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The Role of ESG in Capital Markets

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Panelists:

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Robyn Zolman

MCLE Information
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- **All questions regarding MCLE Information should be directed to CLE@gibsondunn.com**

Today’s Panelists

Crystal Simpson is a Managing Director in Evercore’s advisory business and heads the Energy Equity Capital Markets group, which includes Sustainable Energy & Clean Technology, Oil & Gas, Power & Utilities, Mining and Chemicals. She focuses on the origination and execution of public and private equity and equity-like transactions. Ms. Simpson has worked with Energy companies for 21 years. She joined Evercore in 2019 and was previously a managing director at Barclays and co-head of the Natural Resources Equity Capital Markets group. She joined Lehman Brothers in 2001 as part of the Natural Resources coverage group and gained extensive experience across the spectrum of investment banking transactions, including mergers and acquisitions, restructurings and capital raises. Ms. Simpson has spent 18 years in Equity Capital Markets, originating and executing initial public offerings, follow-ons, equity-linked offerings, private investments in public equities (PIPEs), private convertible preferred offerings and pre-IPO private capital for energy companies.

Aaron Briggs is a partner in Gibson Dunn’s San Francisco office and a member of the firm’s Securities Regulation and Corporate Governance Practice Group. Mr. Briggs’ practice focuses on advising technology, life sciences and other companies and their boards of directors on a wide range of securities and governance matters, including ESG, corporate governance, SEC disclosure and compliance, shareholder activism, executive compensation, investor communications, disclosure effectiveness and stakeholder engagement matters. Prior to re-joining the firm in 2018, Mr. Briggs served as Executive Counsel – Corporate, Securities & Finance at General Electric. In addition, Mr. Briggs was named Corporate Governance Professional of the Year by *Corporate Secretary Magazine*.

Yair Galil is of counsel in Gibson Dunn’s New York office and a member of the firm’s Global Finance, Business Restructuring and ESG Practice Groups. Mr. Galil’s experience includes representation of sponsors, issuers, financial institutions and investment funds in complex financing transactions. The business contexts for these transactions have ranged from corporate finance (including sustainability-linked credit facilities), to leveraged acquisitions and dividend recaps, to debt buybacks and other out-of-court capital restructuring transactions, to debtor-in-possession and bankruptcy exit financings. He also frequently performs credit analyses on a borrower’s debt instruments, and advises on vulnerabilities and potential restructuring approaches.

Today's Panelists (Cont.)

Hillary 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, M&A and ESG Practice Groups. Ms. Holmes' practice focuses on capital markets, securities regulation, corporate governance and ESG counseling. She is Band 1 ranked by *Chambers USA* in capital markets for the energy industry and a recognized leader in Energy Transactions nationwide. Ms. Holmes represents issuers and underwriters in all forms of capital raising transactions, including sustainable financings, IPOs, registered offerings of debt or equity, private placements, and structured investments. Ms. Holmes also frequently advises companies, boards of directors, special committees and financial advisors in M&A transactions, conflicts of interest and special situations.

Jason Meltzer is a partner in Gibson Dunn's Washington, D.C. office and a member of the firm's Litigation Department and Class Actions and ESG Practice Groups. Mr. Meltzer has experience in a wide range of complex commercial litigation, with an emphasis on securities and consumer products class action defense. Mr. Meltzer also has extensive experience representing clients in antitrust, mass tort, breach of contract, commercial fraud, insurance and merger-related litigation. Mr. Meltzer routinely counsels Fortune 100 companies on minimizing litigation risks in connection with their ESG disclosures, has authored several publications on the topic, and has defended multiple class actions challenging ESG statements as false or misleading.

Robyn Zolman is Partner-in-Charge of the Denver office of Gibson, Dunn & Crutcher and a member of the firm's Corporate Transactions Practice Group. Her practice is concentrated in securities regulation and capital markets transactions. Ms. Zolman represents clients in connection with public and private offerings of equity and debt securities, tender offers, exchange offers, consent solicitations and corporate restructurings. She also advises clients regarding securities regulation and disclosure issues and corporate governance matters, including Securities and Exchange Commission reporting requirements, stock exchange listing standards, director independence, board practices and operations, and insider trading compliance. She provides disclosure counsel to clients in a number of industries, including energy, telecommunications, homebuilding, consumer products and biotechnology.

