

ACROSS THE BOARD

Keeping companies and
their boards a step ahead

A Conversation with Bill Cohan & Larry Cunningham

ESG and the Future of Corporate Governance

MARCH 29, 2023

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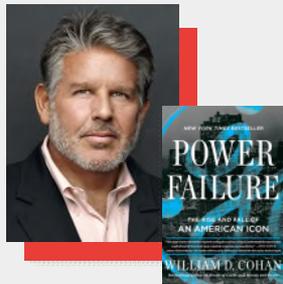


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THE RISE AND
STALL OF ESG
ESG at the Crossroads



A CONVERSATION
BETWEEN BILL
COHAN & LARRY
CUNNINGHAM
Moderated by Anna Pinedo

The Backstory Which Brings Us Here Today

THE RISE	THE STALL
The UN's Good Intentions (2004-2005)	Empirical Academic Critiques of ESG
ESG's Virtuous Ideas and Issues	Individual Investor Surveys Down on ESG
ESG Management Strategies	Funds Flow Out of ESG
ESG Investment Strategies	ESG Faces Rising Scrutiny/Divides States
Tailwinds for ESG Proliferation	ESG Coalitions Under Stress
The Huge Money in ESG: The ESG "Ecosystem"	ESG Activism Shows Volatility
The Political Thicket	ESG as Top-Down, One-Size-Fits-All

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Origins in the Good Intentions of the United Nations

SINCE 2004-2005

UN Sustainability Development Goals (UNSDGs)

17 sustainable development goals—from “no poverty” and “zero hunger” to “peace”—say meeting these goals goes hand-in-hand with strategies to improve health and education, reduce inequality, and spur economic growth—all while tackling climate change and working to preserve oceans and forests



UN Principles of Responsible Investing (UNPRIs)

An introduction to responsible investment and related policies, structures and processes—and associated management principles



UN Guiding Principles on Business and Human Rights (UNGPHR)

A leading human rights standard for states and international businesses



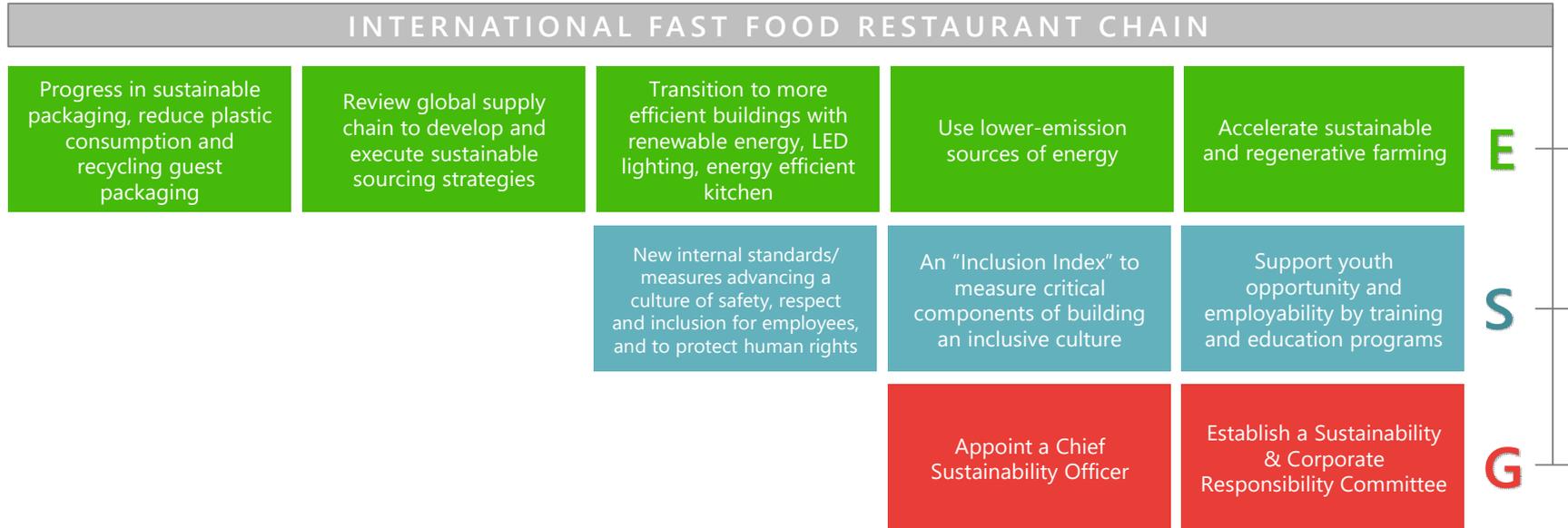
ESG Issues Came to Coalesce Around... Many Virtuous Ideas

