SKY Harbor Global Funds

Responsible Investing for a Sustainable Future

Staying the Course on Sustainability

People, Planet, Purpose, Profits & Politics

Our Purpose

To grow our clients' assets by investing in high yield sustainable corporations that have committed to benefit all their stakeholders and society as a whole.

How We Do It

By compounding current income over time, protecting principal and giving our clients the returns they expect and the information they need.

Why We Do It

We believe that Sustainable Corporations will prosper over the long term, attract lower cost capital, and generate superior returns to their investors.

Sustainability SKYSights

Mid-year 2021 Outlook:

A summer of major milestones

Biden's ESG-related Executive Orders

The SEC's focus on sustainability sharpens

Sustainability developments in the EU

Carbon Pricing Redux

Sustainability Mid-year Outlook 2021

I. Major milestones and mega-trends

2021 Summer Milestones capped by French SRI Label award

This summer marks a special milestone for SKY Harbor Capital Management, LLC, as we celebrate the 10th anniversary of our founding on August 5. Along with this milestone, we are pleased to announce an important capstone to our anniversary celebration: as of June 23, 2021, all three sub-funds of SKY Harbor Global Funds (the "Fund") have been awarded the government-backed French SRI Label, which will be assessed by an authorised independent auditing firm to ensure that the integration of environmental, social, governance, and human rights sustainability factors in the Fund's investment process meets the demanding standards established by the French Ministry of Finance for the protection of investors.

The French SRI Label is designed to identify only those financial products that have demonstrated —after a stringent due diligence investigation — a genuine and long-term commitment to implementing a sustainable and responsible investment approach that incorporates extra-financial objectives and reportable ESG metrics. We are especially proud that, as of the award date, the Fund's US Short Duration Sustainable High Yield Fund stands alone among the list of Label awardees with an actively managed US short duration socially responsible corporate high yield strategy.

As a reminder, SKY Harbor Global Funds and all its sub-funds satisfy the requirements under Article 8 the EC Sustainable Finance Disclosure Regulation (the "SFDR"), which became effective on March 10, 2021. And this is the third consecutive year that one or more of the Fund's investment strategies has been awarded with the Luxembourg-based LuxFLAG ESG label.

In observing these milestones, we pause to take stock of the journey of the last decade and to reflect on what we have accomplished on behalf of our clients, investors, friends and family. It has been an exciting and gratifying journey punctuated by market highs and lows and by ever-increasing government regulation and policy initiatives, particularly with respect to sustainability, some of which we shall address in this mid-year outlook.

SKY Harbor's investment process evolves with the embrace of sustainable investing

Since our founding, SKY Harbor's core investment process and approach to corporate high yield investing has stayed true to our historical roots and continues to be guided by our investment philosophy of providing superior risk-adjusted returns through the compounding of current income over time and protecting principal. These bedrock principles have not changed over the past decade.

This is not to say, however, that our investment process has remained static during the last 10 years. Before the mid-way mark of our decade-long journey, we recognized that modern investment management was quickly evolving in the face of global warming and that the investment management industry will need to play a critical role in meeting that challenge — and others — if it seeks to remain relevant to an ever-growing population of investors who demand sustainable investment strategies without sacrificing performance. And as we have previously observed, corporate sustainability is even more imperative for the corporate high yield asset class.

Accordingly, in October 2015 (several months before the ink dried on the Paris Accord), we subscribed to the UN Principles for Responsible Investment ("PRI"). Our support of the PRI was just the beginning of our increasing embrace of corporate sustainability and commitment to responsible investing for a sustainable future.

SKY Harbor's workstream of sustainability-related commitments continues unabated

Learning from the UN Guiding Principles on Business and Human Rights

Suffice it to say, perhaps at the risk of understatement, that during the past decade there was much learning to be gleaned about both macro and micro economic and market developments in the corporate high yield asset class. Over the years, we have strived to identify economic and market trends that we believed are most relevant to credit markets and offer our insights on those trends to our clients and investors through high frequency financial and market commentary.

The past decade also offered ample opportunity to witness the evolution and impact of the global movement — yes, it is indeed a movement — toward corporate sustainability and, importantly, we believe we have been thoughtful and deliberate about how to integrate these notions as we assess the issuers of high yield debt securities that comprise the investment portfolios within our sustainable investment strategies.

And the topics continue to evolve. We note that this summer the UN Guiding Principles on Business and Human Rights ("UNGPs") also marked the 10th anniversary of their publication and their unanimous endorsement by the UN Human Rights Council on June 16, 2011, making the framework the first corporate human rights responsibility initiative to be endorsed by the UN. The UNGPs set forth 31 guiding principles implementing the UN "Protect, Respect and Remedy" framework on the issue of human rights and the role and responsibilities of multinational corporate enterprises and other business entities.

The 31 principles enumerate foundational and operational principles in implementing the framework comprising (1.) the state's duty to protect human rights (including the duty to protect against human rights abuse by business enterprises and other third parties), (2.) the responsibility of business enterprises to respect human rights regardless of their size, sector, operational context, ownership, and structure; and (3) access to judicial, administrative, legislative or other appropriate grievance mechanisms for business-related human rights abuses.

The UNGPs were a ground-breaking initiative and foreshadowed perhaps unintentionally the rise of stakeholder capitalism, a notion that has gained increasing currency in the past several years. Typical of principles-based “soft law” guidance, however, it can take time for the “how-to-implement” phase to take hold, particularly among the heterogenous and diverse group of entities that make up modern corporations throughout the world. In fact, while promulgating its principles for business enterprises to respect human rights, the UNGPs recognized that, “the scale and complexity of the means through which enterprises meet that responsibility may vary according to [the above-mentioned] factors and with the severity of the enterprise’s adverse human rights impacts.” It took another 8 years before the non-profit Corporate Human Rights Benchmark Ltd (“CHRB”) to publish the CHRB UNGP Indicator Assessment (For companies in all sectors) in April 2019. The document sets forth a stand-alone methodology to assess how companies are approaching their responsibilities to respect human rights through the implementation of the Protect, Respect and Remedy framework outlined in the UNGPs.

The work of the CHRB is echoed in SKY Harbor’s proprietary sustainability assessment tool (the “Value Rubric”), which serves as a “sorting hat” if you will, to determine which companies satisfy SKY Harbor’s minimum sustainability criteria to be included in sustainable investment strategy portfolios. Familiarity with the Value Rubric by regular readers of our Sustainability commentary and disclosures is assumed but further details can be found at the Fund’s website cited below.

