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How to Define Environmental, Social and Governance Is 'the Million-Dollar Question'

By Christine Schiffner
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Welcome to The National Law Journal's Inadmissible feature, a regular Q&A series with Washington, D.C., legal professionals. The interviews take a short, to-the-point look at an issue at the intersection of law and politics and strategic risk mitigation led by professionals in the nation's capital.

In this edition, Skadden, Arps, Slate, Meagher & Flom partners Anita Bandy and Marc Gerber discuss grey areas and the scope of environmental, social and governance frameworks, as well as potential approaches by the U.S. Securities and Exchange Commission in relation to corporate disclosures.

In the context of ESG and corporate governance, what issues and risk factors have you seen lately?

Marc Gerber: The two biggest ESG risk categories that boards and management need to assess, monitor and report have been climate change and human capital management. Over the past two years, we've seen companies examine climate risks more closely, including how those factors continue to evolve and gain nuance. Companies have specifically been focusing on matters such as mitigating their exposure to climate transition, disclosure of greenhouse gas emissions reduction targets, and reducing the use of plastics.

In addition, human capital matters, such as workplace culture and [diversity, equity and inclusion] programs, continue to be matters that we see many companies addressing.

(L-R) Anita Bandy and Marc Gerber, partners at Skadden, Arps, Slate, Meagher & Flom. Courtesy photos

Anita Bandy: The U.S. Securities and Exchange Commission has increased its focus on climate risk and is using its existing authority to pursue cases. The agency has filed two significant cases relating to climate: one against a large public company and the other against an investment adviser. In both cases, the SEC needed to establish alleged materiality of the disclosures. If the proposed rulemaking in its current state is finalized, the SEC may move away from its principle-based approach that permits the issuer to decide the materiality of its disclosures. Disclosure could be deemed material by the SEC just by virtue of being mandated by the new rulemaking.

In a recent settled case involving an investment adviser in which the commission alleged that the adviser disclosed conducting environmental quality reviews of funds that were invested in an ESG

strategy even though those reviews allegedly did not occur consistently, the SEC pointed to the fact that the disclosure was made in fund prospectuses and materials that went to the board to establish materiality.

As the SEC waits to determine whether to scale back its climate proposal in light of the *EPA v. West Virginia* decision, we have seen the agency pivot to focus on social and governance issues. In two recent high-profile cases, the SEC again used its existing authority to send a message about its expectations and priorities in those areas. One case addressed executive compensation and the other addressed workplace conduct and disclosure controls that the SEC alleged did not operate effectively.

We can also expect the SEC to focus on proxy disclosures about executive compensation if, for instance, a workplace conduct issue has disclosure or compensation implications, or perhaps invites risks that warrant a risk factor disclosure or a disclosure in the management discussion and analysis section of a filing for a company.

Against this backdrop, how important is it for companies now to review their ESG disclosures and what are the priorities to focus on?

AB: Now is the time for companies to closely review their existing disclosures on file and make sure the activities they have chosen to disclose are commensurate with the disclosure.

We can expect the SEC to closely scrutinize disclosures that tout an environmental target or a goal that has been achieved or planned to be achieved, as well as the controls environment surrounding these disclosures.

MG: To provide an example: If you've been espousing that your goal is to be carbon-neutral by 2040 and you've now figured out that meeting that goal will actually take until 2050, because your disclosure will be scrutinized and you now know there is no basis for the 2040 goal, you would want to update your disclosure to say the goal is further out and the company does not expect to be carbon-neutral before 2050.

Given the overall ambiguity about ESG disclosure requirements, how broadly should clients define ESG?

MG: That is the million-dollar question. I spoke on a panel earlier this month where participants raised the real question of what ESG is meant to capture. People think about the acronym ESG and interpret the scope of "environmental, social and governance" matters differently: Investors, companies and the SEC are all talking past one another to some degree.

At the end of the day, for Delaware corporations, your ESG priorities should somehow align with shareholder welfare. There should either be some nexus between creating value for shareholders or reducing risk that would be value-destructive.

While there are lots of ESG topics, not every topic is as relevant for every company. If you're a Delaware corporation, your duty ultimately is to shareholders, but that duty doesn't preclude you from thinking about ESG. I advise companies that what that really means is to figure out what the relevant ESG issues are and then what enhances or creates a risk to shareholder value. Those are the ESG topics to prioritize.

AB: I think the SEC's focus from a regulatory perspective is not just limited to climate. The commission is very much also focused on disclosures addressing social and governance issues, whether that means proxy disclosures, the disclosure controls environment governing social and governance issues focused on workplace audit, workplace culture, executive conduct and executive compensation. Those are all issues that I think are being closely scrutinized based on some of the recent SEC cases.

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