ESG in 2021 So Far: An Update

Posted by Marc S. Gerber, Greg Norman and Simon Toms, Skadden, Arps, Slate, Meagher & Flom LLP, on Saturday, September 18, 2021

Editor's note: Marc S. Gerber, Greg Norman and Simon Toms are partners at Skadden, Arps, Slate, Meagher & Flom LLP. This post is based on a Skadden memorandum by Mr. Gerber, Mr. Norman, Mr. Toms, Louise Batty, Adam M. Howard and Caroline S. Kim. Related research from the Program on Corporate Governance includes The Illusory Promise of Stakeholder Governance (discussed on the Forum here) and Will Corporations Deliver to All Stakeholders?, both by Lucian A. Bebchuk and Roberto Tallarita; For Whom Corporate Leaders Bargain by Lucian A. Bebchuk, Kobi Kastiel, and Roberto Tallarita (discussed on the Forum here); and Restoration: The Role Stakeholder Governance Must Play in Recreating a Fair and Sustainable American Economy—A Reply to Professor Rock by Leo E. Strine, Jr. (discussed on the Forum here).

The rapidly growing focus on environmental, social and governance (ESG) matters that marked 2020 continued to shape events for companies operating or based in the U.K. and Europe in 2021. Discussions of ESG are occurring at all levels, from the boardroom to investors to employees, and governments, regulators and companies are all being encouraged to take these matters into consideration. In our 1 February 2021 article ("ESG: Key Trends in 2020 and Expectations for 2021"), we set out what we thought would be the key ESG trends to watch this year. In this article, we take stock of those predictions, discuss new issues that have emerged over the year and identify the trends we think will be prominent during the remainder of 2021.

Looking Back: Correct Predictions

A number of our key expectations at the outset of the year have been borne out.

ESG Funds[1]

In the first quarter of 2021, inflows into European "sustainable" funds totalled €120 billion, 18% more than the first quarter of 2020, according to Morningstar, and that comprised slightly more than half of all fund inflows for the first time. Of that, €36.5 billion went to passive index and exchange-traded funds (ETFs). Despite the latter growth, there is concern that passive funds will struggle to match the service provided by active managers due to (i) the subjectivity involved in determining appropriate ESG credentials until there is a standardisation of ESG data and

[1] Morningstar, "European Sustainable Fund Flows: Q1 2021 in Review"; *Financial Times*, "Rise of ESG renews debate over whether passive funds can deliver" (25 June 2021); FT Adviser, "FCA warns on 'poor-quality' ESG fund applications" (19 July 2021); Financial Conduct Authority, "Authorised ESG & Sustainable Investment Funds: improving quality and clarity" (19 July 2021)

reporting and (ii) the ease with which active managers can react to controversy compared to passive ETFs, which must wait for an index committee review before changing investments.

In the U.K., the Financial Conduct Authority (FCA) issued a warning in July to all ESG funds, both passive and active, of the need to improve. This took the form of a "Dear Chair" letter setting out guiding principles for the products. Although the FCA states that it welcomes innovations in the market, the rapid pace of change has raised some issues. In particular, the FCA is concerned by the number of poor-quality fund applications it has seen and the impact this may have on consumers.

The FCA's guidelines are based on three principles:

i. The design of the fund and disclosure of its ESG investment strategy should be fairly reflected in the fund's documentation;
ii. The implementation of the fund's ESG investment strategy should be appropriately resourced and consistent with its disclosed objectives; and
iii. ESG-related information disclosed by the fund should be easily available and comprehensible for investors to enable them to make investment decisions.

It will be of particular interest over the next few months to see the impact, if any, that these new guidelines have on the ESG fund application process.

Sustainable Finance Market[2]

As we predicted in February 2021, the market for green bonds has boomed. According to a report by the Climate Bond Initiative, global issuance of green bonds is on track to reach between $400 billion and $500 billion in 2021, nearly double the record high of $270 billion in 2020, with $54 billion invested in ESG bond funds in the first five months of 2021 alone.

Moreover, the sustainable finance market has continued to expand beyond green bonds. Although non-investment-grade sustainability-linked notes only appeared for the first time in March 2021, they have proved popular in Europe, with €3.44 billion worth issued by June. Nearly two-thirds (65%) of widely syndicated leveraged loans in the European market contained an ESG pricing ratchet in Q2 2021, adjusting the margin on the debt based on ESG-related performance. This is a very significant development, given that ESG pricing ratchets were largely an investment grade phenomenon in 2020.

