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The Role of ESG in Capital Markets

Part of the

Raising Capital in the Current Environment Series

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Today's Panelist

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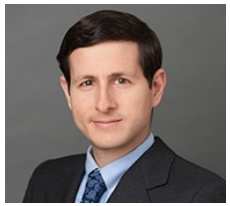
Hillary H. Holmes is a partner in the Houston office of Gibson, Dunn & Crutcher, Co-Chair of the firm's Capital Markets practice group, and a member of the firm's Securities Regulation and Corporate Governance, Energy and Infrastructure, Oil and Gas, M&A and Private Equity practice groups. Ms. Holmes' practice focuses on capital markets, securities regulation, and corporate governance, primarily in the energy industry. Ms. Holmes represents public companies and private companies of all sizes, MLPs, investment banks, management teams, and private equity in all forms of capital raising transactions, including IPOs, registered offerings of debt or equity, private placements, 144A offerings of debt or equity, joint ventures, structured investments, de-SPAC transactions, direct listings, sustainable financings, and spin-offs. Ms. Holmes provides regular counseling regarding securities laws, SEC reporting, ESG issues and governance matters.

Perlette M. Jura is a partner in Gibson, Dunn & Crutcher's Los Angeles office. Her practice focuses on complex trial and appellate litigation. She co-chairs the firm's Transnational Litigation and its Environmental Social Governance practice groups. She has played a key role in a number of the firm's most high-profile transnational, environmental and technology-driven matters. Ms. Jura has extensive experience working with the food and beverage, agricultural, aerospace, automotive, emerging technology and energy industries. In 2021, Ms. Jura was named among the Lawdragon Global Litigation 500, which recognizes those who specialize in international arbitration, public international law and advise leading corporations. She was recognized by Benchmark Litigation as one of the "Top 250 Women in Litigation" in 2020 and 2019.

Michael A. Mencher is a corporate associate in the San Francisco office of Gibson, Dunn & Crutcher. He is a member of the Firm's Capital Markets, Securities Regulation & Corporate Governance and ESG practice groups. His practice focuses on advising technology, life sciences and other public and pre-public companies on governance, ESG and sustainability, investor relations and SEC reporting and compliance matters and representing issuers in a wide variety of capital markets transactions, including initial public offerings and follow-on equity financings, sustainable finance transactions, private placements and debt financings.



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ESG Narrative in Attracting Capital

