Compliance Solutions Across Industries
SCCE
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The Nexus of Governance and Compliance

Moderator: Jonah Crane

Panelists: Leo E. Strine, Jr. and Eric Young

EESG That Is Effective and Efficient . . . And Just Makes Good Business Sense

A Framework to Help Corporate Managers Align EESG with Legal Requirements, Reporting and Monitoring

Slides prepared by Leo E. Strine, Jr. and Kirby M. Smith
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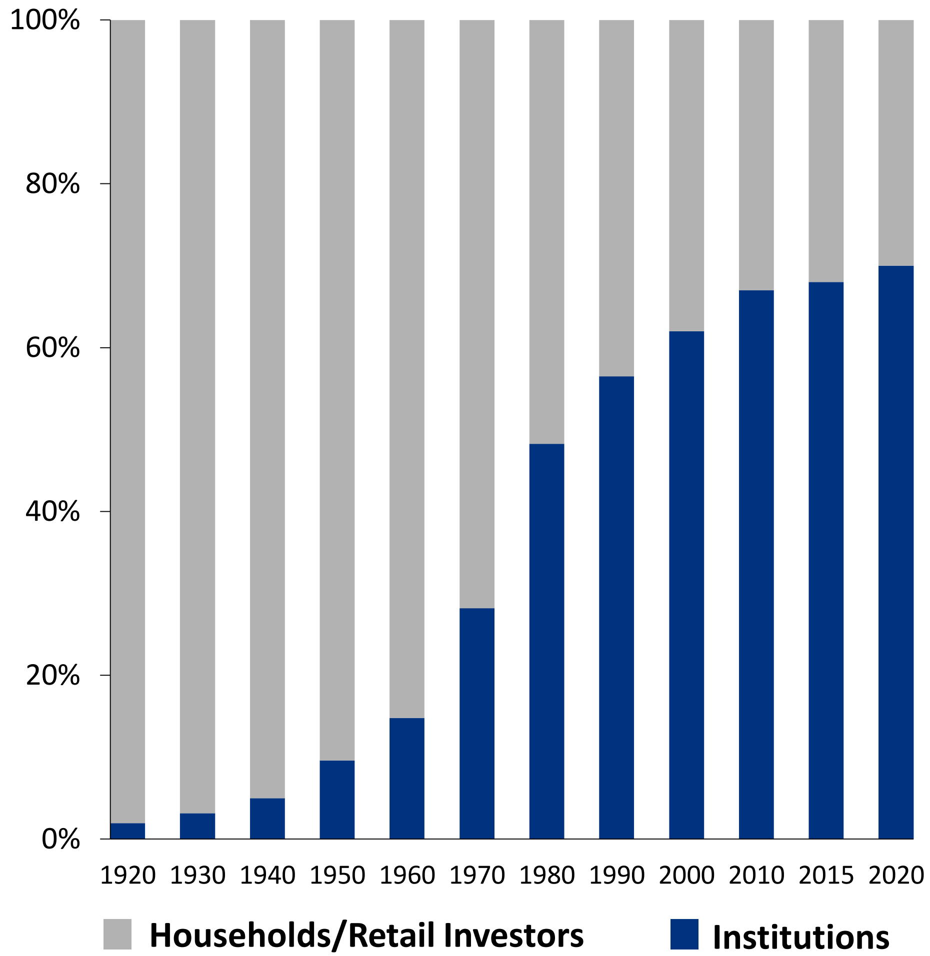
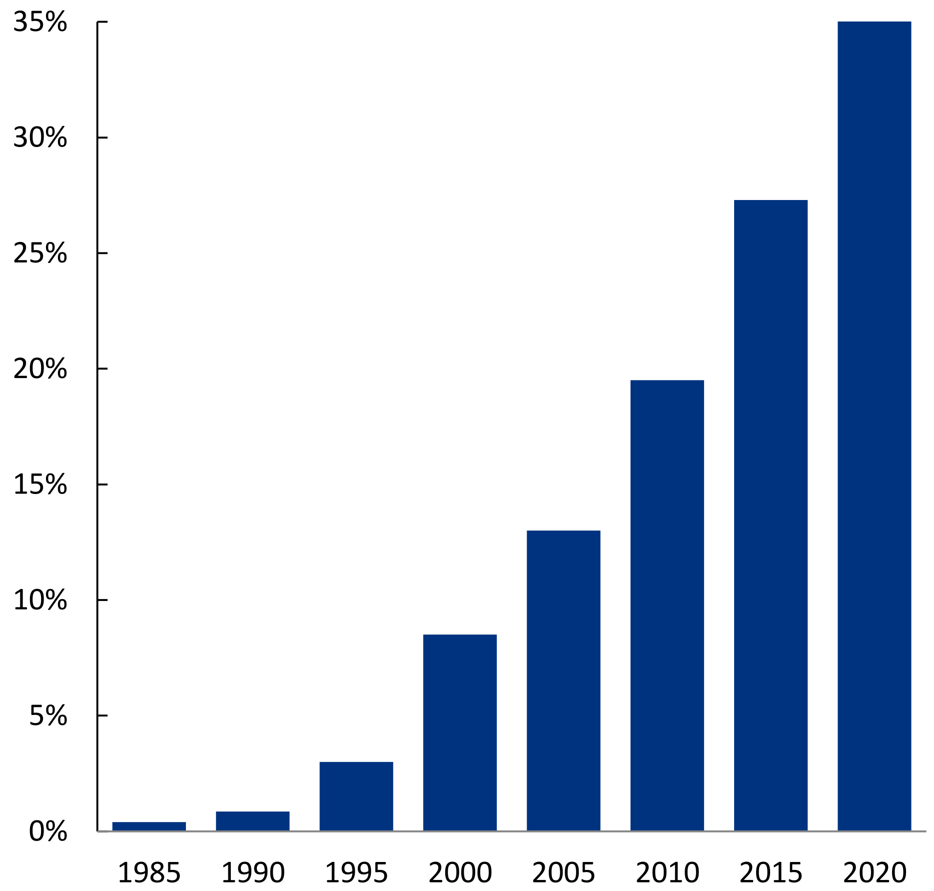
The Rise of Institutional Ownership and Index Funds

