PAUL HASTINGS

ESG & Human Capital: Changing Rules and Expectations

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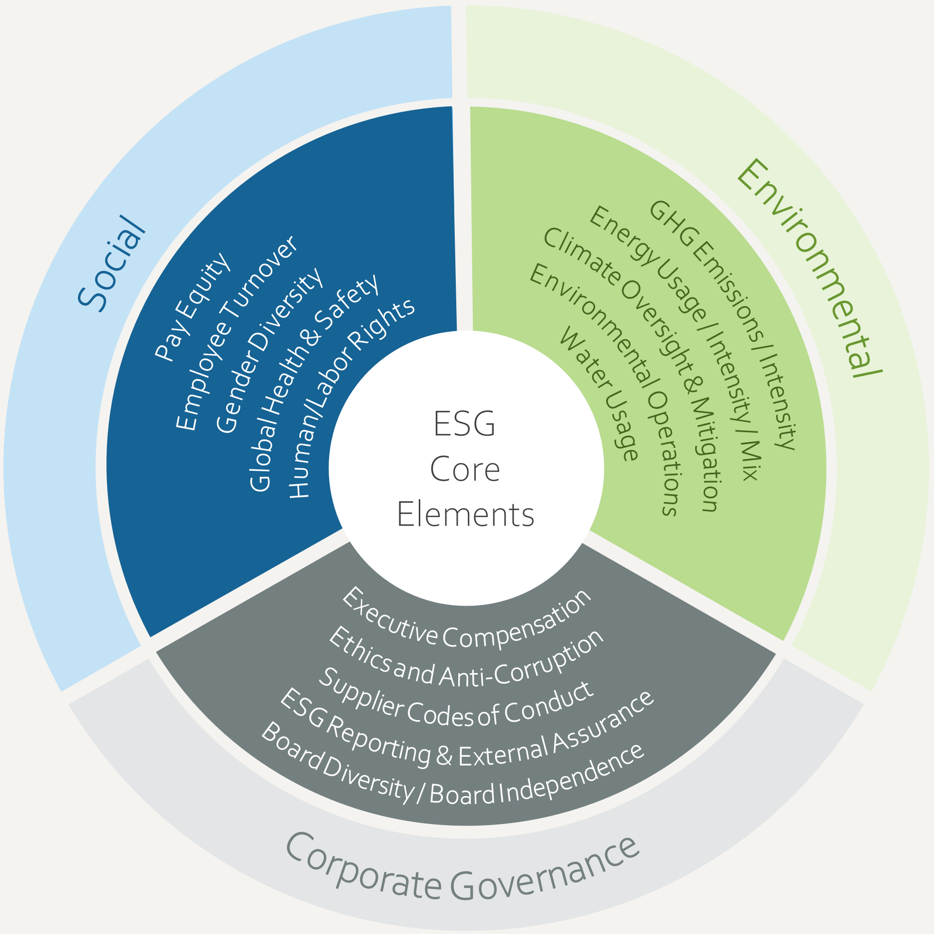
Overview

- What Employers Need to Know
  - What is ESG?
  - How does Employment Law intersect with ESG requirements?
- Expectations for ESG
  - How did we get here?
- The Rules
  - Increasing regulatory focus on human capital, “fairness” and employment concepts
  - International bellwether laws on mandatory human rights due diligence
- Hypothetical
  - What legal risks are there for trailblazing DEI initiatives?
- Best practices for supporting your company’s ESG/DEI goals while navigating ESG

What *Employers* Need to Know

What is ESG?

- Corporations are facing growing pressure from investors, shareholders, stakeholders, and regulators to identify, assess, and disclose ESG-related risks.
- **Environmental**, **social**, and **governance** (“ESG”) is a term used to represent an organization’s **corporate financial interests** that focus mainly on sustainable and ethical impacts.
- Capital markets use ESG to evaluate organizations and determine future financial performance.



What is ESG?

