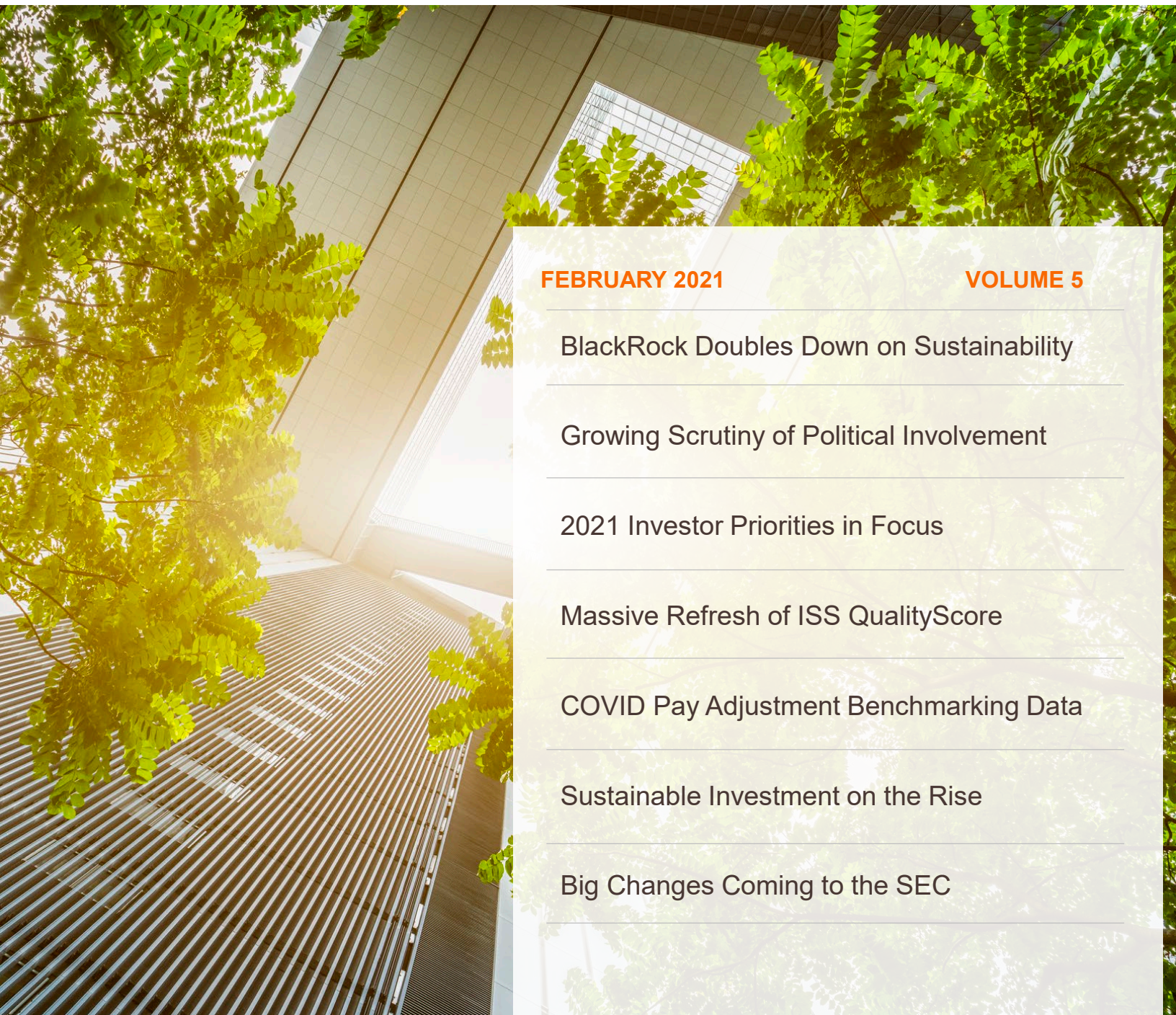


KING & SPALDING

# ESG Agenda

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Environmental. Social. Governance.