ENVIRONMENTAL	SOCIAL	GOVERNANCE
Climate change/GHG emissions	Customer satisfaction	Board composition
Air and water pollution	Data protection and privacy	Audit committee structure
Biodiversity	Gender and diversity	Bribery and corruption
Deforestation	Employee engagement	Executive compensation
Energy efficiency	Community relations	Lobbying
Water management	Human rights	Political contribution
Water scarcity	Labor standards	Whistleblower schemes

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ESG Management Strategies



Source: [Performance & ESG Reporting](#)

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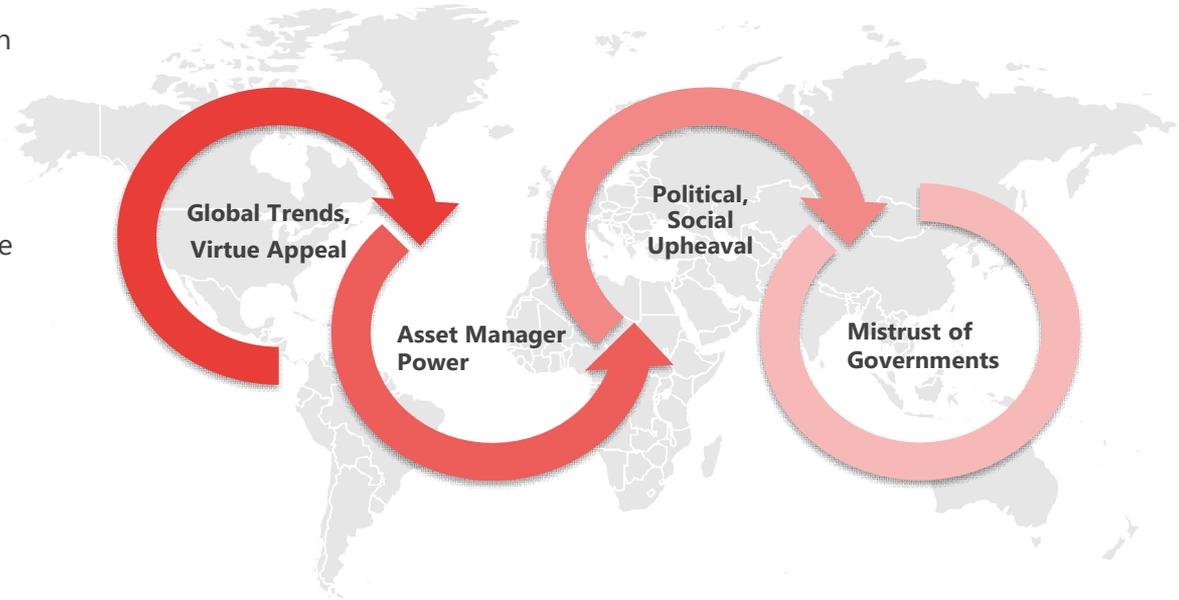
ESG Investment Strategies



Source: Mayer Brown Author Commentary

Tailwinds for ESG Proliferation

- The concept of “sustainability” caught on as a virtue, along with “accountability” and “expectations” of “stakeholders,” in the mid-2010s
- Institutional asset managers gained enormous power, lent their weight to the movement, especially via Larry Fink’s public letters to CEOs from ~2013
- Since 2019, social movements, such as *MeToo* and *BLM*, gained rising power
- Trust in government solutions eroded, creating demand for action through NGOs and corporations, increasing through the pandemic



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Huge Money in ESG: The ESG Ecosystem

Framework Developers	Standard Setters	Taxonomies	Coalitions	Advisors	Money Managers
UN Global Compact (UNGC)	International Sustainability Standards Board (ISSB)	The EU Taxonomy	UN PRI CERES Climate Action 100 Interfaith Center on Corporate Responsibility	Accountants Auditors Consultants Proxy Advisors Law Firms Search Firms	State Pension Funds (NY, CA)
International Integrated Reporting Counsel (IIRC)	Global Reporting Initiative (GRI)	The Common Ground Collaborative			Index Funds (BlackRock, State St., Vanguard)
Task Force on Climate-Related Financial Disclosure (TCFD)	Sustainability Accounting Standards Boards (SASB)	The ASEAN Taxonomy	NGOs—Climate Focused		ESG Focus (Impax, Trillium, NEI)
Climate Disclosure Standards Board (CDSB)	International Organization for Standardization (ISO)		Climate Governance Initiative Carbon Tracker Initiative Regenerative Crisis Response Committee Friends of the Earth Amazon Watch Partnership for Carbon Accounting Financials (PCAF) As You Sow Center for Climate and Energy Solutions Institute for Governance and Sustainable Development World Benchmarking Alliance World Resources Institute		ESG-Branded Funds (Baillie Gifford, BNP Paribas)
	Greenhouse Gas (GHG) Protocol				