Webcast Agenda

I. Development of ESG Debt Products

II. ESG in Equity Capital Markets

III. Current Trends and Challenges of ESG Financing

IV. Enhanced ESG Disclosure Rules and Expectations

V. Litigation and Liability Considerations

An Era of Heighted ESG Focus

- While the interest in ESG issues and risks has evolved steadily over the last decade, the past several years have witnessed an even greater focus on ESG by companies, investors, proxy advisors and regulators
  - Voluntary reporting by companies on ESG-related matters has increased
  - SEC and stock exchanges have adopted, or are proposing, ESG-related rules
  - ESG-related shareholder proposals (e.g., diversity and climate change) were some of the most popular proposal topics in 2021
  - Investors are seeking out ESG financial products and sustainable issuers
- With the growth of specialized ESG funds seeking to invest, 2021 saw a more than double increase in issuances of ESG debt products and a rapid increase in sustainable equity investments

I. Development of ESG Debt Products

Types of ESG Debt Products

- "Use of Proceeds" products
  - ***Green bonds and loans*** – proceeds from issuance are earmarked for eligible projects, such as a renewable energy project or a clean transportation project
  - ***Social bonds and loans*** – proceeds are tied to "eligible social projects" (e.g., affordable basic infrastructure, access to essential services and socioeconomic advancement)
  - ***Sustainability bonds*** – proceeds are a hybrid of green and social projects
- "Incentive-Based" products
  - ***Sustainability-linked loans (SLL)*** – while proceeds are typically made available for the company's general use, the terms of the loan are linked to, and incentivize achievement of, predetermined sustainability performance targets (SPTs) along predetermined, sustainability-relevant, key performance indicators (KPIs)
  - ***Sustainability-linked bonds (SLB)*** – similar to SLLs, SLBs are structured around the selection of relevant ESG KPIs and a pricing mechanism tied to the verified achievement of a KPI target

ICMA Principles Framework

- The International Capital Markets Association promulgates voluntary guidelines for green, social, sustainability and sustainability-linked bonds
- 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 a detailed (but not exhaustive) list of eligible green and social projects
- **Four Key Features** of ESG offering documents based on ICMA framework:
  - 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.

ESG Bond Third-Party Opinion Process

- 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 Key Features
- 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
    - 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)
    - Third-party reviews may often suggest revisions to ESG offering framework documents to better align with ICMA principles and market expectations

Green Bonds – Mondelēz International, Inc.

- Issuer: **Mondelēz International, Inc.** – one of the world's largest snack companies, including iconic snack brands such as *Cadbury*, *Milka* and *Toblerone* chocolate; *Oreo*, *belVita* and *LU* biscuits; *Halls* candy; *Trident* gum and *Tang* powdered beverages

- ESG Product: €2.0 billion Green Bonds

- Date of Issuance: September 2021

- Use of Proceeds: "Mondelēz International intends to allocate the net proceeds from the offering to eligible projects that further the company's commitment to more sustainably sourced ingredients, reducing waste in packaging, and tackling climate change."

- Eligible Project Categories:

  - Environmental management of living natural resources and land use,

  - More sustainable water and wastewater management,

  - Pollution prevention and control, and

  - Renewable energy, energy efficiency, and clean transportation

Sustainability-Linked Bonds – Aris Water Solutions, Inc.

- Issuer: **Aris Water Solutions, Inc.** – environmental infrastructure and solutions company delivering full-cycle water handling and recycling solutions to energy company operations
- ESG Product: $400 million Senior Sustainability-Linked Notes
  - First sustainability-linked issuance in water infrastructure industry
- Date of Issuance: April 2021
- Use of Proceeds: Repayment of outstanding credit facility and redemption of preferred equity
- Sustainability-Linked Bond Framework adopted in March 2021
  - KPI: Increase recycled produced water sold and reduce groundwater withdrawals sold (expressed as % of barrels of recycled water sold per year / total barrels of water sold per year)
  - Sustainability Performance Target: Increase barrels of recycled produced water sold to 60% by 2022 from a 2020 baseline of 42.1%
  - Redemption prices on Notes are subject to increase if issuer fails to satisfy the Sustainability Performance Target

