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ESG Integration: A Value Proposition, not a Values Imposition

We began the year with the view that 2020 could very well be the break-out year for ESG. Then the pandemic spread, the global economy ground to a halt under worldwide shelter-in-place mandates, and in the US, racial strife not seen since the birth of the civil rights movement in the 1960s became top of mind in a presidential election year. Contrary to some early predictions that these superseding events would dissipate the ESG and climate-related initiatives that began gathering steam in 2019, recent developments, however, belie those predictions. In this review of recent developments in ESG we begin with the latest development.

Following the Labor Day holiday weekend in the US, the Market Risk Advisory Committee of the US Commodities Futures Trading Commission ("CFTC") issued a somewhat surprisingly progressive and forward-looking report produced by the Climate-Related Market Risk Subcommittee (the "Report"). It is surprisingly progressive in light of the general hostility of the current US administration to climate-related issues in particular and ESG in general. Among the Report's key findings:

- Climate change poses a major risk to the stability of the US financial system and to its ability to sustain the American economy.
- This reality poses complex risks for the US financial system (e.g., disorderly price adjustments in various asset classes and associated knock-on impacts, physical and transition risks).
- Although put differently, with respect to climate impact, the Report states that Regulators are concerned as much about unknown unknowns as they are about known unknowns to borrow a turn of phrase made famous by former Secretary of Defense Donald Rumsfeld.
- US financial regulators must recognize that climate change poses serious emerging risks to the US financial system, and they should move urgently and decisively to measure, understand and address these risks.
- The US financial community can and should be proactive in providing solutions and be a catalyst for investments that accelerate economic resilience and transition to a net-zero emissions economy. The Report states that, "Financial innovations, in the form of new financial products, services and technologies, can help the US economy better manage climate risk and help channel capital into technologies essential for the transition."
- The Report asserts that regulators should be concerned with climate-related "sub-systemic" shocks — meaning shocks that impact a particular sector, asset class or region of the country, although not threatening the stability of the entire financial system can still have serious impacts — think California wildfires or hurricane damage.
- Regulators and market participants are still in the early stages of understanding and experimenting with how best to monitor and manage climate risk, especially in light of insufficient data and analytical tools, a critical constraint.
- Exacerbating progress is the lack of common definitions and standards for climate-related data and financial products that impair the ability of market participants and regulators to monitor and manage climate risk.
- Corporate disclosure of information on material, climate-related financial risks is an essential building block to ensure that climate risks are measured and managed effectively.
- The absence of an economy-wide carbon pricing regime in the US and other barriers (including the "misperception" that ESG trades off financial returns relative to traditional investment strategies) are holding back capital from flowing to sustainable, low-carbon activities.

The CFTC Report's Key Recommendations:

The Report outlines 20 recommendations, the highlights of which include:

- The US should establish a price on carbon that must be fair, economy-wide and effective in reducing emissions consistent with the Paris Agreement. "This is the single most important step to manage climate risk and drive the appropriate allocation of capital." It is Recommendation Number One.
- All relevant federal regulatory agencies should incorporate climate-related risks into their mandates and develop a strategy for integrating these risks in their existing monitoring and oversight functions.
- US regulators should join, as full members, international groups convened to address climate risk — think Paris Agreement, among others.

- Financial regulators should coordinate with the private sector to develop US-appropriate standards and classification systems or taxonomies for physical and transition risks, exposure, sensitivity, vulnerability, adaptation and resilience that span asset classes and sectors.
- Financial regulators should clarify the definition of "materiality" for disclosing medium- and long-term climate risks and then make disclosure of material climate risks mandatory under law.
- Public companies should be required to disclose Scope 1 and Scope 2 emissions.
- Without making a direct reference to the Department of Labor's contrary guidance, the Report recommends that the US and financial regulators review relevant laws, regulations and codes and provide any necessary clarity to confirm the appropriateness of making investment decisions using climate-related factors in retirement and pension plans covered by ERISA, as well as non-ERISA plans with an ERISA-style fiduciary obligation. The Report writes: "This should clarify that climate-related factors—as well as ESG factors that impact risk-return more broadly—may be considered to the same extent as 'traditional' financial factors, without creating additional burdens."

Discussion:

a) US public and private initiatives

The Report is by far the most detailed and progressive report issued by a US regulatory agency under the current administration with respect to climate change, which has generally been at best disinterested and at worst hostile to the notion of climate change and the impact of climate change on the financial system, not to mention on the planet and people. The Report is 190+ pages long. While perhaps none of the findings and key recommendations will be entirely new or original to thoughtful followers of climate science and sustainability, the Report nevertheless provides a thorough treatment of the complexity and scope of the topic, and importantly as a committee of a key US government regulator, it expressly recognizes the threat that climate change poses to the US financial system, which by extension implies a threat to the global financial system.

