ESG and Climate Disclosure: Key Frameworks, Developments, and Practical Tips

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Roadmap

I. Overview of ESG Trends and Frameworks

II. Recent Climate Initiatives
   A. Proposed SEC Rules on Climate Change
   B. Proposed Federal Acquisition Council’s Climate Disclosure Rules

III. Greenwashing Concerns and Enforcement

IV. Anti-ESG Landscape

V. Panel Discussion
Overview of ESG
## Menu of ESG Areas

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<th>E is for “Environment”</th>
<th>S is for “Social”</th>
<th>G is for “Governance”</th>
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<tr>
<td>• Greenhouse gas emissions</td>
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<td>• Climate change</td>
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<td>• Corporate giving and philanthropy</td>
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<td>• Child and forced labor</td>
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<td>• Diversity and inclusion</td>
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<td>• Supplier practices</td>
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<td>• Board structure and composition (including tenure and diversity)</td>
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<td>• Executive compensation</td>
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<td>• Shareholder rights</td>
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<td>• Enterprise risk management</td>
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<td>• Audit oversight</td>
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<td>• Disclosure and reporting</td>
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<td>• Ethics and compliance</td>
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<td>• Privacy and cybersecurity</td>
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Why Should You Care About ESG?

- Investors, stockholder advisory firms and other stakeholders are increasingly holding boards and corporations more accountable for ESG issues
- Increase in ESG stockholder proposals for inclusion in proxies and ESG activist campaigns
- Buyers/investors increasingly conducting ESG due diligence
- Comparisons with peers and competitors
- Proposed SEC climate rules
Current ESG Areas of Focus

• ESG is now global
  – Regulators, investors and NGOs are developing and adopting disclosure frameworks for a range of considerations, such as:
    – Climate change and greenhouse gas ("GHG") emissions
    – Diversity, equity, and inclusion ("DEI")
    – Supply chains (both respect to the “E” and the “S”)

• ESG-related disclosures continue to become more mainstream
  – Also subject to scrutiny from both regulators and private litigants

• Anti-greenwashing efforts are taking center stage
  – Regulatory action and litigation are on the rise

• Backlash against ESG is trending in the U.S., where it has become a political hot-button issue
Climate Disclosure
Focus: *Current Regulatory Framework*
Key Climate Disclosure Frameworks

• Third-Parties, Investors and NGOs
  – Task Force on Climate-related Financial Disclosures (TCFD)
  – Sustainability Accounting Standards Board (SASB) and International Sustainability Standards Board (ISSB)
  – Global Reporting Initiative (GRI)
  – CDP (formerly Carbon Disclosure Project)
  – Science-Based Targets Initiative (SBTi)

• U.S. Federal Regulatory Efforts
  – Securities and Exchange Commission (SEC) Climate Proposal
  – FAR Council Climate Proposal for Major and Significant Federal Suppliers
  – SEC Proposal on Investment Companies and Advisers’ Use of ESG Factors
The SEC on Climate and ESG

January 2010
SEC issues interpretive guidance on climate disclosures

March 2021
SEC announces formation of an Enforcement Task Force focused on climate and ESG issues

March 2022
SEC proposes rule on climate change disclosure

September 2021
SEC posts sample comment letters addressing specific climate-related risk disclosures
Overview of SEC Climate Proposal

• In March 2022, the SEC proposed rules that seek more “transparency, comparability and reliability” in climate-related disclosures

• SEC signaled that climate-related information is material and necessary to make an informed investment decision

• Two prong approach:
  – **Qualitative**: Climate Risks, Management, Targets, Governance
    – TCFD - Widely-used disclosure framework
  – **Quantitative**: Climate Metrics on GHG emissions
    – Greenhouse Gas Protocol Framework - Scopes 1, 2, and 3 GHG reporting framework
SEC Climate Proposal
Prong 1 (Qualitative): “Climate-related Disclosure” Section