The foundational criteria established by the UNGPs and CHRB also dovetail with the OECD Guidelines for Multinational Enterprises, which addresses *responsible business conduct*, a notion that encompasses a company’s efforts to voluntarily identify, prevent, address or mitigate adverse externalities related to human and labor rights, the environment and corruption. Externalities can be viewed as side effects or consequences of business or industrial processes that impact other parties (usually adversely) without being reflected in the cost of goods or services involved. In short, externalities generally do not impact a company’s bottom line because governments or society in general have not promulgated legislation to impose (by way of taxing or other market-based mechanisms such as carbon pricing) a financial cost associated with creating, generating or contributing to those externalities . We explain in more detail our approach to responsible business conduct in the investment process in SKY Harbor Global Funds' Sustainability Policies and Procedures, which is posted on the Fund's website at www.skyharborglobalfunds.com/sustainability/ as part of the Fund's sustainability-related disclosures mandated by the SFDR.

The Path to 2030

Regular readers of SKY Harbor's sustainability commentary are well aware that our ESG integrated investment approach incorporates extra-financial objectives that include, among other things, the goal of promoting corporate action in support of one or more of the 17 Sustainable Development Goals (the "SDGs").

The SDGs were adopted by the United Nations at the September 25-27, 2015, meeting at the UN Headquarters in New York, as part of the United Nations' celebration of its seventieth anniversary. The adoption of the SDGs was a historic decision to promulgate "a comprehensive, far-reaching and people-centered set of universal and transformative Goals and targets" that is at the heart of the UN Global Compact.

> In adopting the SDGs, the UN resolved, between 2015 and 2030: ". . . to end poverty and hunger everywhere; to combat inequalities within and among countries; to build peaceful, just and inclusive societies; to protect human rights and promote gender equality and the empowerment of women and girls; and to ensure the lasting protection of the planet and its natural resources. We resolve also to create conditions for sustainable, inclusive and sustained economic growth, shared prosperity and decent work for all, taking into account different levels of national development and capacities."

The year 2030, the target date for achieving the aspirations captured in the UN resolution is now less than a decade away. While we make no predictions as to how or to what extent the SDGs will be achieved by 2030, we share our views with respect to three broad trends that we believe will persist and provide much content for the 20th SKY Harbor anniversary celebration.

Firstly, while the debate between shareholder primacy and stakeholder primacy dates back to the early decades of the last century, it seems clear to us that after nearly 100 years, a paradigm shift is taking place with the ascendency of stakeholder primacy emerging as the dominant corporate philosophy. We believe the trend toward stakeholder primacy will persist, whether it is called corporate purpose, corporate sustainability, enlightened capitalism, or by any other name. The pandemic highlighted the importance of corporate executives to respond thoughtfully with respect to social issues such as the safety and welfare of their employees, customers and suppliers. That trend, we believe, is unlikely to reverse. Illustrative of this trend, the Wall Street Journal recently reported that, "CEOs of major U.S. companies have reason to be worried about growing unrest on a range of social issues."[1] The article reported on a recent study that found that "CEOs who riled shareholders on social issues [including environmental issues] were more likely to receive compensation penalties and be fired than when shareholders were unhappy about the CEOs' wealth-oriented actions, such as those focused on strategy and governance." CEO compensation is but one consequence of inattention to ESG issues. Companies tone deaf to the demands of their primary stakeholders, including their shareholders, may also risk depreciating market value.

Yet another lasting trend, based on what we have observed and learned during the past decade, is that externalities that may have persisted — sometimes even for decades — without impacting a company's bottom line can suddenly emerge and adversely impact a company's market value. The large global oil companies, who have seen their market values dramatically diminish, seemingly overnight, come to mind as Exhibit A in the case for paying close attention to externalities. We believe that the time lag between uncompensated externalities and actual adverse financial impact has shortened and will continue to shorten in coming years, fueled by

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[1] Abhinav Gupta, *CEOs Ignore Social Issues at Their Own Peril*, Wall Street Journal online, June 26, 2021 (subs. Req'd)

the increasing frequency of global climate disasters as well as the uninterrupted trend of investors applying strict scrutiny over the sustainability *bona fides* and responsible business conduct of business enterprises of all sizes and shapes.

Finally, as we navigate toward 2030, we see an acceleration of the hardening of "soft law" as governments continue to focus on policy, legislation, and regulation with respect to corporate conduct in the context of sustainability. Guidelines on voluntary efforts will, we believe, become less voluntary and more mandatory as governments, regulators, and civil society ramp up demands for corporate accountability and transparency on issues implicating environmental, social, governance, and human rights factors. The hardening of soft law is already evident in a number of developments in the first half of 2021, particularly with the Securities and Exchange Commission, which we summarize later in this mid-year outlook.

II. Highlights of President Biden's H1 2021 Sustainability Initiatives

Biden Administration Focus on Climate and Social Issues

To set the stage for our review of recent ESG-related developments we briefly review observations and predictions we made at the beginning of 2021. Despite the warning attributed to Niels Bohr, the atomic scientist who is credited with saying: "Prediction is very difficult, especially if it's about the future," we made a number of forward-looking statements in our SKY Harbor Sustainability Outlook 2021. In re-visiting our Sustainability Outlook, released in January, a good number of our predictions appear to have transpired, although in fairness, we made predictions based on broad trends that arguably may have a tendency to render more accurate predictions — or not!

We began our 2021 Outlook with the observation that elections have consequences; no doubt an obvious statement but nevertheless, the initial signals by the Biden-Harris campaign with respect to climate and social issues has by and large played out during H1 of 2021. To wit, the number of executive orders (as further detailed below) pertaining to climate action and inequality has, as we predicted, flourished in lieu of actual legislation given the divided nature of congress.