The Report comes in the wake of a letter addressed to Federal Reserve chairman Jerome Powell earlier this summer written by a bipartisan group of 72 public and private sector leaders including investors with nearly $1 trillion in assets. The letter calls for the Fed to take action on climate change, noting that the climate crisis "poses a systemic threat to financial markets and the real economy." Perhaps prescient of the CFTC's Report last week, the letter echoes the Report's key recommendation that the Fed must "implement a broader range of actions to explicitly integrate climate change across [the Fed's] mandates."

The Letter, which was organized by Ceres, a sustainability nonprofit organization, is yet another example of the growing concern and yes, actual activism, demonstrated by leaders of the business community including (perhaps most loudly) from the financial sector. The CFTC Report comes within a few weeks of the anniversary of the Business Roundtable's (the "BRT")(a group of CEOs from America's largest corporations) highly publicized (and hotly debated in some circles) restatement of the Purpose of a Corporation. The BRT's restatement on the Purpose of a Corporation was signed by 181 CEOs, all of whom have committed to lead their companies for the benefit of all stakeholders — customer, employees, suppliers, communities and --- wait for it --- shareholders. The BRT statement is obviously broader than addressing climate change, but its concern for climate is expressed by one of its core commitments: "Supporting the communities in which we work. We respect the people in our communities and protect the environment by embracing sustainable practices across our businesses."

b) Au courant in Europe

While the trend stateside in climate change and sustainability generally is clearly visible and moving upward albeit in seemingly fits and starts, the trend has established a firm foothold in the EU, where a trio of climate- and sustainable-related regulations have been promulgated during the past year, with the first effective date scheduled to come into effect as soon as March 10, 2021, in the form of Regulation (EU) 2019/2088 on Sustainability-related disclosures in the financial services sector (the "Sustainable Finance Disclosure Regulation" or "SFDR"). As a "regulation" and not an EU "Directive," the force of law is effective on the scheduled date without the need for member states to pass conforming legislation.

While a more detailed analysis of the SFDR and its associated regulatory technical standards ("RTS") can be put aside for another time, suffice it to say, that the SFDR will be imposing significant disclosure requirements and have important implications for asset managers and funds established or marketed in the EU (and in Switzerland and the UK, which despite Brexit, has largely adhered to the EU regulatory standards with respect to the financial sector). The aim of the SFDR is to strengthen protection for end-investors, improve disclosures to investors with enhanced disclosure obligations implicating a broad range of financial market participants, including UCITS, AIFs and their management companies and investment managers. Financial market participants will be required by March 10, 2021 to ensure their communications, organizing documents (including Prospectuses and KIIDs), websites and marketing communications are SFDR-compliant.

The overarching principle underlying the SFDR is the notion, embedded in the Regulation, that financial market participants and financial advisers broadly defined have a fiduciary duty to integrate in their processes, including in their due diligence processes, to "assess on a continuous basis not only all relevant financial risks but also including all relevant sustainability risks that might have a relevant material negative impact on the financial return of an investment or advice. Therefore, financial market participants and financial advisers should specify in their policies how they integrate those risks and publish those policies."

The notion that sustainability assessment is part of an investment manager's fiduciary duty as stewards of assets on behalf of their clients is in sharp contrast to the approach by the US Department of Labor ("DOL"), which earlier this summer issued a proposed regulation defining pension plan fiduciaries under the Employee Retirement Income Security Act of 1974 ("ERISA"), which many read to be discouraging plan fiduciaries from taking ESG into consideration in making investment decisions as well as adding new recordkeeping requirements setting forth how plan fiduciaries can meet their fiduciary obligations when making ESG investments. The proposal met with widespread objections from both retail and institutional investors during the comment period. Comments from a variety of investors criticized the proposed regulation as being out of touch with current reality and manifesting a serious misunderstanding of the concept of integrating ESG into the investment process. Many of the comments pointed to recent studies that have shown a significant correlation between positive investment performance and ESG. As of the end of Q1 2020, the Investment Company Institute reported total US retirement assets at $28.7 trillion and accounted for a third of all household financial assets in the United States — a significant portion of which are governed ERISA regulations as interpreted by the DOL. With respect to retirement assets both directly and not directly governed by ERISA, the fear is that the recent DOL posture will have a chilling effect on the financial industry's progress toward ESG integration, which already significantly lags European private and public initiatives.

c) It's the investor, stupid!