Environmental	Social	Governance	Human Rights
GHG emissions/ energy usage	Executive compensation and human capital	ESG/HR governance and oversight systems	Forced labor
Renewables	Gender pay gap	Board diversity and independence	Child labor
Water and waste	Turnover	Business ethics/ anti-corruption	Workplace health and safety
Environmental oversight (operations and supply chain)	Diversity & inclusion/ non-discrimination	Cyber security and data privacy	Fair & living wage
Climate impact/mitigation	Worker health and safety	Supplier code of conduct	Access to affordable health care
Scope 1, 2 and (potentially) 3 emissions	Child and forced labor (operations and supply chain)	External assurance	Worker rights (who is a “worker”?)
Board and management oversight	Human rights (operations and supply chain)	Human capital reporting and disclosures	Right to a sustainable environment and future

Where Employment Concepts Intersect?

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GHG emissions/ energy usage	**Executive compensation and human capital**	ESG/HR governance and oversight systems	Forced labor
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Board and management oversight	**Human rights (operations and supply chain)**	Human capital reporting and disclosures	Right to a sustainable environment and future

Employment Law topics define "Social" and "Governance"

Expectations for ESG

How Did We Get Here?

Growing Demand for ESG Disclosures

- Stakeholders, including investors, consumers, and the market, are **increasingly prioritizing ESG disclosures and risks in evaluating investment opportunities**.
- In addition to investors, regulators and stock exchanges are similarly developing requirements around ESG disclosures.

How Did We Get Here?

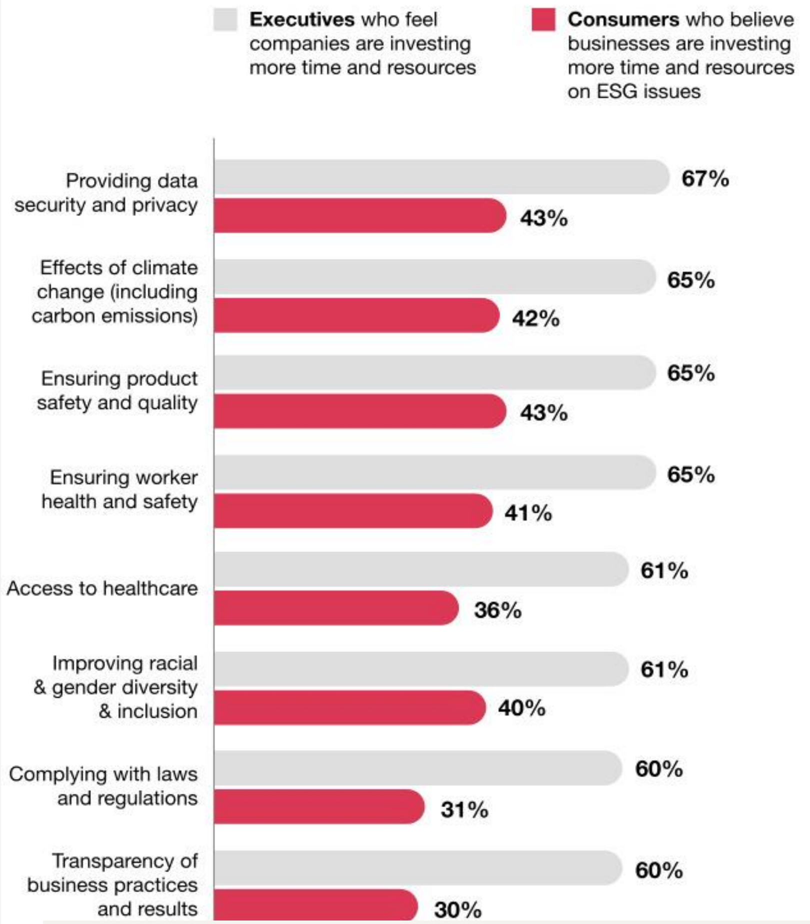
Consumers and Investors' Expectations

- In the United States, over $68 trillion in wealth will transfer to millennial investors by 2030. Seven out of ten of them expect their wealth managers to screen investments based on ESG criteria.
- According to a survey of limited partners (LPs) by Bain & Company and the Institutional Limited Partners Association (ILPA):
  - 93% of limited partners would walk away from an investment opportunity if it posed an ESG concern;
  - 50% cite better investment performance as a key reason to incorporate ESG.
- In recent years, there has been a shift towards the creation of sustainability-focused funds and investments within PE.
- Regulators, in turn, are promoting consistent, comparable, and reliable information for investors concerning funds' and advisers' incorporation of ESG factors into their portfolios.