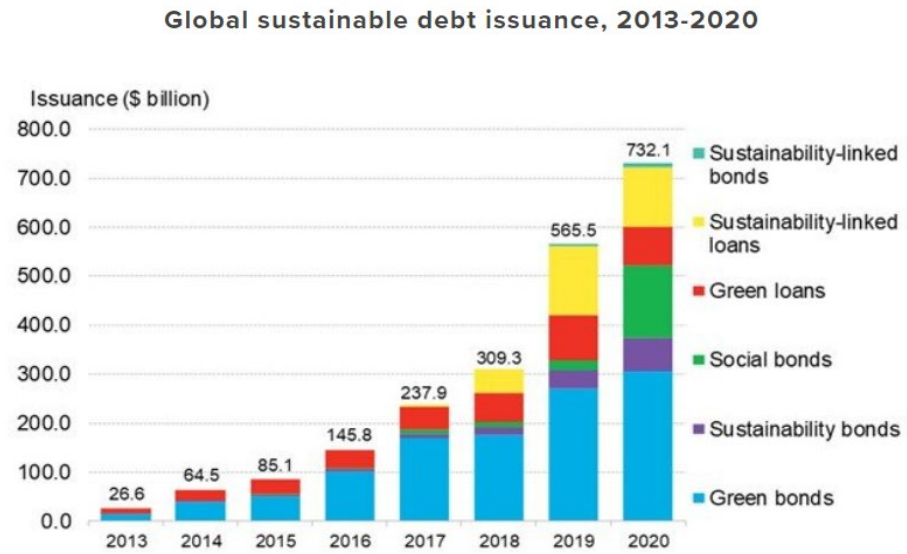
Investor ESG Focus

- The past decade has witnessed intense institutional investor, proxy advisor, activist investor and regulatory focus on corporate ESG issues including:
  - Environmental sustainability;
  - Corporate social responsibility (particularly regarding diversity and inequality issues);
  - Corporate political practices, including lobbying and contributions;
  - ESG corporate governance, including board and management diversity and oversight of ESG issues and reporting; and
  - Transparency around ESG issues, including the quality of ESG reporting.
- Growth of specialized ESG funds cater to this focus, investing in sustainable issuers and ESG financial products.
- Institutional and other funds increasingly pursue ESG products in order to:
  - Meet investor demand and signal ESG commitment;
  - Push issuers to pursue ESG strategies that contribute to long-term business prospects and mitigate risk; and
  - Diversify ESG portfolios to hold both sustainable issuers (e.g. clean energy companies) and ESG bonds/loans from issuers in other industries (finance, consumer goods, technology, etc.).

ESG Finance: Market Overview

- ESG Bonds (both SEC registered and unregistered offerings):
  - Bonds with an ESG-related Use-of-Proceeds
    - Green Bonds
    - Social Bonds
    - Sustainability Bonds
    - Transition Bonds
  - Sustainability-Linked Bonds

- ESG Loans
  - Green and Social Loans
  - Sustainability-Linked Loans

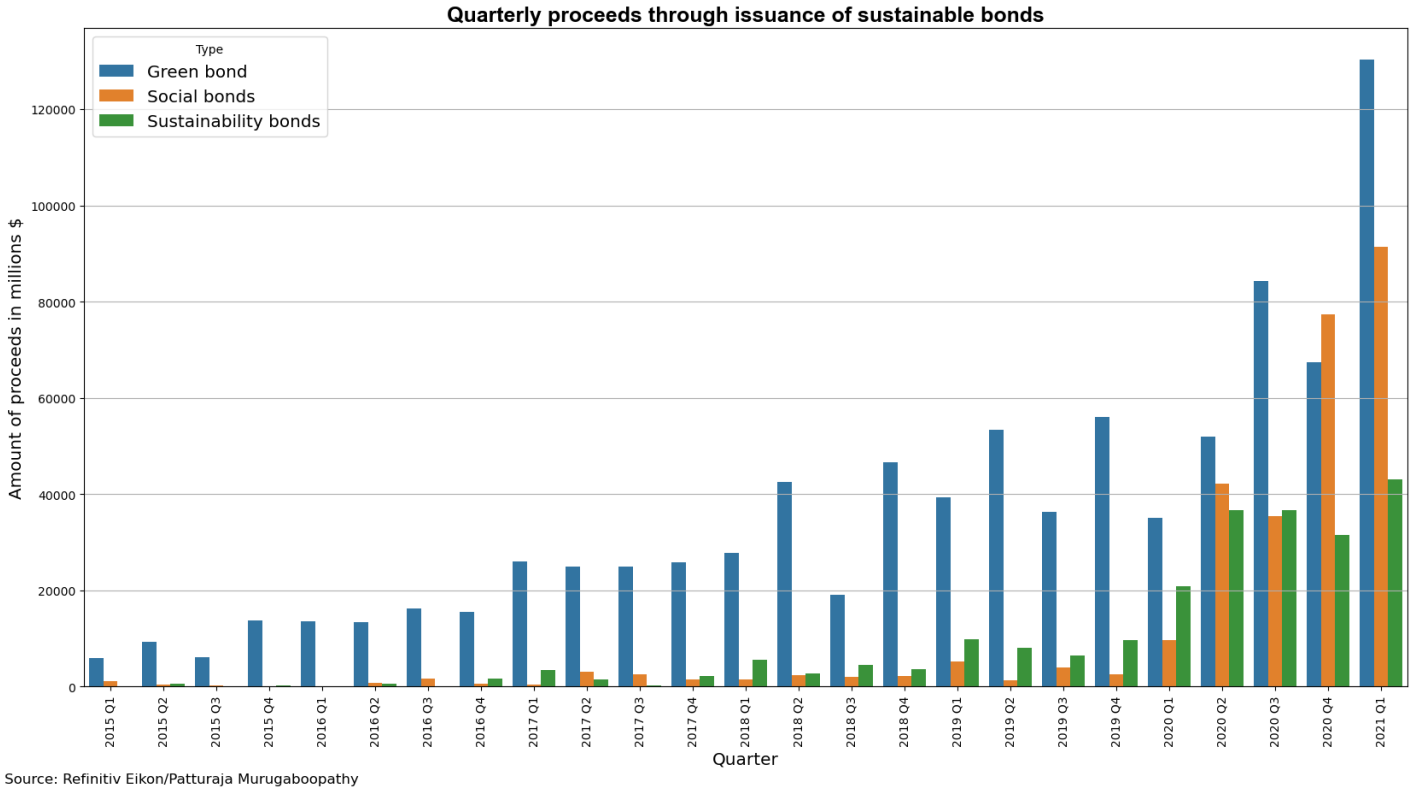


Source: BloombergNEF, Bloomberg LP, 2020.