Share of Institutional Ownership of U.S. Common Stock



Indexed Assets as a Percentage of All Mutual Fund Industry Assets

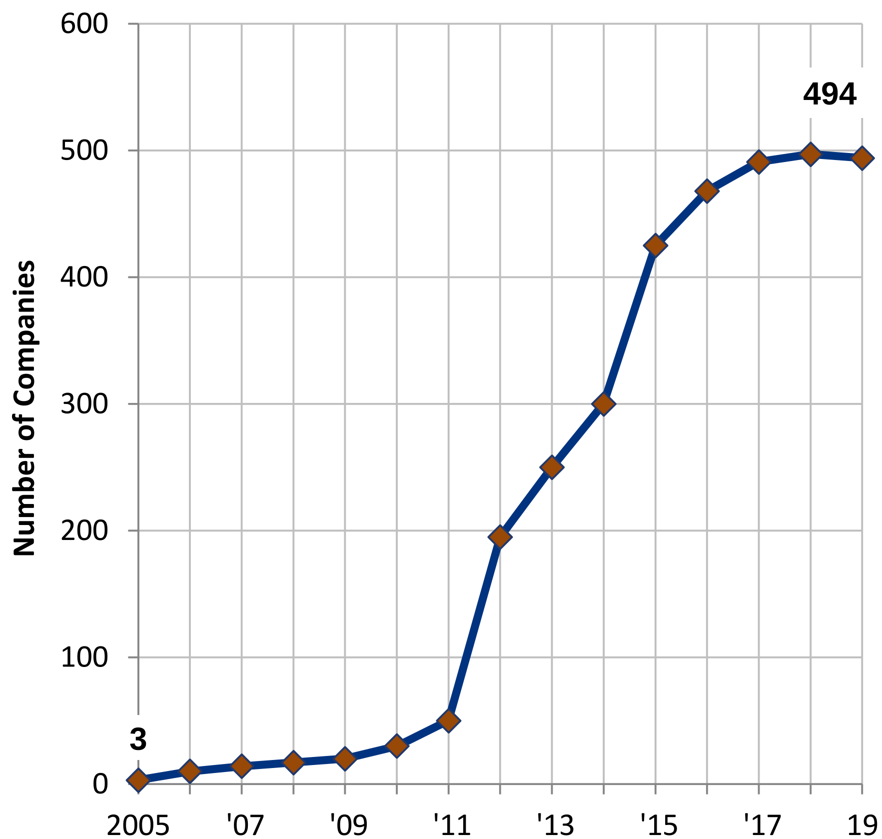


Source: Blume and Keim (2012), Wharton School Dept. of Finance, *"Institutional Investors and Stock Market Liquidity: Trends and Relationships"*; Strategic Insight 2010; Proxy Pulse (2015); Broadridge Financial Solutions, Inc. (2015, 2019); Bloomberg (2016); 2016 and 2019 data for S&P 500 companies only.

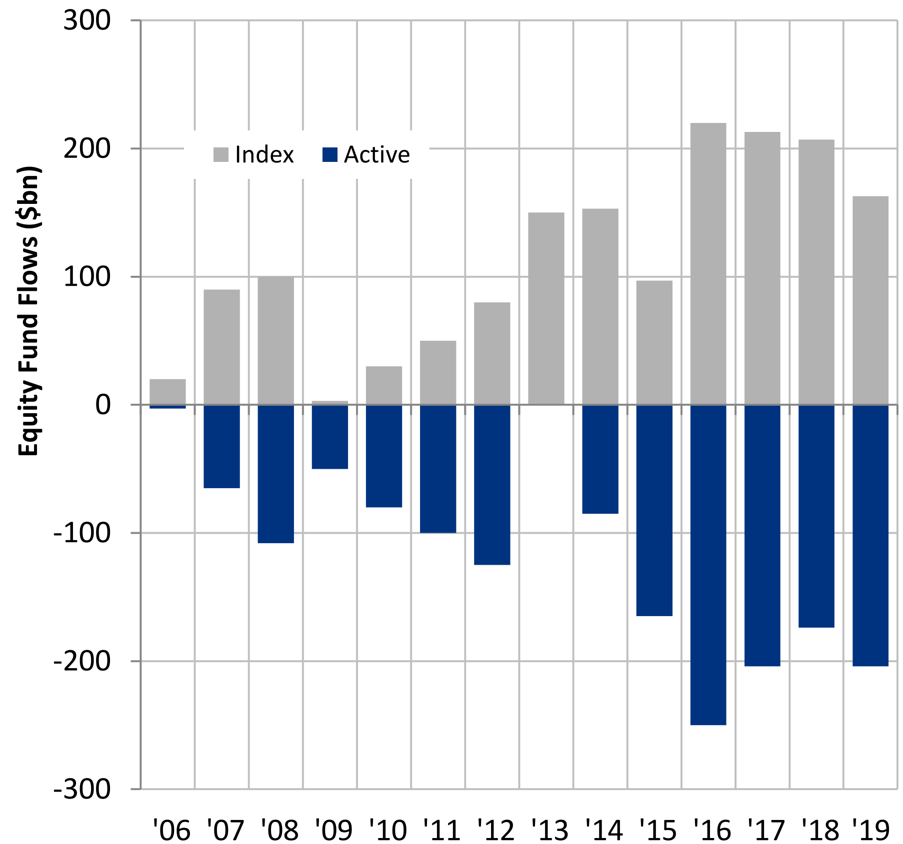
The Rise of Institutional Ownership and Index Funds
(cont'd)

- In the U.S., index funds are accumulating larger stakes in more big companies, and equity flows have dramatically favored passive funds over active ones.

Number of S&P 500 Companies in which Vanguard Group's U.S.-Based Index Funds and Exchange-Traded Funds Owned 5% or More



Active vs. Index Funds—U.S. Equity Flows



Sources: Morningstar (funds and stock ownership), dated January 29, 2018; S&P Global Market Intelligence (S&P 500 constituents, share classes, share counts and market values), Capital IQ and Vanguard 13-F for December 31, 2019.

The Rise of Institutional Ownership and Index Funds
(cont'd)

- Passive mutual funds are accumulating larger stakes in all companies, often collectively exceeding the holdings of actively managed funds.

- The top 10 institutional investors owned 31% of the S&P 500 in 2019, an increase from the 24% this same group owned in 2008.