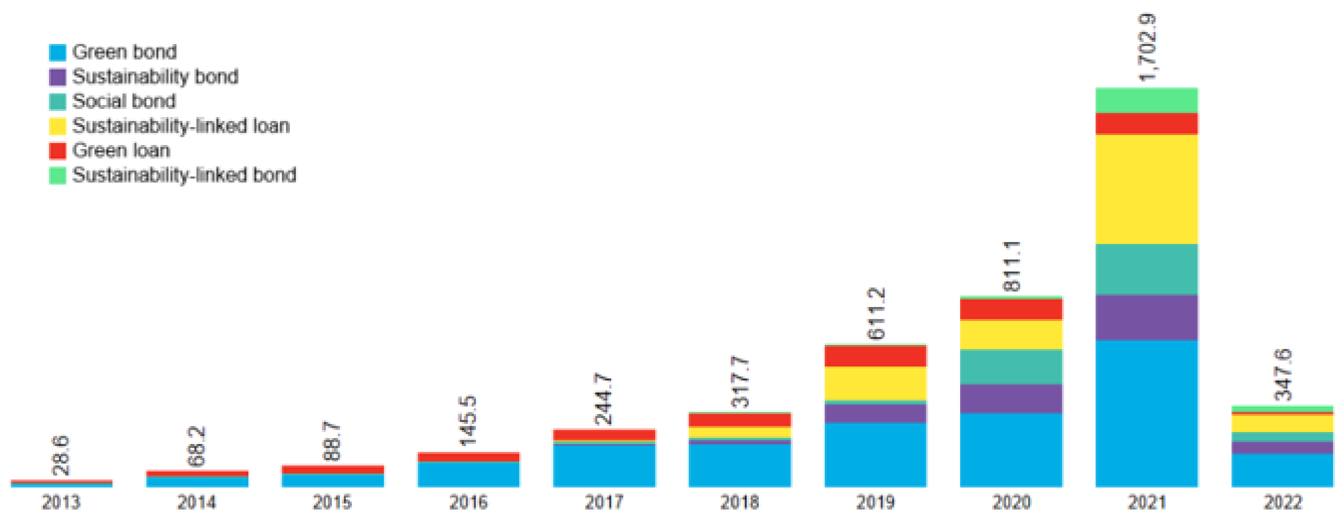
Sustainability-Linked Loan – Xylem Inc.

- Borrower: **Xylem Inc.** – global water technology company committed to developing innovative water technology solutions
- ESG Product: $800 million Revolving Credit Facility with Sustainability-Linked Pricing
  - One of the first sustainable improvement loans in the United States and the first in the General Industrial Sector
- Date of Execution: March 2019
- Interest rate is index-linked to borrower's annual ESG score as rated by Sustainalytics, determined based on methodology in effect as of March 2019

Development of ESG Debt Products

Green bonds/loans have historically been the most prominent ESG product, monopolizing ESG finance until 2018, and continue to remain the most significant in both offering numbers and proceeds

Global Sustainable Debt Issuance, 2013 – 2022 (YTD)