- "Unlabeled" ESG Investments:
  - Issuances from "inherently" sustainable issuers (what PIMCO calls "Climate Leaders"), such as clean energy companies, that are not explicitly labeled as Green or Social Bonds.

ESG Finance: Market Overview

- The first quarter of 2021 has witnessed record growth in Green, Social and Sustainability bonds, including approximately $130B in global Green Bond issuances.
- Financial institutions/development banks and sovereign issuers are the most significant global ESG finance issuers, representing 41% and 21% respectively of Q1 2021 Green Bond issuances.



Source: Refinitiv Eikon/Patturaja Murugaboopathy

ESG Finance: Historical Developments and Trends

- Historically, Green Bonds/Loans have been the most prominent ESG product, monopolizing ESG finance until 2018 and remaining the most significant both in offering numbers and proceeds.
- Green Bonds have grown enormously in the past five years, with less rapid growth since 2019:
  - $270B in global 2020 Green Bond issuances, up from $266B in 2019 and $170B in 2018.
  - 2019-2021 has witnessed the increased importance of sustainability-linked loans and social bond offerings, with global Social Bond issuances over $150B in 2020, a more than 10x increase from 2019.
    - Surge in Social and hybrid Sustainability bond offerings in 2020-21, paralleling increased investor focus on social issues, including racial, gender and economic inequality.
    - Social Bonds continue to be more prominent among EU issuers ($50B in France vs $8B in the US).
- Increased focus on ESG Finance challenges:
  - Lack of an official ESG product taxonomy or reporting standard.
  - No commonly accepted definition of what constitutes environmental sustainability or corporate social responsibility (e.g. is nuclear power a “green” investment?).
  - SEC and other regulator focus:
    - Quality, consistency and comparability of ESG reporting.
    - March 2021 SEC call for comments on proposed climate disclosure rules.
    - April 2021 SEC Risk Alert regarding ESG fund internal control weakness around ESG standards.

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Developed ESG Finance Products

ICMA Principles Framework

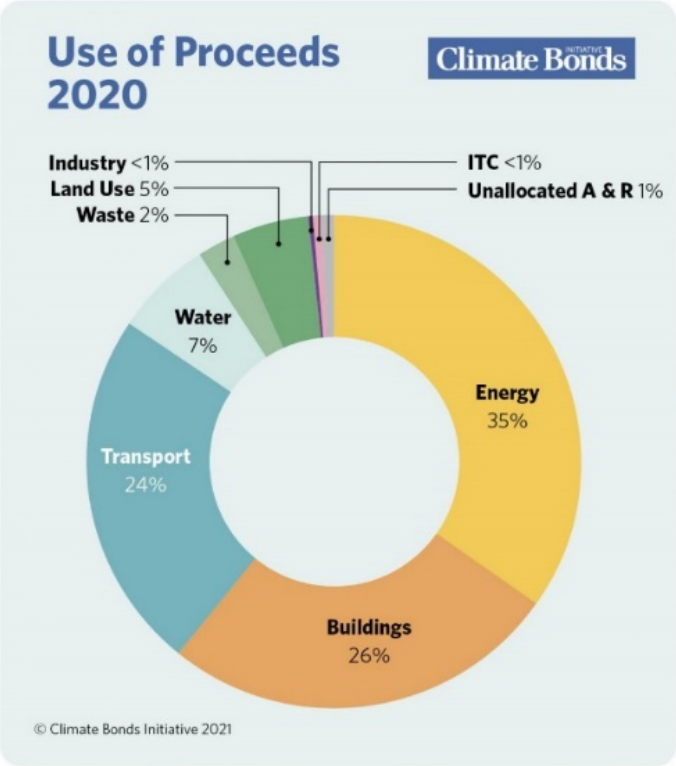
- The International Capital Markets Association promulgates voluntary guidelines for Green, Social, Sustainability and Sustainability-Linked Bonds.
  - Basis for market expectations regarding process, form and substance of ESG bond offerings, including investor criteria.
- ICMA principles define basic features of offering documentation content, post-offering reporting and the scope of eligible ESG projects or KPIs underlying bonds.
  - Green and Social Bond Principles include an influential (but not exhaustive) list of eligible green and social projects, forming the basis of third-party opinion provider and investor expectations.
- Under the ICMA approach, Green, Social and Sustainability bond offering documents consistently include four key features:
  - a designation and description of projects to be financed by offering proceeds;
  - a description of how such projects are evaluated and selected by the issuer;
  - a description of how offering proceeds will be managed and tracked to ensure they are used for qualifying projects; and
  - a description of any ongoing commitment to report publicly on the use of proceeds until full allocation.

