KING & SPALDING

ESG Agenda

Environmental. Social. Governance.

APRIL 2021 VOLUME 6

Biden's Audacious Climate Change Pledge

- **Biden pledges to reduce American GHG emissions to half of 2005 levels**
- **Is this the year institutional investors begin to support climate proposals?**

At an Earth Day summit for world leaders, President Biden pledged to reduce American greenhouse gas emissions to less than half of 2005 levels. The target is more ambitious than other emission reduction pledges, falling short of only Britain. Experts believe that the ambitious goal can be achieved but only through rapid and sweeping changes; political and regulatory efforts in support of the pledge could be stymied by an evenly-divided Senate.

Biden's pledge reflects a growing consensus that climate change poses an existential risk to society and the economy. For example, insurance giant Swiss Re released a report that said the effects of climate change will shave 11 to 14% off economic output by 2050 compared with growth levels without climate change, amounting to as much as $23 trillion in reduced annual global economic output.

As the public has generally become more supportive of efforts to combat climate change, many pressure groups have focused their attention on the world's largest asset managers, seeking to compel them to use their stakes in public companies to effect change. Historically, the largest asset managers expressed vague support for oversight of climate issues, and rarely supported those weak statements with votes for climate-related shareholder proposals or against director nominees.

But that is changing. A recent analysis found that 13 of the 30 largest asset managers now consider oversight of climate change when casting votes on director nominees. Investors like BlackRock have signaled they will be much more likely to support shareholder proposals on climate matters. Given the size of their holdings, its support would dramatically change the narrative (and potentially the outcome) at many companies. Moreover, as other investors feel pressure to compete on their environmental stewardship, BlackRock's support could cause other managers to support more climate proposals as well. With more than 100 climate-related proposals filed this year – see Issues to Watch This Shareholder Proposal Season, page 5 – we will soon see if investor bark matches their bite.

How Pledges to Cut Emissions Compare

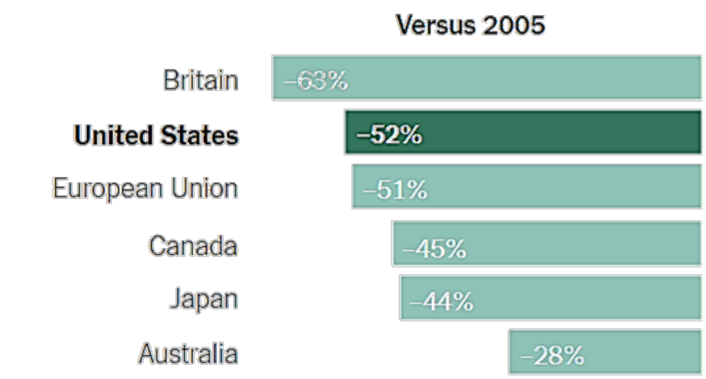
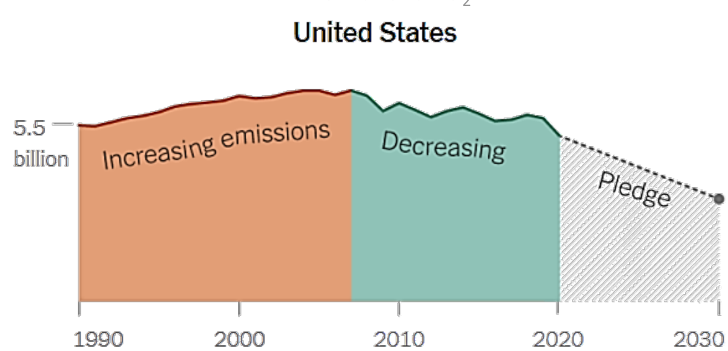


Chart reflect high end of emissions reduction pledges.

Trajectories for the World's Largest Emitters

In metric tons CO_2



Source: The New York Times, citing Rhodium Group data

KEY QUESTION FOR COMPANY LEADERS

- Which of our most important stakeholders are requesting greater attention to climate impacts? If they asked us to discuss the subject with them, would we be able to share a compelling story about our current efforts and future plans?