**FEBRUARY 2021**

**VOLUME 5**

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BlackRock Doubles Down on Sustainability

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Growing Scrutiny of Political Involvement

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# BlackRock Doubles Down on Sustainability

- **BlackRock signals substantially more assertive posture on climate-related issues**
- **New approach to shareholder proposals saw BlackRock support 54% of environmental and social proposals in the second half of 2020**

It is an annual ritual to digest the latest wisdom and demands from Larry Fink's annual letter to public company CEOs. The letter is an important indicator of BlackRock's stewardship priorities, important to the thousands of companies for which BlackRock is one of the largest shareholders. BlackRock's annual letter is important for other reasons, including media coverage and a perceived effect on policy at other asset managers. Regardless of how much BlackRock's policies reflect existing market sentiment or move it, the letter typically identifies a priority area or goal that is immediately added to the agendas of boards around the country.

The priority being added to agendas right now: net zero. In the letter, Fink announced that BlackRock is "asking companies to disclose a plan for how their business model will be compatible with a net zero economy." Disclosure should also describe how that plan is incorporated into long-term strategy and reviewed by the board of directors, Fink wrote.

Last year, BlackRock engaged with 440 carbon-intensive companies to discuss climate risk, voting against 64 directors and against management recommendations on proposals at 69 companies. It placed another 191 companies "on watch" who are, as of this year, at higher risk for votes against.

Expect BlackRock to be even more assertive in the future. In a letter to clients released alongside Fink's missive, BlackRock announced plans to engage with more than 1,000 carbon-intensive companies this year. The firm also reminded readers that its approach to shareholder proposals has changed. "As a long-term investor, BlackRock has historically engaged to explain our views on an issue and given management ample time to address it. However, given the need for urgent action on many business-relevant sustainability issues, we will be more likely to support a shareholder proposal without waiting."

The new voting philosophy was adopted in the second half of 2020, and saw BlackRock support a whopping 54% of environmental and social proposals.



*"During 2020, 81% of a globally-representative selection of sustainable indexes outperformed their parent benchmarks. This outperformance was even more pronounced during the first quarter downturn, another instance of sustainable funds' resilience that we have seen in prior downturns... It's not just that broad-market ESG indexes are outperforming counterparts. It's that within industries – from automobiles to banks to oil and gas companies – we are seeing another divergence: companies with better ESG profiles are performing better than their peers, enjoying a 'sustainability premium.'"*



— LARRY FINK, CEO OF BLACKROCK

## KEY QUESTIONS FOR BOARDS

- What carbon-reduction initiatives do we have in place currently?
- In addition to the risk of shareholder or other stakeholder scrutiny for sustainability practices, have we evaluated sustainability-related opportunities that may be available to us?

# Growing Scrutiny of Political Involvement

- **Many companies are reevaluating their political involvement**
- **Companies will face pressure directly from certain stakeholders who are themselves being pressured to do more**

Attention to corporate political involvement has grown dramatically in recent years, as important stakeholders have demanded public companies align their political activities with preferred causes. As companies and their leaders have responded, issuing statements and crafting policies on important issues of the day, some critics have noted where the rhetoric conflicts with how companies have directed corporate political and lobbying dollars. How can a company commit to combat climate change, for example, if it contributes to politicians who are viewed as climate change deniers?

Recently, many companies have chosen to suspend donations to candidates in response to violence at the Capitol in January. A Washington Post study found that 20 of the 30 largest corporate backers of the Republican Party have suspended their donations; 12 have done so completely, while eight have suspended donations only to lawmakers who objected to election results. Seven of the remaining ten companies were still evaluating their response; just three companies have said that they have no plans to change their approach. Others have gone further, with at least one major company discontinuing its corporate political action committee.

This environment is likely to accelerate attention to these issues – attention that was rising before the events at the Capitol. In the 2018 proxy year, there were 51 proposals at S&P 500 companies to enhance reporting of political and lobbying activity. None passed, with an average of 28.7% support. In the proxy year that ended June 30, 2020, there were 55 such shareholder proposals. Average support increased to 35.5%, and six proposals received majority support.