Green Bonds

- **Green (and Social) Bonds are largely structurally identical to other bond offerings**:
  - Offering documents contain a use of proceeds describing eligible projects and post-offering reporting.
    - Use-of-proceeds disclosure often references an external "Green Bond Framework," which is not incorporated by reference.
  - In addition, issuers are increasingly including robust Green Bond related risk factors including:
    - Risks regarding ESG investor expectations;
    - Eligibility of the Green Bond for inclusion in ESG funds and indexes; and
    - Continuing uncertainty regarding the definition of sustainable investment products and the existence of multiple competing taxonomies and ESG reporting standards.
  - Green Bonds involve no difference in pricing mechanism, offering process or legal liability regime.
  - Generally no difference in covenants between Green Bonds and traditional unsecured bonds.
    - No covenants related to Green Projects and other covenants determined by issuers' particular credit ratings and market demands.
    - Commit to reporting on allocation of proceeds to Green Projects, but failure to do so or to allocate such proceeds in a timely and complete manner does not constitute a covenant breach or event of default.
- **ICMA Principles do not take a position on the appropriate "technologies, standards, claims and declarations" for defining and tracking environmentally sustainable benefits.**
  - The selection of projects and reporting processes, and the support of such decisions in the absence of a definitive standard, is a key feature of Green Bond offering preparation and the external review process.

Green Bonds

- "Eligible green projects" categories under the ICMA Green Bond Principles include, but are not limited to:
  - renewable energy;
  - energy efficiency;
  - pollution prevention and control;
  - sustainable resource and land use management;
  - biodiversity conservation;
  - clean transportation;
  - sustainable water and wastewater management;
  - climate change adaptation;
  - eco-efficient products, production technologies and processes;
  - green buildings.



- Green Bonds may fund both individual projects (such as a solar farm or climate friendly headquarters) or a wide variety of possible projects (often detailed in a Green Bond Framework intended to cover multiple possible offerings).

ESG Bond Third-Party Opinion Process

- The ICMA Green (and Social) Bond Principles recommend the appointment of an external reviewer to opine on the adherence of an individual offering (or multi-offering framework) to the four core requirements under the ICMA Principles:
  - the use of proceeds (eligible projects);
  - project selection and evaluation;
  - management of proceeds; and
  - proceed allocation reporting.

- The use of such third-party opinions (TPOs) has become standard market practice in Green, Social and Sustainability Bond and Sustainability-Linked Bond offerings.
  - TPOs provide comfort to ESG investors and also allow issuers to preview and address areas of potential investor concern.

- The TPO process is one of the most time consuming processes in an ESG product offering, with issuers often asked to supply reviewers with detailed information regarding the company's sustainability practices, reporting and industry (particularly in the context of SLLs and SLBs) and suggesting revisions to ESG offering framework documents to better align with ICMA principles and market expectations.

Sustainability-Linked Loans (SLLs)

- Defining Characteristic: Loan terms are linked to, and incentivize achievement of, predetermined sustainability performance targets (SPTs) along predetermined, sustainability-relevant, key performance indicators (KPIs).
  - Typically a discount, or penalty to, the interest margin for exceeding, or falling short of, the targets.
  - No restriction on use of proceeds – making the product accessible to a broader range of issuers.