Political Thicket

BATTLES OF IDEAS

- ESG Coordination Revives Philosophical Debate over Markets versus Mandates
- Priorities Revive Corporate Purpose Debate: Shareholder Primacy v. Stakeholder Model
- Critiques of Capitalism Look Like *Threats to Capitalism Itself*

SEEDS OF DOUBT

- ESG Phonies: Greenwashing, Pinkwashing, Other Miscreant Behavior
- Promised Economic Value of ESG Investing/Managing Doubted
- Money Managers Seen Prioritizing Personal Values Over Client Financial Interests
- Politics as Usual: Democrats v. Republicans (DOL, SEC, States)

Empirical Academic Critiques of ESG

- *Atz, Holt, Liu & Bruno, [Does Sustainability Generate Better Financial Performance?](#), (2022) J. Sustainable Fin. (meta review of ~1400 empirical studies 2015-2020 finding that “the financial performance of **ESG investing has on average been indistinguishable from conventional investing** [with one in three studies indicating superior performance] in contrast with research in the wider management literature, as well as industry reports”).*
- *Hartzmark & Sussman, [Do Investors Value Sustainability?](#), J. Fin. (2019): yes, based on net flows from low- to high-rated funds, but alas, “**evidence does not show that high-sustainability funds outperform low-sustainability funds**” (using Morningstar ratings).*
- *Gibson et al., [Do Responsible Investors Invest Responsibly?](#), Rev. Fin. (2022) (**US firms that signed the UN’s PRI do not, on average, receive higher ESG ratings, and some receive worse**, particularly those that are retail-facing or those which signed the PRI late) (potential indication of greenwashing).*
- *Raghunandan & Rajgopal, [Do ESG Funds Make Stakeholder-Friendly Investments?](#), Rev. Acct. Studies (2022) (mutual funds **labeling themselves ESG actually invest in companies with worse records on compliance** with labor and environmental laws) (potential indication of greenwashing).*
- *Flugum & Souther, [Stakeholder Value: A Convenient Excuse for Underperforming Managers?](#) (2022): “Firms falling short of earnings expectations are more likely to cite stakeholder-focused objectives in their public communications [suggesting] **managers push to be evaluated by subjective stakeholder-based performance criteria when falling short on objective shareholder-based measures**. This relation between underperformance and stakeholder language becomes stronger after the 2019 Business Roundtable statement and appears unrelated to a firm’s actual ESG-related activity.”*

Surveys: Individual Investors Down on ESG

STANFORD UNIVERSITY (GSB, ROCK CENTER, HOOVER)

- 2470 individual investors
- Older (>58 years): unwilling to tradeoff investment returns for ESG
- Younger (18-41 years) with <\$50K savings: unwilling to trade investment returns for ESG
- Younger (18-41 years) with >\$250K savings: willing to trade investment returns for ESG

NORC (UNIVERSITY OF CHICAGO) & FINRA INVESTOR EDUCATION FOUNDATION

- 1228 retail investors
- Investment returns of potential investment: Most important factor
- Environmental aspects of potential investment: Least important factor

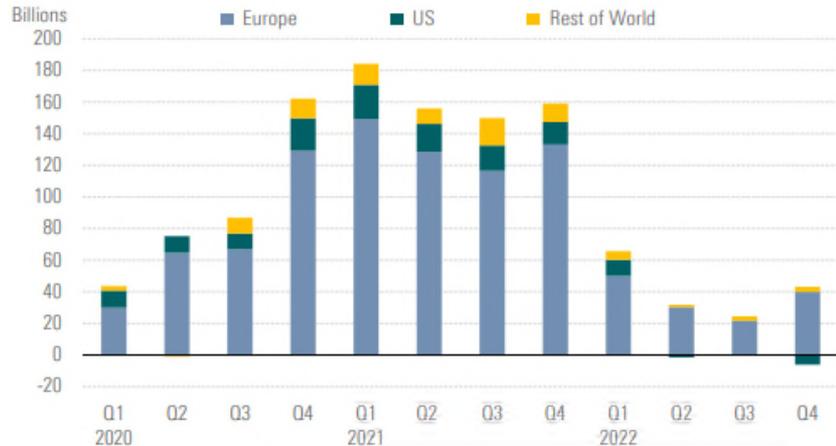
US GALLUP POLL

- 953 US adult individual investors
- Most prioritized investment return and risk over environmental losses

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Funds Flowing *Out* of ESG

QUARTERLY GLOBAL SUSTAINABLE FUND FLOWS (\$BILLIONS)



Source: Morningstar Direct, Manager Research. Data as of December 2022.