S&P 500 Top 10 Shareholders

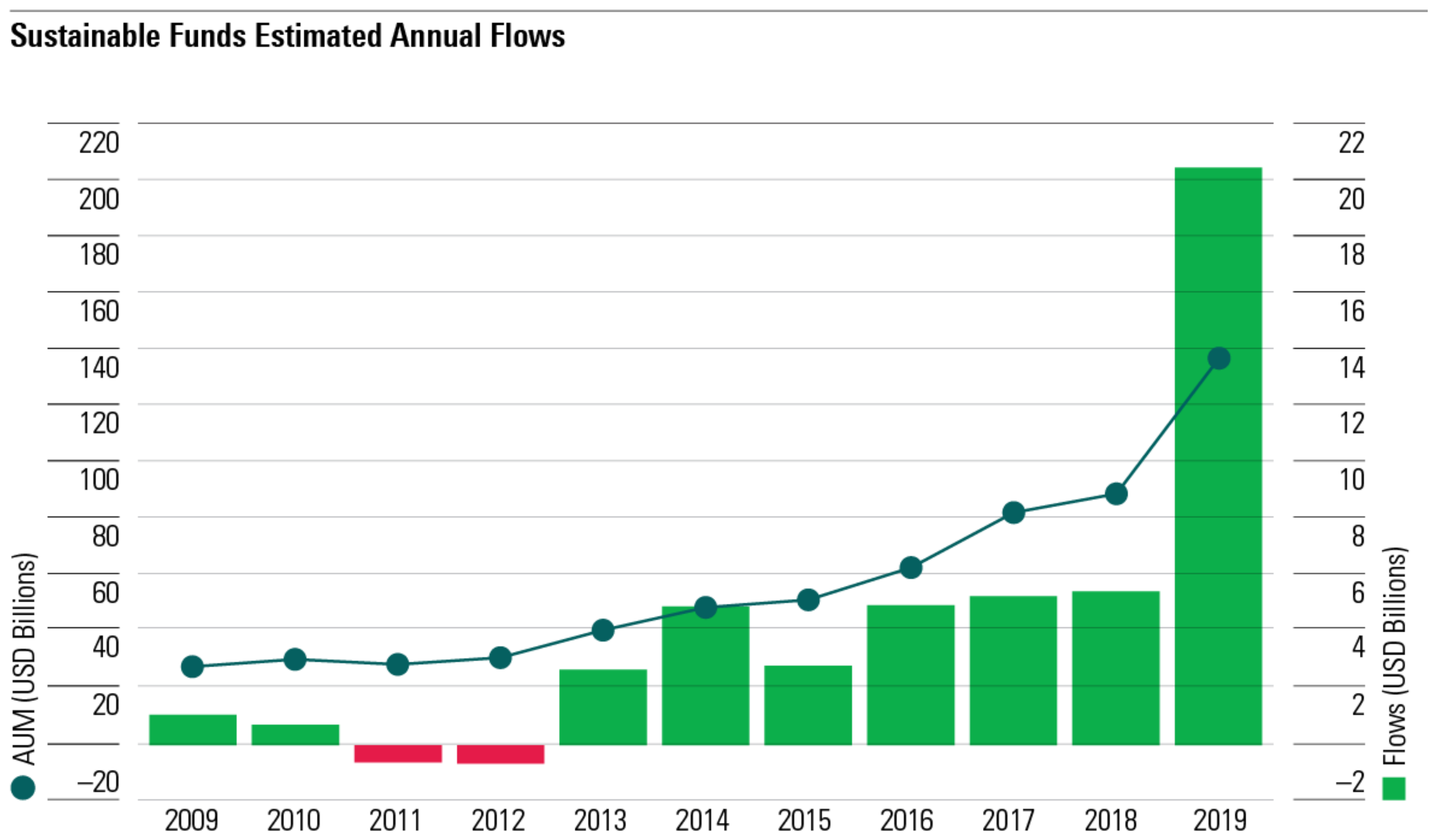
#	Shareholder	Ownership Stake	Cumulative Holdings
1	Vanguard	8.2%	8.2%
2	BlackRock	6.6%	14.8%
3	State Street	4.4%	19.2%
4	Capital Group	3.1%	22.3%
5	Fidelity	2.2%	Top 5 24.4%
6	T. Rowe Price	1.8%	26.3%
7	Geode Holdings	1.4%	27.6%
8	Northern Trust	1.2%	28.9%
9	Wellington Management	1.1%	30.0%
10	BNY Mellon	1.0%	Top 10 31.0%

Source: Lazard, 2019 Review of Shareholder Activism.

Leading Institutional Investors are Governance Focused

Investor	Key Areas of Engagement with Public Companies
BlackRock (Indexed + active BR positions)	• Long-term strategic plan reviewed by board and updated (2016-19) • Long-term approach ≠ infinite patience (2017-20) • ESG (board composition, diversity, climate); human capital (2017-20) • Corporate purpose; strategy, capital allocation and pay (2018-19) • Purpose alignment with culture, strategy; world leadership (2019-20)
State Street Global Advisors	• Structures for independent boards; long-term value (2016) • Board to protect the long term in activist settlements (2016) • Pay concerns; incentives aligned with strategy (2017-18) • Sustainability in strategy/value creation (2017-20) • Gender diversity on boards (2017-19) • Board ownership of strategy and ESG (2018; 2020) • Corporate culture alignment with strategy (2019-20)
Vanguard	• Director involvement; strategy; informed voting—outlier? (2016) • Thinking like a long-term activist in the best sense (2017-18) • Dealmaking with companies in activist situations (2017-19) • Maintaining long-term focus; how does board work with and evaluate management (2017-20) • "Four Pillars" (Board; Governance; Pay; Strategy/Risk) (2017-20) • Societal risks as material risks to long-term value? (2019-20) • Beginning in 2020, active portfolio managers will direct votes of allocated accounts

Investors Are Flocking to EESG-Oriented Funds . . .



Source: https://www.morningstar.com/articles/961765/sustainable-fund-flows-in-2019-smash-previous-records.

. . . and Institutional Investors Are Increasingly Focused on EESG

"Our focus in recent years has been on good governance and other practices that affect a company's ability to generate positive returns for investors over the long run. Those issues span a variety of [ESG] topics material to sustainable performance. **We approach these issues from the perspective of long-term investment value, not from a political or social agenda (aka 'values'). This distinction is especially important to understand in light of growing concerns about the influence of large index managers**."