The return to global engagement, which we foreshadowed, beyond re-entering the Paris Accord has also been evident during the first six months of the Administration. Among other efforts, President

Biden convened 40 world leaders in a virtual Leaders Summit on Climate in April 2021. The President opened the summit by remarking that climate change is "the existential crisis of our time," and took the occasion to announce an aggressive plan to cut the United States' greenhouse gas emission by 50% from 2005 levels by 2030 and re-establishing US leadership after years of inaction and denialism of climate change under the previous Administration. The current Administration's emphasis on electric vehicles and related trillion Dollar plus infrastructure plan may have significant benefits for a number of industry sectors including within the high yield market. Moreover, apropos of SKY Harbor's sustainable strategies that eschew investment in certain fossil fuel sectors, Treasury Secretary Janet Yellen was reported to be working on a plan for the Treasury Department to secure private financing to help countries move away from fossil fuels and adapt to climate impacts that have already become unavoidable.[2]

H1 2021 ESG-related Executive Orders

To date, President Biden has issued 52 executive orders ("EOs") compared to 42 EOs issued by President Trump over the same period in his first year in office. These are in addition to a number of presidential documents in the form of executive proclamations and memoranda, which generally do not have the same force of law and impact as executive orders. By our count, no fewer than 16 EOs implicate issues around ESG including social justice, labor, and human and LGBTQ+ rights. Set forth below is a tabular summary of the more prominent ESG-related EOs issued as of the date of this publication.

Citation	Signing Date	Title	EO no.
86 FR 34593	6/25/2021	**Diversity, Equity, Inclusion, and Accessibility in the Federal Workforce**	14035
86 FR 29675	5/28/2021	**Advancing Equity, Justice, and Opportunity for Asian Americans, Native Hawaiians, and Pacific Islanders**	14031
86 FR 27967	5/20/2021	**Climate-Related Financial Risk**	14030
86 FR 25947	5/7/2021	**Establishment of the Climate Change Support Office**	14027
86 FR 22829	4/26/2021	**Worker Organizing and Empowerment**	14025
86 FR 19569	4/9/2021	**Establishment of the Presidential Commission on the Supreme Court of the United States**	14023
86 FR 13797	3/8/2021	**Establishment of the White House Gender Policy Council**	14020
86 FR 13803	3/8/2021	**Guaranteeing an Educational Environment Free From Discrimination on the Basis of Sex, Including Sexual Orientation or Gender Identity**	14021
86 FR 11849	2/24/2021	**America's Supply Chains**	14017
86 FR 7619	1/27/2021	**Tackling the Climate Crisis at Home and Abroad**	14008
86 FR 7483	1/26/2021	**Reforming Our Incarceration System To Eliminate the Use of Privately Operated Criminal Detention Facilities**	14006
86 FR 7471	1/25/2021	**Enabling All Qualified Americans To Serve Their Country in Uniform**	14004
86 FR 7211	1/21/2021	**Protecting Worker Health and Safety**	13999
86 FR 7009	1/20/2021	**Advancing Racial Equity and Support for Underserved Communities Through the Federal Government**	13985
86 FR 7023	1/20/2021	**Preventing and Combating Discrimination on the Basis of Gender Identity or Sexual Orientation**	13988
86 FR 7037	1/20/2021	**Protecting Public Health and the Environment and Restoring Science To Tackle the Climate Crisis**	13990
86 FR 7049	1/20/2021	**Revocation of Certain Executive Orders Concerning Federal Regulation**	13992

[2] See Scott Detrow and Nathan Rott, *At Biden Climate Summit, World Leaders Pledge To Do More, Act Faster*, updated April 22, 2021, available at: Biden Climate Summit Draws Bolder Pledges From World Leaders : NPR.

While a deeper dive into each of the above listed EOs is beyond the scope of this column, two in particular, however, merit more than a passing glance.

EO 14008: Tackling the Climate Crisis at Home and Abroad

Executive Order 14008, *Tackling the Climate Crisis at Home and Abroad*, was signed at the end of President Biden's first week in office on January 27, 2021. There is a good chance that, for the remainder of 2021 and beyond, news coverage of the Administration's climate action initiatives will find root in this EO.

In a sharp reversal of the prior Administration's policies, the 15-page EO 14008 prioritizes climate action by acknowledging that the "United States and the world face a profound climate crisis," and accordingly puts climate action as the centerpiece of US foreign policy and national security. The executive order officially provided for re-joining the Paris Agreement and building upon the Paris Agreement's three over-arching objectives: a safe global temperature, increased climate resilience, and financial flows aligned with a pathway toward low greenhouse gas emissions and climate-resilient development. The order signaled a number of developments that have already taken place by the date of this publication, such as the April Leaders Climate Summit; developing a national determined contribution ("NDC") under the Paris Agreement ahead of the 26th UN Climate Change Conference of the Parties ("COP 26") scheduled for November 2021 in Glasgow, Scotland; appointing former Secretary of State John Kerry as the Special Presidential Envoy for Climate; and immediately begin to develop a climate finance plan to promote the flow of capital toward climate-aligned investments and away from high-carbon investments (see above reference to Secretary Yellen's reported effort at Treasury to secure private financing to help countries move away from fossil fuels and adapt to climate impacts that have already become unavoidable).

Executive order 14008 also created the White House Office of Domestic Climate Policy ("Climate Policy Office"), which "shall coordinate the policy-making process with respect to domestic climate-policy issues" and which shall have a staff headed by the Assistant to the President and National Climate Advisor. President-elect Biden announced in December 2020 that Gina McCarthy, the former administrator of the Environmental Protection Agency under President Obama, will serve as the first national climate advisor. The National Climate Advisor is a high-profile position and is emblematic of the Administration's commitment to climate action. One of the duties of the National Climate Advisor is to chair a National Climate Task Force (the "Task Force") established by EO 14008. The Task Force's remit is to “facilitate the organization and deployment of a government-wide approach to combat the climate crisis.” We believe that the whole-of-government commitment will animate policy and regulation by agencies that regulate the capital markets including but not limited to the Federal Reserve, Office of the Comptroller of the Currency (“OCC”), the Federal Deposit Insurance Corporation (“FDIC”), the Securities and Exchange Commission (“SEC”), Commodity Futures Trading Commission (“CFTC”) and the US Department of the Treasury.

The whole-of-government approach to the climate crisis outlined in the EO 14008 sets forth the Administration’s policy to “organize and deploy the full capacity of its agencies to combat the climate crisis” and to “implement a Government-wide approach that reduces climate pollution in every sector of the economy; increases resilience to the impacts of climate change; protects public health; conserves our lands, waters, and biodiversity; delivers environmental justice; and spurs well-paying union jobs and economic growth, especially through innovation, commercialization, and deployment of clean energy technologies and infrastructure.”

