investing including:

- U.S. companies with high (top quintile) ESG ranking in the S&P 500 index have outperformed their counterparts with lower (bottom quintile) ESG ranking by at least 3% every year for the past five years;
- ESG metrics are the best measure for signaling future earnings risk—superior even to financial risk factors, like the level of a company's leverage; and
- U.S. companies with higher ESG scores tend to enjoy lower cost of capital.[14]

On issues such as climate change, the CEOs of major asset management companies are personally involved. For example, in January 2020, BlackRock's chairman and CEO Larry Fink garnered attention around the world through his annual letter to CEOs in which he made a compelling argument that climate change has become a defining factor for companies' long-term prospects.[15] In January 2021, Mr. Fink upped the ante by asking in his annual letter that companies disclose business plans aligned with the achievement of net-zero GHG emissions by 2050.[16] Following BlackRock's lead, most every major asset manager now offers sustainable versions of their standard investment products (equity and fixed assets). These movements by U.S.-based asset managers are in line with demands across the Atlantic.

Governments Engagement

As a consequence of adopting the Paris Agreement and the U.N. 2030 Agenda for Sustainable Development in 2015, the European Union developed an action plan for financing sustainable growth which included as its first action the EU Taxonomy Regulation. The regulation set forth criteria to be considered for determining the degree to which an economic activity or product qualifies as 'environmentally sustainable' in terms of contribution to certain objectives in the taxonomy.[17] EU rules will require asset managers, insurers, and pension funds to disclose environmental and social risks in their investments. Rules have been established for climate change mitigation and climate change adaptation objectives, and rules covering circular economy, water and healthy ecosystems are slated to be set at the end of 2021 and 2022.[18] Large companies, many of which are in the asset managers' portfolios, have been required since 2018 to disclose information on environmental and social (E&S) impacts under the EU's Non-Financial Reporting Directive, or NFRD (Directive 2014/95/EU), which was reviewed for possible reforms and improvements under the EU Green Deal announced in December 2019.[19] Since March 2021, certain manufacturers of financial products have been required to comply with the regulation on Sustainability-Related Disclosures in the Financial Sector with respect to sustainability risks and whether and how negative externalities on environment and social justice are considered.[20]

On April 21, 2021, the European Commission adopted a proposal for a Corporate Sustainability Reporting Directive. This directive will be based on the EU's forthcoming taxonomy on sustainable finance that is designed to help listed companies with compliance and to give investors insight into what the EU considers to be green, non-green or transitional (e.g., switching from coal to natural gas). The new Corporate Sustainability Reporting Directive requires that reported ESG information be audited or assured and that data be digitally tagged for input to the European Single Access Point envisaged under the EU's Capital

Markets Union Action Plan.[21,22] The objective is to facilitate reporting by regulated financial market (FM) participants who are "required to complete their first set of disclosures against the Taxonomy, covering activities that substantially contribute to climate change mitigation and/or adaptation, by the 31st of December, 2021."[23] Participants will "be required to state:

- how and to what extent they have used the Taxonomy in determining the sustainability of the underlying investments;
- to what environmental objective(s) the investments contribute; and
- the proportion of underlying investments that are Taxonomy-aligned, expressed as a percentage of the investment, fund or portfolio."[24]

These EU reporting requirements are aligned with but expand on existing disclosure regulations of the financial sector.

Even though ESG Investing clearly has been enjoying an upward trend in the United States, it should be noted that in June 2020, the U.S. Department of Labor, which oversees private-sector retirement schemes such as corporate pensions and 401(k) plans, proposed to restrict, if not outright eliminate, certain ESG investment practices of fiduciaries under Title I of the Employee Retirement Income Security Act of 1974 (ERISA).[25] Published in the Federal Register on Friday, November 13, 2020, the Final Rule "Financial Factors in Selecting Plan Investments" became effective January 12, 2021. Providing some foundation for questioning ESG hype, the rule states:

> As ESG investing has increased, it has engendered important and substantial questions and inconsistencies, with numerous observers identifying a lack of precision and rigor in the ESG investment marketplace. There is no consensus about what constitutes a genuine ESG investment, and ESG rating systems are often vague and inconsistent, despite featuring prominently in marketing efforts.[26]

While it acknowledged that ESG factors can be pecuniary factors, the proposed rule had noted that ESG factors are pecuniary only if they present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories. The proposed rule therefore required that the weight given to ESG factors should reflect a prudent assessment of potential risks and returns.[27]

