What Is ESG and Why Is It So Important?

Where the SEC has been and where it should head.

STEPHEN HALL & JASON GRIMES

WHITEPAPER

July 14, 2021

INTRODUCTION

ESG Issues Are the Subject of Intense and Growing Interest

The way companies address environmental, social, and governance ("ESG") issues has drawn steadily increasing attention in recent years. It has now become the subject of keen interest among investors, public interest advocates, private companies, the financial sector, and regulators both here and abroad. Since roughly 2006, when the acronym "ESG" was first coined, more and more investors have been basing their investment decisions at least in part according to the way that companies incorporate these factors into their operations, risk assessments, and planning processes.

Just a few data points reflect the growing influence of the ESG factors. According to Bloomberg, investors held up to $37.8 trillion in ESG assets at the end of 2020, a number that could grow to $53 trillion by 2025, which would represent a third of the projected total of $140 trillion in assets under management. And increasingly, brokerage firms and mutual fund companies are offering exchange-traded funds (ETFs) and other financial products specifically designed to track ESG criteria.

More and more investors have been basing their investment decisions according to the way that companies incorporate ESG into their operations, risk assessments, and planning processes.

As the public and private sectors attempt to keep pace with this trend, we offer a brief overview of the SEC's engagement on the ESG factors and the direction the agency appears to be taking on these important issues under the new administration. While the agency is making significant progress on some ESG fronts, considerably more focus is necessary in all three areas, especially as to social justice.

What Does ESG Mean?

Each one of the three terms in "ESG" encompasses a variety of important aspects of corporate planning and operations that many investors want to know more about before deciding whether to buy a stake in a company.

Environmental criteria reflect how a company contributes to, or mitigates, degradation of the environment. The most prominent example is a company's approach to climate change caused by greenhouse gas emissions: How does the company contribute to climate change, what risks does the company face from climate change, and how is the company addressing those risks and the climate change problem more generally? Environmental criteria may also reflect a company's energy use, its handling of waste and other pollutants, and its position on deforestation and other issues of natural resource conservation.

Social criteria examine a wide range of issues about social relations. A significant aspect is how the company treats its employees and whether it provides them with fair compensation and benefits. These factors also reflect the composition of a company's workforce: Does it reflect racial and gender diversity, and, importantly, is that diversity reflected up and down the corporate ladder? The "social" aspect of ESG also concerns whether the company's vendors reflect its own stated values and where the company stands on human rights issues.

Governance criteria deal with how well a company is managed by its leadership and whether the company has sufficient controls in place to ensure management serves the interests of, and is accountable to, various company stakeholders. Important components include executive compensation that produces the right incentives for management, adequate board oversight, and robust auditing and other controls. Governance criteria also evaluate how the company treats shareholders and whether it provides them with the full and fair right to participate in corporate governance by voting through the proxy process.

Why Does the ESG Movement Matter?

In the context of securities regulation, the ESG movement—and the additional disclosures that it generates—is a profoundly important phenomenon on multiple levels.

It better equips investors to allocate capital in accordance with their personal values. Investors are increasingly using the ESG criteria to make investment decisions that align with their core values. Accordingly, they want and need—and are in effect demanding—access to information about the degree to which companies have incorporated the ESG considerations into their structures and operations. This information enables investors to tailor their investment decisions and allocate their capital in ways they think are most effective in advancing their personal values.

In the context of securities regulation, the ESG movement—and the additional disclosures that it generates—is a profoundly important phenomenon on multiple levels.

It will induce positive changes in our society. More disclosure about how companies are actually incorporating the ESG factors into their businesses will help make those factors a reality on several levels. That in turn means progress toward increasing the sustainability, fairness, and quality of life our society can maintain.

First, the society at large, including policy makers, will be equipped with more granular information with which to assess the current state of play on the ESG factors and to prioritize solutions. Second, the process of formulating and making ESG disclosures will, at least to some degree, make companies more aware of deficiencies in their own adherence to the ESG factors and naturally incline them to take actions and adopt corporate policies that align better with the factors. Finally, to the extent investors

reward companies that embrace the ESG factors with greater investment, that will induce companies to implement the ESG factors more earnestly and widely.

In short, to the extent profit-seeking companies see value in taking steps to prevent the ongoing degradation of the environment, address racism and sexism, reduce income inequality, and prevent fraud and other corporate malfeasance, all at the insistence of profit-seeking investors, the results will be market-based solutions, or at least mitigants, of some of our societies' most vexing problems. Such solutions will be increasingly important in light of the political polarization that will likely prevent or impede legislative solutions to these challenges for some time to come.

Companies that perform well on ESG metrics often generate better investment returns than companies that fail to take these important issues into account.

