SULLIVAN & CROMWELL LLP

# ESG Trends and Hot Topics

July 2021

**Key Developments**

*Hot topics in ESG for directors and executives to consider:*

- Regulators and investors are focused on ESG-related disclosure requirements, particularly on climate change and board and workforce diversity. Requirements are likely to be extended to US public companies and US investment funds, as well as private companies and subsidiaries operating in the EU and UK.
- The risk of ESG-related litigation, regulatory action and shareholder proxy battles continues to grow. Companies should comprehensively review their ESG-related strategy and disclosure, including in materials not filed with authorities or used in securities offerings.
- The global sustainable finance market is likely to be significantly boosted by new central bank and regulatory actions, but more rigorous criteria for ESG-labeled products are also being implemented. Companies should consider relevant opportunities to participate in this market.
- Financial regulators are focusing on climate risk management and climate change's effects on financial stability. Financial institutions should assess their current approach to climate risks and opportunities and prepare for related new requirements and supervisory expectations.

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## Disclosure and Governance Updates

### ***United States***

**SEC to Enhance Climate Risk Disclosure Requirements.** The SEC intends to draft by the end of the year a proposal for new rules requiring disclosure of registrants' climate-related risks. The new rulemaking will be informed by feedback to the SEC's wide-ranging request in March for public input on new climate risk disclosure requirements. SEC Chairman Gary Gensler noted in public remarks on July 28 that climate-related disclosures should be mandatory and contain sufficient detail for investors to gain consistent, comparable and "decision-useful" information on the climate risk of companies in which they might invest. Chair Gensler's July remarks suggested that the SEC's approach will be informed by, but distinct from, existing international standards, such as those published by the Task Force for Climate-related Financial Disclosure (TCFD). S&C's memo on Chair Gensler's July remarks is available here, and S&C's memo on current climate disclosure requirements and the SEC's March solicitation is available here.

**SEC Plans Further Rules for Human Capital Management (HCM) and Board Diversity Disclosure.** The SEC is also intending to propose new rules by October 2021 aimed at enhancing disclosure related to HCM and the diversity of board members and nominees. In a June speech, SEC Chairman Gensler said that new HCM rules could include metrics such as workforce turnover, skills and development training, compensation, benefits, workforce demographics (including diversity), and health and safety. This proposed rulemaking would supplement August 2020 amendments to Regulation S-K requiring disclosure of registrants' human capital resources. An analysis of disclosures under the amended Regulation S-K shows substantial variation in the depth and specificity of companies' HCM disclosure. S&C's memo on the August 2020 amendments is available here.

**SEC Decision on Nasdaq's Board Diversity Proposal Expected in August.** In February 2021, Nasdaq filed with the SEC an amended proposal aimed at increasing board diversity. The SEC's final decision on the amended rules is expected by August 7, 2021. The new rules would require most Nasdaq-listed U.S. companies to have, or explain why they do not have, at least two diverse directors, including (i) one director who self-identifies as female and (ii) one director who self-identifies as an underrepresented minority or as LGBTQ+, within a two-to-five-year phase-in period. Non-US issuers, smaller companies and companies with five or fewer directors would have to meet (or explain why they do not meet) somewhat less stringent requirements. S&C's memo on the initial rule proposal and trend towards requiring greater board diversity is available here.

**Proposed U.S. Legislation Would Increase Disclosure Mandates.** The US Senate and House of Representatives are currently considering multiple bills that could increase companies' obligations to disclose ESG-related metrics. On June 16, 2021, the House passed H.R.1187, the Corporate Governance Improvement and Investor Protection Act, which would require SEC registrants to disclose information on climate risks and GHG emissions, political activity expenditures, executive pay increases, board cybersecurity expertise, board and executive diversity and other ESG-related metrics. However, the bill is unlikely to be passed by the Senate in its current form.

## ***European Union***

On July 6, 2021, the European Commission adopted a new sustainable finance strategy aiming to channel private finance into economic activities relevant to the EU's environmental and sustainability goals. The plan largely reinforced existing initiatives and proposals (several of which are highlighted below), with an emphasis on implementing the so-called 'double materiality' concept, which requires companies to assess and disclose both the sustainability-related business and financial risks faced by the company and the impact of the company's activities on the environment and society.