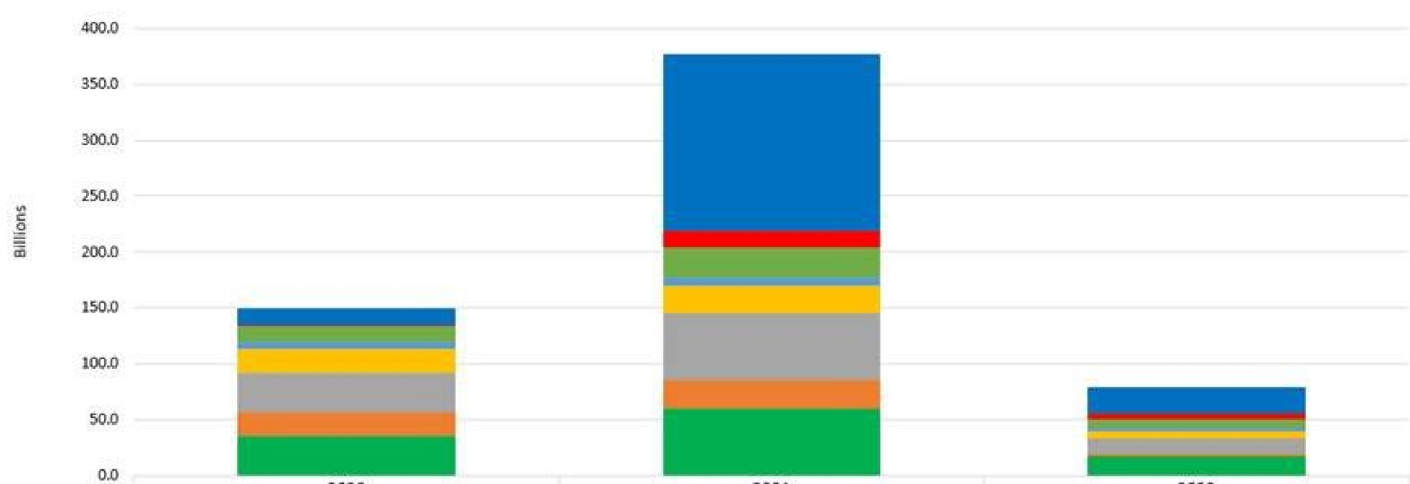


Source: BloombergNEF, Bloomberg LP

The Rise of Sustainability-Linked Offerings

While green bonds/loans remained a large portion of the ESG market, 2021 saw a surge in sustainability-linked offerings in the North American market

North America Sustainable Debt Issuance, 2020 - 2022 YTD



	2020	2021	2022
Sustainability-linked Loan	15,327,201,034.1	158,217,317,762.4	23,192,127,850.0
Sustainability-linked Bond	900,000,000.0	15,173,422,910.0	5,482,914,600.0
Sustainability Bond	14,375,132,908.4	26,726,883,931.1	7,975,702,415.0
Social Bond	6,371,953,100.0	6,605,596,153.6	2,646,418,244.0
Green Municipal Bond	21,017,857,687.8	24,966,107,935.9	6,732,707,000.0
Green Mortgage Bond	35,150,993,467.0	60,094,709,488.0	13,260,951,947.0
Green Loan	21,797,094,718.9	24,681,908,359.1	2,485,751,325.8
Green Bond	35,055,618,815.5	60,424,924,766.8	17,428,781,162.9