ESG Financing and Green Bonds On the Rise

- **Sustainability-linked financing growing globally, likely to become more common in the US**

Corporate issuers and borrowers, as well as sources of financing, have shown increased interest in demonstrating commitment to ESG performance through financing arrangements. In the first quarter of this year, companies issued $130 billion in green bonds (focused on environmentally friendly projects), and $135 billion in social and sustainability bonds, according to data from Refinitiv.

As companies consider the benefits of demonstrating financial alignment with sustainability goals, more mainstream lenders and investors incorporating ESG goals into broader investment policies are helping drive demand.

Relatedly, earlier this month, BlackRock Inc. made headlines upon entering an ESG-linked $4.4 billion credit facility with interest rates tied to BlackRock's ability to meet certain pre-established E&S goals. The goals include meeting targets for women in senior leadership roles and Black and Latino employees in its workforce, as well as AUM in dedicated sustainable investments. BlackRock's borrowing costs could increase or decrease, depending on the number of targets met.

On the bond side, most "green bonds" issued in recent years required the issuer to spend the proceeds on specified projects. The sustainability-linked bond – or "SLB" – is a relatively new product that began in Europe, supported by European Union policies as a means of countering climate change, and is now beginning to gain traction in the U.S. market. SLBs show a commitment to an ESG goal without raising funds for a particular project. Like the BlackRock loan, SLBs incorporate forward-looking sustainability KPIs and sustainable performance targets into the financial and/or structural terms of the bonds. The flexibility to use KPIs to fit a company's sustainability strategy has made the product more attractive to a wider range of issuers than more traditional green bonds. One of the main critiques of SLBs, however, is whether rewarding bond holders when the interest due on the bond increases if the issuer fails to meet its KPIs in the time agreed.

Although the market is still evolving, investor demand for SLBs continues to grow and we expect to see more U.S. companies exploring these instruments as viable financing options.

2021 Q1 Activity

$264 Billion

Cumulative Green, Social, and Sustainability Bond Borrowing

99

Social and Sustainability Bonds Issued

Source: Reuters, citing Refinitiv Data

KEY QUESTION FOR COMPANY LEADERS

- Have we considered, or should we be considering, the potential benefits of an ESG-linked financing?

ESG Priorities in the Gensler SEC

- **Commissioner Lee ended her tenure as Acting Chair with a flurry of activity**
- **No change of direction expected with 3-2 Democratic SEC majority**

On Saturday, April 17, Gary Gensler was sworn in as Chair of the Securities and Exchange Commission. He joined the SEC at a moment when the Democratic Commissioners, led by then Acting Chair Allison Herren Lee, had been advancing a number of ESG initiatives. As we noted in our last issue, then-Acting Chair Lee appointed the first Senior Policy Advisor for Climate and ESG, and directed the Division of Corporation Finance to "enhance its focus on climate-related disclosure in public company filings."

Since our last publication, the SEC has gone further, and

- Requested public input on the Commission's disclosure rules and guidance as they apply to climate change disclosures.
- Called for changes to shareholder proxy voting disclosures in part to provide readers more information in a more timely fashion given "soaring demand" for ESG investment strategies.
- Launched a Climate and ESG Task Force within the Division of Enforcement, charged with "develop[ing] initiatives to proactively identify ESG-related misconduct" and coordinate Division resources to "mine and assess information across registrants to identify potential violations."
- Announced it was reopening the comment period for 2016's universal proxy proposal, which would amend Schedule 14A and related rules to require the use of a single proxy card with all candidates up for election, allowing shareholders to vote for their preferred combination of dissident and management nominees on one card.

Although Gensler's confirmation ended Commissioner Lee's term as Acting Chair, the SEC is expected to continue its focus on ESG issues. Gensler has made no attempt to distance himself from Lee's actions as Acting Chair; in fact, he may go even further. Gensler recently named Heather Slavkin, Former Director of Capital Markets Policy at the AFL-CIO, as his Policy Director. Her background with organized labor could mean even greater attention to human capital management issues and new HCM disclosure obligations.