Perhaps what is most tone deaf about the proposed DOL regulation is the failure to recognize that ESG integration and sustainable investing is ultimately investor driven. It is not an urge by investment managers and investment product manufacturers to impose a moral or idealistic set of values on their clients and investors. In short, ESG integration in the investment process is a value proposition not a values imposition. Reuters reported just last week that, "In a year shaped by health and economic crises, investors increased support for shareholder proposals that back environmental and social causes, according to data that experts say indicates a trend that will likely intensify in 2021." The article further reported that shareholders of large fund complexes including Blackrock and Vanguard supported more than twice the number of environmental and social-oriented shareholder proposals during the 2020 annual meeting season compared to last year. At the Chevron annual meeting this year over 53% of the shares voted in support of a proposal calling for Chevron to report on climate lobbying aligned with the Paris Agreement.

Morningstar reported that investment flows to sustainable funds in the United States including ESG-integration, impact and Sustainable Sector funds, continued at a record pace in Q2 2020 with an estimated flow of $10.4 billion, which nearly matched inflows in Q1 bringing estimated total to nearly $21 billion in the first half of 2020. The total investment in sustainable funds in all of 2019 was a then record $21.4 billion, which itself was four times the previous record year, according to Morningstar. While most of those flows were into equity funds, the depth and trend of the ESG movement can reasonably be expected to spill over to other asset classes over time — including fixed income. And if there's any doubt about the sustainability of the sustainability trend, recent articles indicate that Gen Z (those born between 1995 and 2010) are embracing the fundamental precepts of sustainability in their purchasing decisions and behaviors, which suggests the trend will continue to the next generation of investors.

d) Divergent approaches to ESG are to be expected . . .

In one sense, the divergent approaches taken by the CFTC Subcommittee and the DOL-proposed ERISA ESG regulation is also reflective of what is going in the marketplace. Because there is no single standard or definition of ESG or sustainable investing, confusion, misconceptions and divergent approaches and interpretations are common not only among private sector market participants but also among global securities regulators as manifested by the different approaches taken by the US and EU. Even within the EU different approaches and variations are emerging. In early March 2020 the AMF, the French securities regulator, issued AMF Position/Recommendation Paper DOC-2020-03 ("AMF Doctrine"), which it updated in early July. The AMF Doctrine forges a separate but related path for UCITS and AIFs marketed in France that sets forth new reporting and filings in relation to non-financial criteria and in particular with respect to sustainable investing. The AMF Doctrine applies to all funds (UCITS and AIFs) that are authorized for marketing to non-professionals in France — regardless of whether the funds are actually marketed to non-professionals. That immediately implicates UCITS, which as a reminder are public funds designed for retail even if a UCITS has only institutional investors. AIFs can be either authorized for non-professional investors or not. The AMF Doctrine is complicated but can be described in a single word — stringent. What it sets out to achieve is the French version of truth in labeling. Think the difference between Champagne and sparkling wine. The disclosure and filing requirements go far beyond current EU standards including standards set by many non-governmental ESG labeling organizations.

e) . . . even or especially among ESG Rating agencies

Divergent ESG approaches are also evident in the many companies that have sprung up in the past few years that have sought to monetize the ESG trend by providing ESG ratings services. A detailed discussion of ESG rating services is beyond the scope of this summary but suffice it to say that the number of organizations purporting to provide ESG ratings continues to grow. Sustainalytics, now wholly owned by Morningstar, and MSCI are two well-established ESG rating agencies. But others have joined the fray: Bloomberg, Dow Jones Sustainability Index, Institutional Shareholder Services (ISS), Thomson Reuters are further examples of a growing universe. The rating agencies and those with proprietary approaches generally rely on questionnaires, surveys and publicly available information to rank and rate companies. As with many aspects of ESG, divergent approaches by the rating agencies are also widely evident, which to some extent dilutes their purported effectiveness in providing meaningful and accurate ratings assessments. As one Harvard Business School professor wrote in the latest issue of Institutional Investor: ". . .one assessor's A+ is often another's C-. Saudi Aramco — responsible for massive carbon emissions from the oil it sells — was rated higher than sustainability-focused Costco by a top provider." The professor goes on to write: "A 2019 study found the correlation among leading ratings providers — including MSCI, Sustainalytics, Bloomberg and RobecoSAM — to be only 30 percent. This contrasts sharply with a 99 percent correlation among credit ratings agencies." This suggests that given the current state of ESG reporting and the quality and quantity of publicly (un)available data, a well-conceived, well-documented and well-executed do-it-yourself proprietary approach using a repeatable methodology may be just as effective as retaining an ESG ratings vendor, especially since rating agencies probably offer only limited insight into the inner workings of their methodologies.

f) Toward a unified reporting framework

The alphabet soup of reporting frameworks involving ESG and climate change has probably reached the number of letters in the alphabet if we include all the frameworks that are in the market. The most common frameworks that have seen increasing adoption by companies are the SASB, TCFD and GRI, although again, there are others in use. The TCFD (the Task Force on Climate-related Financial Disclosure) is primarily focused on climate as the name suggests while the GRI (Global Reporting Initiative) is aimed at a much broader targeted audience of stakeholders encompassing economic, environmental and social standards. The Sustainability Accounting Standards Board (SASB) is styled after GAAP with the intent to create standardized reporting of ESG data deemed to be financially material to a company's financial health. SASB provides customized standards covering 77 industry sectors.