It will help investors reap higher investment returns. Finally, and especially relevant to the SEC and the markets and investors it is supposed to protect, companies that perform well on ESG metrics often generate better investment returns than companies that fail to take these important issues into account. While many investors care about the ESG issues primarily because they seek to advance important policy goals, many understand that companies taking the ESG factors seriously offer better financial returns.

The reason for this advantage should be clear. The overwhelming scientific consensus is that climate change represents a potentially catastrophic threat and that the effort to combat climate change will lead to transformational change in all sectors of our society. In the face of these inevitable, pervasive, and powerful forces, it's easy to spot the smart investment: Companies that are better prepared to deal with the impact of climate change and to compete in a decarbonized economy will likely be safer and better investments than companies choosing to ignore these threats. Indeed, research has shown that investing with a focus on sustainability (part of the "E" in ESG) can lead to higher returns. Similarly, companies that focus on diversity (part of the "S" in ESG) tend to do better than companies that lag on diversity. And it has long been known that companies with better governance—including appropriate compensation arrangements that don't incentivize excessive risk-taking and boards that don't simply rubber stamp management decisions—outperform their peers.

The upshot is that investors want the ability to evaluate and influence the performance of companies based on the ESG factors. This is critical for all investors, those who are value-driven as well as those who are profit-driven. And that includes tens of millions of retail investors who enter the securities markets to save for critical life goals such as financing college educations and preparing for decent retirements. They depend on complete and accurate disclosures on all matters that are relevant to their investment decisions. Facilitating investors' ability to evaluate and influence company performance under the ESG factors, then, is not a fringe concern for the SEC but central to its core mission of protecting investors, ensuring the integrity of the markets, and promoting efficient capital formation.

What Role Has the SEC Played and Where Is It Headed?

The SEC has increasingly focused on ESG issues over the last decade, with much of the early attention devoted to executive compensation reform in the corporate governance arena. More recently, the SEC has turned to climate change and is expected in the near term to develop a disclosure framework for climate-related risks. The social justice component of the ESG factors has received comparatively little attention from the SEC so far, but we expect that to change as the SEC fills out its agenda over the coming months and years. As a positive point of reference, Chair Gensler has made clear that climate change and human capital issues will be important and early priorities during his tenure.

Chair Gensler has made clear that climate change and human capital issues will be important and early priorities during his tenure.

Governance Issues

The SEC's early attention to governance followed passage of the Dodd-Frank Act, which required multiple rulemakings to address some of the financial market breakdowns that helped cause and exacerbate the 2008 financial crisis. Compensation arrangements encouraged companies to take excessive risks and also resulted in grotesque pay disparities.

Early on, the SEC proposed rules to ensure the independence of compensation committees, to limit compensation schemes that lead to excessive risk-taking, to require disclosure of pay ratios in proxy statements, and to require the clawback of wrongly-awarded compensation. Better Markets generally supported these important governance reforms, urging the SEC to strengthen them in some respects and finalize them without delay. However, while the SEC finalized some of its proposals on executive compensation, it failed to complete key rulemakings on risky compensation incentives, claw backs, and pay versus performance disclosures, which remain open. Better Markets has urged the SEC to make finalizing them a high priority.

Governance issues also encompass the ability of shareholders to participate in corporate governance through the proxy voting process. Late in the Obama administration, the SEC proposed a "universal proxy" rule that would have ensured that shareholders voting by proxy in a contested board election would be able to vote for any combination of board candidates, rather than choosing only management's proposed slate or only a dissenter's proposed slate. This was and remains a critically important governance reform.

Unfortunately, the SEC under the Trump administration was often hostile to ESG concerns—a hostility that went hand-in-hand with its hostility to Main Street investors, as Better Markets detailed in a June 2020 release. It allowed important rulemaking initiatives, such as the universal proxy proposals and

the unfinished executive compensation proposals, to languish. It also proposed and finalized two rules that severely limited the ability of shareholders to hold management accountable and to have a say on important corporate policies. One creates obstacles for proxy advisory firms, which are often the only voices providing a counterweight to inherently biased management recommendations. The other makes it more difficult for shareholders to submit proposals for consideration at shareholder meetings. As Better Markets pointed out in opposition to both of these flawed and unnecessary rules, they rob shareholders of the ability to influence the direction of the corporations they own, shielding management teams from real accountability when they underperform and ignore critical issues, including the ESG factors.

There are auspicious signs that the SEC under Chair Gensler will move forward with the unfinished business on the governance front and also remedy the flaws in some of the Trump-era rules. For example, the SEC announced on June 1 that it would revisit its flawed proxy advisor rule, a move that Better Markets applauded. The SEC is also reviving the long-dormant universal proxy rule, reopening the comment period and signaling it is prepared to finalize the rule. As Better Markets pointed out in its supplemental letter once again urging the SEC to act expeditiously, the universal proxy is not just a governance issue. It also impacts the environmental and social aspects of ESG. If put in place, the universal proxy will ensure that shareholders are able to vote in a way that reflects their own values and perceptions about responsible corporate approaches to the many ESG issues that have come to the forefront—including climate change, racial justice, and wealth inequality.