Is Shareholder Proposal Reform Imperiled?

Although now outside of the SEC's hands, it is also worth noting that legislation has been filed in Congress to use Congressional Review Act (CRA) authority to overturn the Rule 14a-8 shareholder proposal reforms adopted in 2020 under the Clayton-led Commission. Under the CRA, recently finalized agency rules can be nullified by a resolution passed by the House and Senate and signed by the President. While there is potential that this strategy could succeed, a 50-50 Senate with some outspoken and emboldened moderate Democrats makes passage far from assured.

KEY QUESTION FOR COMPANY LEADERS

- Given greater SEC scrutiny, are we confident with the quality of our ESG disclosures and ESG controls?

Early 2021 Proxy Voting Results

- **Significantly more opposition to say on pay votes, especially at larger companies**
- **Support for director nominees steady so far, but expect numbers to drop over the season**

Although it is still early in the proxy season, an analysis of early voting results reveals some interesting trends.

Say on Pay. In the early days of the pandemic, some investors and proxy advisors cautioned companies that their pandemic-related pay actions would be put under a microscope, as a referendum not just on corporate performance but also on the level of commitment to their current compensation design when times got tough. While acknowledging the unprecedented effects on public companies, many suggested positive adjustments to pay would be viewed skeptically.

Early results show more scrutiny of pay than last year. Based on Proxy Insight voting results available on April 28, 2021, average support for all say on pay proposals has dropped roughly 1% in the Russell 3000 compared to calendar year 2020. Failures are also up over last year, with 3% of Russell 3000 companies failing so far this year, compared to roughly 2% last year.

In the S&P 500, average support has declined at a slightly lower rate, dropping from 89.8% to 87.7%. Four S&P 500 companies have failed say on pay votes so far, compared to 11 in the entirety of 2020.

ISS has been more critical of executive pay this year than last, especially at larger companies. While the sample size is small, in the S&P 500, ISS has recommended in favor of just 77.1% of say on pay resolutions so far, compared to 89.2% last year. In the Russell 3000, ISS supported 86.4% of proposals, down about 3.5% from last year.

Director Elections. Investors and proxy advisors have identified more reasons than ever to vote or recommend against the election of particular directors, including lack of diversity, tightening of overboarding policies, presence of disfavored governance provisions, lack of responsiveness to shareholders, compensation decisions, and more. Over the past few years, the average level of support for directors has dropped, and the likelihood of an ISS recommendation against directors has grown.

As of now, however, support for director nominees has not diminished. In the Russell 3000, support for directors is marginally higher, at 95.5% this year. ISS has supported 94.8% of Russell 3000 directors so far, up from 89.3% in 2020. In the S&P 500, average voting support this year is roughly the same as in 2020 – 96.7% – and ISS support has increased from 97.8% to 98.5%. Expect these numbers to drop as the proxy season continues to unfold.

KEY QUESTIONS FOR COMPANY LEADERS

- What did we learn from engagement with major investors about their pay program preferences this year?
- Are our directors aware of the potential for negative voting recommendations and lower voting percentages this year?
- Will evolving proxy advisor and investor standards cause us to consider any governance or disclosure changes for next year?

Issues to Watch This Shareholder Proposal Season

- **Hot topics thus far are climate change, political activity, diversity, and governance**
- **Expect support levels to beat historical averages as investors promise more “yes” votes**

Climate Change. Climate change remains the dominant environmental topic this year, with at least 136 climate-related shareholder resolutions filed so far this proxy season. Consistent with recent years, the most popular type of environmental proposals concern greenhouse gas emissions. With some major investors including BlackRock announcing their intent to support more proposals of this nature, we expect already significant average support levels to rise. Relatedly, an emerging effort to require companies to hold an annual advisory “say on climate” vote giving shareholders a chance to weigh in on climate strategy is gaining traction. Investors appear to be split on this concept, but activist fund TCI intends to convince 100 S&P 500 companies to adopt “say on climate” by the end of 2022.