There is pressure on investors to support more of these proposals. Last year, BlackRock announced that

it would “seek confirmation from companies, through engagement or disclosure, that their corporate political activities are consistent with their public statements on material and strategic policy issues. Moreover, we expect companies to monitor the positions taken by trade associations of which they are active members on such issues for consistency on major policy positions and to provide an explanation where inconsistencies exist.”

But BlackRock and the other largest asset managers – Vanguard, State Street, Fidelity, JPMorgan, and BNY Mellon – were targeted by Majority Action and the Service Employees International Union for not doing enough. In a public letter released this February, the group claims that these large asset managers themselves donated heavily to candidates who opposed certification of electoral college results and also did little to encourage companies to be more transparent. All but one voted against a majority of shareholder proposals seeking greater disclosure; BlackRock and Vanguard voted against all such proposals.

In this environment – where companies are being pressured directly by stakeholders to do more, and many of those stakeholders are also scrutinized for their advocacy efforts – reviewing corporate political involvement practices makes sense. Companies should be particularly mindful to evaluate how political decisions – including lobbying and trade association involvement – are overseen by senior management and the Board. As pressure continues to build for greater transparency about political involvement, companies should also consider voluntary enhancements to political activity disclosure.

## KEY QUESTIONS FOR BOARDS

- Has our company faced any pressure from stakeholders – particularly employees or shareholders – about our political involvement?
- Are we subject to any criticism for political involvement that may be perceived as in conflict with stated corporate values?

# 2021 Investor Priorities in Focus

- **Voting and engagement policy update season is underway**
- **Interest in board composition, climate risk oversight expected to remain strong**

We covered updates to voting guidelines at BlackRock and proxy advisors in our [last issue](#). Some other investor policy changes or explanations have been released recently; the most material are summarized below.

**Vanguard** Announced an update to its oversight of boardroom diversity, noting that with 2021 annual meetings, Vanguard will start to vote against directors at companies where “progress on board diversity falls behind market norms and expectations.” A footnote suggests boards lacking any female or racially/ethnically diverse members will be targeted this year, but expect those goal posts to move in future years.

Vanguard also issued a statement that suggests it will continue to be reluctant to support shareholder proposals (counter to BlackRock’s intent to vote for more such proposals). There are three central questions the asset manager will ask when evaluating proposals; a “no” on any makes Vanguard’s support unlikely:

- 1) Does the proposal address a material issue relevant to the company?
- 2) Does the proposal suggest a change that advances long-term shareholder interests?
- 3) Does the proposal address gaps in the company’s current practices or stated intentions?

**STATE STREET GLOBAL ADVISORS** The annual letter from CEO Cyrus Taraporevela noted two key priorities for 2021: (1) climate risk, and (2) racial and ethnic diversity.

On climate risk, SSGA reiterated its request to have companies use the Task Force on Climate-Related Financial Disclosure (TCFD) framework to guide their oversight of climate risk. To date, SSGA has engaged with roughly 600 companies on this score.

On diversity, SSGA announced an intent to vote against directors for lacking racial and ethnic diversity disclosure:

- In 2021, SSGA will vote against the Chair of the Nominating & Governance Committee at companies in the S&P 500 and FTSE 100 that do not disclose the racial and ethnic composition of their boards;
- In 2022, SSGA will vote against the Chair of the Compensation Committee at companies in the S&P 500 that do not disclose their EEO-1 Survey responses; and
- In 2022, SSGA will vote against the Chair of the Nominating & Governance Committee at companies in the S&P 500 and FTSE 100 that do not have at least one director from an underrepresented community on their boards.

**Fidelity** Limited updates, but an increased attention to board composition. Fidelity will now vote against some or all directors if a board has no women (or has ten or more members and has fewer than two women directors), or if a public company CEO sits on more than two unaffiliated public company boards.

## KEY QUESTIONS FOR BOARDS

- How do we track voting and engagement policy developments at significant shareholders?
- How do our shareholder engagement priorities align with those of our largest investors?