- Key challenges for the product are establishing meaningful KPIs and suitably ambitious SPTs.
  - LMA/APLMA/LSTA published "Sustainability-Linked Loan Principles" in 2019, as a voluntary framework representing "the next step in collaboratively developing global standards for sustainable lending."
  - Ongoing refinement of industry guidance, aimed at ensuring the integrity of the asset class; current guidance references five core principles:
    1. Selected KPIs should be relevant, core and material to the borrower's overall business; and capable of being measured consistently and benchmarked.
    2. SPTs should be calibrated so they remain relevant and ambitious throughout the life of the loan.
    3. The loan's characteristics should tie economic incentives to achievement of the SPTs.
    4. Borrowers should provide periodic reporting to enable monitoring of KPI performance.
    5. Borrowers should obtain independent and external verification of their performance.

Sustainability-Linked Loans – Growth History

- The first sustainability-linked loan was issued in 2017 by Philips, a Dutch health technology company. In the US, the first two SLLs were entered into by energy companies, CMS Energy and Avangrid, in mid-2018. The selected KPIs varied considerably – some loans looked to third-party ESG ratings from companies like Sustainalytics, while others targeted specific variables, such as reductions in GHG emissions, or the percentage of development projects that are LEED certified.

Source: Bloomberg LP

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Emerging ESG Finance Products

Sustainability-Linked Bonds

- Under the ICMA Sustainability-Linked Bonds Principles, SLBs have a very similar structure to SLLs.
  - SLBs do not limit allocation of offering proceeds to eligible projects.
  - ESG status is achieved through a pricing mechanism allowing for an interest rate adjustment based on the issuer's achievement of environmental or social goals.
  - As with SLLs, SLBs are structured around the selection of "core," "relevant" and "material" ESG KPIs and a pricing mechanism tied to the verified achievement of a KPI target.
  - SLBs may be attractive alternative to Green or Social Bonds:
    - Built-in ESG pricing benefits;
    - Avoid allegations of "green washing" insofar as SLBs have concrete economic consequences for failing to meet sustainability goals; and
    - Allow issuers without eligible green projects to participate in green finance.
- SLB third-party opinions are also standard practice in the emerging SLB market, with such opinions generally reporting on:
  - Selection of Key Performance Indicators (KPIs);
  - Calibration of Sustainability Performance Targets (SPTs);
  - SPT linked pricing mechanisms characteristics; and
  - Reporting and verification.

Social Bonds

- Social Bonds are similar in structure to Green Bonds, structured around the allocation of offering proceeds to "eligible social projects."
  - ICMA Social Bond Principles also set market standard and closely track the Green Bond Principles.
- Social Bonds are a prominent component of European ESG finance market, including among sovereign issuers, but still an emerging product in the US.
  - Internationally, Social Bonds experienced enormous growth in the past half year, with gross proceeds over $70B in Q4 2020 and over $80B in Q1 2021.
- Eligible projects under the ICMA Social Bond Principles include:
  - Affordable basic infrastructure (e.g., clean drinking water, sewers, sanitation, transport, energy).
  - Access to essential services (e.g., health, education and vocational training, healthcare, financing and financial services).
  - Affordable housing.
  - Employment generation, and programs designed to prevent and/or alleviate unemployment stemming from socioeconomic crises, Food security and sustainable food systems.
  - Socioeconomic advancement and empowerment (e.g. equitable access to services, resources, and opportunities and equitable participation and integration into the market and society, including reduction of income inequality).

Sustainability (Hybrid Green/Social) Bonds

- Sustainability Bonds are a use-of-proceeds focused product, where eligible proceeds are a hybrid of Green and Social projects.
  - Under the ICMA Sustainability Bond Guidelines, there are no unique features of a Sustainability Bond offering vis-à-vis Green or Social Bonds, other than that projects may have both environmental and social benefits.
- Sustainability Bonds may be attractive to issuers desiring greater flexibility.
  - Sustainability Bond frameworks can cover a wide variety of both environmental and social projects:
    - One offering could be used to fund projects ranging from investments in minority owned businesses, sustainable office renovations, wind farms and relief to communities impacted by COVID-19.
  - Flexibility to combine potentially profit-generating Green projects with less profitable Social projects in a single use-of-proceeds framework.
- Increasingly popular option among financial institutions and largest corporate issuers.
  - Early indications that the hybrid Green/Social model of Sustainability Bonds may prove more popular in the US market than standalone Social Bonds.