President Biden’s whole-of-government approach also set forth a section concerning the *Use of the Federal Government’s Buying Power and Real Property and Asset Management*, which sets forth the Administration’s policy of “aligning the management of Federal procurement and real property, public lands and waters, and financial programs to support robust climate action.” Among the initiatives set forth in the EO, as appropriate and consistent with applicable law:

- Develop a comprehensive plan to use all available Federal procurement authorities to achieve or facilitate a carbon pollution-free electricity sector no later than 2035;
- Increase renewable energy production on public lands and waters with the goal of doubling offshore wind by 2030;
- Pause new oil and natural gas leases on public lands or offshore waters pending completion of a comprehensive review and reconsideration of Federal oil and gas permitting and leasing practices;
- Eliminate fossil fuel subsidies from the President’s budget request for Fiscal Year 2022;
- Identify opportunities to provide in the President’s budget request for Fiscal Year 2022 for priority funding to spur investments in innovation, commercialization, and deployment of clean energy technologies and infrastructure; and

- Directed each Federal agency to submit a draft action plan to the National Climate Task Force and the Federal Chief Sustainability Officer by May 27, 2021 that describes the steps each agency can take with regard to its facilities and operations to bolster adaptation and increase resilience to the impacts of climate change.

President Biden's executive order ends with a section entitled *Securing Environmental Justice and Spurring Economic Opportunity*, which as the title suggests, directs federal agencies as part of their missions to "make achieving environmental justice part of their missions by developing programs, policies, and activities to address the disproportionately high and adverse human health, environmental, climate related and other cumulative impacts on disadvantaged communities, as well as the accompanying economic challenges of such impacts." This section, focusing essentially on social justice, is very much in tune with the other ESG-related EOs set forth in the table above.

Rolling Back the Trump Regulatory Roll Backs

We noted in our Sustainability Outlook 2021 that, in the early months of the Biden Administration, to begin chipping away at its ambitious climate action agenda, President Biden may have no other viable options other than to issue a tsunami of EOs to reverse the tide of former President Trump's generally hostile attitude toward regulation in general and environmental regulation in particular. Notably, among the 52 EOs signed by President Biden to date, no fewer than 19 EOs were issued specifically to revoke EOs of the previous administration. Among the EOs revoked was EO 13772, *Core Principles for Regulating the United States Financial System*, issued by former President Trump on February 3, 2017. Executive order 13772's core principles included to "make regulation efficient, effective, and appropriately tailored," but was widely seen as part of the previous Administration's concerted effort to roll back as much of the regulatory agenda of the Obama-Biden Administration as possible if not by legislative action then by EOs or agency directives. As a reminder, while EOs may have the force of law, as demonstrated during the past several Administrations they can be easily revoked and revised by successor Administrations.

EO 14030 Climate-Related Financial Risk

Among the ESG-related EOs during the first half of 2021 and particularly relevant to investors and corporate issuers is EO 14030, *Climate-Related Financial Risk*, signed on May 20,2021. EO 14030 sets forth the Biden Administration's policy "to advance consistent, clear, intelligible, comparable, and accurate disclosure of climate-related financial risk," which specifically includes "both physical and transition risks."

EO 14030 directs the Assistant to the President for Economic Policy and Director of the National Economic Council (Director of the National Economic Council) and the Assistant to the President and National Climate Advisor (National Climate Advisor), in coordination with Secretary Yellen and the Director of the Office of Management and Budget (OMB) (currently led by Acting Director Shalanda Young), to develop, by September 17, 2021, a comprehensive, Government-wide strategy regarding:

(a) the measurement, assessment, mitigation, and disclosure of climate-related financial risk to Federal Government programs, assets, and liabilities in order to increase the long-term stability of Federal operations;

(b) financing needs associated with achieving net-zero greenhouse gas emissions for the U.S. economy by no later than 2050, limiting global average temperature rise to 1.5 degrees Celsius, and adapting to the acute and chronic impacts of climate change; and

(c) areas in which private and public investments can play complementary roles in meeting these financing needs—while advancing economic opportunity, worker empowerment, and environmental mitigation, especially in disadvantaged communities and communities of color.

FSOC: A Player in Assessing Climate-Related Financial Risk

In our Sustainability Outlook 2021, posted in January, we wrote that, with the appointment of Janet Yellen as Secretary of the Treasury, 2021 will see greater formal recognition by the government of the risk that climate change poses to the U.S. financial markets, and with that recognition we predicted that the Financial Stability Oversight Council ("FSOC") "may very well emerge as a player in the sustainability conversation in 2021."

In furtherance of the policy to advance disclosure of climate-related financial risk and consistent with applicable law and subject to the availability of appropriations, Section 3 (a) of EO 14030, *Assessment of Climate-Related Financial Risk by Financial Regulators*, provides that, Secretary Yellen as Chair of FSOC shall engage FSOC members to consider the following actions by FSOC:

(i) assessing, in a detailed and comprehensive manner, the climate-related financial risk, including both physical and transition risks, to the financial stability of the Federal Government and the stability of the U.S. financial system;

(ii) facilitating the sharing of climate-related financial risk data and information among FSOC member agencies and other executive departments and agencies (agencies) as appropriate;

(iii) issuing a report to the President by November 16, 2021 (within 180 days of the date of the order) on any efforts by FSOC member agencies to integrate consideration of climate-related financial risk in their policies and programs, including a discussion of:

(A) the necessity of any actions to enhance climate-related disclosures by regulated entities to mitigate climate-related financial risk to the financial system or assets and a recommended implementation plan for taking those actions;

(B) any current approaches to incorporating the consideration of climate-related financial risk into their respective regulatory and supervisory activities and any impediments they faced in adopting those approaches;

(C) recommended processes to identify climate-related financial risk to the financial stability of the United States; and

(D) any other recommendations on how identified climate-related financial risk can be mitigated, including through new or revised regulatory standards as appropriate; and

(iv) including an assessment of climate-related financial risk in the FSOC's annual report to the Congress.

As we have previously mentioned, while executive orders have the force of law so long as they are not overturned or revised by successor Administrations, executive orders do not have the permanence of legislation. Statutes, on the other hand, and the rules promulgated thereunder are not so easily overturned by successor Administrations or even by a future Congress. The attempts during the Trump years to overturn the Affordable Care Act (a/k/a Obamacare) is illustrative.