In the final rule, finding that ESG terminology may be useful for general investment discussions but falls short of regulatory clarity, DOL removed all ESG terminology from the regulatory text.[28] Although many commenters claimed that the proposal ignored materiality of ESG factors, the proposal acknowledged that ESG factors could present issues of material business risk. According to DOL, the proposed rule "sought to make clear that, from a fiduciary perspective, the relevant question is not whether a factor under consideration is "ESG," but whether it is a pecuniary factor relevant to an evaluation of the investment or investment course of action under consideration."[29] In the end, however, DOL concluded "that 'ESG' terminology, although used in common parlance when discussing investments and investment strategies, is not a clear or helpful lexicon for a regulatory standard."[30]

While many people criticized the DOL proposal and rule as a blatant attempt of Trump appointees to thwart ESG investing, the reasoned discussion reflects the conundrum of ESG terminology and reporting standards geared strictly to financial materiality versus those geared for a broader audience.[31] This situation is characterized by the ESG term—"double materiality." Derived from the EU's NFRD which introduced a 'double materiality perspective', companies have to report not only about how sustainability issues affect their business but also about their own impact on people and the environment.[32] For example, an external issue such as water availability could result in a financial impact on a company, and at the same time the company's operations may have an impact on water availability for a community, which has broader environmental and social consequences.[33]

In May 2020, the U.S. Securities Exchange Commission (SEC) Investor Advisory Committee's Investor-as-Owner Subcommittee voted 14-4 to approve a recommendation that urged the SEC to begin updating the reporting requirements of public companies to include material, decision-useful ESG factors.[34] On February 1, 2021, the SEC named Satyam Khanna, a former agency attorney and ex-adviser to President Biden, as its first ever senior policy adviser for ESG regulatory issues. In March 2021, the acting Chair of the U.S. Securities and Exchange Commission (Allison Herren Lee) was quoted regarding climate disclosure that it is "time to move from the question of 'if' to the more difficult question of 'how' we obtain disclosure." To this end, the SEC has launched a new Climate and ESG Task Force and public consultation on climate disclosures. Interestingly this new task force is headed by the former (four month) acting deputy director of SEC enforcement, Kelly Gibson. In an interview with Law360, Gibson stated,

> Firms should make sure that when they do speak on climate or ESG issues that the disclosures are not materially false or misleading, or that they are omitting material information. And if an asset manager is marketing an ESG fund, it has to do so in a way that's not materially false or misleading while adhering to client mandates and restrictions. So I would suggest that they keep those principles in mind.[35]

It should be noted, however, that mandatory disclosures may not just be limited to climate change. SEC Chair-

man Gary Gensler has asked staff for recommendations on potential disclosure requirements with respect to human capital, which may include metrics on workforce turnover, compensation, benefits, workforce diversity, and safety and health. According to Gensler, "Investors have said that they want to better understand one of the most critical assets of a company: its people."[36]

Basics of ESG Investing

The Principles for Responsible Investing (PRI) is an investor initiative in partnership with the UNEP Finance Initiative and U.N. Global Compact. The beginnings of PRI can be traced to January 2004 when former U.N. Secretary General Kofi Annan approached over 50 CEOs of major financial institutions and invited them to participate in a joint initiative under the auspices of the U.N. Global Compact with the support of the Swiss Government and the International Finance Corporation (IFC), the private sector arm of the World Bank Group. The goal of the initiative was to explore ways in which ESG could be integrated into capital markets. A year later this initiative produced a report entitled "Who Cares Wins" which "made the case that embedding [ESG] factors in capital markets makes good business sense and leads to more sustainable markets and better outcomes for societies."[37] At the same time, the UNEP FI produced the "Freshfields Report" which showed that ESG issues are relevant for financial valuation. Those two reports formed the foundation for the launch of the Principles for Responsible Investment (PRI) at the New York Stock Exchange in 2006 and the launch of the Sustainable Stock Exchange Initiative (SSEI) shortly thereafter in 2007.[38]

Today PRI has over 3,800 signatories, including asset owners and investment managers who represent over $103 trillion of assets under management (AuM).[39] This staggering total represents approximately 90% of the global assets under management.[40]

The PRI "defines responsible investment as a strategy and practice to incorporate ESG factors in investment decisions and active ownership."[41] However, responsible investing can take several forms including:

- Environmental or "Green" Investing—requires an environmental benefit from the investment;
- Socially Responsible Investing (SRI) —typically uses best-in-class positive or exclusionary negative investment screening;
- Impact Investing—tracks ESG and economic impacts resulting from the investment; and
- Sustainably Linked Investing—includes financial incentives to meet ESG performance goals.