The growth of this market reflects both investors' increased focus on ESG and the appeal of lower borrowing costs that green debt offers governments and companies. This so-called "greenium" can be difficult to measure given the rarity of concurrent issuances of green and conventional instruments. However, there is a direct comparison available in Germany, where the

[2] *Financial Times*, "Investors pile $54 billion in to ESG bond funds in fiery start to 2021" (25 June 2021); Forbes, "How green are green bonds" (2 June 2021); *Climate Bond Initiative* "Sovereign, Green, Social, and Sustainability Bond Survey: The ultimate pow er to transform the market" (24 January 2021); *LCD*, "ESG goes mainstream across global leveraged finance markets in 2021" (25 June 2021); *Covenant Review*, "ESG Trendlines in European Leveraged Loans — Q2 2021" (14 July 2021); *Financial Times*, "Borrowers tap hot ESG demand to sell green bonds at a premium" (9 April 2021); ICMA, "*Green & Social Bond Principles 2021 edition issued*" (10 June 2021); Bloomberg, "EU's gold standard in green w ill command biggest debt premiums" (10 July 2021); *Corporate Counsel*, "Sustainable Finance: Green Bonds Shine — But It's Not Easy Being Green" (10 June 2021).

benchmark green government bond has a yield around 0.05% points lower than its conventional "twin". The pricing of the so-called green Bund is the same as the standard bond, yet investors have accepted the lower return on the former. This has led to concerns that the market could be a bubble waiting to burst.

There are also concerns about "greenwashing" as the market moves beyond investment grade products. For instance, despite requirements that green instruments contain specific terms on the use of proceeds, many of those instruments state that the issuer may not be able to use the proceeds for the intended purposes. That gives borrowers an out and calls into question the validity of the "green" label. As a result, the International Capital Market Association has updated its green and social bond principles, which are the global standard for a $1.6 trillion market, putting a greater focus on transparency. The principles recommend a framework for the instruments, external review of the key performance indicators (KPIs) used to measure sustainability achievements and more information at issuer-level in order to build confidence among investors.

The EU also intends to introduce more stringent rules requiring impact reporting and external reviews in order for a product to be labelled as a "European Green Bond". Issuers will need to make extra efforts to qualify for that designation, but the intention is to achieve cheaper borrowing costs because investors appear willing to pay a premium for ethical quality. (We discuss greenwashing further in the final section below.)

ESG Activism[3]

As predicted, activists of various sorts pressed companies aggressively on ESG issues this year. Through 9 June 2021, globally there had been 169 ESG shareholder proposals in the 2021 annual general meeting season, which have garnered average support of almost 34% of shares voted, primarily supported by fund managers that are becoming increasingly vocal about their support for ESG proposals. In comparison, only 171 resolutions were filed in the whole of 2020, with support averaging less than 29% of shares voted.

ESG challenges to "Big Oil" captured the most attention. Most notably, activist hedge fund Engine No. 1 elected three directors to the board of Exxon Mobil and sponsored two shareholder proposals that won majority support, all against the board's recommendation. One proposal called for an annual report on lobbying, while the second requests a report describing how the company's lobbying efforts align with the goal of limiting global warming.[4]

Meanwhile, a district court in the Hague ruled in favour of climate campaigners who challenged Royal Dutch Shell's emissions policy. The decision requires the company to take greater action in order to meet the Paris Climate Goals. In the U.K., BP successfully defended a call for greater action on climate change, but the resolution received 21% of the votes, meaning the company will

[3] *Financial Times*, "BP dodges new climate target calls as activist pressure grows" (12 May 2021); Bloomberg, "The world's biggest investors get louder about ESG" (9 June 2021); Bloomberg, "Shareholder activism campaigns rebound out of pandemic" (21 June 2021); *Financial Times*, "A $140 billion asset sale: the investors cashing in on Big Oil's push to net zero" (6 July 2021); Bloomberg, "After Exxon, activism's next shareholder victory could be the S in ESG" (15 June 2021).

[4] See "What the Exxon Mobil Shareholder Votes Mean" in Skadden's publication *The Informed Board* (16 June 2021).

have to return to investors to discuss their concerns, in accordance with the U.K. Corporate Governance Code.

Some commentators have argued that Engine No. 1 only succeeded due to Exxon's ESG and financial performance, making the company a traditional activist target. Others have emphasised that the shareholder pressure may not reduce the use of oil and gas or emissions from their production; that it may simply result in energy assets changing hands. Even if listed companies make divestments in order to meet carbon emissions targets, there remain plenty of private and state-owned buyers willing to purchase these assets. As a result, the impact of such activism is perhaps overstated. Currently, only 12% of oil and gas reserves are held by public companies.