# Massive Refresh of ISS QualityScore

- **Substantial increase in detail requested on information security risk oversight**

On February 8, ISS unveiled methodology changes for its Governance QualityScore ratings. QualityScore ratings are, by themselves, unlikely to drive investor or other stakeholder behavior. But the items on which the scores are based often reflect significant investor interest. Given the high visibility of QualityScore rankings, items rated by QualityScore do tend to get greater attention and more robust disclosure, which can move market practice. New questions for U.S. companies (whether entirely new factors, or factors that now apply in the U.S.), are:

## **AUDIT: INFORMATION SECURITY RISK OVERSIGHT / MANAGEMENT**

- What percentage of the committee responsible for information security risk is independent?
- How often does senior leadership brief the board on information security matters?
- How many directors with information security experience are on the board?
- Does the company disclose an approach on identifying and mitigating information security risks?
- What are the net expenses incurred from information security breaches over the last three years relative to total revenue?
- Has the company experienced an information security breach in the last three years?
- What are the net expenses incurred from information security breach penalties and settlements over the last three years relative to total revenue?
- Has the company entered into an information security risk insurance policy?
- Is the company externally audited or certified by top information security standards?
- Does the company have an information security training program?
- How long ago did the most recent information security breach occur (in months)?

## **BOARD STRUCTURE**

- Does the board exhibit ethnic or racial diversity?
- What percentage of the sustainability committee is independent?
- What percentage of the board has familial relationships with other directors?
- How many executive directors serve on an excessive number of outside boards?
- Does the Board Chair serve on a significant number of outside boards?

## **COMPENSATION**

- What is the level of disclosure on diversity and inclusion performance measures for the short-term or any long-term incentive plan for executives?
- Has the company made special grants to executives excluding the CEO in the most recent fiscal year?
- What percentage of the CEO's total compensation was due to special grants in the most recent fiscal year?

## **SHAREHOLDER RIGHTS**

- What is the percentage of multiple voting rights or voting certificates relative to total voting rights?
- What percentage of issued share capital is composed of non-voting shares?

## **KEY QUESTION FOR BOARDS**

- Are the areas covered by these questions receiving appropriate Board attention?

# COVID Pay Adjustment Benchmarking Data

- **Most companies that made COVID-related pay adjustments did so to annual incentives**
- **Wide variety of approaches used, but exercising discretion most common**

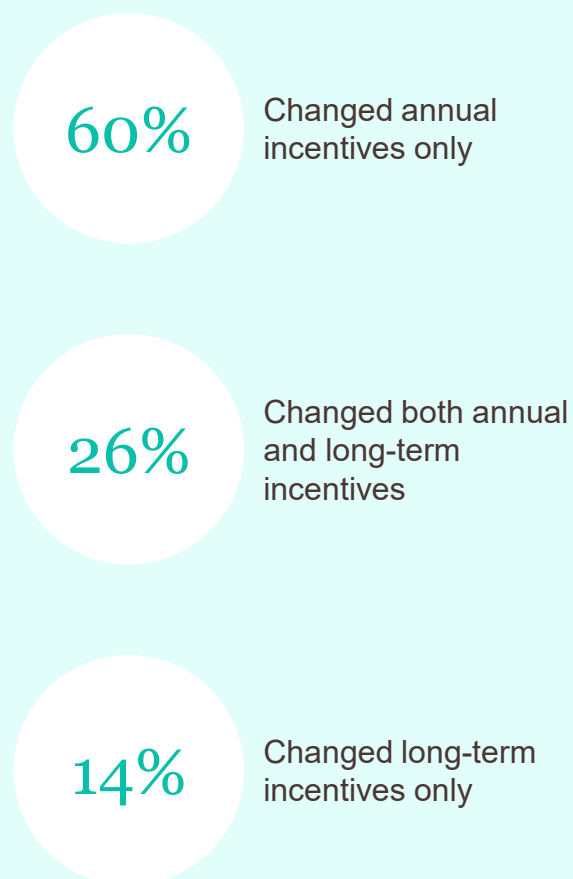
Compensation Advisory Partners, a compensation consultant, recently analyzed the proxy statements of 100 S&P Composite 1500 companies to evaluate how they adjusted pay in response to the pandemic. Forty-two of the companies – all of which have September 30 fiscal year ends – made incentive changes.