Political and Lobbying Activity. Corporate political involvement proposals are also popular this year, with at least 30 filed so far. Attention to corporate political activity – including lobbying efforts and trade association memberships – has grown in recent years, but this past year may prove to be a watershed given (1) growing attention to corporate statements on important social issues, such as race relations, and whether political activities are consistent with public corporate statements, (2) blowback against corporate contributions to legislators who challenged the certification of the electoral college vote in January, and (3) significant pressure on businesses to take positions on Georgia’s new voting law. On the heels of calls for disclosure and accountability on political spending following the attack on the Capitol, expect investors to support more of these proposals.

Diversity. Against a backdrop of recent legislation in California requiring board quotas based on racial and ethnic categories, and sexual orientation, as well as Nasdaq’s proposed rule that would require listed companies to disclose statistics in a prescribed matrix format, the number of diversity-related proposals has increased significantly this year. Investors expect 40 resolutions to require disclosure of EEO-1 data, up from 22 last year. Other diversity-related proposals seek more detail on diversity, equity, and inclusion initiatives, with many filed at companies that publicly supported the Black Lives Matter movement last year. Proposals for “Rooney Rule” policies for board selection have become less common given significant voluntary adoption by the corporate community, but there has been an uptick in attention to Rooney Rule requirements for employee hiring.

Governance. Outside of the E&S space, traditional shareholder rights topics remain both common and frequently supported. There have already been at least 150 of these governance proposals filed this year. Some of these proposals seek to either create special meeting, written consent, or proxy access rights, or make existing rights more shareholder friendly. Other proposals seek to eliminate takeover defenses seen as unfriendly to shareholders, including classified boards and supermajority voting requirements. Last year saw an uptick in the level of support for proposals to require an independent board chair, including the passage of two proposals; it is not yet clear if that was a blip or the beginning of a trend.

KEY QUESTION FOR COMPANY LEADERS

- Are we tracking proposals that are relevant to our company, peers, and largest investors?

ESG Limits on Retirement Plans Won't Be Enforced

- **Department of Labor says it will not enforce Trump Administration regulations that limited the consideration of ESG factors by employee retirement plans**
- **Announcement signals likely shift to increased acceptance of ESG-focused investments in 401(k) Plans**

On March 10, 2021, the U.S. Department of Labor ("DOL") announced that it will not enforce two regulations, published in November and December 2020, restricting employee retirement plans' consideration of ESG factors in the investment of plan assets. The move followed President Biden's executive order directing federal agencies to review regulations promulgated during the Trump Administration that may be inconsistent with his administration's policy objectives related to health and the environment.

Both regulations prohibit retirement plans from focusing on ESG factors at the expense of the economic interests of plan participants. The first regulation applied this restriction in the context of selecting plan investments (for example, the funds offered in a 401(k) plan). The second regulation applied it to the exercise of shareholder rights, including proxy voting on shareholder proposals, by plan fiduciaries.

The DOL's announcement does not mean that retirement plan fiduciaries now have approval to prioritize ESG factors when evaluating investments or exercising shareholder rights. Both regulations remain on the books. But the DOL also announced that it intends to "revisit" both regulations in the future.

ESG-focused funds reportedly account for one-third of total U.S. assets under management, but under 3% of 401(k) plans offer them as investment options. If the DOL ultimately promulgates new regulations that approve 401(k) plans' consideration of ESG factors, it could open up a $6.4 trillion market. For now, plan sponsors may be wary, knowing that someone else might seek to enforce the ESG regulations, even if the DOL will not.

ESG Funds in Retirement Plans

\$6.4 trillion

Assets in 401(k) plans, 2019

3%

Percentage of 401(k) plans that offer an ESG fund as an investment option

Source: Plan Sponsor Council of America; Morningstar

KEY QUESTIONS FOR COMPANY LEADERS

- What ESG funds, if any, does our 401(k) plan currently offer?
- How should we capitalize on the growing interest in ESG funds, both with our employees and also with our investor relations strategies?