– Cyrus Taraporevala, State Street Global Advisors

"To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. **Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate**."

– Laurence D. Fink, BlackRock

"Three years ago, we first called on boards to consider sustainability across the environmental, social and governance (ESG) spectrum. Having already engaged with companies on a number of governance matters for many years, we see that shareholder value is increasingly being driven by issues such as climate change, labor practices, and consumer product safety. **We believe that addressing material ESG issues is good business practice and essential to a company's long-term financial performance – a matter of value, not values.**"

– Cyrus Taraporevala, State Street Global Advisors

"Some people may be surprised to hear we have a dedicated team that analyzes and engages on an array of governance, environmental, and social risks. But this is nothing new for Vanguard. Through quiet diplomacy, we often discuss headline-grabbing issues directly with company leaders. For example, conversations about climate risk oversight and disclosure are a regular part of our engagements with companies in carbon-intensive industries. . . . **We also know that over the long term, the interests of fund shareholders and the broader stakeholder community often converge."**

–Vanguard

2021 Updates to ISS Policies on ESG

Institutional Shareholder Services (ISS) has released 2021 voting policy updates that require boards to oversee ESG performance.

Diversity and Inclusion:

- Beginning in 2021, ISS would highlight in research reports U.S. companies "with no apparent racial and/or ethnic diversity."
- Beginning with the 2022 proxy season, ISS would apply a new withhold-the-vote policy (similar to its gender diversity policies), generally recommending against the chair of the nominating committee (or other relevant directors on a case-by-case basis) where the board has no apparent racial and/or ethnic diversity.

Environmental and Social Risk Oversight:

- ISS is proposing making explicit that "demonstrably poor risk oversight of environmental and social issues, including climate change" under extraordinary circumstances may result in ISS recommending withhold votes against individual directors, specific board committee matters or the whole board.

BlackRock: Focus on Climate and Sustainability (2021)

- In his 2020 Letter to CEOs, Larry Fink reiterated his focus on long-term thinking, acknowledging that the vast majority of BlackRock's capital is from long-term savers
- The letter re-emphasized BlackRock's commitment to sustainability and net-zero emissions, but also emphasized BlackRock's focus on social issuing, including confronting issues of race and ethnicity in a company's talent pool
- BlackRock encouraged companies issuing sustainability reports to disclose their talent strategy, including how the strategy interacts with a company's long-term plans to improve diversity, equity and inclusion
- Overall, the letter emphasized that BlackRock expects more disclosure on stakeholder issues in the coming years

> "Questions of racial justice, economic inequality, or community engagement are often classed as an "S" issue in ESG conversations. But it is misguided to draw such stark lines between these categories. For example, climate change is already having a disproportionate impact on low-income communities around the world – is that an E or an S issue? What matters is less the category we place these questions in, but the information we have to understand them and how they interact with each other. Improved data and disclosures will help us better understand the deep interdependence between environmental and social issues."
>
> — *Larry Fink, BlackRock Chairman & CEO, January 2021*

BlackRock: Focus on Climate and Sustainability (2020)

- In his 2020 Letter to CEOs, Larry Fink reiterated his prior year's statement that long-term profits cannot be achieved without embracing a corporate purpose and considering the needs of all stakeholders—not just shareholders.
- Of particular emphasis in Fink's 2020 letter was environmental sustainability and reporting. BlackRock believes that climate change will reshape financial markets and is focused on ensuring that companies are investing sustainably.
- To promote such investment, Fink encouraged more companies to improve their disclosure around these topics and embraced the Sustainability Accounting Standards Board ("SASB") as providing a clear set of standards for reporting sustainability information across a wide range of issues, from labor practices to data privacy to business ethics.

> "We believe that all investors, along with regulators, insurers, and the public, need a clearer picture of how companies are managing sustainability-related questions. This data should extend beyond climate to questions around how each company serves its full set of stakeholders, such as the diversity of its workforce, the sustainability of its supply chain, or how well it protects its customers' data. Each company's prospects for growth are inextricable from its ability to operate sustainably and serve its full set of stakeholders. . . . Given the groundwork we have already laid engaging on disclosure, and the growing investment risks surrounding sustainability, **we will be increasingly disposed to vote against management and board directors when companies are not making sufficient progress on sustainability-related disclosures and the business practices and plans underlying them**."
>
> *— Larry Fink, BlackRock Chairman & CEO, January 14, 2020*

BlackRock: Focus on Purpose (2019)