**EU Moves Ahead with EU Taxonomy Disclosure Requirements.** In July 2021, the European Commission adopted a delegated act under Article 8 of the EU Taxonomy Regulation to require disclosure by large companies, banks, asset managers and insurers of certain KPIs quantifying the proportion of environmentally sustainable economic activities in their business, investments, lending or underwriting activities. The disclosure obligations will begin to be phased in from January 1, 2022 for the 2021 reporting period. S&C's memo on Article 8 and the Taxonomy KPIs is available here.

**EU Proposes Corporate Sustainability Reporting Directive.** In April 2021, the European Commission adopted a proposal for a Corporate Sustainability Reporting Directive (CSRD) that would require substantially all large or listed companies, banks, asset managers and insurers in the EU to report in alignment with a new EU sustainability reporting standard. The CSRD would also, for the first time, introduce an audit requirement for reported sustainability information. The new reporting standard could be adopted as early as 2022, and companies would then be required to apply the standards beginning with reports covering financial year 2023.

**New EU Measure Expected on Human Rights and Corporate Due Diligence.** The European Commission is expected to publish a new proposed directive on mandatory human rights and environmental supply chain due diligence. A broadly worded proposal on the directive was adopted by the European Parliament in March 2021, which would require that companies undertake ongoing global due diligence on potential or actual adverse impacts on human rights, the environment and good governance across their value chain and require EU member states to ensure that companies can be held liable and be required to remediate any harm arising out of such adverse impacts. S&C's memo on the European Parliament's proposal is available here.

## ***UK***

**UK Proposes Expansion of TCFD-Aligned Disclosure Requirements.** In May 2021, the UK's Department for Business, Energy & Industrial Strategy (BEIS) closed a public consultation on proposals for implementing mandatory TCFD-aligned disclosures by 2022 for all UK-listed companies, large private companies and limited liability partnerships. Regulations on the TCFD mandate are expected by the end of 2021 to apply for accounting periods starting on or after April 6, 2022. Similarly, in June 2021, the UK's Financial Conduct Authority published new proposals to require issuers of standard listed equity shares to either provide TCFD-aligned disclosure or explain why such disclosure is not provided, a requirement that has applied to premium listed companies since January 2021. The FCA's public consultation also addresses whether

asset managers, life insurers and FCA-regulated pension providers should be required to provide TCFD-aligned disclosures.

### *Hong Kong*

**Hong Kong Targets Enhanced Board Diversity, TCFD Adoption.** In April 2021, the Hong Kong Stock Exchange (HKEx) issued a consultation paper seeking to strengthen its corporate governance rules' ESG-related requirements, including a proposal to require that HKEx-listed issuers eliminate single-gender boards within three years and disclose targets and timelines for achieving board- and workforce-based gender diversity. HKEx also noted that it will provide issuers additional guidance on TCFD adoption, following an announcement in December 2020 by Hong Kong's Securities and Futures Commission that it plans to mandate TCFD-aligned climate-related disclosures by 2025.

## Shareholder Activism and Institutional Investor Updates

**US Proxy Proposals on Climate and Diversity Substantially Increase.** A record eleven climate-related Rule 14a-8 shareholder proposals and eight shareholder proposals related to workforce and board diversity were passed at S&P 1500 US companies in 2021. The success of ESG-related proposals comes as prominent institutional investors and proxy advisors have updated their climate- and diversity-related voting policies to address the quality of boards' oversight of related risks. Our annual proxy season review covering this year's shareholder proposals is available here. S&C's overview of recent changes to major investor and advisor voting policies is also available here.

## Litigation Developments

**Uptick in Derivative Litigation on Workplace Matters.** Corporate stockholders have filed a range of derivative actions in the US alleging inadequate board efforts to promote gender and racial diversity in the workplace. Several courts have held that such diversity-related derivative litigation was barred by plaintiffs' failure to demonstrate that a majority of directors were conflicted from deciding whether to pursue the claims. However, Alphabet, Inc. agreed to settle a derivative suit alleging that the directors violated their fiduciary duties by, among other actions, fostering a corporate environment permissive of sexual harassment and discrimination. Pursuant to the settlement, Alphabet set aside $310 million to promote diversity, equity, and inclusion at Google. *In re Alphabet S'holder Derivative Litig.*, Case No. 19-cv-341522 (Cal. Super. Ct., Santa Clara Cnty.).