Cyber Breach Disclosure Trends

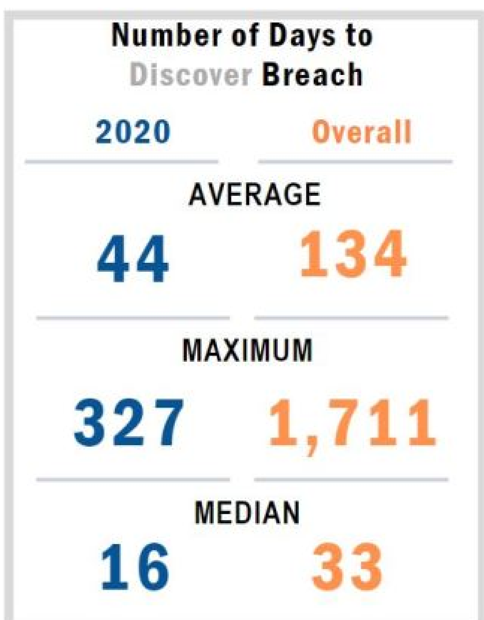
- **Annual cybersecurity breach report shows large number of disclosed breaches**
- **Breaches discovered more quickly, disclosed slightly later**

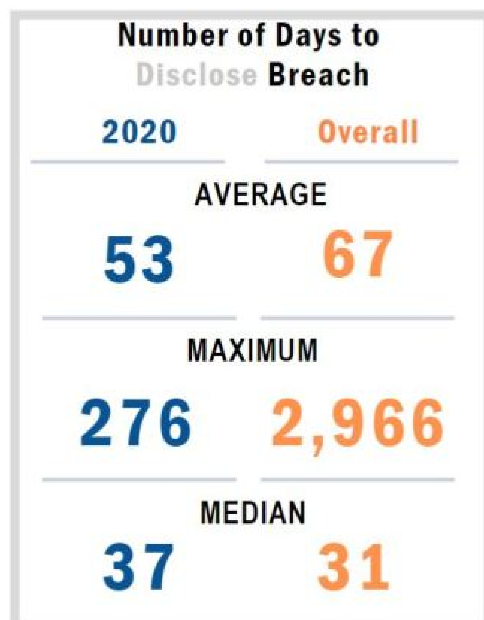
Audit Analytics recently released its third annual *Trends in Cybersecurity Breaches* report. The report analyzes public disclosure of cybersecurity incidents over 2020 and compares those disclosures to data over the last decade.

Unsurprisingly, breaches remain common, with 117 disclosed last year, the third highest total in the past decade. The number of disclosed breaches fell from an all-time high of 144 in 2019. The report authors hypothesize that this may not be due to fewer breaches, but instead due to less effective monitoring programs as many companies moved to remote work last year.

Disclosures are generally much more detailed now than in the past. Last year, 90% of disclosures identified the type of breach, compared to 71% in 2018. Malware was most common, accounting for 40% of 2020 breaches; unauthorized access attacks constituted 30% of the total.

Companies discovered breaches last year much more quickly than historical averages; the median time to discover was 16 days, nearly half of the ten-year average. There is a wide-range of practice with how promptly breaches are disclosed. The overall average is nearly two months after a breach, but the median disclosure of 37 days indicates that many companies are disclosing more swiftly.





Source: Audit Analytics Trends in Cybersecurity Breaches (2021)

KEY QUESTIONS FOR COMPANY LEADERS

- Have we completed a tabletop exercise to pressure test our cybersecurity response plan?
- How frequently do we review the cyber threat landscape with our senior leadership team? With the board?

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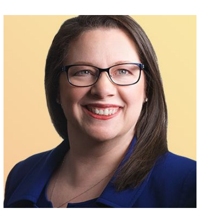

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