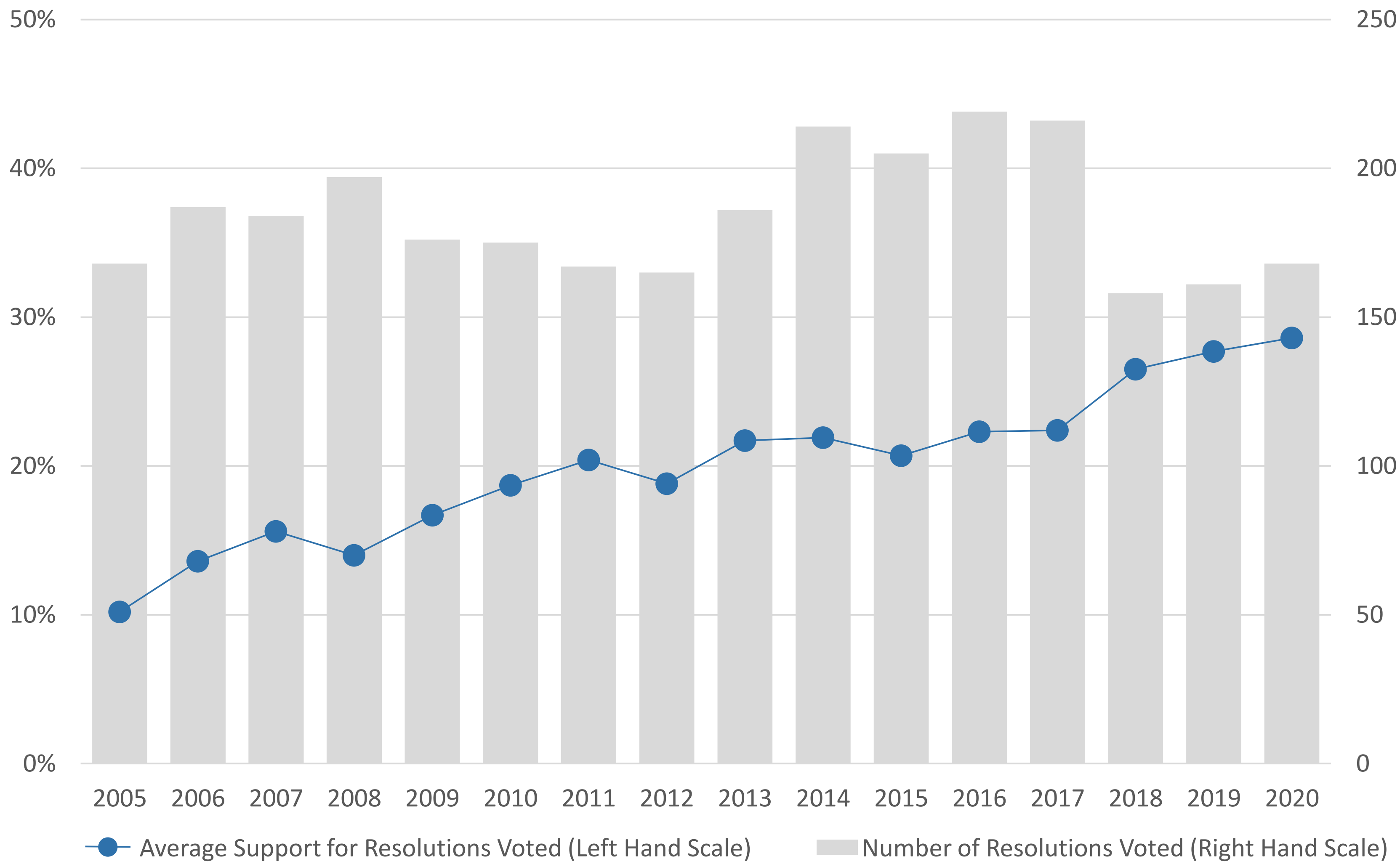
- In his 2019 Letter to CEOs, Larry Fink reiterated his prior year's statement that every company must have a clear purpose in its business model and corporate strategy.
- Fink again stated that companies should demonstrate their commitment to their communities, particularly on issues central to the world's future prosperity.
- BlackRock's Investment Stewardship engagement priorities for 2019 are: Governance, including board diversity; corporate strategy and capital allocation; compensation that promotes long-termism; environmental risks and opportunities; and human capital management.

"**Purpose is not the sole pursuit of profits but the animating force for achieving them. Profits are in no way inconsistent with purpose—in fact, profits and purpose are inextricably linked.** Profits are essential if a company is to effectively serve all of its stakeholders over time—not only shareholders, but also employees, customers, and communities. Similarly, when a company truly understands and expresses its purpose, it functions with the focus and strategic discipline that drive long-term profitability. Purpose unifies management, employees, and communities. It drives ethical behavior and creates an essential check on actions that go against the best interests of stakeholders. Purpose guides culture, provides a framework for consistent decision-making, and, ultimately, helps sustain long-term financial returns for the shareholders of your company."

— Larry Fink, BlackRock Chairman & CEO, January 17, 2019

Growing Support for ESG Shareholder Proposals

16-Year Trend in Average Support for Resolutions Addressing Environmental and Social Issues



Source: *FactSet, as of January 2, 2021.*

Rising Demand for an EESG Focus

Institutional Investors are not alone in demanding more focus on ESG:

Business Roundtable Adopts New Corporate Purpose

"While each of our individual companies serves its own corporate purpose, we share a fundamental commitment to all of our stakeholders. . . . Each of our stakeholders is essential. We commit to deliver value to all of them, for the future success of our companies, our communities and our country."

Senator Warren Proposes Accountable Capitalism Act

- Large U.S. companies must become benefit corporations, with a legal requirement to consider all the interest of corporate stakeholders—including employees, customers, shareholders and the communities in which the company operates.
- Boards must include substantial employee participation.
- Companies must obtain supermajority support before they can spend corporate dollars on politics.

SEC Commissioner Lee Calls for Enhanced EESG Reporting

Both diversity and climate risk generally fall under the rubric of Environmental, Social, and Governance or ESG risks. ESG investing is no longer just a matter of personal choice. Asset managers responsible for trillions in investments, issuers, lenders, credit rating agencies, analysts, index providers, stock exchanges—nearly all types of market participants—use ESG as a significant driver in decision-making, capital allocation, pricing, and value assessments . . . . A broad swath of investors find ESG risks to be as or more important in their decision-making process than financial statements, surpassing traditional metrics such as return on equity and earnings volatility.

GAO Report Calls Attention to EESG Issues

"Institutional investors with whom we spoke generally agreed that ESG issues can have a substantial effect on a company's long-term financial performance. All seven private asset managers and representatives at five of seven public pension funds said they seek ESG information to enhance their understanding of risks that could affect companies' value over time. . . . Additionally, most institutional investors said that there is fragmentation in the format or location of companies' ESG disclosures, which can make this information hard to compile and review."

The Proliferation of EESG Reporting Guidelines

Proliferating EESG Ratings Providers

1) No uniform standards
2) Need to monitor and correct
3) Need to be proactive in articulating company goals

The Magazine for Clean Capitalism
Corporate Knights

Bloomberg

CDP
DISCLOSURE INSIGHT ACTION

SUSTAINALYTICS

Dow Jones Sustainability Indexes

RepRisk
100k+ companies

ISS

MSCI

the answer company™
THOMSON REUTERS®

You Can't Manage What You Don't Measure

BlackRock®

Push for "more widespread and standardized" disclosure.
(SASB & TCFD)

STATE STREET GLOBAL ADVISORS SPDR®

Introduced R-Factor® ratings system.
(SASB)

WORLD ECONOMIC FORUM

Push for "a common, core set of metrics." Backed by Big Four
(GRI, SASB, TCFD & others).

Laggards can expect to face consequences.