The less-than-permanent nature of executive orders, nevertheless, belies their potential influence during the years in which the Administration that promulgated them are in office, especially when created during the early months of a first term presidency with the hopeful — or feared — promise of a two-term tenure.

The significance of EO 14030, and particularly the potential impact Section 3 (a) on climate-related financial risk disclosure can perhaps be better appreciated by noting that the EO directs the *members of FSOC* to consider the actions expressly set forth in Section 3(a).

FSOC comprises ten voting members and five nonvoting members. The Council is chaired by the Secretary of the Treasury. Among the ten voting members are: the Comptroller of the Currency ("OCC"), the Director of the Bureau of Consumer Financial Protection ("CFPB"), the Chair of the Securities and Exchange Commission ("SEC"), and the Chair of the Commodity Futures Trading Commission ("CFTC").

In turning to the specific developments concerning a number of ESG-related disclosure proposals particularly those before the SEC, it would be difficult to imagine that the recently appointed Chair of the SEC, Gary Gensler, as a returning member of FSOC with a reputation of advancing a heavy of agenda of regulatory reform during his tenure as Chair of the CFTC under President Obama, has not given EO 14030 more than one close read — and including it as required reading by his SEC staff — particularly the above Section 3 (a) (i) through (iii). The impact of EO 14030 may well be felt on the SEC's ultimate decisions regarding a number of current ESG-related proposals stacked on its pending workstream.

III. The SEC's focus on Sustainability: Greenwashing & Transparency

The Wall Street Journal reported that, the Senate confirmation of Gary Gensler as Chair of the SEC on April 14, 2021, by a vote of 53-45 with only three Republican Senators voting in favor, reflected the Republican Party's "limited appetite for a policy agenda that is expected to include requiring more disclosure from public companies on matters such as the potential impact of climate change on their businesses, " but is an approach to which Mr. Gensler is reportedly open to considering.[3] As to how far he will go remains to be seen, although the *denouement* on a number of pending proposals may emerge before year-end.

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[3] Paul Kiernan, *Gary Gensler Is Confirmed as SEC Chairman by Senate*, Wall Street Journal Online, updated April 14, 2021, 7:00 PM ET (subs. req'd).

The divided Senate vote is also reflective of the tension between the Republican-appointed and Democrat-appointed Commissioners at the SEC, which — suffice it to say without summarizing the pros and cons of the debate here in the interest of brevity — is manifested by a continuing stream of speeches and commentary nearly diametrically opposed to each other with respect to mandatory disclosures related to ESG and in particularly with respect to climate risk, human capital, and diversity (including LGBTQ +). While Mr. Gensler's confirmation will ensure a Democratic majority at the SEC for the foreseeable future, nevertheless, he will need to at least consider the resistance and arguments posited by his Republican-appointed colleagues as well as views representing the concerns of public issuers, which as we highlighted in our Sustainability Outlook 2021 and which continue to revolve around concerns regarding the notion of materiality (as defined by generations of US court decisions) coupled with the not unreasonable concerns over litigation risk absent a safe harbor to go along with mandatory disclosures.

Thank you to Allison Herren Lee for SEC Chair Gensler's Running Start on ESG Disclosure

If Chair Gensler can be seen has having a running start on the issue of public company disclosure, much of it can be attributed to SEC Commissioner Allison Herren Lee, whom President Biden designated as Acting Chair of the SEC after former Chair Jay Clayton resigned in late December 2020. During her brief but action-packed tenure as Acting Chair, Ms. Lee took a number of steps to focus the SEC on sustainability:

- February 1, 2021. Ms. Lee appointed Satyam Khanna to serve as the first Senior Policy Advisor for Climate and ESG at the SEC with the job to advise the agency on environmental, social, and governance matters and advance related new initiatives across its offices and divisions related to climate risk and other ESG developments.
- February 24, 2021. Ms. Lee directed the Division of Corporate Finance to enhance its focus on climate-related disclosure in public company filings, noting that that last time the SEC provided guidance to public companies regarding climate change disclosure requirements was in 2010.
- March 4, 2021. The SEC announced the creation of a 22-member Climate and ESG Task Force in the Division of Enforcement, the purpose of which appears to be enhanced enforcement in sanctioning so-called "greenwashing." The Task Force "will develop initiatives to proactively identify ESG-related misconduct," including identifying material

gaps and misstatements in issuers' disclosure of climate risks under existing rules. Not to be left out, investment advisers' and their funds' ESG strategies will also be the subject of Task Force scrutiny.

- March 15, 2021. Ms. Lee requested public input ("RFI") from investors, registrants, and other market participants on a series of 15 questions[4] revolving around the issue about whether current disclosures about climate change risks, impacts and opportunities adequately inform investors about known material risks, uncertainties, impacts, and opportunities, and whether greater consistency could be achieved. In calling for public input, Ms. Lee noted that, in May 2020, the SEC Investors Advisory Committee urged the Commission to begin updating reporting requirements for issuers to include material, decision-useful, environmental, social, and governance, or ESG criteria, and in December 2020, the ESG Subcommittee of the SEC Asset Management Advisory Committee recommended that the Commission require the adoption of standards by which corporate issuers disclose ESG risks.
- April 9, 2021. The Division of Examinations (f/k/a Office of Compliance Inspections and Examinations or "OCIE") issued a Risk Alert regarding investment advisers, registered investment companies, and private funds offering ESG products and services. The Risk Alert highlighted recent deficiencies concerning the gap between purported ESG policies and objectives and actual practice.[5]

President Biden's choice of Mr. Gensler to head the SEC was reported in mid-January a few days before the President designated Allison Herren Lee as Acting Chair of the Commission. Under these circumstances, it would seem highly likely that Ms. Lee's ESG-related initiatives had the tacit support of nominee Gensler and thus will find continuing support now that he has been officially installed as the

[4] See *Public Input Welcomed on Climate Change Disclosures*, March 15, 2021, available at: https://www.sec.gov/news/public-statement/lee-climate-change-disclosures.