How Did We Get Here?

Consumers and Investors' Expectations

Consumers are not convinced that businesses are making adequate investments in ESG issues



Source: *PwC Consumer Intelligence Series,* June 2, 2021

Key findings

51%

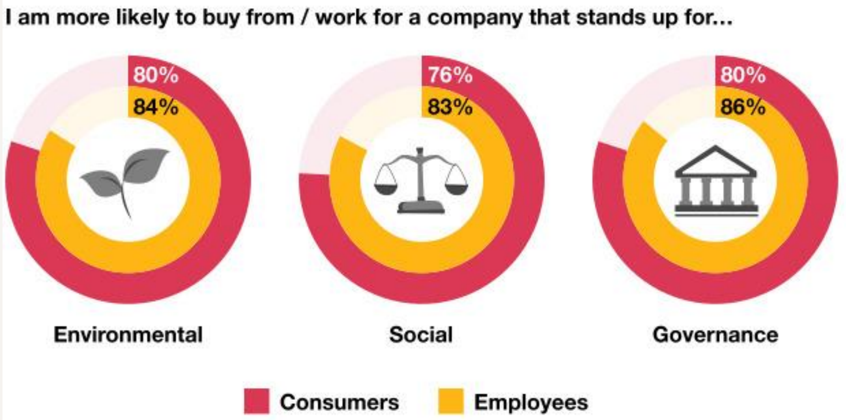
of respondents say environmental sustainability is more important to them today than it was 12 months ago.

49%

of consumers say they've paid a premium for products branded as sustainable or socially responsible in the last 12 months.

Source: *Research Brief: Balancing sustainability and profitability,* IBM Institute for Business Value (2022).

ESG commitments are driving consumer purchases and employee engagement



Source: *PwC Consumer Intelligence Series,* June 2, 2021

88%

of investors believe companies that prioritize ESG initiatives represent better opportunities for long-term returns than companies that do not

Source: Edelman Trust Barometer Special Report: Institutional Investors

How Did We Get Here?

Expectations of Boards

Boards owe a duty of care to shareholders to address "mission critical" risks, including ESG

- ***In re Caremark International Inc. Derivative Litigation* (Del. Ch. 1996):** Directors breach their duty of care when they fail to make a good faith effort to oversee a corporation's operations and compliance with the law.

- In a *Caremark* claim, a plaintiff must demonstrate that the board:
  - **Prong One:** Failed **to implement a corporate information and reporting system**; or
  - **Prong Two**: Failed to adequately **monitor or oversee management**, preventing the board from being informed of risks or problems requiring their attention.

How Did We Get Here?

Expectations of Boards

Boards owe a duty of care to shareholders to address "mission critical" risks, including ESG

- ***Marchand v. Barnhill* (Del. 2019)**: A board's utter failure to attempt to establish a reasonable reporting system is an act of bad faith in breach of the duty of loyalty.
  - Delaware Supreme Court found "**no board-level system of monitoring or reporting on food safety existed**" at Blue Bell, though food safety was "**essential and mission critical**."
  - Court stressed it is not enough for management to merely discuss general operations with the board.
- ***In re Clovis Oncology, Inc. Derivative Litigation* (Del. Ch. 2019)**: Courts are more likely to find Caremark oversight liability at the board level when the board fails to monitor existing compliance systems.
  - Case involved claim that directors misled the market about a clinical drug's efficacy.
  - Despite receiving reports indicating that the company was improperly conducting clinical trials, **board did not act to correct the situation**.
  - The Delaware Chancery Court found that the board "**consciously ignored red flags** that revealed a mission critical failure to comply with the … regulations."
- ***In re Boeing Company Deriv. Litigation* (Del. Ch. 2021)**: The Board had no committee, no oversight and failed on both prongs of Caremark.