There are also many terms—such as sustainable investing, ethical investing, and impact investing—associated with the plethora of investment approaches that consider ESG issues.[42] Most lack formal definitions, and they are often used interchangeably.

As a longstanding financial sector columnist, John Rekenthaler, has noted:

> [a] key difference between ESG and its predecessor, 'socially conscious investing,' is that socially conscious managers implicitly admitted that their strategies might reduce their returns, while ESG investors do not. Socially conscious investors used negative screens to eliminate stocks that violated their beliefs. In contrast, ESG investors seek positive attributes, which they claim will make their companies better investments.
>
> . . . ESG investors obviously expect the third part of their acronym, governance, to improve their portfolios' performance. Their environmental and social concerns less clearly reflect self-interest, but ESG managers maintain that environmental and social concerns pose material risks that investors must consider, and that companies that manage such risks well will make their businesses more sustainable. At worst, [considering those risks] won't hurt.[43]

Regardless of the investment approach, the following are the accepted principles of Responsible Investing, as defined by the PRI:

- Principle 1: We will incorporate ESG issues into investment analysis and decision-making processes.
- Principle 2: We will be active owners and incorporate ESG issues into our ownership policies and practices.
- Principle 3: We will seek appropriate disclosure on ESG issues by the entities in which we invest.
- Principle 4: We will promote acceptance and implementation of the Principles within the investment industry.
- Principle 5: We will work together to enhance our effectiveness in implementing the Principles.
- Principle 6: We will each report on our activities and progress towards implementing the Principles.

ESG Pursuit in Practice

Frameworks capturing ESG themes and requirements for the financial sector, geared to downside "do no harm" risk management, were first developed and advanced by multilateral development banks (e.g., IFC, EBRD, IIC) in the late 1990s and early 2000. Lending to and investment in financial intermediaries (FIs) was a significant line of business for those banks, and they in turn had procedures in place for project review, deal commitment and supervision of FIs who were required to develop environmental management systems (now environmental and social management systems) to meet multilateral development bank requirements. Over the years, the development banks created frameworks for transactions such as term

loans, corporate loans, project finance and investments in private equity funds.

In 2003, 10 multinational banks announced the adoption of the Equator Principles, a framework for project financing based on the IFC's then environmental and social policies and guidelines.[44] A decade later, given the uptake of the Equator Principles by 90-some banks/institutions and demand for a similar framework for debt securities, a group of international banks created the Green Bond Principles now governed by the International Capital Market Association (ICMA), which serves as the Secretariat for other resources such as the Social Bond Principles and the Sustainability Bond Guidelines.[45, 46]

In practice, the management of ESG risks entails assessment of the various aspects of the transaction. Such assessments typically begin with identifying inherent risks and the willingness and capacity of the target company to manage them. Depending on the result, actions to manage material risks can be captured in legal agreements and offering documents. ESG investor requirements may include charter statements, positive covenants, negative covenants, conditions precedent to disbursement, events of ESG defaults, notices, and cure periods/mechanisms.[47] We note, however, that any one entity's ability to influence the ESG efforts of another party is highly dependent on legal leverage and somewhat dependent on moral suasion or positional advocacy.

Lending documents geared to project finance (that is, project specific debt instrument agreements) provide great opportunities for the exercise of legal leverage; shareholder certificates providing minority equity stakes not so much. PRI's guidelines are designed to address the latter for equity investing, whereas the Equator Principles were designed to address the former (although they have expanded to cover broader areas of banking). The Principles of Responsible Banking (PRB), launched in conjunction with UNEP FI in September 2019, provides lenders a framework to address ESG considerations with their borrowers. Lenders, who must comply with reporting requirements, such as EU directives, should also be responsive to similar ESG concerns of investors and business imperatives.[48]

Conundrums–Lack of Clear Definitions and Reporting Standards

Much of the world of lending and investment involves financial intermediation which is a construct under which an asset owner provides funds to an investment manager who then lends or invests those funds to provide a return or reward. The PRI are reflective of this construct. Principle 1 speaks to analysis and decision-making processes in investing; Principle 3 represents a commitment to seek disclosure on ESG issues by entities in which a signatory invests; and Principle 6 is a commitment for each signatory to report on its activities and progress towards implementing the Principles. The analysis under Principle 1 would be based on independent research and monitoring and/or purchased research or ratings derived from corporate ESG disclosures or reports. Therefore, reporting is central, as it is captured in Principle 3 (reporting by and from others) and 6 (self-reporting).