- Actual or likely *material impact of climate-related risks on the company’s financial statements, business operations, or value chain*, including:
  - *Physical Risks* – Both “acute” and “chronic”
  - *Transition Risks* – The change-over to a less carbon intensive economy
- Impact on Strategy, Business Model, Outlook
- Climate-Related Risk Management – process for identifying, assessing, and managing risks
- Climate Targets or Goals, and Transition Plan – *if applicable*
- Any analytical tools used to assess climate risks (e.g. *scenario analysis* or *internal carbon pricing*)
- Opportunities – such as clean energy infrastructure and investments
SEC Climate Proposal

Discussion of Climate-Related Governance

• Board Oversight
  – Identify members that oversee climate risks and their climate expertise
  – Processes for, and frequency of, climate risk discussions
  – How Board considers climate strategy, risk-management and financial oversight, including setting any climate targets or goals

• Management Oversight
  – Identify positions or committees dedicated to climate risks
  – Extent of climate expertise
  – Whether/how frequently report to the Board
SEC Climate Proposal
Prong 2 (Quantitative): Climate Metrics - GHG Data

• Calculate and disclose, in detail:
  – Scope 1 - Direct GHG emissions
  – Scope 2 - Indirect, from purchased electricity and other energy
  – Scope 3 - Indirect, upstream and downstream in value chain
    • If (1) material, or (2) have GHG target/goal that includes Scope 3
    • Safe Harbor liability protection applies (i.e., no reasonable basis or bad faith required for liability)

• Attestation Report by an independent attestation provider
  – Covering Scope 1 and Scope 2
SEC Climate Proposal

Audited Financial Statements – Required Notes

- For each total line item for which there is an impact of 1% or greater
  - *Examples*: Revenue; general and administrative expenses; sale of property (in statement of cash flows); contingent liabilities
- Disaggregated climate risks and cost impact on line items
- Financial estimates and assumptions
- Audited by an independent registered public accounting firm
SEC Climate Proposal

Timeline

- Phase-in timeline depends on status of filer *(as originally proposed)*

<table>
<thead>
<tr>
<th>Registrant Type</th>
<th>Disclosure Compliance Date (assuming proposal finalized “as-is” Spring 2023)</th>
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<tbody>
<tr>
<td></td>
<td>All proposed disclosures, incl. Scope 1 and 2 GHG metrics, but not Scope 3</td>
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<tr>
<td>Large accelerated filer</td>
<td>Fiscal year 2024 (filed in 2025)</td>
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<tr>
<td>Accelerated filer and non-accelerated filer</td>
<td>Fiscal year 2025 (filed in 2026)</td>
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<tr>
<td>Smaller reporting company</td>
<td>Fiscal year 2026 (filed in 2027)</td>
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<td></td>
<td>Exempt</td>
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- The proposal also contemplates a *phase-in for attestation/assurance requirements*
  - Limited assurance one fiscal year after initial climate disclosures (i.e., same timeframe as Scope 3 disclosures)
  - Reasonable assurance after two additional fiscal years
  - SRCs would be exempt from the assurance requirement
FAR Council Climate Proposal

• In November 2022, FAR Council proposed climate-related amendments to the Federal Acquisition Regulation for major federal suppliers

• The proposal defines two levels of impacted suppliers:
  – **Significant Contractors:** Receive at least $7.5 million in annual federal obligations
  – **Major Contractors:** Receive more than $50 million in annual federal obligations
FAR Council Climate Proposal

• Significant and Major Contractors would be required to:
  – Measure and report **Scope 1** and **Scope 2** emissions

• Major Contractors would also be required to:
  – Measure and report **Scope 3** emissions
  – Submit an annual climate disclosure by completing **TCFD**-aligned portions of **CDP** climate change questionnaire
  – Develop and validate emissions reduction targets via the **Science-Based Targets Initiative**
  – Publish such disclosure and targets on a public website
Climate Disclosure – Outlook