How Did We Get Here? *Employees' Expectations*

Employee activism has changed…

- Efforts to impact employers' ability to recruit:
  - Rallying student groups to protest company presence for job fairs; and
  - Commenting on Glassdoor and related job/recruiting sites.
- Invitations to politicians and influencers to weigh in.
- Use of the press/social media:
  - Using online platforms to tell employee's stories and sending that story to the press; and
  - Employer responses to the press are challenged in social media comments.
- Targets of Employee Activist Movements have included in the past three years…
  - Diversity, Equity, and Inclusion (Black Lives Matter);
  - Handling of COVID-19;
  - #MeToo;
  - Arbitration programs;
  - Confidentiality provisions;
  - Pay equity; and
  - Hazard pay and sick leave.
- **These areas overlap with core focus points for ESG.**

How Did We Get Here? *Employees' Expectations*

Employee activism has changed…

Half of Millennial Employees Have Spoken Out About Employer Action on Hot-Button Issues" – Cision.

Have ever spoken up to support or criticize employer's actions over a controversial issue that affects society				
	Total U.S. Employees	**Millennials**	**Gen Xers**	**Boomers**
	%	%	%	%
Yes	38	48*	33	27
No	59	49	64*	70*
Prefer not to respond	3	3	3	3

Right of Employees to Speak Up				
	Total U.S. Employees	**Millennials**	**Gen Xers**	**Boomers**
	%	%	%	%
In support of their employer	84	85	84	84
Against their employer	75	82*	76	65

Source: Employee Activism in the Age of Purpose: Employees (UP)Rising, Weber Shandwick, United Minds & KRC Research (2019)

The ESG Regulatory Landscape

The SEC’s Increasing Focus on ESG

March 2021
Establishment of the **Climate and ESG Task Force** in the SEC’s Division of Enforcement.

March 2022
New **proposed rules** on **cybersecurity risk management** and **incident disclosure.**

March 2022
New **proposed rules** on **climate-related disclosures.**

April 2022
Mining company charged over **misleading statements** about safety.

May 2022
New **proposed rules** on **disclosures by investment companies and advisers** & **fund names.**

May 2022
Investment charged over **ESG misstatements and omissions.**

November 2022
Goldman Sachs Asset Management settles with SEC for pol/proc failures in marketing ESG funds ($4M penalty).

Q1/Q2 2023
Expected issuance of **final rules** on **climate-related disclosures.**

SEC Human Capital Disclosure Requirements

Current

Modernization of Regulation S-K Items 101, 103, and 105
A Small Entity Compliance Guide

- Include, as a disclosure topic, a description of the registrant's human capital resources to the extent such disclosures would be material to an understanding of the registrant's business; and

Future?

WORKING GROUP ON HUMAN CAPITAL ACCOUNTING DISCLOSURE
PETITION FOR RULEMAKING

June 7, 2022

Human Capital Disclosure			
	Full-Time Employees	Part-Time Employees	Contingent Workers
Mean Tenure			
Employee Turnover			
Num. Employees			
	Total Compensation by Category		
Salary			
Bonus			
Pension			
Stock Awards			
Option Awards			
Non-equity incentive compensation			
Pension & Deferred Compensation			
Health Care			
Training			
Other			

Figure 3. Proposed Grid Disclosure for Workforce Investments.[18]

Status of EEO-1 Component 2

EEO-1 Component 2 Data:
Aggregated employee wage and hours worked data, categorized by EEO-1 classification, race, ethnicity, and sex.

2016
Obama Administration requires employers to report pay data to EEOC.

2017
Trump Administration reverses.

2019
Following litigation, court compels EEOC to collect pay data.

2020
EEOC declines to continue collection until further study, concludes in 2022.

April 2022
"Watch out, it is coming," Equal Employment Opportunity Commission cautioned employers on the return of EEO-1 Component 2 pay data reporting.

Nov. 2019
OFCCP would not "request, accept, or use Component 2 data, as it [did] not expect to find significant utility in the data given limited resources and [the data's] aggregated nature."

Sept. 1, 2021
OFCCP rescinds November 2019 notice as "premature and counter to the agency's interests in ensuring pay equity." OFCCP will evaluate the data's utility, "because the joint collection and analysis of compensation data could improve OFCCP's ability to efficiently and effectively investigate potential pay discrimination."