For those companies that made changes to the annual incentive plans, the most common approach was to exercise discretion with the award (14 companies). Note that adjustments were not universally positive; at Disney, for example, the annual incentive award was reduced to 0% from the 21% that was justified by the incentive plan “in light of the circumstances this year.” Other approaches were to add or change metrics (9), adjust the performance period (8), reset goals (4), or attempt to exclude COVID from performance (3). Most of these adjustments were made retrospectively, but a few companies made changes on a go-forward basis.

With long-term incentives, it was more common to adjust on a go-forward basis than to revise the outstanding plan. Forward-looking changes included changing performance metrics (5), changing the incentive vehicle (4), adjusting the performance period (2), or revising the payout scale (1). Those that revised their outstanding plans adjusted the performance period (3), revised the payout scale (2), or attempted to exclude COVID from performance (2).

Companies yet to file their proxies that made compensation adjustments will benefit from the growing pool of disclosure examples from earlier filers (and the associated voting results) as they finalize their own disclosure.

## Where Changes Were Made



Source: [CAP Analysis](#) (Feb 5, 2021)

## KEY QUESTION FOR BOARDS

- Has executive compensation, particularly our approach to pay during the pandemic, been a focus of recent shareholder engagements?



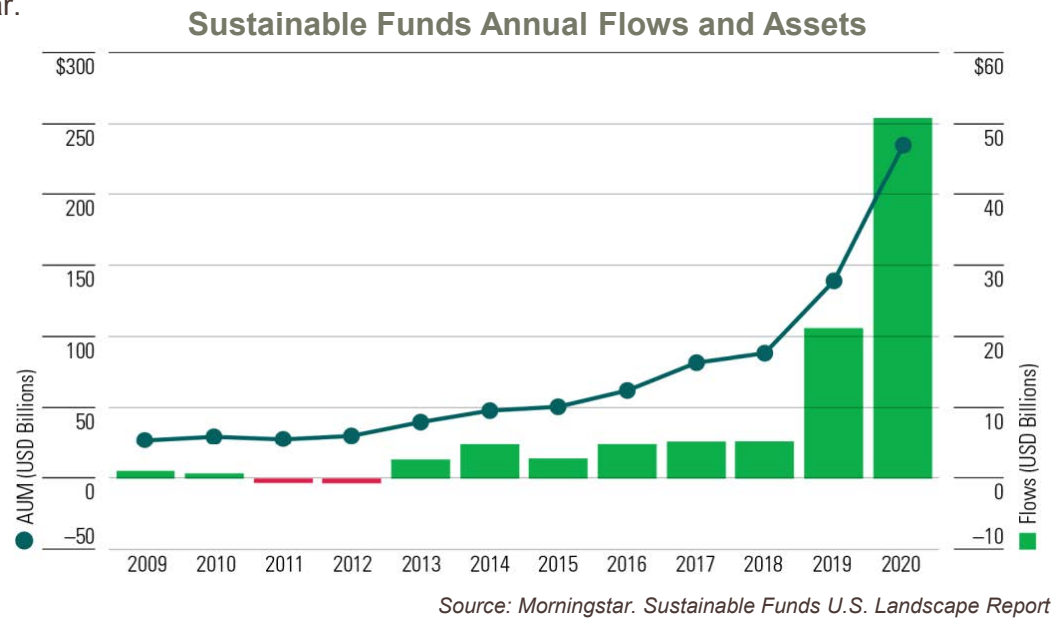
# Sustainable Investment on the Rise

- Record growth in both the number of sustainable investing options and the flows into sustainability-centric funds
- Sustainable investments outperformed other investments, with higher upside and lower downside

There are more sustainable funds, with more fund flow, and better returns than ever before, according to a February 10 report from Morningstar.

In 2020, there were 392 sustainable open-end and exchange-traded funds for investors, up 30% from 2019. Seventy-one sustainable funds were launched last year, and another 25 existing funds were repurposed as sustainable funds.

The funds themselves are growing rapidly. There was a record \$51.1 billion in net flows in 2020, more than double that of 2019 (see graphic).