**US False Advertising Lawsuits Rise for Sustainability-Related Claims.** Several recent cases have been brought by private plaintiffs against companies in US state courts under state consumer protection laws for false or misleading sustainability-related claims, including claims filed in June 2021 against Red Lobster in California and Coca-Cola in the District of Columbia. In addition, environmental groups brought false advertising claims against Chevron in March 2021 before the Federal Trade Commission. These cases are in the early stages thus far.

**US Climate-Change Lawsuits Reach Supreme Court.** A growing number of US state and local governments have sued oil and gas companies seeking to hold them liable for alleged damage caused by climate change. Nearly all cases have been filed by plaintiffs in state courts because such suits have met limited success in federal courts applying more restrictive federal laws. Defending companies often then seek to remove cases to

federal court. In a setback to plaintiffs, the Supreme Court's May 2021 decision in *BP P.L.C.* v. *Mayor & City Council of Baltimore* broadened the scope of appellate review of federal court orders remanding such cases back to state court.

**Dutch Court Requires Shell to Reduce Emissions.** In May 2021, the Hague District Court ruled that Royal Dutch Shell was required to reduce Shell group carbon emissions activities by 45% by the end of 2030 as compared to 2019 levels. This is the first case in which a court has imposed a legal obligation on a private company to reduce carbon emissions. The court based its ruling on the Dutch Civil Code's unwritten standard of care, referencing as well standards set by international agreements including the UN Guiding Principles on Business and Human Rights and the Paris Agreement. Shell announced in July 2021 that it is appealing the ruling.

## Sustainable Finance Developments

**Updates to ICMA Principles for Green, Social and Sustainability Bonds.** In June 2021, the International Capital Market Association (ICMA) published updated principles for green bonds, social bonds and sustainability bonds. Although voluntary, the ICMA standards have been widely adopted in the global bond markets as a baseline standard. The 2021 updates were modest, with the key changes being the addition of recommendations that issuers adopt a green/social/sustainability bond framework and obtain external review(s) to confirm that their framework is aligned with ICMA standards and that, post-issuance, bond proceeds have been allocated in accordance with their framework. Both of the recommendations already reflect current market practice for the vast majority of issuers.

**Updated EU Green Bond Standard Released.** In July 2021, the European Commission published its proposal for a voluntary EU Green Bond Standard (EU GBS), usable by EU and non-EU issuers. The EU GBS would require that proceeds be allocated fully to assets and expenditures that qualify as sustainable under the EU Taxonomy, in contrast to the ICMA Principles, which allow flexibility in what an issuer identifies as a "green" use of proceeds. Issuers would also be required to obtain a pre-issuance external review of the bond's Taxonomy alignment and to prepare and obtain a post-issuance review of a report on the bond's use of proceeds once they are fully allocated. Unlike the ICMA Principles, reviewers of EU GBS bonds must be registered with and supervised by the European Securities and Markets Authority (ESMA). The Commission's EU GBS proposal will next be submitted to the European Parliament and the Council of the European Union for consideration.

**Launch of New and Revised ESG Loan Principles.** In April 2021, the LMA, LSTA and APLMA, loan market trade associations in the US, UK and Asia, launched inaugural voluntary Social Loan Principles for loans used to exclusively finance or re-finance projects that address a specific social issue and/or seek to achieve positive social outcomes. The social loan principles are modeled on the existing LMA/LSTA/APLMA Green Loan Principles (which were in turn modeled on the ICMA's green and social bond principles). In May 2021, the LMA, LSTA and APLMA launched updated voluntary Sustainability Linked Loan Principles to encourage additional borrower accountability. In a sustainability-linked loan, the loan's economic terms are linked to the borrower's performance against pre-selected KPIs addressing relevant ESG challenges. The updated principles require borrowers to obtain independent verification of their performance against the selected KPIs.