State Pay Equity Reporting Requirements

Requiring employers to provide pay data to state governments:

California

- **California SB 973, Expanded by SB 1162 (Expansion Effective Jan. 1, 2023)**
- Employers must list the number of employees working in California facilities by race, ethnicity, and sex, both by job category and by specified pay band.
- Starting Jan. 1, 2023 – employers (100+ employees) <u>also</u> must report the median and mean “hourly rate” within each job category by race, ethnicity, and sex. And private companies with 100 or more workers “hired through labor contractors” within the prior calendar year now must submit a separate pay data report for those labor contractor workers.

Illinois

- **Illinois Public Act 101-0656**
- Starting January 1, 2023, employers (100+ employees) must send most recent EEO-1 report to IDOL for each county in which the employer has employees or facilities. **Report will be made public.** Must provide individual employee pay data with the written statement, organized by gender and the race and ethnicity categories used in most recently-filed EEO-1 report, and must include “the total wages … paid to each employee during the past calendar year[.]”
- By March 24, 2024, and every two years thereafter, company must certify compliance to the State.

New York

- **New York Senate Bill 9427A**
- Starting Sept. 17, 2023, employers (4+ employees) must keep and maintain records necessary to demonstrate compliance including, but not limited to, the history of the compensation ranges for each job, promotion, or transfer opportunity, and the job description if one exists.

International Bellwether Laws on Mandatory Due Diligence

The last few years have witnessed a sprint towards mandatory ESG due diligence and disclosure, with Europe taking the lead.

International Sustainability Standards Board ("ISSB")

In November 2021, the International Financial Reporting Standards Foundation formed ISSB to develop a global baseline of sustainability-related disclosure standards. In March 2022, ISSB published proposed standards for general sustainability-related disclosures as well as specific climate-related disclosures.

Corporate Sustainability Reporting Directive ("CSRD")

In April 2021, the European Commission adopted a proposal for CSRD, which would replace the Non-Financial Reporting Directive ("NFRD") and provide investors with more detailed and assured ESG-related information. In February 2022, the European Commission proposed to expand the scope of CSRD to increase company accountability.

Draft Directive on Corporate Sustainability Due Diligence

In February 2022, the European Commission published a draft directive on corporate sustainability due diligence, which would require large EU and non-EU companies to identify, disclose, and mitigate human rights and environmental impacts of their operations and value chains.

International Bellwether Laws on Mandatory Due Diligence

Focus on Corporate Sustainability Due Diligence Draft Directive.

CORE DUE DILIGENCE OBLIGATIONS	Duty on Member States to ensure that companies **carry out human rights and environmental due diligence** in line with the United Nations Guiding Principles for Business and Human Rights, requiring **7 main actions:** 1) **Integrating due diligence into companies' policies:** integrate due diligence into corporate policies, and have in place a due diligence policy that reflects the company's diligence approach. 2) **Identifying actual and potential adverse impacts:** conduct due diligence on whether company operations, those of their subsidiaries and established business relationships in their value chains cause, contribute to, or are directly linked to potential or actual adverse impacts. 3) **Preventing potential adverse impacts:** prevent adverse impacts including through action plans, contractual clauses with business partners, and necessary investments, or where prevention is not possible or not immediately possible, adequately mitigate potential adverse impacts that have been identified. If potential adverse impacts can't be prevented or adequately mitigated, refrain from entering into relevant new or extending existing relationships. 4) **Providing mitigation measures/remedy:** take appropriate measures to end actual negative impacts that have been, or should have been identified, whether through compensation to individuals or communities, corrective action plans, contract assurances, investment into management or production processes and infrastructure, terminating business relationships where relevant adverse impacts, and ceasing future business activities. 5) **Developing complaints procedure:** companies to adopt grievance mechanisms allowing concerns to be raised directly and through unions/NGOs, for their own operations, subsidiaries, and their value chains. 6) **Monitoring:** assess periodically (at least every 12 months) the effectiveness of their due diligence processes to identify, mitigate, prevent, and terminate negative impacts in their operations and those of their established business relationships, through qualitative and quantitative indicators. 7) **Communicating publicly:** report on the nature of the diligence steps, potential and actual impacts, and actions taken to mitigate or remedy impacts.