[5] See *The Division of Examinations' Review of ESG Investing*, April 9, 2021, available at: https://www.sec.gov/files/esg-risk-alert.pdf.

head of the agency. Ms. Lee continues to serve as one of the five Commissioners and has continued to actively advocate for SEC-mandated ESG disclosure.[6]

The Public Response to the SEC's RFI

The SEC received over 5,700 comment letters from the public in response to then Acting Chair Lee's RFI and her 15 questions concerning additional SEC-mandated sustainability disclosures.[7] The overwhelming majority of the responses were in support of additional climate change and other sustainability-related disclosure by public companies.

The business community as represented by comments from the Business Roundtable ("BRT")[8] and the US Chamber of Commerce's Center for Capital Markets Competitiveness was also generally supportive of the SEC initiative to update its climate-related disclosures although somewhat less enthusiastic concerning other sustainability-related metrics, which the Chamber felt were "subjective."

As we foreshadowed in our January 2021 Sustainability Outlook, materiality and litigation risk will continue to be key points of concern among the business community. The Business Roundtable, for example, urged that any new disclosures "continue to rely generally on a principles-based approach tied to traditional concepts of materiality." In addition the BRT also suggested:

- Providing for a transition period including delayed compliance dates to allow sufficient time for companies to prepare the disclosure for the first time.
- Allowing the disclosure to be provided on a different schedule from the annual report (in a manner similar to Conflict Materials reports).
- Appropriately tailoring disclosure requirements to companies of different sizes.

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[6] See *Living in a Material World: Myths and Misconceptions about "Materiality,"* Commission Allision Herren Lee remarks at the 2021 ESG Disclosure Priorities Event hosted by the American Institute of CPAs, the Chartered Institute of Management Accountants, Sustainability Standards Board, and the Center for Audit Quality, May 24, 2021, available at: https://www.sec.gov/news/speech/lee-living-material-world-052421.

[7] See *Comments on Climate Change Disclosures*, available at: https://www.sec.gov/comments/climate-disclosure/cll12.htm.

[8] See comment letter of June 11, 2021 by Maria Ghazal, Senior Vice President and Counsel, Business Roundtable , available at: https://www.sec.gov/comments/climate-disclosure/cll12-8906771-244124.pdf.

- Providing an alternative mechanism for disclosure to be furnished other than filed for purposes of the Securities Exchange Act of 1934.
- Providing a liability safe harbor for any newly mandated metrics and data points and for forward-looking information provided in response to new disclosure requirements.

SEC's Pending Workstreams for H2 2021

With the aforementioned developments in mind, the SEC certainly has a full plate to digest with respect to the overarching issue of sustainability disclosures. In this regard, on June 11, 2021, the Office of Information and Regulatory Affairs released the "Spring 2021 Unified Agenda of Regulatory and Deregulatory Actions,"[9] which included both short- and long-term regulatory actions planned by the SEC.

Notable among proposals in the "final SEC rulemaking" stage include disclosure relating to climate risk, human capital including workforce diversity and corporate board diversity, and cybersecurity risk. With respect to corporate board diversity at least, insight into the shape of any final rulemaking will certainly come from the SEC's decision regarding the proposed change in the Nasdaq listing rule, which if approved by the SEC, would require companies listed on the exchange to meet certain minimum diversity targets or explain in writing why they are not complying.[10] The SEC announced in a posting on its website in March that a final decision has been postponed until this summer, which means imminently.

Against the backdrop of the overwhelming public response to the SEC's RFI and in light of the whole-of-government approach set forth in EO 14008 and EO 14030 described above, we believe the SEC will shortly begin to issue an Advanced Notice of Proposed Rulemaking ("ANPRM") on a number of sustainability-related disclosure topics with climate change foremost on the list. An ANPRM is a preliminary notice, published in the Federal Register, announcing that the agency is considering a

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[9] Available at:
https://www.reginfo.gov/public/do/eAgendaMain?operation=OPERATION_GET_AGENCY_RULE_LIST&currentPub=true&agencyCode=&showStage=active&agencyCd=3235&csrf_token=7CE97CC2D49C9B6B70868F7B2752E582C86F1945A4A46F34426C18AF1ABE101E611318F64B67159C3A36E7556BD0FB872C8F.

[10] See NASDAQ's proposed listing requirement, available at:
https://listingcenter.nasdaq.com/assets/Board%20Diversity%20Disclosure%20Five%20Things.pdf.

regulatory action. The SEC typically issues an ANPRM before it develops a detailed proposed rule. The ANPRM describes the general area that may be subject to regulation and usually asks for public comment on the issues and options being discussed. Because an ANPRM is issued only when an agency believes it needs to gather more information before proceeding to a notice of proposed rulemaking, there is also a reasonable possibility that the SEC believes it has enough preliminary information based on the public response to Acting Chair Lee's request for input and other sources that the agency may proceed directly to a Notice of Proposed Rulemaking on these topics before year-end 2021. Given Mr. Gensler's activist history as Chair of the CFTC, this possibility cannot be ruled out, although most of the comment letters received in the RFI while expressing support for the notion of increased transparency and disclosure, many did not deal with specific metrics and what metrics, if any, should apply to a prescriptive or principles-based regime. Thus any proposed disclosure mandate by the SEC may still need to be vetted by the ANPRM process.

IV. Developments in EU Sustainability

The much-anticipated EU Regulation 2019/2088 concerning sustainability-related disclosure in the financial services sector ("SFDR") became effective on March 10, 2021, and EU financial market participants have accordingly spent the first part of the year deciding whether to categorize themselves or their funds as Category 6, 8 or 9 under the SFDR.

One of the motivations in promulgating the SFDR is to prevent greenwashing, and one of the mechanisms to achieve that required level of transparency are the Level 2 Regulatory Technical Standards ("RTS"), which are comparable to the Rules and Regulations promulgated by US regulatory agencies under various statutes, such as the Securities Act of 1930 or the Securities and Exchange Act of 1934 and other statutes.