So what information is contained in ESG reports obtained by signatories, and what information is contained in reports of signatories? ESG reporting hinges at a minimum on "materiality." Companies therefore need to know what issues are material and what terminology should be used to describe them. Unfortunately, there has been little consensus and therefore much confusion over ESG terminology and reporting guidance.

According to Joel Makower (chairman and executive editor, GreenBiz Group), corporate reporters who are responsible for compiling and disclosing ESG data are frustrated by what Makower has referred to as the "alphabet soup" of current standards and frameworks: CDP, GRI, IIRC, PRI, SASB, TCFD, UNGC and more.[49] Indeed, "[t]he existence of multiple ESG reporting frameworks and the lack of consistency and comparability of metrics" have been characterized by business leaders of the International Business Council of the World Economic Forum (WEC) as "*pain points* preventing companies from credibly demonstrating to all stakeholders their progress on sustainability and their contributions to the SDG."[50]

Standard setting and framework development organizations recognize this pain. In their recently released Statement of Intent to Work Together, five such organizations—the Carbon Disclosure Project (CDP), the Carbon Disclosure Standards Board (CDSB), the Global Reporting Initiative (GRI), the International Integrated Reporting Council (IIRC), and the Sustainability Accounting Standards Board (SASB)—stated:

> In financial reporting, there is market agreement that there should be standards, and market acceptance that such standards require ongoing maintenance and evolution through rigorous, independent standard-setting processes, robust governance and due process oversight. Companies, investors and other stakeholders allocate resources to fund and participate in the standard-setting process, in addition to installing the right oversight through governance structures . . . We need to create an equivalent mindset when it comes to sustainability disclosure, so that actors coalesce around a set of generally accepted frameworks and standards that have global legitimacy through regulatory mandates or other recognition by policymakers, and engage actively in the related ongoing standard-setting processes. Only then will the proliferation of alternative initiatives stop, companies' frustration be reduced, and quality

and consistency of the reported information be improved.[51]

The Statement of Intent was facilitated by the Impact Management Project and the WEC, which itself issued a White Paper developed in collaboration with four global accounting firms setting forth Stakeholder Capitalism Metrics to be considered at WEC's 2021 Annual Meeting.[52] At that meeting in January 2021, 60-some business leaders and their organizations committed to utilize those metrics.[53] Setting the metrics themselves aside, the Statement of Intent shows that the interdependencies or relationships of corporate reporters, standard setters and data users are quite complex. They co-exist in a "nested ecosystem" geared to the fact that ESG portfolio building and management is much more complicated than investors simply obtaining sustainability reports from investees and making investment decisions upon review and consideration. While this sort of relatively simple review can hold true for a fund manager looking to build a portfolio of 10 companies, mass ESG investing requires advanced systems and data architecture serving information producers and information users underpinned by frameworks and standards as shown in figure 1 below.

The sustainability and integrated reporting organizations who issued the Statement are

> trying to arrive at the same level of maturity that the financial reporting eco-system has achieved *via* IFRS [International Financial Reporting Standards] and U.S. Generally Accepted Accounting Principles (GAAP) . . . . [Our] standards would provide a common set of sustainability topics and related disclosure requirements that would result in high-quality information being shared in the public domain, which can then be consumed by a wide variety of data aggregators, analytics providers, ratings and indices."[54] The objective is to establish through multi-stakeholder consultation "a globally agreed set of sustainability topics and related disclosure requirements, based on evidence of demand among various stakeholders for a disclosure solution." This would allow users to filter information based on their needs (e.g., economic decision making/materiality).[55] "The resulting standards would enable companies to collect information about performance on a given sustainability topic once, but provide relevant information to different users through appropriate communication channels (e.g., sustainability reports, annual integrated reports, websites)."[56]

In June 2021, IIRC and SASB merged into a unified organization called the Value Reporting Foundation, which will develop, align, maintain and/or provide as resources integrated thinking principles; the Integrated Reporting Framework, and SASB standards.[57] According to SASB, "[f]rameworks provide a set of (often) industry agnostic, principles-based guidance for how information is structured and prepared and which broad topics are covered" whereas "[s]tandards offer industry-specific, replicable and detailed requirements for what should be reported for each topic."[58]

The concept of filtering and the "big picture" view of the relationship between standards and frameworks, including their relationship to the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB), is presented in figure 2.