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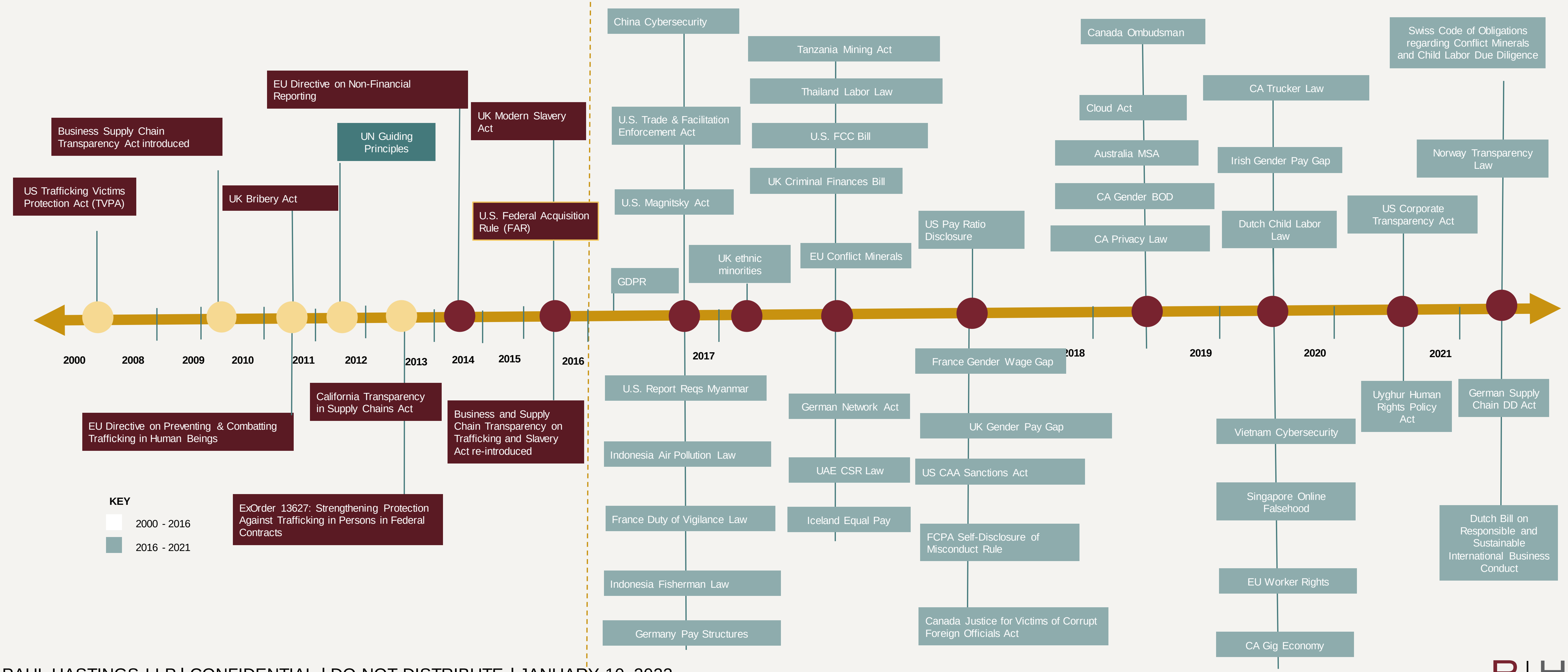
International Bellwether Laws on Mandatory Due Diligence



International Bellwether Laws on Mandatory Due Diligence

Mandatory legislation in force:

- *French Corporate Duty of Vigilance Law (2017)*
- *Swiss Mandatory Human Rights Due Diligence (2022)*

Mandatory legislation adopted:

- *Dutch Child Labor Due Diligence Act (TBD)*
- *German Supply Chain Due Diligence Act (2023)*
- *Norway Transparency Act (July 2022)*

Mandatory legislation in a draft stage:

- *Dutch Parliamentary Proposal on Responsible and Sustainable International Business Conduct*
- *Belgium Parliamentary proposal on the corporate duty of vigilance and care in value chains*
- *Austrian Parliamentary Proposal for a Supply Chain Law*

Mandatory legislation discussions are advanced:

- *The Netherlands: Announced desire for due diligence law to go beyond the existing Child Labor Due Diligence Act*
- *Luxembourg and Finland: Government commitment to mandatory human rights due diligence law*
- *Spain: Government plan for due diligence legislation*
- *Denmark, Sweden, Italy, Portugal, Switzerland, UK, Ireland: Civil society seeking human rights due diligence laws*