EU Delays SFDR Level 2 RTS to July 1, 2022

The SFDR provides for additional detailed rules to be promulgated under the Level 2 RTS, which were issued on February 4, 2021, and initially provided for an effective date of January 1, 2022. By early

July, however, the EU decided to postpone the effective date of the RTS to July 1, 2022, "due to the length and technical detail" of the RTS.[11]

The RTS provides detailed guidance for pre-contractual disclosures, website disclosures and periodic reporting with respect to sustainability-related information under the SFDR including information in relation to the "do not significantly harm" principle (specifying the details for how sustainable investments do not significantly harm sustainable investment objectives).[12] The final draft RTS sets forth detailed rules with regard to the content, methodologies and presentation of disclosures pursuant to Article 2 a (3), Article 4(6) and (7), Article 8 (3), Article 9 (5), Article 10 (2) and Article 13 (4) of the SFDR. In an attempt to improve transparency and comparability of product disclosures, the final draft RTS provides harmonized templates for pre-contractual and periodic disclosures. This was done because of uncertainty regarding the content of pre-contractual disclosures when the RTS consultation paper was initially launched in 2020.

With respect to principal adverse impact reporting, one welcome revision from the initial proposed draft of the RTS is the reduction of the number of mandatory environmental and social indicators to a total of 14, which is down from the 32 mandatory indicators of principal adverse impacts of sustainability factors that were contemplated in April 2020. Despite this notable relief, the package of obligations in the RTS is substantial, bulky, and certain to generate additional questions about implementation. The delay until July 1, 2022, will be much appreciated by financial market participants but leaves less than a year to prepare for a highly detailed, far-ranging and resource-intensive regulatory mandate.

Carbon Pricing gathers increased momentum

In our Sustainability Outlook 2021, issued in January, we discussed the prospect of a carbon tax, noting that Treasury Secretary Janet Yellen is a founding member of the Climate Leadership Council

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[11] See Huw Jones, *EU further delays sustainable finance rules for asset managers*, Reuters, July 9, 2021, available at: https://www.reuters.com/business/sustainable-business/eu-further-delays-sustainable-finance-rules-asset-managers-2021-07-09/.

[12] See *Final Report on draft Regulatory Technical Standards* for complete details, available at: https://www.esma.europa.eu/sites/default/files/library/jc_2021_03_joint_esas_final_report_on_rts_under_sfdr.pdf.

("CLC"), a group that, among other things, advocated for a carbon tax and a border carbon adjustment, the latter of which is designed to impose a carbon-related tax on imports from countries deemed to have implemented inadequate or insufficient means to achieve a carbon-free future. While we acknowledged the Biden Administration's (and Democrats generally) reluctance to resort to a market-based solution (versus outright taxing and/or regulation) built on a carbon pricing mechanism, a number of developments during H1 and the early months of H2 2021, nevertheless, suggests that carbon pricing may be quietly and inexorably gathering more widespread support.

A few months after President Biden's inauguration, the influential Washington oil industry lobbying group, the American Petroleum Institute ("API"), announced its support for a "market-based, economy-wide" approach to tackling climate change and specifically for the introduction of a carbon price.[13] As reported by the Financial Times, the decision is a complete turnaround for the lobbying group, which actively advocated to oppose legislation that would have introduced carbon pricing under the Obama Administration, although many of the group's members have since voiced support for the policy, and the API is reported to have changed its stance "so as not be frozen out of the conversation in Washington."[14]

Moreover at the Leader Summit on Climate hosted by President Biden, Kristalina Georgieva, Managing Director of the International Monetary Fund ("IMF"), in a speech presented on April 22, 2021, stated that carbon pricing "has proven to advance investments in renewable energy, electric mobility, energy efficient buildings, reforestation and other climate friendly activities — with positive impact on growth and jobs, while reducing carbon emissions."[15] According to Ms. Georgieva, the IMF's analysis "shows that, without [carbon pricing], we will not reach our climate stabilization goals. Ms. Georgieva's remarks also suggested that, carbon pricing is gaining momentum, and that "many businesses now use a shadow carbon price in their models." The problem, however, according to Ms. Georgieva is the average

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[13] See Myles McCormick, *Big Oil lobbyist throws weight behind carbon pricing*, Financial Times, March 25, 2021 available at: https://www.ft.com/content/1dd8a3fd-54db-4aff-8d1e-44bcd1362084 (subs. req'd).

[14] Id.

[15] See *IMF Managing Director's intervention at the Leaders Summit on Climate, Session 2: Investing in Climate Solutions*, as prepared for delivery, April 22, 2021, available at: IMF Managing Director's intervention at the Leaders Summit on Climate, Session 2: Investing in Climate Solutions.

global price is currently $2 a ton, and needs to rise to $75 a ton by 2030 to curb emissions in line with the goals of the Paris Agreement.[16]

The IMF's claims of increasing use of carbon pricing by businesses is corroborated by research done by the Carbon Disclosure Project ("CDP"), a non-profit that runs the world's environmental disclosure system. The CDP estimates that since 2015, the number of companies using or planning to use an internal carbon price has increased 80%.[17] Of the nearly 6,000 companies surveyed by the CDP, more than 2,000 disclosed that they currently use an internal carbon price or plan to implement one within the next two years.[18] CDP research also reveals that nearly half of the world's 500 largest companies are now factoring some form of carbon pricing in their business plans, with a median carbon price in 2020 of US$ 25 per ton of CO^2e, with companies in Asia and Europe applying the highest average price of $28. Carbon prices in the EU emissions trading scheme, however, reached all time highs of US$44.80 per ton in March 2021 and is hovering around closer to US$65 per ton at the time of this writing. This compares with the estimate of US$ 51 per metric ton of GHG estimated by Interagency Working Group on the Social Cost of Greenhouse Gases,[19] which we highlighted in the March edition of SKYSights.

EU Plans to Meet Net Zero Aspirations

Carbon pricing (and taxes on polluters) is also one of the three policy levers that the 27 members of the EU plan to use to cut average emissions by 55% by 2030 and net zero by 2050. In

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[16] Id.