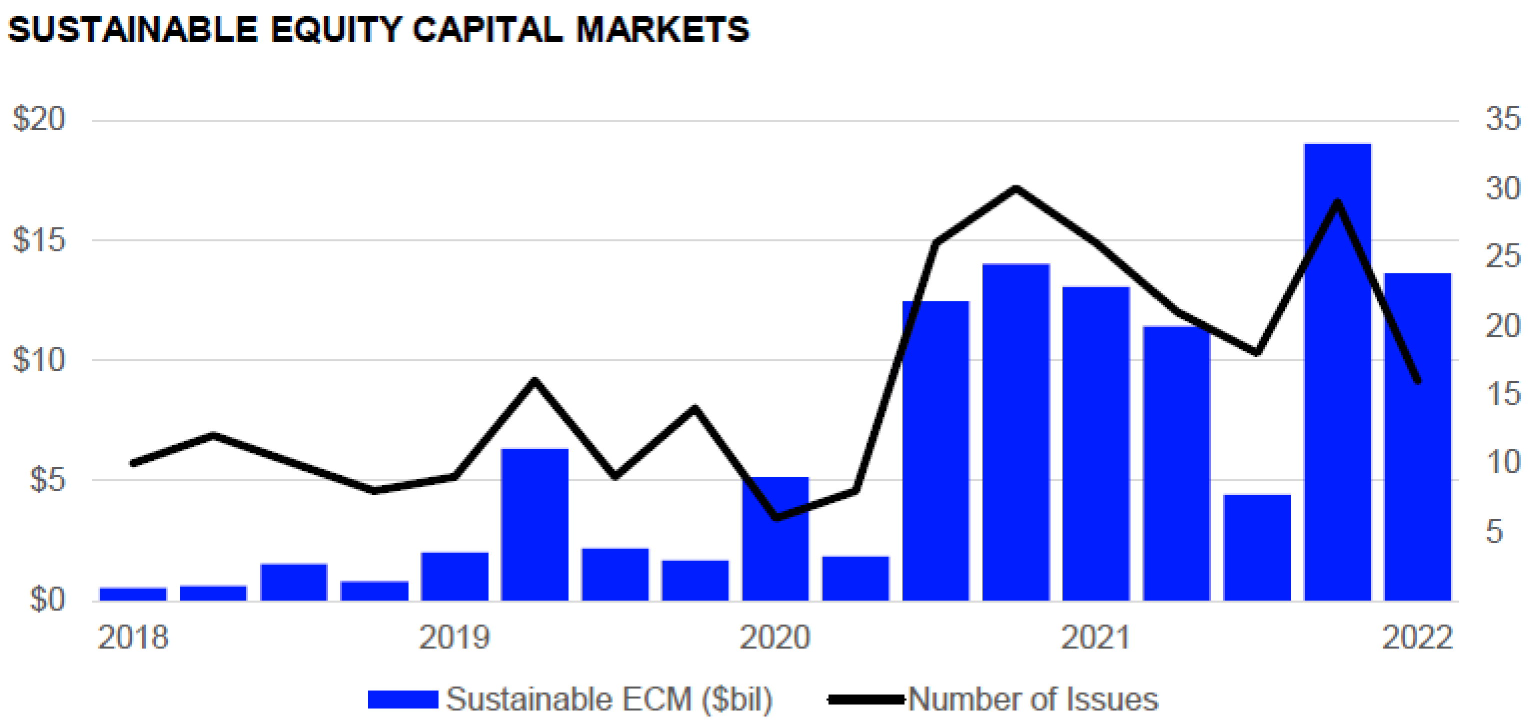
Bloomberg

II. ESG in Equity Capital Markets

ESG Equity Investments

- ESG equity investing reflects a growing focus of investors on metrics beyond just financial performance
- Funds have been formed with investment frameworks tied to ESG metrics
  - Portfolios vary based on framework – some funds may focus on investing in companies focused on reducing climate change while others may focus on social or human rights issues
- Funds rely on sustainability reports prepared by companies and third-party ESG scores to help identify attractive investments based on investment framework
  - Some frameworks may exclude companies from their portfolio based on ESG scores or if the company is in a select industry or provides a certain product
- There are a number of third-party services that provide ESG scores on public companies
  - Currently, no unified ESG rating methodology exists

Development of Global ESG Equity Capital Markets



Source: REFINITIV™

III. Current Trends and Challenges of ESG Financing

Current Trends and Challenges in ESG Financing

- Shift from green bonds/loans to sustainability-linked bonds/loans
  - North American issuances in 2021 reflected over a 500% increase in SLBs/SLLs as compared to 2020
  - For 2021, issuances for SLBs/SLLs in North America totaled over $200 billion as compared to approximately $170 billion for green bonds/loans
  - Sustainability-linked products provide a broader umbrella for investment criteria beyond environmental issues
- ESG metrics will continue to be an increased focus for equity investors
  - Sustainable equity transactions in 2021 totaled over $25 billion as compared to nearly $23 billion in 2020
  - Companies seeking access to this capital will reflect greater transparency in ESG self-reporting
- Current market conditions may impact 2022 volume for both debt and equity ESG financing
- Increased focus by regulators on ESG disclosure may impact timing on costs for companies accessing the capital markets, regardless of type of financial product

IV. Enhanced ESG Disclosure Rules and Expectations

SEC Increases Focus on ESG

Since 2020 ↓	The SEC's Division of Examinations makes ESG investing an examination priority
August 2020 ↓	SEC adopts rules requiring human capital management disclosure
March 2021 ↓	New SEC Climate and ESG Task Force focused in part on ESG-related misconduct; then-Acting Chair solicits public input on need for climate change disclosure requirements
April 2021 ↓	Division of Examinations releases Risk Alert observing "deficiencies and internal control weaknesses from examinations of investment advisers and funds regarding ESG investing"
May 2021 ↓	SEC Chair Gary Gensler announces climate disclosure a top priority and early focus
Spring/Fall 2021 ↓	SEC Reg-Flex agendas include climate change disclosure
Fall 2021 ↓	Comment letters issued on 2020 10-Ks exclusively focused on absence of climate change disclosures
March 21, 2022	**SEC approved rule proposal for new climate change disclosure requirements for both U.S. public companies and foreign private issuers**

Hot Topics in SEC Rulemaking – ESG Disclosures

Climate Change

- ***Background***: After increasing focus on climate change, including a round of comment letters last year, SEC proposed rules for climate change disclosure in March 2022
- ***Focus areas***: Prescriptive rules to create a new climate change reporting framework (risks, governance, strategy, goals, GHG emissions) based in part on TCFD and the GHG Protocol. Includes amendments to both Reg S-K and Reg S-X
- ***Timing***: Comment period ends June 17, 2022. Final rules may be adopted as early as end of 2022, with phase-in based on filer status likely commencing with reports filed in 2024 containing 2023 financials