• SEC climate rule expected to be finalized by year-end
  – Legal challenges to climate rule are expected

• SEC will continue to scrutinize climate commitments and disclosures regardless of whether rule is adopted

• Federal government continues to take an all-of-government approach to GHG reductions
Heightened SEC Scrutiny and Greenwashing
SEC and ESG: Current Regulatory and Disclosure Framework

- Demand for information by investors is now driving disclosure
- SEC follows long-standing principles of disclosure and fiduciary duty
- Materiality-based approach by SEC in the past
- Active regulatory and enforcement agendas
  - Exam priorities and risk alert warning against “greenwashing” and misstating sustainability practices
  - Division of Enforcement’s Climate and ESG Task Force
  - Proposed Rules on Climate-Related Disclosure for Public Issuers and ESG Disclosures by Investment Advisers and Registered Funds
SEC v. Vale

- Vale S.A., publicly-traded mining company, charged for alleged false and misleading ESG disclosures about the safety and risks associated with dam collapse causing hundreds of casualties and alleged substantial environmental harm
- Claims predicated on ESG statements in annual sustainability reports, such as Vale’s adherence to “strictest international practices” in evaluating dam safety
- Complaint identifies other alleged false and misleading statements in investor presentations, president and CEO public comments to investors, and on webinar posted on company’s website
- All disclosures—required or voluntary—are fair game!
Heightened SEC Scrutiny

• Since 2020, the SEC has emphasized that ESG-related issues are important to investors
  – “The use of ESG-related disclosures has gone from a fringe concept to a mainstream, global investment and geopolitical priority.”
    Investor-as-Owner Subcommittee of the SEC Investor Advisory Committee (May 14, 2020)

• In 2021, the SEC signaled that ESG disclosure would be an enforcement priority

• Perceived material misstatements or omissions relating to ESG disclosures can give rise to an SEC civil action under Section 10(b) of the Exchange and Rule 10b-5

• Such disclosures or omissions can also be the subject of a private action
  – Section 11 of the Securities Act provides for a private right of action if a company’s registration statement for a public offering either contains an untrue statement of a material fact or omits a material fact that renders a statement made misleading
Shift in Approach in ESG Disclosure

• While companies continue to include ESG disclosures in SEC filings, company websites, press releases, and standalone Corporate Social Responsibility ("CSR") reports, there has been a shift in the approach to ESG disclosure
  – Previously, when ESG became a “hot topic” companies took the “everything-but-the-kitchen-sink” approach and highlighted everything and anything they could
  – Now, companies must be intentional and cautious in their ESG disclosures
• SEC v. Vale SA demonstrates the SEC’s commitment to identify false and misleading ESG disclosure, requiring companies to bring a heightened level of rigor into their ESG reporting and putting companies on notice that the SEC will not hesitate to prosecute companies that engage in greenwashing
Anti-ESG Landscape
The ESG Debate

• ESG investing has become embroiled in the so-called “culture wars”

• Facing challenges at three levels:
  – Federal legislative
  – Federal judicial
  – State regulatory

• Uniquely American phenomenon

• Puts asset managers and fiduciaries “between a rock and a hard place”
Panel Discussion

Practical Considerations in the ESG Space
Appendix
What is ESG?

ESG refers to Environmental, Social and Governance

- **Environmental**: how a company obtains, uses, and affects natural resources. Topics covered may include water usage, waste disposal, air emissions, climate change, scarce resources, and impact on natural habitats and biodiversity.

- **Social**: how a company interacts with or affects individuals or groups of people, communities, and humanity. Topics may include labor relations, workforce diversity, safe working conditions, product safety, employee health, community development, human rights, conflict minerals, and related supply chain matters.