**Central Banks Prioritizing Climate-Friendly Assets.** In July 2021, both the European Central Bank and the Bank of Japan (BOJ) announced that they would begin providing targeted support for private sector efforts to address climate change. The ECB said that it would integrate climate change considerations into its monetary policy framework, including considering issuers' alignment with climate-related EU legislation in its allocation of corporate bond purchases. The BOJ announced that it would launch a lending program likely within 2021 to provide funds at zero interest rate to financial institutions supporting efforts to address climate change. The BOJ also announced it would begin buying non-Yen-denominated green bonds issued by foreign governments and institutions.

## Financial Institutions Developments

**Increasing US and International Regulatory Focus on Climate-Related Financial Risk.** In May 2021, US President Joe Biden issued an executive order on climate-related financial risk directing the US Treasury Secretary, in her capacity as the chair of the US Financial Stability Oversight Council (FSOC), to engage with FSOC members (including US federal and state financial regulators) to assess the climate-related financial risk to the financial stability of the US federal government and the US financial system. In July 2021, the international body Financial Stability Board (FSB) released three climate-related reports, including a roadmap for addressing climate-related financial risks. The FSB noted that actions under the roadmap seek to ensure that all financial risk decisions appropriately take account of climate change. The FSB also emphasized the need for globally consistent and comparable disclosures of companies' climate-related financial risks, recommending in particular use of a framework based on the TCFD recommendations. Already, the ECB, Bank of England and certain other central banks and bank regulators have introduced climate stress tests for supervised entities.

## Investment Funds and Asset Management Developments

**US SEC Sharpens Oversight of ESG Investments.** The SEC is increasingly focused on accountability of asset managers promoting ESG-aligned investment products and strategies and recently announced that it is considering proposing, by April 2022, requirements for investment companies and investment advisers related to ESG factors, including ESG claims and related disclosures. Recent SEC publications and commissioner statements suggest areas of future regulatory focus for investment funds include: reviewing the adequacy of disclosures around ESG strategies, ensuring that funds' processes and practices match their disclosures, reviewing marketing materials for false and misleading statements and ensuring that proxy voting policies align with the funds' stated strategies. In particular, in his July 2021 comments, SEC Chairman Gensler noted that, in light of the significant growth in the number of funds marketing themselves as "green" or "sustainable," which have no standardized meanings in the US market, updates to fund disclosures and naming conventions could bring needed transparency to the asset management industry. The SEC's heightened focus follows action by the EU (under the Sustainable Finance Disclosure Regulation) and the UK FCA to introduce disclosure obligations for ESG-focused investment funds.

**Expected US DoL Rulemaking Related to Plans' ESG Investments.** In March 2021, the US Department of Labor's (DoL) Employee Benefits Security Administration (EBSA) announced that it would not enforce two rules promulgated by the Trump Administration in 2020, which according to the EBSA have created a perception that ERISA plan fiduciaries are at risk if they include any ESG factors in the financial evaluation of plan investments. In May 2021, the Secretary of Labor was directed by US President Joe

Biden's executive order to consider publishing, by September 2021, a proposed rule to "suspend, revise, or rescind" these two rules.

## Insurance Sector Developments

**NYDFS Looks to Finalize Climate Guidance for Insurers.** In March 2021, the New York Department of Financial Services, the state's insurance regulator, issued proposed guidance for insurers on managing the financial risks from climate change. The guidance is the first climate-related guidance issued by a US insurance regulator and includes expectations for governance, business models and strategies, risk management, scenario analysis and public disclosure. The proposed guidance is expected to be finalized by the end of the third quarter of 2021. S&C's memo on the proposed guidance is available here.

**EU, UK and France Issue New Climate-Based Insurance Regulations.** European and UK regulators are promulgating multiple new disclosure requirements and proposed stress tests applicable to insurers operating in those jurisdictions. The new delegated act adopted in July 2021 under Article 8 of the EU Taxonomy, as discussed above, requires insurers/reinsurers to disclose certain KPIs quantifying the portion of their investments and underwriting activities that qualify as sustainable under the EU Taxonomy. In addition, as regulators globally prepare climate-related stress tests for financial institutions, the Bank of England's Biennial Exploratory Scenario, launched in June 2021, and the French Prudential Supervision and Resolution Authority's Assessment, published in May 2021, have assessed the financial resiliency of insurers to certain climate scenarios.

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