Human Capital

- ***Background***: SEC indicated that it plans to revise Human Capital Management disclosure requirements it adopted in August 2020 with a view towards making them more prescriptive
- ***Likely focus areas***: Per Chair Gensler, metrics such as workforce turnover, demographics such as diversity, info on skills and development training, compensation, benefits, health and safety
- ***Timing***: SEC may propose rule updates later in 2022, but would go through new comment letter and rule finalization process

Cybersecurity

- ***Background***: SEC has for years been increasing its focus on cyber controls & disclosures, and in March 2022 proposed new rules for cybersecurity disclosures
- ***Focus areas***: Incident reporting on Form 8-K for material cyber breaches, material updates on Form 10-Q, annual reporting of cyber risk management and strategy and board oversight (including director expertise)
- ***Timing***: Comment period ended May 9, 2022. Final rules may be adopted later in 2022; unclear when effective date would be

Some Implications around ESG Disclosures in SEC Filings

1. **Liability:** potential increased disclosure liability beyond Rule 10b-5 anti-fraud liability (which applies to ESG disclosures outside SEC filings), meaning potentially easier for shareholders to bring a claim
2. **Controls:** need to evaluate existing disclosure controls and, for info included in the financial statements (e.g., proposed Reg S-X changes for climate change), internal controls to assess what enhancements are needed to ensure timely, accurate, complete & reliable info
3. **Certifications:** ESG disclosures would be covered under CEO/CFO representations that the 10-K/10-Q doesn't contain a material misstatement or omission
4. **Auditor comfort:** need to work with your auditor to make sure they are comfortable with any new disclosures as they could be subject to the comfort letter process in an offering or, for info included in the financial statements (e.g., proposed Reg S-X changes for climate change), included in the scope of the audit
5. **Board oversight:** need to work with your board/appropriate committees to get them comfortable with new disclosure requirements and processes being put in place to support the company's compliance

Increasing Investor Expectations Around ESG for 2022

	Board Oversight	Climate Change	Human Capital Management
ISS	• Disclosure of board oversight of mitigation of climate risks	• TCFD-aligned disclosure • Disclosure of GHG reduction targets	
GLASS LEWIS	• Clear disclosure of board-level oversight of E&S issues		
BlackRock	• Disclosure of board oversight of material ESG risks • Will hold directors accountable for material ESG-related risk failures	• TCFD-aligned disclosure • Disclosure of GHG reduction targets (Scope 1/2) & Net Zero-aligned business plan	• Disclosure of how approach to HCM is aligned with strategy • Disclosure of steps taken to advance DEI • Disclosure of EEO-1 report
State Street	• Disclosure of board oversight of climate-related risks & opportunities and human capital management	• TCFD-aligned disclosure • Disclosure of GHG emissions & reduction targets (Scope 1/2) • Enhanced disclosure for carbon-intensive industries	• Disclosure of how HCM approach linked to strategy, comp & ben, engagement, DEI initiatives & targets • Disclosure of EEO-1 report
Vanguard	• Will hold directors accountable for material failures of risk oversight related to E&S issues	• Likely to support proposals requesting disclosure around climate risks & climate impact assessment	• Likely to support proposals requesting disclosure around workforce diversity

Some Reasons Why Investors' ESG Expectations Matter

1. **Engagement:** you will be expected to talk about E&S issues when you engage with investors, even if you intended the meeting to be about other matters like governance and executive compensation

2. **Governance scores:** proxy advisor reports and scoring, which are visible to your institutional investors, now include E&S issues

3. **Shareholder proposals:** E&S shareholder proposals are among the most popular proposal topics and increasingly getting high levels of support (e.g., climate change assessments, workforce diversity reporting)

4. **Director elections:** E&S issues are increasingly forming the basis for lower support for directors as investors tighten their voting policies and activists leverage these issues in campaigns (e.g., vote no campaigns, even proxy contests)

5. **Access to capital:** from 2018 to 2020, total U.S.-domiciled assets under management using sustainable investment strategies grew >40% from $12T to $17T*

Source: US SIF Foundation, Report on US Sustainable and Impact Investing Trends (2020), available here.