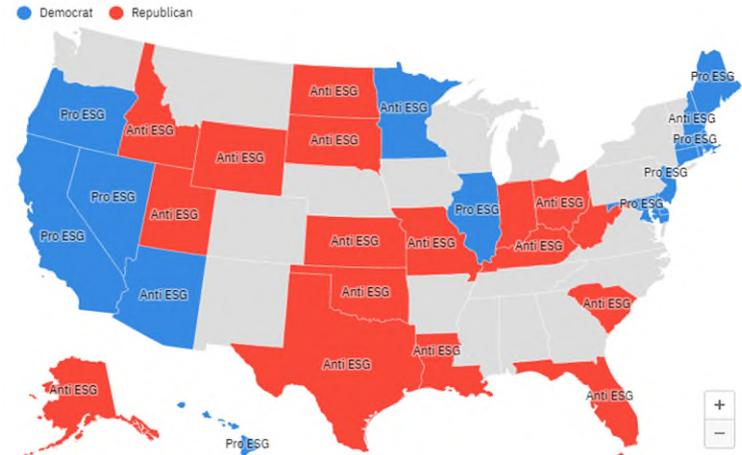
- Mostly European, maps pandemic
- Rose from Q1 2020 . . .
- Peaked Q1 2021 . . .
- Fell sharply Q1 2022 . . .
- Reversed Q4 2022 (outflows)

ESG Scrutiny On the Rise

- Major European bank's claims re: sustainable investing practices probed by US and European regulators, leading to CEO departure
- Major European bank's head of responsible investing suspended due to remarks dismissing climate risk
- Major US asset manager fined by SEC for misstatements and omissions relating to ESG reviews of funds
- May 2022: "Investor Democracy Is Expected Act" introduced in Senate; would require managers of passive investment funds to pass through voting where position exceeds 1%
- SEC charged Vale with making false and misleading statements about safety of its dams prior to January 2019 Brumadinho dam collapse
- NAIC requires insurers that respond to the NAIC Climate Risk Disclosure Survey to comply with TCFD reporting by November 2022

Red states far more likely to introduce anti-ESG bills

Bills introduced either in support of or against integrating ESG principles into investment decisions



Note: Colours refer to party that received the most votes in the 2020 presidential election as a proxy for political leaning.
Source: Capital Monitor

CAPITAL MONITOR

ESG Coalitions Under Stress

- Glasgow Financial Alliance for Net Zero (**GFANZ**, launched 2021), includes sub-groups:
 - * Net Zero Asset Managers initiative (**NZAM**) ~275 asset managers with ~\$60 trillion AUM
 - * Net Zero Banking Alliance (**NZBA**) ~120 banks with ~\$70 trillion in assets
- GFANZ is accredited by the UN's Race to Zero initiative, the overarching campaign, which has increased demands on its members, leading to tensions among NZAM and NZBA members, with large NZBA members threatening to withdraw, including BofA, JP Morgan and Morgan Stanley (see [Banking Dive](#), October 10, 2022)
- Such coalitions draw heightened scrutiny and raise concerns regarding anti-trust violations (see [Financial Times](#), February 27, 2023)

ESG Activism Shows Volatility

- Number of “conservative” proposal submissions doubled 2021 to 2022
- Increasing coordination among “progressive” proponents
- BlackRock climate bulletin – declining to support prescriptive proposals
- Throttling traditional energy companies (halting finance, killing assets)
- Civil rights audits, racial equity audits, anti-arbitration
- Abortion on the corporate ballot

G: Top-Down, One-Size-Fits-All

INDEXERS

The board chair should not be CEO or there should be a lead independent director.

The board should be majority independent.

All board committees should have only independent directors.

At least 30% of directors should be non-straight, white, males.

All directors should attend at least 75% of meetings and none may serve on >4 public company boards.

All directors should face term limits.

All directors should face age limits.