Yet SEC Adopts a Principles-Based Approach

- Pressure for enhanced EESG reporting is not only growing among investors and politicians. Recent amendments to Regulation S-K will place more focus on the actual metrics boards and management use to monitor and run their business.
- Despite the proliferating EESG Rating and Disclosure systems, on August 26, 2020, the SEC adopted a "principles-based" approach to disclosure about a company's business, legal proceedings and risk factors
- This approach permits issuers to determine, in their judgment, what is material to their business and the risks their business faces and requires issuers to provide more meaningful principles-based narrative disclosure around areas that affect their business, such as human capital, sustainability, and regulatory compliance.
- The SEC refrained from adopting specific guidance around what metrics each company should disclose, recognizing that each business and industry is different, and disclosures should be tailored by each company's management team and board.

> "Our rules also are designed to elicit disclosure tailored to each company's particular industry and business model, while being flexible enough to continue to allow for fulsome disclosure as businesses evolve in the future. . . . [The] rules require that, in crafting their human capital disclosure, companies must incorporate the key human capital metrics, if any, that they focus on in managing the business, again to the extent material to an understanding of the company's business as a whole. Experience demonstrates that these metrics, including their construction and their use, widely from industry to industry and issuer to issuer, depending of a wide array of company-specific factors and strategic judgments. . . . It would run counter to our proven disclosure system, particularly as we first increase regulatory emphasis in an area of such wide variance, for us to attempt to prescribe specific, rigid metrics that would not capture or effectively communicate these substantial differences. That said, under the principles-based approach, I do expect to see meaningful qualitative and quantitative disclosure, including, as appropriate, disclosure of metrics that companies actually use in managing their affairs."
>
> *— Jay Clayton, SEC Chairman & CEO, August 26, 2020*

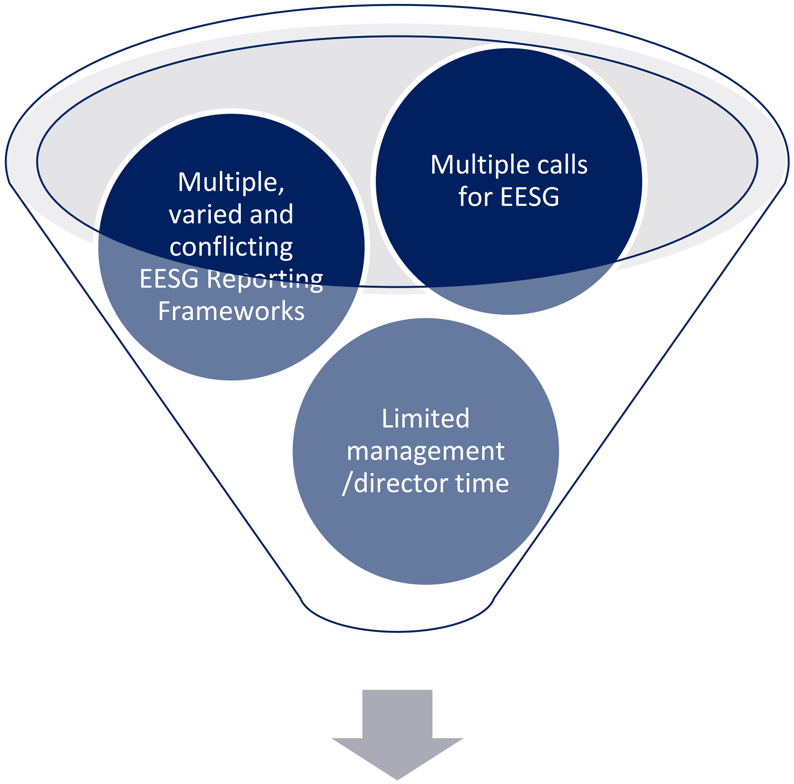
And Investors Prefer Bespoke Company-Specific Disclosure over Consistency for Now

- Although certain Institutional Investors have adopted or championed specific EESG disclosure regimes, overall Institutional Investors are more focused on obtaining timely, actionable, focused, and material EESG disclosure and less fussed about the format it is provided
- Blackrock, for example, has encouraged companies to make progress towards "TCFD- and SASB-aligned reporting." And in 2020, Blackrock will be asking companies it invests in to "(1) publish a disclosure in line with industry-specific SASB guidelines by year-end, if [the company] ha[s] not already done so, **or disclose a similar set of data in a way that is relevant to [the company's] particular business**; and (2) disclose climate-related risks in line with the TCFD's recommendations, if [the company] ha[s] not already done so." That is, although Blackrock is encouraging companies to place their disclosures within an existing framework, Blackrock recognizes that similar data more relevant to the particular business at issue can be useful.
- Similarly, State Street has embraced the SASB guidelines, but recognizes that "material ESG issues are also deeply embedded within a company's business operations." As such, State Street seems to prefer that companies "identify, manage and publicly disclose what they consider to be financially material ESG issues" rather than adopt any single ESG disclosure framework.

> "[M]ost institutional investors said that there is fragmentation in the format or location of companies' ESG disclosures, which can make this information hard to compile and review. **However, these investors generally said that it is more important for companies to focus on providing disclosures than on how or where the disclosures are presented.**"
>
> — *GAO Report: Disclosure of Environmental, Social and Governance Factors and Options to Enhance Them (July 2020)*

Cutting through the Noise:
A Principled Approach to EESG

The EESG Noise



Our Solution: Return to First Principles

Managers and directors can cut through the noise and implement an EESG program that is tailored to corporate needs and capitalizes on existing governance structures without utilizing increasingly scarce corporate resources by aligning EESG with the company's existing compliance and operational risk systems.

First Principles: Conduct Lawful Business by Lawful Means

- Corporate law requires corporations to conduct only lawful business by lawful means.
- This first principle of corporate law is enshrined in the corresponding fiduciary duty of directors to implement a reporting system to monitor the corporation's compliance with the law and then use that system to oversee the corporation's operations.

> "Corporate boards may [not] satisfy their obligation to be reasonably informed concerning the corporation, without assuring themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance."
>
> — *Chancellor William T. Allen, In re Caremark Int'l Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996)

Caremark's Flexibility

- Although directors and officers must "implement an oversight system and then monitor it," they are given a great deal of latitude in how they implement that system.
- Each corporation is different, and the appropriate monitoring system should be tailored to the corporation's legal obligations, operations, and risks.