If put in place, the universal proxy will ensure that shareholders are able to vote in a way that reflects their own values and perceptions about responsible corporate approaches to the many ESG issues that have come to the forefront.

Finally, the SEC's Spring rulemaking agenda of planned regulatory activity signals that in addition to revitalizing independent proxy advice and the universal proxy, the agency intends finally to complete the unfinished executive compensation rulemakings. It also intends to address ESG disclosures as they relate to investment companies and funds, and it plans to enhance registrant disclosures regarding human capital management. While the regulatory agenda is an imprecise and largely aspirational set of goals, it nevertheless provides useful insight into the agency's overall priorities.

Environmental Issues

On the environmental front, the SEC issued guidance on climate risk disclosures in February of 2010 but thereafter devoted sporadic attention to this aspect of the ESG framework until more recently. In May last year, its Investor Advisory Committee issued a major recommendation calling upon the SEC to "begin in earnest an effort to update the reporting requirements of Issuers to include material, decision-useful, ESG factors." Then on March 4th of this year, the SEC announced the formation of an enforcement task force focused on climate and ESG issues.

In another pivotal development, on March 15, 2021, then-acting-Chair Allison Lee requested public input from investors and other market participants specifically on climate change disclosures. This was a prelude to possible rulemaking, and the SEC's Spring agenda confirms that the Division of Corporation Finance "is considering recommending that the Commission propose rule amendments to enhance registrant disclosures regarding issuers' climate-related risks and opportunities." Better Markets strongly urged the SEC to adopt robust disclosure requirements on climate risk, ensuring that investors are able to make meaningful comparisons across companies and industries.

In March 19 remarks to the Asset Management Advisory Committee, Commissioner Crenshaw confirmed the trend: "[I]nvestors are using ESG-related information to make investment decisions and to allocate capital more than ever before." And she framed the SEC's core objective: "a clear disclosure regime that yields consistent, comparable, reliable, and understandable ESG disclosures to investors."

In a sign that ESG factors will soon have greater impact "on the ground," on April 9, 2021, the SEC's Division of Examinations issued a risk alert describing observations from recent examinations of investment advisers that offer and manage ESG investment options. And on June 28, the SEC's Office of the Investor Advocate issued its Report on Objectives for Fiscal Year 2022, supporting strong and comparable ESG disclosure requirements.

A recent speech by SEC Commissioner Lee nicely frames the current state of play on climate and the other ESG factors. It dramatically illustrates the importance of the ESG factors in corporate governance by citing data showing that of the top 100 revenue generators globally, 71 were corporate entities while only 29 were governments. In other words, large companies have become the economic powerhouses of the world economy and their approaches to the ESG factors will shape the nature and sustainability of our future economy and our society at large. The speech also laid to rest the debate over whether corporate boards must, or even may, consider the ESG factors, given the indubitable connection between a company's handling of the ESG factors and shareholder value. Hence the "tremendous and growing investor demand for climate and ESG disclosure."

The SEC is on the threshold of the new "ESG era" and therefore has much to do. With respect to climate change, it must follow-through with its intention to propose, finalize, and ultimately defend a robust climate-related disclosure rule for public companies. It must ultimately expand climate-related disclosure obligations to cover not only public companies but also private companies, which attract an increasingly large share of investor capital. In addition, the SEC will have to evaluate how to incorporate climate-related risks and metrics into the accounting and auditing framework, which provides a key mechanism for standardizing, incentivizing, and evaluating issuer compliance with disclosure requirements. The agency will also have to ensure that fiduciaries are appropriately taking climate factors into account as they render advice to clients, and it must evaluate what reforms are necessary to ensure that credit rating agencies take climate risks into account as they issue ratings.

Social Issues

The SEC is ramping up its efforts to advance important social policy issues such as racial justice through the securities regulation framework, but it has a great deal of ground to cover. To a degree, its overarching mission to protect investors from abuse and to help preserve the stability of our financial markets indirectly promotes economic justice. Financial crises like the one that swept over the nation in 2008 take a disproportionate toll on minority communities. Moreover, when banks, brokers, and other financial market participants engage in predatory behavior, minorities suffer disproportionately. However, more effective and focused initiatives are necessary, by the SEC and all of the financial regulators.