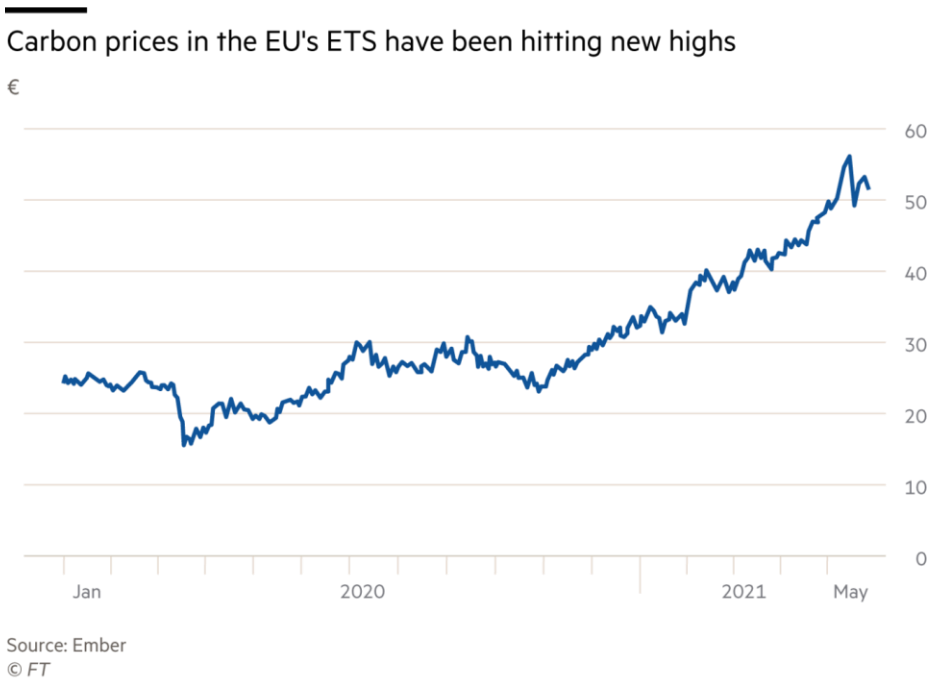
[17] See, *Nearly half of the world's biggest companies factoring cost of carbon into business plans*, CDP, April 21, 2021 available at: https://www.cdp.net/en/articles/media/nearly-half-of-worlds-biggest-companies-factoring-cost-of-carbon-into-business-plans.

[18] Id.

[19] Available at: https://www.cdp.net/en/articles/media/nearly-half-of-worlds-biggest-companies-factoring-cost-of-carbon-into-business-plans.

addition to carbon pricing, the other levers are tougher regulation and emissions standards for industry; and rules to promote investment in low-emissions technology.[20]

The EU's Emissions Trading System ("ETS") was established in 2005 and designed to reduce GHG emissions through the use of a market-based carbon pricing mechanism. The price of carbon credits in the ETS has been steadily rising and hitting new highs in recent months.



The European Commission now proposes to extend the ETS to cover the shipping industry for the first time and to also phase out sectors that have to date benefited from free credits, including airlines that must pay for emissions on flights within the EU.[21] Among its proposals the EU is also planning to extend the ETS to transport and buildings.[22]

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[20] See, Mehreen Khan, *How the EU plans to reshape its economy to limit climate change*, *(Bloc to 27 countries to negotiate over three-pronged approach to reduce greenhouse gas emissions),* July 14, 2021, Financial Times, available at: https://www.ft.com/content/8800128f-eec6-4272-acc7-a51132c6c931 (subs. req'd).

[21] Id.

[22] Id.

EU Cross Border Adjustment Mechanism Finds Fans Among US Legislators

Harkening to a proposal by the Climate Leadership Council, the EU is also planning on becoming the first major economic power to impose a climate-related import tariff based on countries' carbon footprint. The Cross Border Adjustment Mechanism ("CBAM") is intended to stop "carbon leakage," where companies can move their businesses to other jurisdictions to avoid stricter environmental regulation.[23] The CBAM is planned to become effective by 2026, and would impose a levy linked to carbon prices on an array of products such as imported steel, aluminum, fertilizer and cement.[24] The proposed CBAM has attracted world-wide attention including in the US, where Democratic lawmakers have been reported to be drafting legislation for a tax on imports from high carbon emitting countries to help pay for the Administration's $3.5 trillion spending package.[25]

If the Democrats embrace a US version of the CBAM, it will mark a shift in policy for the Biden Administration and will require the Administration to establish a price on carbon. The $ 51 per ton social cost estimated by the Interagency Working Group might be a good starting point, although John Kerry, the President's climate envoy has been quoted that a carbon border tax adjustment should be a "last resort" and that he was "concerned" about Brussel's plans for such a mechanism.[26]

The Biden Administration's concerns aside, an intriguing report from the G-20 seems to suggest that the US reluctance to a CBAM or a US carbon pricing plan may be softening. The G-20 finance ministers — of which of course the US is an active and re-engaged member — at a meeting in Venice recently was reported to have "collectively endorsed carbon pricing for the first time" as one of "a wide

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[23] Id.

[24] See Leslie Hook, Max Seddon, and Nastassia Astrasheuskaya, *EU plan for world's first carbon border tax provokes trading partners*, July 16, 2021, Financial Times, available at: https://www.ft.com/content/de7d12e2-0d04-43d4-b38c-cf795854a4a2, (Subs. Req'd).

[25] See Lauren Fodor and Aime Williams, *Democrats eye carbon border tax to help fund $3.5 trillion spending package,* July 14, 2021, Financial Times, available at: https://www.ft.com/content/c69e21a6-d234-4fe0-87f4-4c2fa05ab74a, (Subs. Req'd.)

[26] Id.

set of tools" to tackle climate change.[27] The issue of taxing carbon emissions has, according to the report, "long divided G 20 members, with the US in particular historically opposed."[28]

Whether by choice or coincidence, the G-20's new-found receptiveness to carbon pricing came virtually at the same time that China, the world's largest emitter of GHG, launched its first national emissions-trading scheme, which reportedly began trading during the week of July 12.[29] Among the 45 countries in the world that already have such mechanisms in place, China's new carbon emissions scheme will be the largest.[30]

Leaving for now the details on what, how, and when, a carbon pricing scheme or an analogous CBAM would look like, carbon pricing and a hybrid government and market mechanism are ideas that are clearly gaining momentum globally as well as in US business and political circles. With the EU and now China charging full speed ahead, it is unlikely the topic will fade and whatever form it takes, if implemented, may have significant impacts on US businesses including among issuers in all sectors of the corporate high yield market.

Stay tuned for H2 2021.

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July 29, 2021

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[27] See Leslie Hook, Kristen Talman, *G20 ministers endorse carbon pricing to help tackle climate change,* Financial Times, July 11, 2021 (Subs. Req'd).

[28] Id.

[29] See Bianca Nogrady, *China launches world's largest carbon market: but is it ambitious enough?,* Nature, July 20, 2021 available at: https://www.nature.com/articles/d41586-021-01989-7.

[30] Id.

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