The past six months signal a shift in favour of ESG activism and Big Oil is unlikely to be the only focus as other investors and campaigners push on ESG issues. Several companies have recently received requests to disclose the company's race and gender diversity figures and activists requested information about fashion house Hugo Boss's supply chains.

Executive Remuneration[5]

Executive remuneration has proved a contentious topic in 2021. A PwC report found that executive pay at the U.K.'s biggest companies dropped by nearly a fifth as companies responded to warnings from institutional investors that they expected remuneration to reflect the impact of the pandemic on stakeholders. Where companies failed to take this into consideration, such as Foxtons and Morrisons, a significant portion of shareholders voted against the companies' remuneration plans — particularly, where those companies received government support during the pandemic, raised emergency cash and/or suffered a substantial fall in share price.

Approval for remuneration resolutions in the U.K. fell to an eight-year low, but support only fell to 91.4% on average, and shareholders who voted against such policies remained reluctant to vote against the individuals responsible for these decisions. Of the companies that faced a revolt on their pay reports this year (defined as at least 20% opposition), less than a fifth faced pushback on the appointment of one or more directors, according to Proxy Insight, so little change was effected by the opposition to pay packages.

EU Sustainable Finance Disclosure Regulation (SFDR)[6]

Six months on from the initial implementation of EU Regulation 2019/2088 on sustainability-related disclosures in the financial services sector, many firms are still adapting to the obligations and requirements. Outstanding questions remain concerning the application of some obligations, particularly to entities established outside the European Economic Area (EEA). Furthermore, there remains a lack of guidance as to the full scope of the obligations — for example, whether a financial product that includes ESG factors in its decision-making process falls within the scope of SFDR Article 8, which sets criteria for ESG funds.

---

[5] *Financial Times*, "UK chief executives suffer big pay cuts" (10 May 2021); *The Observer*, "Executive pay: big names that fell foul of shareholders" (26 June 2021); *Financial Times*, "Investors protest against big payouts for UK bosses" (18 May 2021); *Financial Times*, "Why investor pay revolts need to get personal" (2 June 2021).

[6] FCA Consultation Paper (CP21/17), Enhancing climate-related disclosures by asset-managers, life insurers and FCA-regulated pension providers, June 2021.

There is additional regulatory uncertainty because a number of the obligations under the SFDR are meant to be elaborated on in regulatory technical standards (RTS). While a draft RTS was issued by the Joint Committee of European Supervisory Authorities in February 2021, the standards have not been finalised and the date for implementation was postponed from 1 January 2022 to 1 July 2022. Firms are therefore required to comply with some SFDR disclosure obligations without knowing whether those disclosures will be compliant next summer.

UK ESG Disclosure

In the U.K., the FCA has published an initial consultation regarding ESG disclosures by asset managers consistent with the requirements set by the international Task Force on Climate-related Financial Disclosures (TCFD). The obligations on asset managers are only due to come into force in January 2022 and will only apply to firms with more than £5 billion of assets under management. The obligations appear to be more limited in scope than obligations under the SFDR, and have a greater focus on climate-related disclosures than on social and governance factors.

As discussed above, the FCA has also recently indicated that it will focus on ESG funds, concentrating on the way in which information about ESG investment strategies and related information is disclosed. The FCA has indicated it sees no need for new rules in this area because regulated U.K. firms are already subject to comprehensive standards of disclosure.

Biden Administration ESG Policies[7]

It was clear from the early days of the Biden administration that it would take a very different approach to climate change and ESG matters than the Trump administration, and that has been reflected in a number of actions by different arms of the government.

For example, in March 2021, the U.S. Department of Labor announced that it would revisit, and not enforce, rules adopted in late 2020 that had called into question whether pension funds could consider ESG matters in their investment decision-making and voting decisions as shareholders. Removal of this uncertainty may have contributed to the record-breaking support during the 2021 U.S. proxy season for shareholder proposals relating to environmental and social (E&S) matters, with 34 E&S proposals receiving majority shareholder support, up from the previous record of 21 supported proposals in 2020. These votes are likely to spur enhanced corporate policies and disclosures in the remainder of this year and into 2022, and to alter the calculus for companies that receive shareholder proposals later this year for their 2022 annual meetings.

