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ESG and Sustainability: Key Considerations for 2021

Heading into 2021, corporate, investor and stakeholder focus on ESG will continue to accelerate, with climate change, workplace diversity, employee welfare, human capital management and supply chain sustainability and resilience remaining forefront issues. Just earlier this week, BlackRock's Chairman and CEO issued a letter to CEOs calling on companies to (1) "disclose a plan for how their business model will be compatible with a net zero economy," including how such plans are incorporated into long-term strategy and reviewed by the board, and (2) expand disclosures on talent strategy to fully reflect long-term plans to improve diversity, equity, and inclusion. The World Economic Forum (WEF) also announced this week that 61 of the world's largest companies have committed to disclosing against the core ESG metrics developed by the WEF and its International Business Council, a key further step in the ongoing convergence of ESG disclosures. Hedge fund TSR activist attacks will also increasingly leverage ESG and sustainability-related themes, as will the new breed of ESG impact activist funds.

The fact that ESG-oriented funds recorded unprecedented inflows and outperformed in many respects in 2020 amidst the Covid-19 pandemic demonstrates the possibility of doing well by doing good. At the same time, the pandemic exposed the significant social, economic and reputational costs of not addressing ESG issues, notably systemic racism, employee safety, health and well-being and supply chain resilience. Below is a review of the trends we expect to see in 2021 as investors and other stakeholders scrutinize how companies create and preserve long-term value:

- **Heightened Focus on Climate Change Risks**
- **ESG Goal Setting and Accountability**
- **Workplace Diversity Under Scrutiny**
- **Reshaping of Human Capital Management**
- **Supply Chain Sustainability and Resilience**
- **New Expectations for "Active" Board Oversight**
- **Accelerating Disclosure and Moving to Assurance and Integration**

Heightened Focus on Climate Change Risks. In November 2021, global leaders will meet in Glasgow for the United Nations Climate Change Conference (COP26) to draw up a successor plan to the Paris Agreement. With evidence indicating that the Paris Agreement targets may fall short of limiting global warming to 1.5°C, governments and regulators globally face mounting public pressure to address the threat of climate change. President Biden has already issued an executive order for the United States to re-join the Paris Agreement and key investors have made climate change risk management a key priority for 2021: BlackRock has stated in its 2021 stewardship expectations guidelines that "[t]he events of [2020] have intensified our conviction that sustainability risk—and climate risk in particular—is investment risk" and plans to expand its engagement to the over 1,000 companies that are responsible for producing 90% of greenhouse gas emissions in its investment portfolio. Similarly, in his letter to boards, Cyrus Taraporevala, State Street's CEO and President, said the asset manager will be elevating its focus on climate risk, noting that ahead of COP26, "policymakers are assessing progress on climate change action . . . many jurisdictions are signaling their intentions to make climate risk disclosure mandatory." Vanguard has determined that "it is critical that public company boards fully understand and own climate-related risks."

ESG Goal Setting and Accountability. While many current ESG disclosures are descriptive and historical, we expect a move towards forward-looking ESG disclosures encompassing qualitative and quantitative targets that help demonstrate accountability, commitment and progress towards ESG best practices. A growing number of companies have already publicly disclosed forward-looking initiatives on climate change and diversity. There is also an increasing push among investors for companies to provide disclosures consistent with the recommendations of the Task Force on Climate-Related Financial Disclosure (TCFD), which include, among other things, disclosures regarding climate risk scenario planning and the adoption of targets to manage climate-related risks. In 2021 and beyond, companies will need to consider how to formulate an ESG strategy whose progress can be measured by concrete, reportable targets, goals and forecasts, and decide how best to publicly communicate initiatives that may extend across several decades and require flexibility to evolve and pivot over time.

Workplace Diversity Under Scrutiny. In 2021, it is likely that investor and stakeholder focus on racial and ethnic diversity will move beyond the board and into the broader workplace. The pandemic has exposed the rampant injustices created by systemic issues, and the weight of the pandemic and job loss continues to be disproportionately borne by minorities and women even as people of all

backgrounds are adversely affected. With respect to boards, late last year, Nasdaq filed a proposal with the U.S. Securities and Exchange Commission (SEC) to require listed companies to have, or explain why they do not have, at least two diverse directors, and ISS, Glass Lewis and many investors have amended their 2021 proxy voting guidelines to increase scrutiny of gender and racial diversity on boards. While board diversity will remain a key focus for investors and regulators, the push for diversity is expanding to the workforce: investors, including the New York City Comptroller, BlackRock, State Street and Vanguard, along with ISS, have all called on companies to disclose their workforce EEO-1 data or equivalent workforce demographic information. Vanguard also cautioned in a recent policy statement regarding hiring that "[c]ompanies that fail to include a wider array of individuals will miss out on large portions of the talent pool and put their long term success in jeopardy." A number of financial institutions even recently announced Rooney Rule-style initiatives with respect to workforce recruitment and hiring.

Reshaping of Human Capital Management. The onset of remote work and the disruption, stress and uncertainty created by the pandemic has helped to draw attention to, and in many cases prompted companies to rethink, their approach to human capital management, in particular, employee health and well-being. Investors are now looking at how companies are adapting their employee recruitment, training, development and retention practices, corporate culture and corporate purpose to meet the needs of this new era. Late last year, the SEC amended Regulation S-K to require disclosure of material human capital-related information in annual reports on Form 10-K. The Sustainability Accounting Standards Board (SASB) is also currently reviewing the scope of human capital disclosures across its framework.

Supply Chain Sustainability and Resilience. The pandemic saw unprecedented disruptions to global supply chains and underscored the blind spots in supply chain models geared towards maximizing efficiency at the expense of resilience. In the meantime, concern regarding sustainability, supplier diversity and transparency are gaining traction among consumers as well as investors. Companies looking to rebuild and strengthen their supply chains will need not only to ensure compliance, safety and reliability, but also explore how their supply chains can play an integral role in the company's efforts to promote sustainability, equality and access.

New Expectations for "Active" Board Oversight. As investor and stakeholder scrutiny of ESG continues to accelerate, boards will also continue to face heightened expectations on their oversight of ESG. Management of ESG risks

and opportunities, such as climate change, will often require companies to adopt a long-term strategic approach and investors are looking to boards to oversee the integration of ESG considerations into business strategy and to monitor progress and performance over time. At the same time, growing recognition of stakeholder interests means that boards may also need to play a more active role in overseeing stakeholder engagement and ensure such interests are appropriately accounted for in key business decisions for the benefit of the enterprise.

Accelerating Disclosure and Moving to Assurance and Integration. In 2020, we saw significant strides in the push to create standardized and comparable ESG disclosures with five of the major ESG disclosure frameworks, including SASB and the Global Reporting Initiative (GRI), committing to creating a comprehensive corporate reporting system. With ESG reporting entering the mainstream and reporting standards beginning to converge, we expect companies that have yet to issue ESG reports to face increased investor pressure to do so, and for companies that have already made ESG disclosures, to continue to improve the scope, quality and comparability of their disclosures. Heading into 2021, we also anticipate a growing focus on how companies provide assurance and verification for their ESG data. Boards and management will need to decide the scope of any assurance conducted by third-party service providers, and how to ensure that internal reporting processes yield accurate and verifiable data.

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