Reporting capabilities are furthered by structured information sharing as presented in the conceptual figure 3.

The European Union and the IFRS Foundation (parent of the IASB) will be launching their own sustainability reporting standards, which could become the first concrete international "green" report-

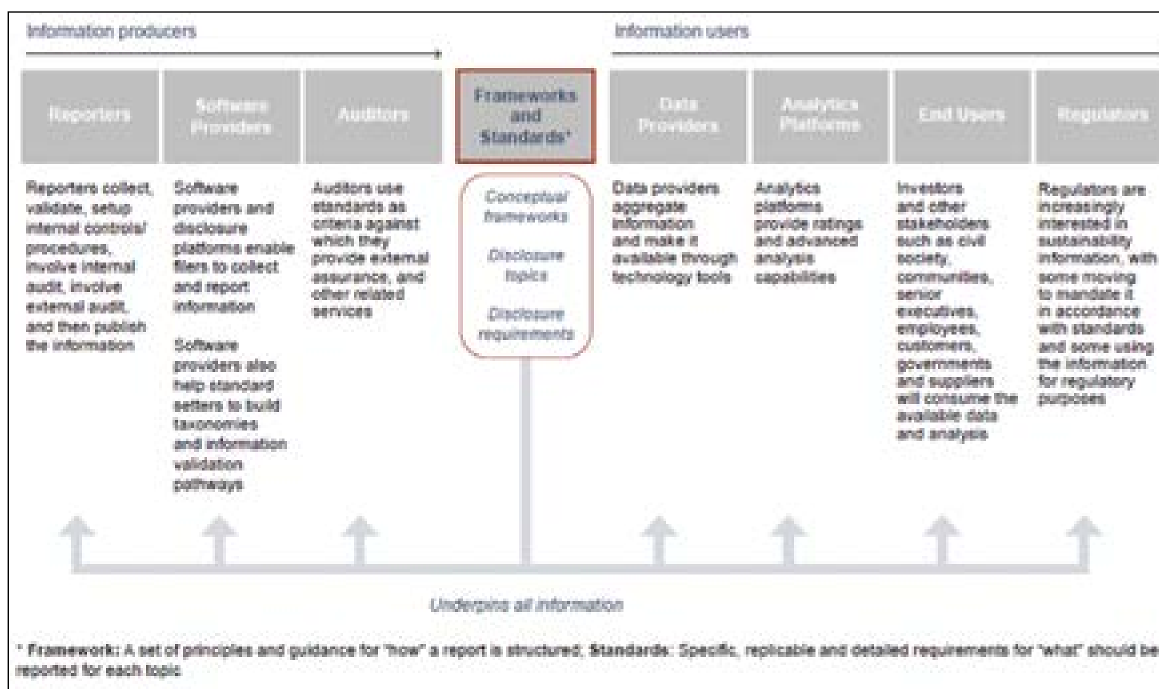

Figure 1: Source: Statement of Intent to Work Together Towards Comprehensive Corporate Reporting. September 2020. Fig. 3.