More recently, the U.S. Securities and Exchange Commission (SEC) announced that it will draw up new ESG rules in the coming months. In a June 2021 speech at London City Week, SEC Chair Gary Gensler stated that he had asked the SEC staff to develop recommendations for mandatory disclosure “around governance, strategy, and risk management related to climate risk”

[7] U.S. Department of Labor, “US Department of Labor releases statement on enforcement of its final rules on ESG investments, proxy voting by employee benefit plans” (10 March 2021); SEC Chair Gary Gensler, Prepared remarks at London City Week (23 June 2021); SEC, “Public input welcomed on climate change disclosures” (15 March 2021); Gensler, Prepared Remarks Before the Principles for Responsible Investment ‘Climate and Global Financial Markets’ Webinar (28 July 2021); SEC, “SEC Announces Annual Regulatory Agenda” (11 June 2021).

and regarding human capital disclosure. The latter could include metrics on workforce turnover, training, compensation and benefits, workforce demographics, and health and safety.

In a July 2021 speech, Chair Gensler reiterated that he had asked the SEC staff to develop a mandatory climate risk rule proposal for the SEC's consideration by the end of 2021. Before he took office, Acting Chair Allison Herren Lee solicited public comment on climate change disclosures. That resulted in the submission of more than 550 unique comment letters.

The SEC's regulatory agenda, published in June 2021, reflects the SEC Chair's focus on ESG matters, including disclosures regarding corporate board diversity, climate change, human capital management and cybersecurity risk governance. The SEC rulemaking process is likely to extend into 2022, however, so, in the near-term, enhanced corporate disclosures are more likely to be in response to the efforts of investors and other stakeholders.

New Areas of Interest

Data, Tech and ESG[8]

As investors have focused on the E in ESG, many have divested fossil fuel-based holdings and shifted investment to technology, which is regarded as greener. For example, large ESG-focused ETFs now look very much like tech-sector ETFs, with Apple, Microsoft, Amazon, Alphabet and Facebook topping the holdings at several.

However, as the technology sector evolves and data becomes increasingly valuable, the need for effective management and safeguarding will determine whether it continues to be seen as an ESG-friendly industry. Cybersecurity, for example, has emerged as a critical governance risk when evaluating investments, a concern that has only been heightened by the shift to remote working during the pandemic.

Tech companies such as Microsoft and Apple have pushed back against calls to include disclosures of ESG issues in SEC filings. The companies have argued that the inclusion of such information would open them up to legal risks, given the current difficulties in quantifying ESG data. This reluctance has arisen despite the fact that both companies have positioned themselves as sustainability leaders and have greatly benefitted from the ESG boom. Microsoft, for instance, is the most widely held company by U.S. ESG funds.

Cryptocurrencies, meanwhile, have been subject to an increased scrutiny for their environmental impact. Greenidge Generation has been sued over its purchase and planned expansion of a power plant in New York State to be used to mine bitcoin. Tesla chair Elon Musk also recently commented on the industry, saying "cryptocurrency is a good idea on many levels and we believe it has a promising future, but this cannot come at great cost to the environment". Whether environmental concerns will affect the growth of cryptocurrencies remains to be seen.

[8] *Forbes*, "Data Governance: the next big ESG controversy" (4 February 2021); Bloomberg, "BlackRock's record-breaking ESG fund looks just like a big tech ETF" (14 April 2021); *Financial Times*, "Top tech groups try to dilute ESG disclosure rules" (20 June 2021); *Financial Times*, "Bitcoin's growing energy problem: 'It's a dirty currency'" (20 May 2021).

Looking Forward: Our Expectations for the Rest of 2021

UN Climate Change Conference[9]

The 26th United Nations Climate Change Conference of the Parties (COP26) is still on track to be held in Glasgow in November 2021, with many participants gearing up to discuss the progress made since the 2015 Paris Agreement and what steps should be taken next.

As the COP26 host, the U.K. government has come in for criticism from the Climate Change Committee (CCC), the government's environmental adviser, for failing to match rhetoric with action. In a recent CCC report on decarbonisation, the committee stated that plans for key sectors had been repeatedly delayed, and it complained of a lack of strategy over the past 12 months. That came just a week after a CCC review of climate risks faced by the U.K. stated that the government had done little to prepare for the inevitable dangers posed by climate change. These have put more pressure on the government to take action in the months before November.