Anti-ESG

Anti-ESG Developments in the United States

Starting in 2021 and gaining momentum in 2022 – expected to accelerate in 2023

- Conservative Republican members of Congress, Governors, state attorneys general, state legislatures, moving to stop or interfere with ESG-related investing and corporate action.
- Recent spike in anti-ESG shareholder proposals – predominantly in the social and environmental spaces. Some researchers have estimated twice as many proposal submissions (52) in the 2022 proxy season that were from anti-ESG proponents as in 2021 (26).
- While anti-ESG proposals haven't historically garnered the same levels of backing as their pro-ESG equivalents, more conservative-leaning ESG proposals are here to stay for the foreseeable future.
- Companies with operations in states with Anti-ESG initiatives need to be fully informed about evolving risk landscape and strategies to address, such as Texas, Arizona, Florida, Pennsylvania, South Carolina, Missouri.
- Anti-ESG investors and activists are on the rise. With Universal Proxy Card, boards and management should expect increase ESG/Anti-ESG activity and engagement.

Anti-ESG Developments in the United States: Diversity

Tech and Media as primary targets

- Strive Asset Management -- which has over $500M in total assets under management, only months after the launch of its first fund -- is leading the charge from investor standpoint.
- In Q3 of 2022, Strive launched several index funds during "Strive's Excellence Campaign", which identified seven companies "with untapped potential if liberated from ESG-imposed constraints."
- To date, technology and media appear to be a priority with regard to DEI.

Hypothetical

Hypothetical – Discussion of Risks

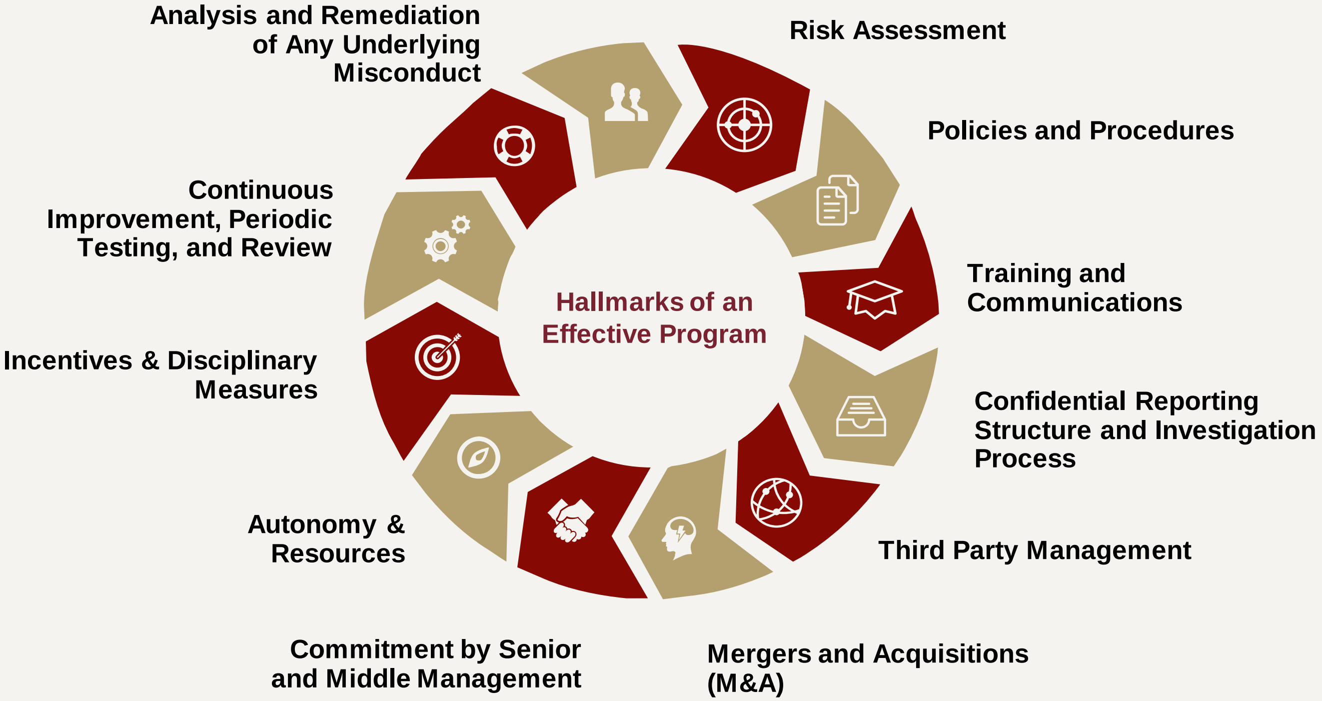
A clothing retail company commits publicly and in internal policies to specific quotas for minority staffing for store employees, and ties executive compensation to improved diverse hiring statistics.