V. Litigation and Liability Considerations

ESG Disclosures are Increasingly a Focus of Litigation

- Litigation risks can come from several sources, including: (i) federal and state securities laws; and (ii) consumer protection laws
  - Private plaintiffs are alleging that ESG statements in Exchange Act reports, on websites, in sustainability reports, and in marketing materials are misleading to consumers
- SEC has also increased its focus on ESG
  - Recently Proposed Rules on Climate Change Disclosure – expected to substantially increase climate disclosures in Exchange Act reports. Will draw scrutiny by regulators and plaintiffs' counsel
  - In 2021, the SEC also created a **Climate and ESG Task Force in the Division of Enforcement** to proactively identify ESG-related disclosure misconduct, consistent with increased investor attention to climate change and ESG-related disclosures

Limiting Litigation Risk: ESG Bonds

- **Strict Liability for Offering Documents and Communications**
  - Securities Act Sections 11, 12—strict liability for any material misstatements or omissions in connection with securities offerings
- **Antifraud Liability for Other Disclosures**
  - Exchange Act Section 10(b) and SEC Rule 10b-5 create liability for fraudulent statements to investors, regardless of where they occur
  - Claims could be raised directly by the SEC or investors
  - Though the Framework and any Sustainability Report will only be published on websites and not filed with the SEC, issuers could 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

Limiting Litigation Risk: ESG Bonds

- Issues likely to attract attention from private plaintiffs' counsel and the SEC's task force could include:
  - Offering an ESG product without a real or accurate plan for use of proceeds on eligible projects;
  - Misstating achievement of an ESG metric or omitting disclosure regarding a material ESG-related event; or
  - Failure to meet any concrete commitments or guarantees to allocate capital to specific types of projects
    - Forward-looking statements accompanied by meaningful cautionary language are entitled to protection under the PSLRA

Limiting Litigation Risk: ESG Bonds

Steps to Mitigate Risks – ESG Bonds:

- Risk Factor disclosures on ESG bonds
    - ESG bond may not be suitable investment for criteria of any particular investor seeking exposure to green, social or sustainable assets/projects
    - No standardized criteria for what constitutes green, social or sustainable assets/projects
    - Issuer has significant flexibility in how proceeds are allocated; accordingly, funds may be allocated to projects that do not meet investment expectations or requirements
    - Forward-looking statement disclaimers, for example addressing why the issuer may not be able to adhere to the green bond framework
    - Potential disclaimers in the Framework, Sustainability Report, and Third-Party Opinions stating that documents do not constitute part of the offering materials for current or future offerings
- Post-offering reporting on Use of Proceeds
    - Be mindful that expectations were set at the time of the offering
    - Be cautious about overstating or misrepresenting

Limiting Litigation Risk: ESG Generally

General Steps to Avoid ESG Misrepresentations – Aspirational/Forward Looking

- Keep ESG statements regarding initiatives and efforts aspirational and forward looking, to the extent possible
- Include forward-looking statement disclaimers, specifying examples of language that signals forward-looking and aspirational statements
- Statements about ESG goals and targets should be appropriately cautioned and utilize aspirational language
- Courts typically dismiss litigation challenges to statements that are truly aspirational and include appropriate qualifications
- By contrast, courts may find more concrete statements actionable under securities and consumer protection laws

Limiting Litigation Risk: ESG Generally

Steps to Avoid Misrepresentations – Great Care for Statements of Fact

- Understand that great care must be taken for concrete and historical statements of fact
- As with SEC filings, ESG disclosures should be subject to rigorous controls and procedures
- Consider using well-established metrics and describing the parameters of the metrics in sufficient detail
- Be mindful regarding positive impact reporting and not overstating or misrepresenting progress
- Educate responsible individuals about growing risk of lawsuits based on alleged misstatements

Limiting Litigation Risk: ESG Generally

Steps to Avoid Misrepresentations – Organizational Practices

- Confirm adequate disclosure controls and procedures in place with respect to information about progress on ESG goals
- Implement and utilize consistent policies, procedures and practices related to ESG and use of ESG-related terminology
- Collaboration across business functions (e.g., financial reporting, marketing, ESG personnel) to confirm cohesion of ESG disclosure
- Involvement of compliance personnel knowledgeable about the company's ESG approaches and practices in information collection and dissemination

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