Every director should be elected annually, not every 2 or 3 years.

No company should use cumulative voting in director elections.

No company should have classes of stock with different voting or economic rights.

No company should have authorized but unissued preferred stock.

DGCL permits
tailoring, going
either way.

Decisional law
permits all, only
requires general
loyalty and care

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ES: Top-Down, One-Size-Fits-All

"Climate risk"	"There is growing consensus that companies can benefit from the more favorable macroeconomic environment under an orderly, timely, and equitable global energy transition... "
"Key stakeholders"	"Companies that build strong relationships with their key stakeholders are more likely to meet their own strategic objectives , while poor relationships may create adverse impacts..."
"Human capital management" (HCM)	"A company's approach to HCM is a critical factor in fostering an inclusive, diverse, and engaged workforce, which contributes to business continuity, innovation, and long-term value creation. "
"Climate risk"	"There is growing consensus that companies can benefit from the more favorable macroeconomic environment under an orderly, timely, and equitable global energy transition..."

Source: Sandy Boss et al., BlackRock, Investment Stewardship, Harvard Law School Forum on Corporate Governance (January 18, 2023) (emphasis added)

2018: "[Y]ou **must** also **understand the societal impact** of your business..."

2019: "Companies **must** demonstrate their commitment to ... the **world's future prosperity.**"

2022: "The **stakeholders** your company relies upon to deliver profits for shareholders **need to hear directly from [CEOs about where they] stand on ... societal issues...**"

Source: Larry Fink Open Letter to the CEOs of US Companies

Sample Board-CEO Framework for Public Comment

CEO DISCRETION	HOT TOPICS WITHIN COMPANY'S BUSINESS	HOT TOPICS OUTSIDE COMPANY'S BUSINESS	OFF-LIMITS
<p>Wages/employee relations generally</p> <p>Prices/customer relations generally</p> <p>Earnings/shareholder relations generally</p> <p>Community and charitable relations</p>	<p>Pandemic screening for airlines (Delta, United), hotels (Hilton, Marriot)</p> <p>Soda tax legislation for beverage companies (Coca-Cola, Pepsi)</p> <p>Environmental legislation for renewable energy companies, electronic vehicle makers (Ford to Tesla)</p>	<p>Federal travel ban targeting Muslim-majority countries</p> <p>Federal gun laws to reduce mass shootings</p> <p>Abortion (e.g., the <i>Dobbs</i> decision)</p> <p>Transgender rights/teachings (Florida law)</p> <p>Voting laws (Georgia)</p>	<p>Endorsing given candidates for office</p> <p>Endorsing or opposing specific political parties or agendas</p>

ESG Getting Unfavorable Press



'The only healthy endgame for ESG is another acronym: RIP. And it will not be a moment too soon.'

By Rupa Subramanya, March 9, 2023

The Free Press



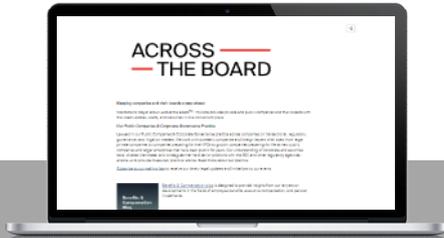
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Across The Board Supplemental Materials

- **March 28** [As Shareholder Proposals Proliferate, Boards Might Consider this Framework to Evaluate Voting Results](#)
- **March 21** [Four Big Takeaways for Boards from McDonald's II on Oversight and Duty](#)
- **March 14** [On Share Buybacks, Directors Should Stick with Economics, Avoid Politics](#)
- **March 7** [The Directors' Role Amid Debates over Corporate Purpose, Stakeholders and ESG](#)
- **February 28** [Dealing with Director Overload](#)
- **February 21** [Beware the Draconian Advance Notice Bylaw](#)
- **February 17** [Five Steps for Directors to Consider About Risk Governance](#)
- **February 14** [Officer Inculcation and Exculpation: Might McDonald's and 102\(b\)\(7\) Converge?](#)
- **February 8** [Boards Need Not Pressure Management to "Hurry Up and Wait"](#)
- **January 30** [A Board Approach to Shareholder Engagement](#)
- **January 24** [CEO Comments on Public Policy: An Internal Governance Framework](#)
- *See also:* Lawrence A. Cunningham, *Who Are Quality Shareholders and Why You Should Care*, 37th Annual Pileggi Distinguished Lecture, Wilmington, DE, reprinted on the [Harvard Law School Forum on Corporate Governance](#) (February 11, 2023)



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