Transition Bonds

- Transition Bonds were first proposed by AXA in June 2019, pursuant to their proposed Transition Bond Guidelines.
  - Transition Bonds would be similar to Green Bonds in structure and would also be defined by their "use of proceeds" and reporting on proceed allocation.
- Unlike Green Bonds, Transition Bonds would allow for proceed allocation to projects not traditionally viewed as "sustainable" or climate friendly, and thus not accepted as "eligible green projects" by third-party reviewers and Green Bond investors.
  - "Transition" projects would be focused on relative improvements, rather than inherent sustainability, i.e. transitions to more climate-friendly forms of energy and industrial production.
  - AXA's examples of such transition investments include "cement, metals or glass energy efficiency investments," "gas transport infrastructure which can be switched to lower carbon intensity fuels," and "coal-to-gas fuel switch in defined geographical areas."
  - As with SLBs, Transition Bonds look to the industry context and the contribution of projects to specific industry transitions towards more sustainable technologies and practices.
- Opportunity for issuers in less sustainable industries to participate in ESG finance, while using a use-of-proceeds focused instrument.
  - The emergence of SLBs has provided a non-use-of-proceeds alternative for such issuers, resulting in decreased attention to Transition Bonds.

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ESG Finance and Reporting Liability Considerations

ESG finance and reporting liability considerations

- **Litigation risk can come from many angles**:
  - Federal and state securities laws.
  - Consumer protection laws.
  - Public nuisance and supply chain claims.
- **SEC has emphasized a focus on ESG**:
  - In March, Acting Chair gave speech discussing near-term agenda for SEC that centers on climate change and ESG topics.
  - SEC announced creation of Climate Change and ESG Task Force.
  - April 9, SEC issued ESG Risk Alert: "***will continue to examine firms to evaluate whether they are accurately disclosing their ESG investing approaches and have adopted and implemented policies, procedures, and practices that accord with their ESG-related disclosures***."

April 9, 2021 SEC ESG Risk Alert: Examination Division

Examinations of firms claiming to engage in ESG investing will focus on, among other matters, the following:

- **Portfolio management.**
- **Performance advertising and marketing.**
- **Compliance programs.**

While the April Risk Alert is directly addressed to funds, the issues it raises around internal controls and reporting consistency parallel areas of concern for issuers.

April 9, 2021 SEC ESG Risk Alert: Division Concerns

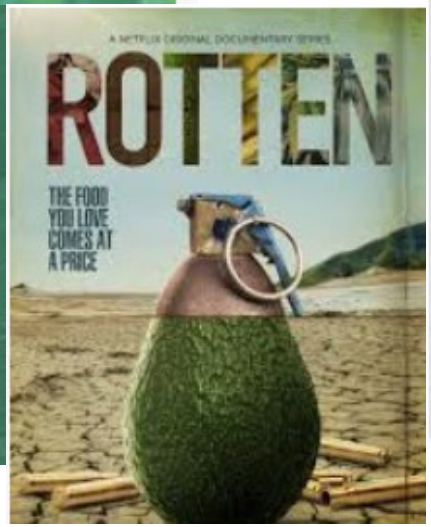
Inadequate controls to ensure that ESG-related disclosures and marketing are consistent with actual practices.

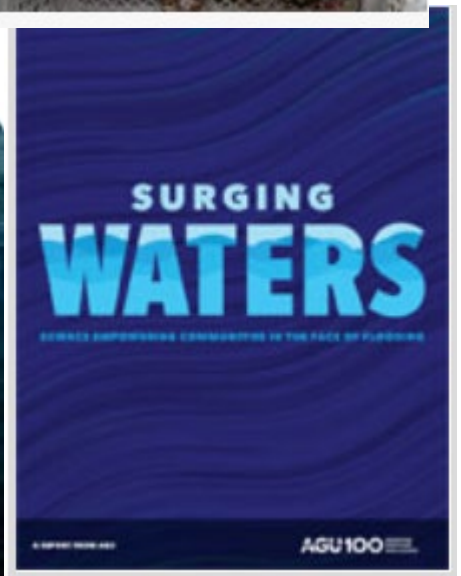
- Inconsistencies between actual firm practices and ESG-related disclosures and marketing materials.
- Lack of adherence to global ESG frameworks despite claims to the contrary.
- Unsubstantiated claims regarding practices and a lack of documentation of ESG decisions and efforts.
- Failures to update marketing materials timely (e.g., continuing to advertise an ESG product or service no longer offered).