- **Governance**: how a company conducts business in an ethical manner and has robust oversight functions in place. Topics may include board and management diversity and engagement, pay equity, supply chain engagement, shareholder access, and political contributions.
ESG Basics – The Foundation

Decades of History & Related Concepts

- Socially Responsible Investing (SRI)
- Corporate Social Responsibility (CSR)
- Impact Investing - financial returns plus measurable impact on ESG
- International and Development Finance Institutions (IFIs/DFIs) ESG frameworks
- Thematic and mission-oriented investment funds
Current ESG Areas of Focus

- Climate change
- Supply chain and labor
- Human capital management
- Diversity, equity & inclusion
- Social initiatives
- Community and philanthropic endeavors
- Risk management of ESG and Board oversight of ESG
- Executive compensation ESG metrics
**GHG Disclosure - “Scopes”**

<table>
<thead>
<tr>
<th>Scope 1</th>
<th>Scope 2</th>
<th>Scope 3</th>
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<tr>
<td><strong>“What you burn”</strong></td>
<td><strong>“What you buy”</strong></td>
<td><strong>“Everything else”</strong></td>
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</table>
| Scope 1 emissions are direct GHG emissions that occur from sources that are controlled or owned by an organization (e.g., emissions associated with fuel combustion in boilers, furnaces, vehicles) | Scope 2 emissions are indirect GHG emissions associated with the purchase of electricity, steam, heat, or cooling | Scope 3 emissions are the result of activities from assets not owned or controlled by the reporting organization and include all sources not within an organization’s scope 1 and 2 boundary

➢ The Scope 3 emissions for one organization are the scope 1 and 2 emissions of another organization (e.g., a supplier)

➢ Scope 3 emissions, also referred to as value chain emissions, often represent most of an organization’s total GHG emissions
Potential ESG Risks

- Lack of measurability and reporting standards
  - No equivalent of GAAP for ESG measurement and reporting
- Greenwashing concerns
  - The SEC is focused on companies that tout ESG commitments but provide limited (or no) information as to how they plan to accomplish such commitments
  - Consumers are bringing class action and tort actions for packaging and advertising claims
- Litigation/activist campaigns from stockholders over alleged breach of fiduciary duties for failing to maximize profits or litigation/activist campaigns from other stakeholders (e.g., consumers/advocacy groups) over allegedly false or misleading statements concerning ESG commitments
- Proxy contests over ESG issues
Potential ESG Risks (cont.)

- Risk that consumers/stockholders will bring lawsuits alleging that ESG-related statements violate state or federal law
  - Claims may allege fraud and breach of fiduciary duty
  - Typically grounded in misstatements, not omissions, of information
  - Claims may relate to:
    - Supply chain
    - Board diversity
    - #MeToo
Aspirations v. Firm Commitments

• Generally, aspirational language is less susceptible to claims than firm commitments
  – Courts have found aspirational statements such as “Sustainability Meets Style” to be nonactionable
  – Contrast this with allegations brought that related to a company’s specific statement that its fur sourcing was “ethical, responsible and sustainable”
ESG Legislation State Tracker Map
The debate over ESG investing at the state and federal levels is rooted in the same underlying issue:

Are fiduciaries considering ESG factors because they prudently believe that those factors are appropriate financial considerations?

Alternatively, are fiduciaries considering ESG factors because of certain ethical or moral beliefs about certain industries and political attitudes?
The Role of States

• State and local governments play an increasing role in ESG efforts because IRA funds are largely distributed to them as block grants

• Primary focus has been on national bank asset managers – now expanding much further

• Risk of being on “wrong” side of a given state’s political perspective is loss of business or debarment
Takeaways

• Important that public disclosures relating to ESG – whether in an SEC-filed document or otherwise – are thoroughly vetted and can be backed up

• The SEC will continue to scrutinize broad statements of commitment without any disclosure as to actionable plans

• Carefully manage ESG-related initiatives, performance and disclosures against the backdrop of potential books and records demands

• Consider aspirational statements vs. firm commitments