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The “ABC’s” of ESG

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In 2020, trillions of dollars flooded ESG funds, and many analysts are expecting this trend to continue in 2021. BlackRock, the largest asset manager in the world, plans to have $1.2 trillion in ESG assets in the next 10 years, and an estimated one-third of all U.S. assets under management are already sustainably invested. Given the importance of ESG to the securities markets, we herein present an elementary primer, explaining ESG issues and how they are affecting companies and their public disclosures—your ABC’s of ESG, so to speak.

So what is ESG, anyway?

The term “ESG” stands for Environmental, Social, and Governance. More simply, ESG captures an array of qualitative issues that may be considered by investors/investment professionals and incorporated into an investment analysis. There is no single comprehensive list of ESG issues, but you can conceptualize them as “hot” topics in the ever-evolving zeitgeist. For example, if opinion pieces in *The New York Times* address an issue, you can bet that it will be on investors’ minds, too. The CFA Institute compiled examples of today’s top ESG issues, as follows:

Although the “soft” issues that fall under this umbrella term are not part of traditional financial metrics and can be difficult to quantify in monetary terms, they have financial relevance as they can affect the risk and return of investments. ESG issues are thus increasingly being considered by investment professionals in their endeavor to identify and evaluate drivers of the risk and return of investments.

As ESG considerations factor more prominently into investment decisions, companies are constantly seeking to understand how they should (and, sometimes, must) account for ESG issues in their disclosures.

The Birth of ESG

The term “ESG” was introduced in 2004 in the UN Global Compact’s landmark report *Who Cares Wins*, which outlined recommendations by the financial industry to “better integrate environmental, social and governance issues in analysis, asset management and securities brokerage.” The report noted that, until then, “the industry [had] not developed a common understanding on ways to improve the integration of environmental, social and governance (ESG) aspects in asset management, securities brokerage services and the associated buy-side and sell-side research functions,” and asserted that more fulsome inclusion of ESG factors in investment decisions would “contribute to more stable and predictable markets.” A year later, the UN Environment Programme published the “Freshfields Report,” which showed that ESG issues are relevant for financial valuation. These reports created the foundation for the ever-changing but increasingly crucial ESG we know today.

Initially, ESG considerations manifested as “exclusionary screening of listed equities on the basis of moral values.” The practice, however, evolved as investors came to understand that ESG issues have palpable financial implications. Indeed, investment professionals now utilize a range of methods to consider ESG issues, including:

- best-in-class selection (i.e., favoring companies with better or improving ESG performance relative to sector peers),
- active ownership (i.e., “entering into a dialogue with companies on ESG issues and exercising both ownership rights and voice to effect change”),
- thematic investing (i.e., investing that is based on trends, a number of which include ESG issues),
- impact investing (i.e., “investing with the disclosed intention to generate and measure social and environmental benefits alongside a financial return”), and
- ESG integration, which is quite simply the “systematic and explicit inclusion of ESG risks and opportunities in investment analysis.”

Legal Risks and Increasing Regulation of ESG Disclosures

There are currently no federal requirements compelling issuers to make ESG disclosures in their public filings, unless they are otherwise material. However, given the current climate of increasing social accountability and reputational risk, along with the stated priorities of the incoming Biden administration, this may change.

Of course, ESG disclosures are already actionable if they are found to be materially false or misleading. Thus far, litigation centering on ESG disclosures generally has arisen in two contexts: (1) securities fraud claims under federal law, and (2) consumer protection or consumer fraud claims under federal or state law. The below cases highlight key trends in securities litigation with ESG-related disclosures at the heart of the matter.

- In re BP plc, Sec. Litig.: Where disclosures related to ESG issues are sufficiently concrete, quantifiable, or falsifiable, they may be material to a reasonable investor and thus actionable under state and federal securities laws.
- In re YUM! Brands, Inc. Sec. Litig.: Where an ESG statement is deemed vague, subjective, or aspirational, it may not be false, misleading, or material to a reasonable investor, and therefore, it may not be actionable.
- *Ramirez v. Exxon Mobil Corp.*: Where an ESG disclosure is included within a quarterly or annual securities report, CEOs and CFOs may be liable as "control" persons for any false or misleading statements.
- In re Eletrobas Sec. Litig.: Where ESG statements are made in response to investors' concerns, especially when those statements are made "amidst contemporaneous questions regarding the company's ethics or investigations of the company's illicit activities," courts have denied motions to dismiss.

Intrigued by the ESG landscape? So are we. To stay up to date on all things environmental, social, and governance, subscribe to Proskauer's Corporate Defense and Disputes blog and we will keep you appraised of the latest developments.

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Special thanks to our litigation paralegal, Emma Dillon for her contributions to the post.

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