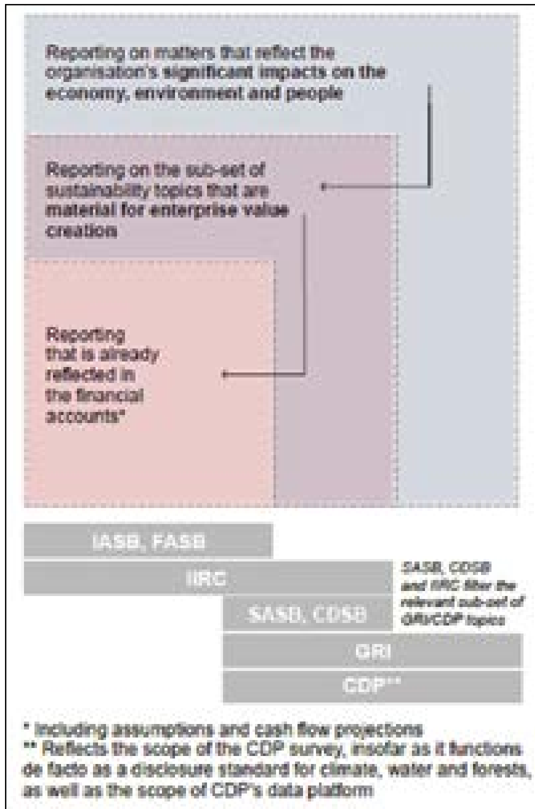

Figure 2: Source: Statement of Intent to Work Together Towards Comprehensive Corporate Reporting. September 2020. Fig. 2

ing requirements.[59] In line with their White Paper, the Big Five accounting firms, issued a protype standard on climate risk, which could serve as a jump-start for standards developed by IFRS.[60]

Even as standards converge, however, official bodies are likely to reflect distinctions between the groups that are developing standards aimed narrowly at financial investors, like SASB, and those aimed at broader disclosure for a wider audience, such as GRI. In this vein, "IFRS's work is likely to be limited to reporting to financial investors, and the EU's effort probably will aim at more comprehensive sustainability reporting for employees, suppliers, and policy setters."[61]

SASB and Economic Decision Making

As noted above, market players and stakeholders are demanding that ESG issues be assessed using well defined accounting and performance metrics similar to those used in financial analysis and reporting. To provide a framework for ESG analysis and reporting, the SASB was created in 2011.[62] It has a purpose complementary to the Financial Accounting Standards Board (FASB), a not-for-profit organization endorsed by the U.S. government to provide guidance on disclosing useful financial information to investors and to help investors decide whether to invest in a company and whether the company's management has made good use of past funding.[63]

SASB is accountable for the due process, outcomes, and ratification of its developed standards.[64] To facilitate this process, SASB identifies financially material issues that are likely to impact the financial condition or operating performance of a company and therefore are most important to investors. In 2018, SASB published potentially "material" ESG issues for investors focused on 11 sectors covering 77 "industries."[65] SASB's Materiality Map® categorizes the major ESG issues into five dimensions: Environment; Social Capital; Human Capital; Business Model & Innovation; and Leadership & Governance (see https://materiality.sasb.org/).[66] SASB continues to work with sustainability professionals, investors, and subject matter experts to monitor existing, evolving, and emerging ESG issues.[67] Because of the organization's extensive research and general acceptance, SASB's mapping of material ESG issues to specific sectors should be considered best or standard practice.

According to SASB guidance, it is the individual companies who decide what is financially material including what ESG information should be disclosed after taking legal requirements into account. Many institutional investors, however, wonder what are the legal requirements.

Over the past two decades, the United Nations Environment Programme (UNEP) has asked the law firm, Freshfields Bruckhaus Deringer (Freshfields), on several occasions to analyze whether and how legal frameworks can allow, if not require, investors to consider ESG issues.[68] Around 2005, the UNEP asked Freshfields *"to consider whether institutional investors such as pension funds and insurance companies are legally permitted to integrate environmental, social and governance issues into their*