April 9, 2021 SEC ESG Risk Alert: Division Concerns

- **Compliance programs did not adequately address relevant ESG issues.**
  - Firms lacked policies and procedures addressing their ESG investing analyses, decision-making processes, or compliance review and oversight.
  - Compliance programs did not address adherence to global ESG frameworks to which the firms claimed to be adhering.
  - Lack of policies and procedures to ensure firms obtained reasonable support for ESG-related marketing claims.
  - Difficulties in substantiating adherence to stated ESG processes.

Recent ESG Litigation – Public Awareness





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ESG Statements Are Increasingly a Focus of Litigation

Private plaintiffs are alleging that ESG Statements in reports, on websites, and in marketing materials are misleading to consumers:

- ***Challenges to CSR statements*:** allegations that statements in annual corporate social responsibility report related to **sustainable farming, animal well-being, and fair treatment of employees** were misleading.
- ***Challenges to auditing programs*:** allegations that disclosures related to retailer auditing program related to labor performance by suppliers was deceptive.
- ***Supply Chain litigation*** (using TVPRA, ATS and similar) being used to accuse companies of aiding and abetting unlawful labor practices because of their ESG claims about supply chains.
- ***Recyclability focus*** - multiple lawsuits filed against companies claiming that their produces are recyclable when, in fact, they are allegedly not actually recycled."

ESG Disclosures Are Increasingly a Focus of Litigation

- **10-Ks and Codes of Conduct: Supply Chain, Food and Safety Measures, Audits.** We've seen attempts to bring Section 10(b) and 20(a) Exchange Act claims challenging statements in 10-Ks, other filings, and codes of conduct, about supply chain food safety measures and audits.

- While you can often fight these at the motion to dismiss stage, even the filing of the suit threatens reputational harm

Limiting Litigation Risk: ESG Bonds

- ✓**Remember –Strict Liability for Offering Documents**: Securities Act Section 11—strict liability for any material misstatements or omissions.

- ✓**Antifraud Liability for Other Disclosures**: Though the Framework and any Sustainability Report will only be published on websites and not filed with the SEC, they will be subject to 10b-5 liability, the same as any information disclosed outside of SEC filings that investors may rely on when buying/selling securities.

- ✓**Disclaimers** in the Framework, Sustainability Report, Third Party Opinion and other ESG-related information should explicitly state that such documents do not constitute part of the offering materials for any current or future offering and caution reliance on the forward-looking information.

Limiting Litigation Risk: ESG Bonds

- ✓ Include a specific disclosure in the Risk Factors section explaining that the ESG Bond may not be a suitable investment for all investors seeking exposure to Green, Social, or Sustainable assets.
  - ✓ This section would disclose that the issuer has significant flexibility in how the proceeds are allocated or re-allocated, that the STP might not be reached, and/or that there can be no assurance that the projects funded will satisfy investor expectations or requirements.
- ✓ Reporting on use and allocation of proceeds.
  - ✓ Be mindful of the expectations that were set.
  - ✓ Fair and honest.

Limiting Litigation Risk: ESG Generally

- ✓ Consistent policies, procedures, and practices related to ESG and use of ESG-related terminology.
- ✓ Compliance personnel who are knowledgeable about the firm's ESG approaches and practices.
- ✓ Mindful positive impact reporting - don't overstate or misrepresent.
- ✓ Statements about hitting specific ESG targets should be clearly **forward-looking** and appropriately cautioned.
- ✓ Confirm company has **adequate diligence procedures** in place with respect to information about progress on ESG goals.

Limiting Litigation Risk: ESG Generally

Take steps to avoid misrepresentations:

- ✓ Simple and clear disclosures.
- ✓ Include risk factors.
- ✓ Include forward-looking statement disclaimers.
- ✓ Consider using well-established metrics and describing the parameters of the metrics in sufficient detail.
- ✓ Educate responsible individuals about growing risk of lawsuits based on alleged ESG misstatements or omissions.
- ✓ As with SEC filings, ESG disclosure should be subject to rigorous controls and procedures.

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