The company also sets a quota for increased contracting with minority-owned businesses.

What are the risks?

Best Practice Next Steps

Elements of an Effective Compliance Program



Three Fundamental Questions:

1	Is the compliance program well-designed?
2	Is the program adequately resourced and empowered?
3	Does the program function effectively in practice?

Evaluation of Existing ESG Practices

- **Take action to evaluate ESG risks and opportunities**, including through:
  - Ensuring that current and future disclosures satisfy reporting requirements;
  - Preemptively bolstering any potential gaps that could negatively attract the attention of investors or regulators; and
  - Monitoring anticipated developments in ESG disclosure requirements.

Action Items

1. Conduct Risk Assessment
2. Develop Comprehensive ESG Strategy
3. Appoint Risk Owner
4. Develop or Enhance ESG Policies
5. Evaluate Existing Disclosures
6. Establish Tone at the Top
7. Implement and Train on Effective Controls

Assessment of ESG Risks

- Conducting an internal ESG risk assessment is the most effective mechanism to **establish a baseline of your company's existing ESG risks and responsive policies and procedures**.
- The risk assessment should:
  - Confirm that existing ESG practices meet regulatory standards; and
  - Identify any gaps in ESG practices that may create ESG risk exposure.

Risk Assessment Best Practices

- ✓ Review existing policies and procedures.
- ✓ Establish how policies and procedures have been executed in practice.
- ✓ Identify instances in which application of policies did not match stated standards.
- ✓ Evaluate whether new/updated policies may be required to meet regulator expectations.
- ✓ Assess any gaps or areas of exposure.

Development of ESG Strategy and Priorities

- A thoughtful and comprehensive approach is more likely to ensure that reporting:
  - Aligns with investors', regulators', and exchanges' disclosure expectations and guidance; and
  - Avoids the ESG-related reporting misconduct that regulators seek to identify.
- The Board should be satisfied that implementation of ESG policies and procedures appropriately address the company's ESG objectives, align with the company's overarching strategy, and effectively mitigate risks posed.

If you have . . .

<u>No</u> Current ESG Strategy/Policies

Create:
- A **playbook** that defines the ESG factors that are paramount to your company; and
- An **approach** for ensuring that those factors are accurately and consistently reported.

<u>Preliminary</u> ESG Strategy/Policies

- Periodically reevaluate both the strategy and the policies to confirm alignment with expectations arising from increased focus on and monitoring of ESG reporting; and
- Deploy an ESG-focused internal communications campaign.

Implementation of Internal Controls

- **Internal controls should be designed to address those ESG factors critical to your business.**
- The framework should monitor relevant risks and ESG metrics identified for disclosure, and be designed to identify potential issues or increasingly relevant ESG-related metrics.
- Controls must ensure that ESG-related requirements are met and that public disclosures reflect actual practices.

Internal Controls

- ✓ **Defensible Policies and Procedures.** The company's governance structures and compliance program should include the metrics against which the company will assess and evaluate ESG programs. This enables the company to assess the efficacy of existing written standards, as well as the need for new/updated written standards.
- ✓ **Monitoring and Internal Audit**. The Board should be involved in establishing systems that provide material information to management and the Board about existing risks, the impact of those risks, and risk mitigation efforts. Periodic audits and monitoring can confirm whether the company is meeting its ESG commitments, and can identify any new or evolving risks that must be addressed.
- ✓ **Due Diligence Considerations**. Existing due diligence criteria should be updated to include those ESG factors essential to the business.

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