Sustainable investing last year proved not just popular but also profitable. “Sustainable funds comfortably outperformed their peers in 2020, especially equity funds. Three of every four sustainable equity funds finished in the top half of their Morningstar Category, and 43% posted top quartile returns. By contrast, the returns of only 6% landed in their category’s bottom quartile. Results for other funds were distributed more evenly across quartiles.” Morningstar also notes that this was not simply a 2020 phenomenon: “Longer-term, the results look even better. Although sustainable funds benefit from their 2020 relative performance in three- and five-year trailing return rankings, they had been overperforming their peers, albeit to a more-modest degree, prior to 2020.”

Sustainable investing strategies were also more successful when using index funds. Morningstar selected 23 ESG index funds that provide close comparisons to traditional index funds that invest in the U.S. and in developed markets outside the U.S. “For the year overall, 22 of these 23 sustainable index funds outperformed the relevant conventional index. The 15 funds in the group with three-year records are all outperforming over that time frame as well.”

## KEY QUESTIONS FOR BOARDS

- Are we being included or excluded from sustainability-centric investment options?
- Do our investors and prospective investors know our company’s sustainability story?

# Big Changes Coming to the SEC

- **Personnel and policy changes at the SEC signal more active enforcement environment, higher likelihood of mandatory ESG disclosure**

President Biden has nominated Gary Gensler to chair the Commission, and his confirmation hearing has been scheduled for March 2. In the interim, Allison Herren Lee, designated as Acting Chair by President Biden, has made it clear that she is not just keeping the seat warm until Gensler's anticipated confirmation. Lee appointed Satyam Khanna to the new position as Senior Policy Advisor for Climate and ESG, with a remit to advise the agency on "environmental, social, and governance matters and advance related new initiatives across its offices and divisions." On February 24, Lee released a statement directing the Division of Corporate Finance to enhance its focus on climate-related disclosures, referencing 2010 guidance on the subject. Lee has long championed ESG initiatives and supported additional ESG disclosure. In dissent from the Regulation S-K amendments adopted in August 2020, Lee wrote, "It's time for the SEC to lead a discussion—to bring all interested parties to the table and begin to work through how to get investors the standardized, consistent, reliable, and comparable ESG disclosures they need to protect their investments and allocate capital toward a sustainable economy."

Lee has also made her mark on the SEC's Division of Enforcement. On February 9, Lee authorized senior officers in the Enforcement Division to approve the issuance of Formal Orders of Investigation, enabling them to subpoena documents and take testimony without prior approval, restoring a prior practice that is designed to accelerate action by the SEC. Two days later, she also eliminated the ability for the Enforcement Division to recommend to the Commission settlement offers that are contingent on granting a waiver, saying that such a policy reinforces "the critical separation between the Commission's enforcement process and its consideration of requests for waivers from automatic disqualifications that arise from certain violations or sanctions." Given Gensler's history at the Commodity Futures Trading Commission, expect other actions that empower the Enforcement Division after confirmation.

In February, the Commission also announced that John Coates will serve as Acting Director of the Division of Corporation Finance. As a member of the SEC's Investor Advisory Committee, Coates had supported proposals for additional disclosure, including on ESG matters. In an op-ed Coates coauthored in December, he called for the SEC to take a greater role, writing, "There should be a nonpartisan agreement that the SEC should play an active role in developing ESG disclosures for U.S. companies," suggesting that the SEC could start by drawing on existing frameworks (specifically SASB and TCFD) to build mandated SEC disclosure.



**Gary Gensler**  
SEC CHAIR NOMINEE



**Allison Herren Lee**  
ACTING SEC CHAIR



**John Coates**  
ACTING DIRECTOR OF  
THE DIVISION OF  
CORPORATION FINANCE



**Satyam Khanna**  
ACTING SENIOR POLICY  
ADVISOR FOR CLIMATE  
AND ESG

## KEY QUESTION FOR BOARDS

- Have we been briefed on how Biden Administration changes at the SEC and elsewhere are most likely to affect our company?



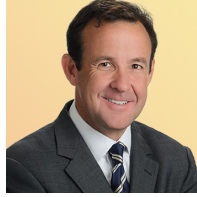
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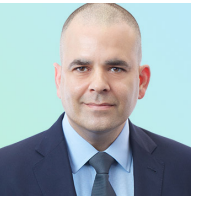
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