Greenwashing Concerns[10]

Greenwashing continues to be a major concern for ESG investors and regulators alike, as we have discussed above. In response, the U.K. Treasury has formed a new panel, the Green Technical Advisory Group (GTAG), to define the requirements for financial investments to be considered environmentally sustainable. This grew out of concerns that investors do not have enough information to understand the environmental impacts of their investments.

The U.K government opted not to adopt the EU's taxonomy regulation — its framework for classifying environmentally-sustainable economic activities, which comes into effect in 2022 — and it is not yet clear what approach the GTAG will take. As mentioned above, the FCA's "Dear Chair" letter to fund managers, sets out its guiding principles for investing, with a particular focus on what greenwashing is and how to avoid it. The overriding principle appears to be consistency, including fund names, objectives, policies and strategies. The FCA's letter included specific examples of greenwashing, including passive funds with ESG-related names making investment decisions based on only high-level criteria and funds claiming to contribute to positive environmental impact that invest in low-carbon companies rather than those contributing to a net-zero transition. The impact of these measures on the U.K. market will become clearer in the coming months.

ESG and Board Composition[11]

Diversity, equity and inclusion has continued to be at the forefront of a number of developments, but there have been continual reminders of the amount of work that remains to be done.

More than half of directors appointed to public company boards in the U.K. in 2020 were women, but more than 80% of the appointees were white and a large proportion of these positions

---

[9] *Financial Times*, "UK failing to match climate rhetoric with action, adviser warns" (24 June 2021).
[10] Bloomberg, "UK tackles 'greenwashing' with push to define sustainability" (8 June 2021).
[11] *Financial Times*, "Women take half of UK board seats" (9 June 2021); *Financial Times*, "UK boards face pressure to increase female directors under FCA plans" (28 July 2021).

continued to be non-executive directorships, with very few women gaining the top executive positions.

At the end of July, the FCA announced a new proposal that would put pressure on U.K. companies to ensure that at least 40% of board directors are women. Under this amendment to the Listing Rules, companies would need to "comply or explain" why they have missed new board diversity targets for gender and ethnic minority representation. Although these targets will not be mandatory, they would provide a way to measure companies' success in bringing greater diversity to their senior management. The FCA intends to consult on these proposals with the market's response likely to shape the FCA's plans over the next six months.

Flexible Working[12]

Throughout the pandemic, employers have had to wrestle with work force issues that fall under the S of ESG. Crafting guidelines for returning to the workplace has proved challenging for both governments and businesses in 2021, as the world faces new variants of COVID-19 and renewed surges. We may now be seeing the "new normal", with a full return to the workplace varying by role and employer, and rules continuing to change with the nature of the pandemic. In many sectors, it seems that hybrid working is likely to become the norm.

This raises new issues. Under English law, for example, employees have a right to request flexible working once they have been with an employer for at least 26 weeks, and employers must address requests in a "reasonable manner". Given that many employees have already worked flexibly for the last 18 months, refusing new flexible working requests may be deemed unreasonable.

Reputational considerations also come into play. The willingness of employers to embrace flexible working patterns is perceived to go hand in hand with diversity and inclusion initiatives. Employers who embrace flexibility are increasingly viewed as those most committed to gender diversity at senior levels, for instance.

However, it is also worth remembering that working from home has been most feasible and widespread in professional and other office-based sectors. In 2020, the proportion of employees working from home in the U.K. rose to 35.9% in 2020, but that was only 9.5% higher than 2019. For many people and industries, the pandemic has therefore not changed working practices. With a full return to office-based work seemingly now somewhat delayed, only time will tell what the long-term effect of all these changes will be.

Another six months of working from home has also led to a rise in conversations surrounding the impact of isolation and remote working on mental health. Some studies have indicated that almost one in five adults in the U.K. were likely to experience some form of depression during the pandemic. As the blurring of private and professional lives led some employees to claim they were working substantially longer hours, employers should consider their duty of care towards employees, which includes their mental as well as physical health. In serious cases, the effect of

---

[12] *The Verge*, "Apple employees push back against returning to the office in internal letter" (4 June 2021); BBC. "The bosses who want us back in the office" (25 March 2021); U.K. Office of National Statistics, "Homeworking hours, rewards and opportunities in the UK: 2011 to 2020" (19 April 2021).

the changed job arrangement on mental health may amount to a breach of this duty of care, giving rise to the possibility that employers could face claims for personal injury or constructive dismissal. In some circumstances, mental illnesses may be considered a disability under the U.K. Equality Act 2010. Employers should therefore be careful not to discriminate and should take reasonable steps to facilitate employees struggling with their mental health.