> "[D]irectors have great discretion to design context- and industry-specific approaches tailored to their companies' businesses and resources. But *Caremark* does have a bottom-line requirement that is important: the board must make a good faith effort—i.e., try—to put in place a reasonable board-level system of monitoring and reporting."
>
> — *Marchand v. Barnhill*, 212 A.3d 805, 821 (Del. 2019)

Recent *Caremark* Decisions: Internal Monitoring and Reporting are Crucial

Evolution of the Board's Oversight and Monitoring Duties

<u>Caremark (1995):</u>

Directors may face exposure only if company "utterly failed" to implement a system for risk identification or if they intentionally "ignored a red flag"

<u>Marchand (2019)</u>:

"[D]irectors must make a good faith effort to implement an oversight system and then monitor it." The mere existence of management-level compliance programs is not enough for the directors to avoid *Caremark* exposure

<u>Clovis (2019)</u>:

A board "comprised of experts" that "operates in a highly regulated industry" should have understood misreporting by management and intervened to fix the problem

<u>Teamsters Local 443 (2020)</u>:

Board materials showing mere director "review" of red flags, when "tangible action" is called for, may not suffice to defeat a *Caremark* pleading

Caremark and EESG

- *Caremark* sets the floor: requiring a business to operate a lawful business by lawful means
- A Company looking to implement an EESG program is focused on going above and beyond the floor, and by doing so, the Company can both satisfy legitimate demands for strong EESG programs and promote compliance with the law

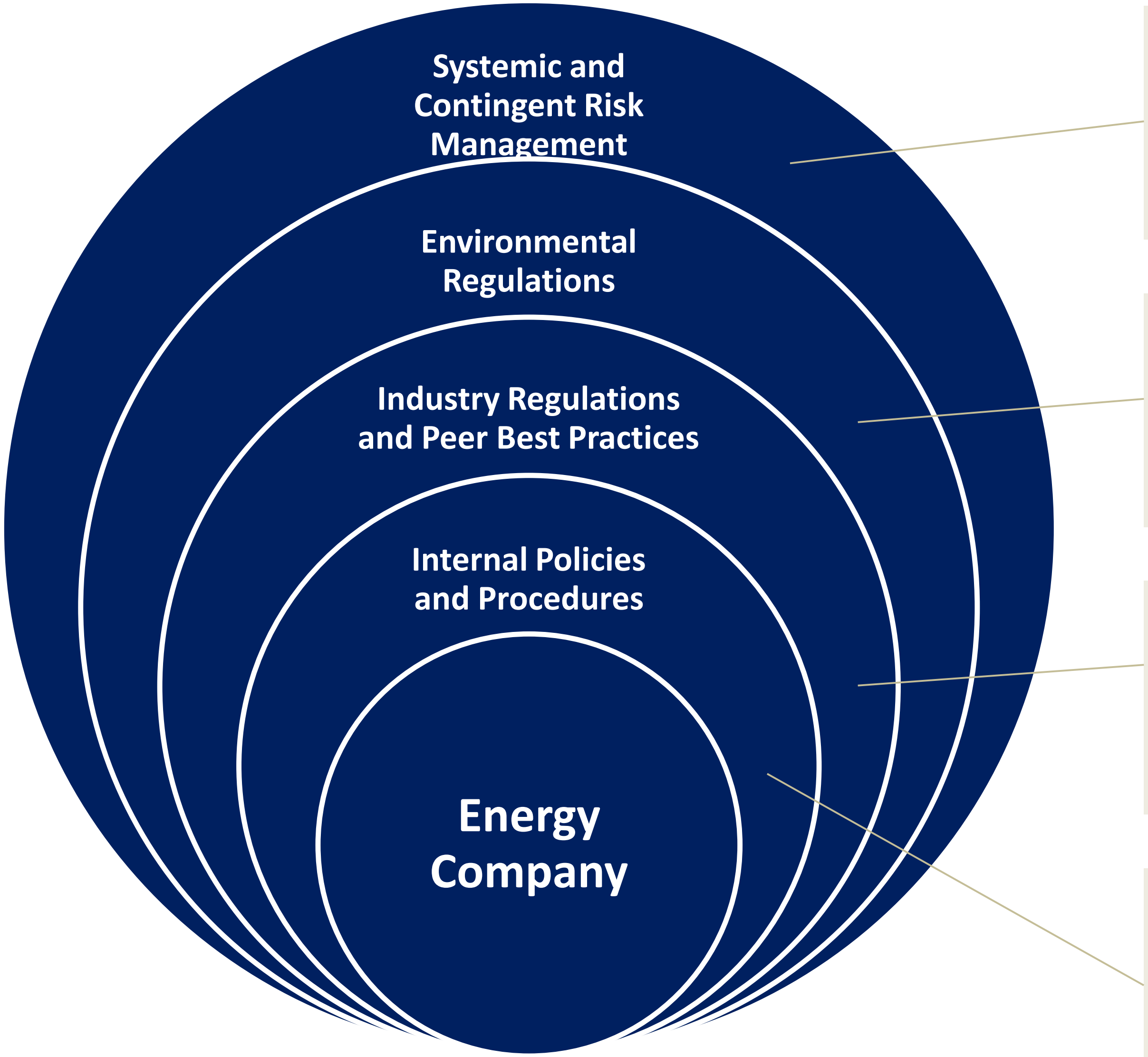
What *Caremark* Requires:

- Understand the company's business:
  - How does the Company make money?
  - What risks are inherent in the Company's operations?
  - What legal requirements must the Company comply with?
  - What key regulatory frameworks does the Company operate within?
- Create a reporting infrastructure for monitoring legal/operational risk:
  - Does the Board receive reports about the amount of operational risk the Company is taking?
  - Has the Board considered the appropriate amount of operational risk?
  - Is the Company complying with its key legal requirements?
- Monitor the Company's legal compliance:
  - Does the Board regularly review reports about legal/operational risk?
  - Does the Board receive regular updates from management about the Company's regulatory compliance or operational risks?

Existing *Caremark* Processes Inform EESG:

- Business operations and risks should be the focus of EESG—the company's biggest risks are also the areas where it can have the largest affect.
- EESG Reporting can be created or enhanced based on the existing reports the Board or management receives on operational risk/compliance.
- Monitoring the Company's EESG performance and setting appropriate EESG targets can only be holistically done if the Board has the information to understand what the current reality is and what is possible.