Recognizing that companies faced with an often bewildering universe of available reporting frameworks, some of which have different targeted audiences in mind, GRI and SASB announced a collaboration on July 13 this year, the purpose of which is to "demonstrate how some companies have used both sets of standards together and the lessons that can be shared." The collaboration stated that, "GRI and SASB also aim to help the consumers of sustainability data understand the similarities and differences in the information created from these standards." The SASB made a similar effort in 2017 in the form of a FAQ to explain how SASB standards and TCFD Recommendations complement each other.

The collaborative effort should be well received as one of the obstacles toward more and better ESG reporting has been the lack of a uniform framework that would encourage reliable, consistent and comparable ESG data. In that regard, BlackRock's Chairman and CEO, Larry Fink, in this year's annual letter to CEOs advocated for standardized and accelerated sustainability disclosures and endorsed SASB and TCFD as the benchmark frameworks.

g) The Five Ps of ESG

The lack of a uniform definition and the myriad approaches to ESG integration and investing coupled with differing reporting frameworks can be a challenge for companies and investors alike. One way to bring a sense of order to the topic is to break it down to five conceptual categories: People, Planet, Profits, Purpose, and Politics. The People covers much of the social and human aspects of the UN Sustainable Development Goals ("SDGs") and the social components of the GRI. Planet involves all things related to environmental concerns and climate action. Profits and Purpose is very much the topic of the day as expressed by the restatement of corporate purpose issued by the BRT last year. The Profits and Purpose categories are a challenge to the century-old notion of shareholder primacy, and judging from not only the BRT's restatement of corporate purpose but recent corporate responses to racial inequality and police treatment of African-Americans, it appears much of corporate America is embracing the 21st century notion of stakeholder primacy. That is, sustainable profitability and stakeholder primacy are not mutually exclusive goals. Politics along with policies and practices is an increasingly critical component of the ESG story in terms of setting the legislative and regulatory agenda in coming years.

One of the benefits of the force of law is the potential to create uniform standards and practices along with remedial and, if necessary, punitive measures to promote, enforce and direct activity toward the common good. Politics and the corresponding legislative action may be the only way to effectively deal with what economists and ethicists call the Tragedy of the Commons. For instance, a closer read of the CFTC's key recommendations suggests that these recommendations can only be achieved through the political, legislative and regulatory processes.

Around the Corner

Coming full circle to the CFTC Report that led this review, many of the developments highlighted here are initiatives that resonate with the key findings and key recommendations set forth in the CFTC Report. To the extent the CFTC Report generates further discussion and thought leadership, it comes at an auspicious time. September 25 marks the 5th anniversary of the UN General Assembly's adoption of the global sustainable development framework: the 2030 Agenda for Sustainable Development, which has at its core 17 Sustainable Development Goals ("SDGs").

The SDGs have been the cornerstone of sustainable investing since its inception and underlies many of the non-financial objectives by ESG funds of all persuasions. We expect the trends highlighted by these recent developments to continue well into 2021 and beyond as both private and public sector initiatives and reporting frameworks converge over time.

With respect to developments in the United States, the convergence very much depends on the outcome of the forthcoming election. A Democratic-controlled agenda will most certainly accelerate ESG developments not only with respect to catch-up on climate change action but likely renewed vigor on the social agenda, especially with respect to gender and racial equality issues.

Concerning financial reporting, illustrative of the Democratic mood is Senator Elizabeth Warren (D-Mass.). POLITICO reported last month that the Senator wrote to Chair Jay Clayton of the Securities and Exchange Commission criticizing the agency for failing in its mission to safeguard investors by not requiring greater disclosure by companies regarding climate change: "It is distressing that by ignoring these climate risks, the Securities and Exchange Commission, under your leadership, is not fulfilling its mission to 'protect investors' and 'maintain fair, orderly, and efficient markets'."

While one can visualize the eyes rolling by some financial participants, the Senator's views about the role of the financial regulator with respect to climate action is exactly what animates the extensive regulatory regimes promulgated by the EU and in other countries. And just as predictions of the demise of ESG in the wake of the pandemic were off the mark, it appears that the ESG trend in financial reporting will continue unabated regardless of the election outcome. Perhaps the only open question is the speed of change and degree of regulatory involvement — at least in the United States. One election result could be cruise control and the other may be akin to a lead foot on the accelerator pedal. Carbon tax anyone?

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