Pursuant to the Dodd-Frank Act, the SEC established the Office of Minority and Women Inclusion. It leads the agency's efforts to promote diversity. As explained in the SEC's most recent Diversity and Inclusion Strategic Plan for fiscal years 2020-22, those efforts are focused not solely on promoting diversity within the SEC; they also encompass promoting diversity in the SEC's network of suppliers as well as in the regulated entities it oversees. Underpinning this work is research demonstrating that organizations with a diverse workforce, especially within the senior management ranks, outperform their peers over time. Another priority will be ensuring that the SEC's education and outreach efforts adequately connect to underserved communities.

In March, the SEC's Investor Advisory Committee approved a series of recommendations relating to greater inclusion of minority and underserved communities in investment and financial services. The Committee supported measures that would increase the acquisition of financial assets and services by minority communities; create a more hospitable environment for investment by minority communities through regulatory oversight of financial services, including tailored disclosure requirements; increase financial literacy and investment in minority communities; and help registered financial services firms strengthen their ability to promote investment by under-represented communities.

On July 7, 2021, the SEC's Asset Management Advisory Committee met to consider recommendations from its Subcommittee on Diversity and Inclusion. The Subcommittee report includes some sobering data on the lack of inclusion of women and minorities in the asset management world:

> Of the $70 trillion in global financial assets under management (hereinafter "AUM") across the investment universe, less than 1% are managed by minority-owned or women-owned firms. Independent from AUM, across the industry of asset management firms, percentages of ownership interests by women and people of color in asset management firms remains startlingly and disproportionately low, by any and every objective measure. Women and people of color also remain dramatically underrepresented (by all objective measures) at the board and senior management levels within asset management firms and fund complexes. This severe underrepresentation also extends to general employment within the industry.

The Subcommittee's recommendations include new disclosure requirements regarding diversity, guidance for fiduciaries selecting asset managers to properly weight diversity, and procedures for managing reports of discriminatory practices.

Finally, with respect to future rulemaking, the SEC's Spring rulemaking agenda includes a noteworthy entry with a near-term proposal date of October: It is considering proposed rule amendments that would enhance registrant disclosures about the diversity of board members and nominees.

CONCLUSION

Overall, we see some reasons for optimism about the SEC's increased focus on ESG issues in capital market regulation. Critics of the ESG movement have expressed their opposition to greater SEC engagement on these vitally important issues, suggesting that the SEC's regulatory initiatives on ESG (especially the "E" and the "S" components) take the agency outside the purview of traditional market regulation and investor protection. This view is misguided and now largely discounted. Skeptics and outright opponents are predictably turning to a variety of other arguments, citing to the costs of mandatory ESG disclosures and calling for safe harbors (as voiced, for example, by Commissioner Roisman) to protect companies from liability for disclosures that are, they say, too difficult to make with any degree of certainty.

The costs and potential liabilities surrounding ESG disclosure are far outweighed by the monumental costs of ignoring climate change, perpetuating social injustice, and maintaining the "profit above all" approach to corporate governance.

In reality, the SEC has a vital and appropriate role to play in ensuring that investor demand for information about the ESG factors is met. That role is an integral part of the SEC's classic, tri-partite mission of protecting investors, maintaining fair and orderly markets, and in particular, facilitating capital formation. Moreover, the costs and potential liabilities surrounding ESG disclosure are far outweighed by the monumental costs—to firms and the society at large—of ignoring climate change, perpetuating social injustice, and maintaining the "profit above all" approach to corporate governance.

Ultimately, if the SEC moves aggressively on this front, its engagement will contribute not only to better capital markets but also to a better and more sustainable world. That engagement has experienced a number of starts and stops over the last decade, but we now see promising signs that the SEC will address ESG issues in earnest over the next four years. As the SEC moves forward on these and other initiatives, Better Markets will continue to proactively engage and advocate for strong rules that can genuinely fulfill the SEC's mission objectives in this area.

Better Banks | Better Businesses
Better Jobs | Better Economic Growth
Better Lives | Better Communities

Better Markets is a public interest 501(c)(3) non-profit based in Washington, DC that advocates for greater transparency, accountability, and oversight in the domestic and global capital and commodity markets, to protect the American Dream of homes, jobs, savings, education, a secure retirement, and a rising standard of living.

Better Markets fights for the economic security, opportunity, and prosperity of the American people by working to enact financial reform to prevent another financial crash and the diversion of trillions of taxpayer dollars to bailing out the financial system.

By being a counterweight to Wall Street's biggest financial firms through the policymaking and rulemaking process, Better Markets is supporting pragmatic rules and a strong banking and financial system that enables stability, growth, and broad-based prosperity. Better Markets also fights to refocus finance on the real economy, empower the buyside, and protect investors and consumers.

For press inquiries, please contact us at press@bettermarkets.com or (202) 618-6430.

1825 K Street, NW | Suite 1080 | Washington, DC 20006 | (202) 618-6464 | www.BetterMarkets.com

© 2021 Better Markets, Inc. All rights reserved.