Example: Overlap Between EESG and Compliance Function



- **Does the company's risk management process incorporate EESG considerations?**
- **Has the Board reviewed risk management through the EESG lens?**

- **Is the company in compliance with federal, state and municipal regulations?**
- **Has the company evaluated future regulatory risks?**

- **Is the company in compliance with industry best practices?**
- **How does the company compare to its peers? Is it a leader in EESG-related initiatives?**

- **Do the company's internal compliance policies incorporate EESG considerations?**
- **Do the company's internal reporting policies facilitate the reporting of EESG risks?**

Bottom Line:
EESG is an Extension of the Board’s Oversight or “*Caremark*” Duty

Management-Led EESG Assessment and Realignment

Management-Led EESG Assessment and Realignment Process

To move towards an EESG reporting and monitoring system that builds on the company's current monitoring and reporting obligations involves engaged management leading a process of (1) assessment; (2) engagement; and finally (3) realignment.

Assessment

- Existing board and committee structure.
- Reporting and monitoring system.
- Industry and company-specific risks and regulatory/compliance issues.
- Regulatory reporting requirements.

Engagement

- Board-level dialogue on company-specific risks and regulatory challenges.
- Senior management responsibilities for risks and legal compliance.
- Firmwide overview of compliance culture and regulatory understanding.

Realignment

- Update board committee responsibilities.
- Adjust management responsibilities for regulatory oversight, risk management and reporting.
- Enhance and expand reporting expectations.
- Set enhanced expectations around compliance and risks.

Assessment

Through an assessment of the Company's existing governance structure, operational risk and legal requirements, and existing reporting capabilities, company management create a holistic picture of the current governance structure around reporting on and monitoring of risks and legal compliance.

Existing Governance Structure

- Existing board committee structure
- Allocation of responsibilities among board committees
- Director skills and committee membership

Operational Risk and Legal Requirements

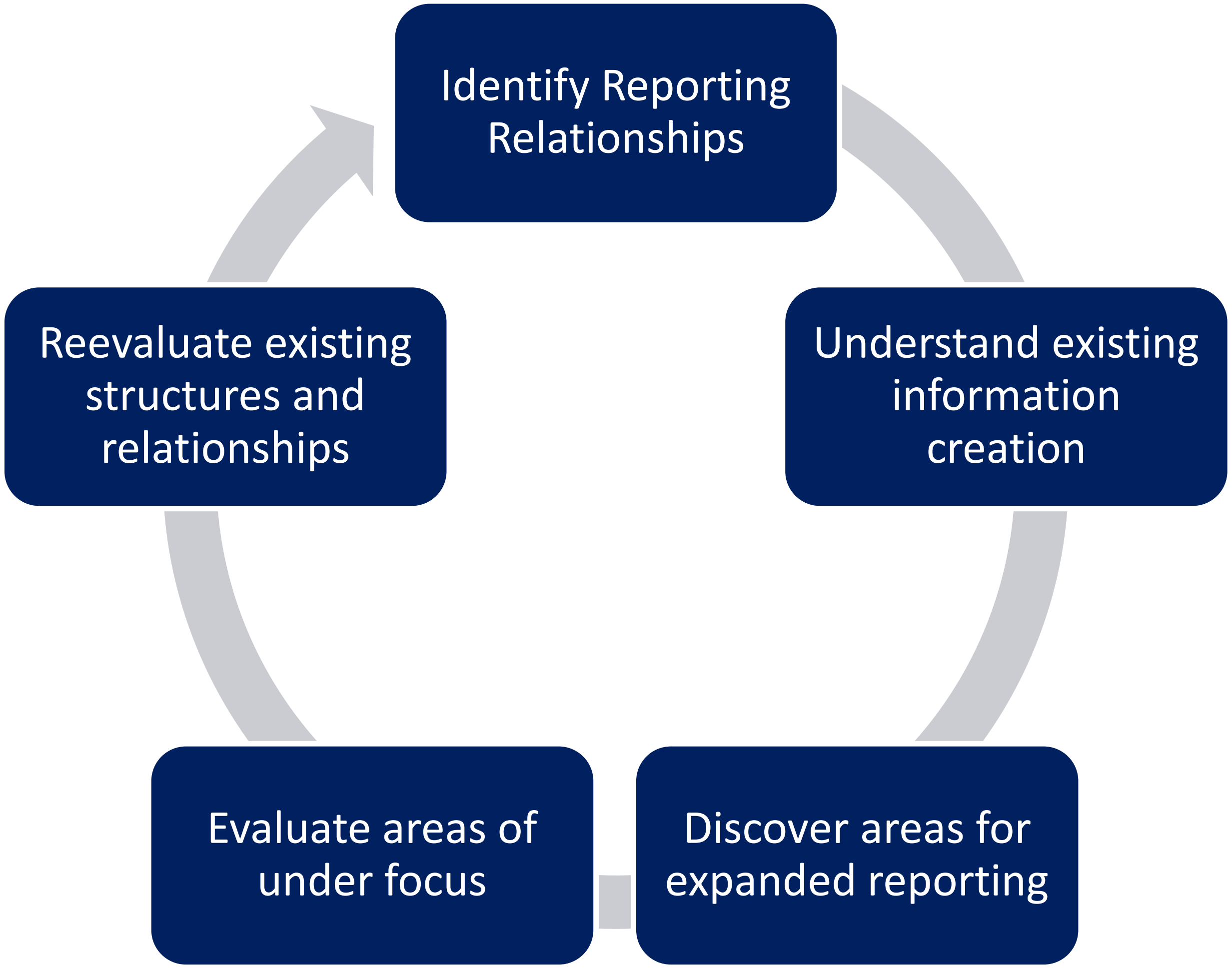
- Industry-specific risks
- Company-specific operational risks
- Regulatory environment

Existing Reporting Capabilities

- Existing board-level reports (e.g., sustainability reports)
- Publicly available regulatory reports

Engagement

Conducting a targeted dialogue with members of management and staff can help create a better understanding of (1) existing internal reporting relationships; (2) existing information creation, dissemination and flow; (3) capacity for expanded reporting or oversight; and (4) under focused areas of risk can be discovered.



Realignment

Based on the additional insights gleaned from engagement with management and key staff, management can engage the board in assessing the necessary realignment of (1) governance responsibilities; (2) management responsibilities and oversight; (3) reporting priorities and expectations; and (4) goals around compliance and EESG.