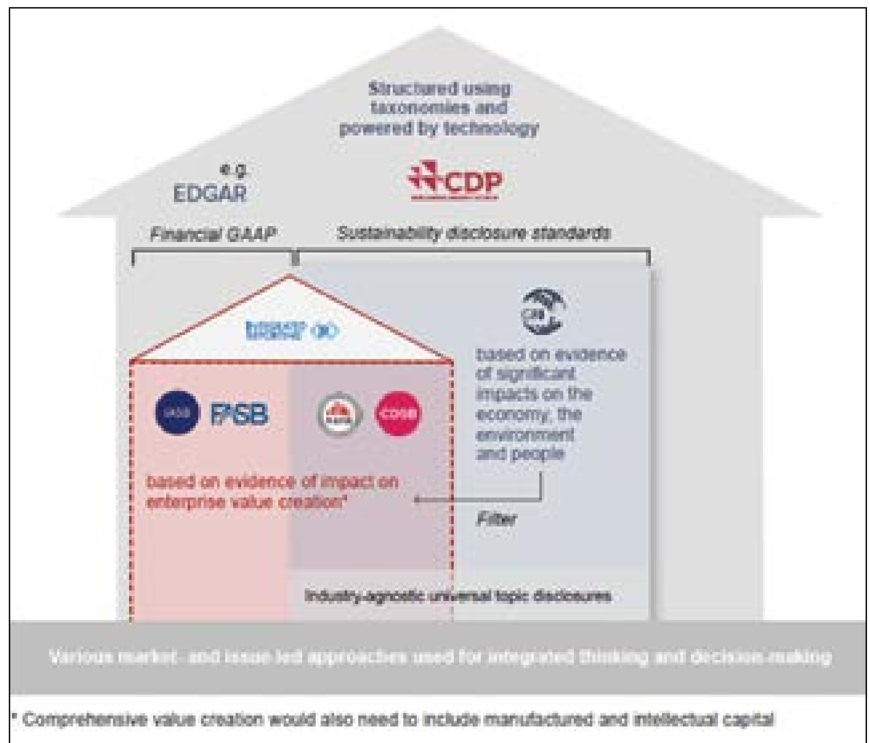

Figure 3: Source: Statement of Intent to Work Together Towards Comprehensive Corporate Reporting. September 2020. Fig. 7.

investment decision-making and ownership practices." In 2005, Freshfields concluded that ESG investing is consistent with fiduciary duty; and in 2015, in a study conducted a decade later, Freshfields concluded that the consideration of ESG factors is "clearly permissible and is arguably required in all jurisdictions."[69] More recently in 2019, UNEP, the PRI and the Generation Foundation asked Freshfields to consider whether fiduciaries can or must consider impacts on sustainability. The project's final report will be released in Summer 2021. The report will present legal analysis based on 11 distinct jurisdictions, identify common global themes, and also present recommendations to align the investment sector with managing sustainability impacts.[70]

In April 2021, Congressional Democrats reintroduced the Climate Risk Disclosure Act. Under the act, companies will have to disclose annually their direct and indirect greenhouse gases (GHG) emissions, the total amount of fossil fuel-related assets and risk management strategies for addressing climate change.[71] The bill would provide the SEC with a mandate to enact disclosure requirements regarding climate change risks.[72] The Biden administration is working to pass the National Green Bank Bill and the Clean Energy and Sustainability Accelerator Act. These bills support hard-to-commercialize clean energy and carbon-cutting investments with public and private ESG funding. According to The Coalition for Green Capital, 15 states (both red and blue states) have recently established Green Banks with 22 other states working to establish their own Green Banks funded by federal and private sources.[73]

In addition to governmental and non-governmental efforts to support ESG, activist shareholders are successfully challenging corporate management to deal more aggressively with ESG challenges such as climate change. For example, ExxonMobil shareholders recently replaced three management-backed board members focused on large-scale clean energy infrastructure and clean tech development. It was the first proxy campaign at a major U.S. company in which the case for change was built around the shift away from fossil fuels.[74]

Assuming legal frameworks are established and climate disclosures become law, lawyers will play an important role in bringing clarity and understanding to their clients. Potential work may include reviewing due diligence reports; providing advice on regulatory compliance; crafting contractual language on representations, warranties, and covenants; and advising on environmental claims as well as providing oversight of voluntary and likely to be required disclosures to investors and regulators. Given the the rapid growth of ESG policies and regulation globally over the past 20 years, PRI has created a database of ESG policies, guidelines, standards and regulations from around the world.[75] Lawyers may find this tool useful in keeping up to date on the latest ESG legal requirements.

Conclusion

ESG Investing is a global financial trend that is influencing trillions of dollars in investment. Many asset managers, global accounting firms, NGOs, and the International Standards Organization (ISO) are working to develop a set of generally accepted frameworks and standards that have global legitimacy regarding a common set of sustainability topics and related disclosure requirements. The objective is to produce high-quality ESG-related information that can be consumed by a wide variety of data aggregators, analytics providers, rating agencies and indexes.

This article presented the status of efforts to foster a mature ESG investment market. Despite these efforts, clear definitions and reporting standards have yet to emerge. This lack of clarity has resulted in potential risks and liabilities to market participants. For example, downside risks associated with greenwashing, misrepresentation or performance exist for issuers or obligors of debt or equity instruments that are purposefully or explicitly underpinned by ESG considerations, attributes or claims. Lawyers, especially those trained in environmental, social, and governance issues, can play an important role in bringing clarity and valuable risk management insight to their ESG-focused clients.

Endnotes

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