Teneo

It's Still Not Easy Being Green:

What A Biden Administration Could Mean for ESG Investing & Corporate Governance

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Introduction

A Biden Administration will certainly have a tremendous impact on ESG issues such as climate change, racial justice and healthcare. Consequently, companies are going to be impacted in a variety of ways on ESG issues, ranging from increasing climate regulation and penalties to criminal justice and diversity. Teneo has written about the potential impact on these and many other issues in our Biden's First 100 Days client piece.

As discussed in our recent client insights pieces here and here, it is no secret that the ESG investing movement has also had a tremendous impact on companies over the past four years. Investors, employees, customers and other stakeholders have all increased their expectations of companies and their boards on issues such as climate change, diversity, employee wellness and many other ESG issues. In response, many companies and boards have significantly enhanced their focus on ESG issues in regard to their strategic and transparency initiatives.

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Over this same period, while many other governments across the world have seemed to embrace the ESG movement through a variety of regulatory initiatives, the Trump Administration took a different approach to ESG. Over the past four years, the Trump Administration has exited the Paris Accord, questioned the validity of ESG investments in company retirement plans, investigated certain company diversity initiatives, increased ownership and duration thresholds for shareholder proposals, enhanced the oversight of proxy advisory firms and elected not to require standardized company ESG disclosure.

So beyond putting a spotlight on many ESG-focused issue areas, how might a Biden Administration impact ESG from an investing and corporate governance perspective? We highlight some of our views on this critical topic below.

ESG Investing: From a Partly Cloudy Day to a Sunny Day?

- Trump Administration: There have been record inflows into ESG investment products this year due to the increasing interest of global pension funds as well as Millennial investors. In addition, ESG funds have outperformed non-ESG funds for much of this year per Morningstar, adding to the momentum of inflows this year and presumably beyond. But the Department of Labor’s recent ruling on retirement plans arguably attempted to challenge this trend by calling into question the validity of including ESG funds in employee retirement plans.
- Biden Administration: A proactive clarification from the Biden Administration that ESG funds are permitted within retirement plans would very likely further accelerate the momentum of retirement capital towards ESG funds and eliminate any uncertainty in the marketplace. This would in turn increase the already growing impact that ESG ratings are having on a company’s access to ESG capital, given that the more money that gets managed to an ESG strategy, the greater the impact that ESG ratings will have on companies.

ESG Disclosure: From Acronym Soup to a Much Clearer Broth?

- Trump Administration: Investors have increasingly supported ESG disclosure frameworks that focus on “financially material” ESG issues, such as the Sustainable Accounting Standards Board (SASB) and the Task Force on Climate-related Financial Disclosures (TCFD). While many companies have begun their journey towards reporting to these confusing disclosure frameworks, major investors are becoming increasingly frustrated by the lack of consistent and standardized ESG disclosure from all companies. Although other governments have made such disclosure mandatory (including the recent announcement that TCFD reporting is now mandatory in the UK), US regulators have resisted calls to develop mandatory disclosure standards beyond a recent tweak to Regulation S-K and human capital management disclosure.
- Biden Administration: A reconstituted SEC under the Biden Administration may seek to enact a mandatory ESG disclosure standard for all companies that could incorporate SASB, TCFD and even EEO-1 diversity disclosure into any potential framework. As the number of ESG disclosure frameworks continues to increase (including a recent ESG disclosure framework released by the World Economic Forum), such a regulatory initiative could be welcomed by investors and companies alike.

Institutional Investors: From Playing Defense to Playing Offense?

- Trump Administration: During the Trump Administration, investor attention to ESG issues has increased significantly

as evidenced by the rise in support for ESG-related shareholder proposals and prevalence in ESG issues as engagement topics. While it is difficult to unpack the precise reasons for this increase, some have argued that it was at least partially linked to the Trump Administration's failure to act on key investor concerns such as climate change and diversity.

- Biden Administration: While a Biden Administration may be more responsive to investors' ESG concerns, we expect that most institutional investors will continue to advance their ESG platform via private ordering because it is now expected of them by their clients. ESG activities are now viewed as a significant factor as asset managers compete for capital from global pensions, Millennials and Generation Z (which now make up about 1 in 10 eligible voters in the US). Many of their clients may even expect their asset managers to have an even greater impact given that a Biden Administration might make it easier for investors and companies to accomplish their ESG goals and advance their ESG initiatives.

Executive Compensation: Adding More ESG to the Mix?

- Trump Administration: While investors have increasingly encouraged companies to tie ESG metrics to executive incentive plans, the Trump administration has presented challenges to companies looking to incorporate quantitative D&I goals. The Department of Labor has launched investigations against a number of companies that have disclosed specific diversity goals. This follows an executive order that prohibited government contractors from offering certain types of racial sensitivity and diversity training. Additionally, the Trump administration saw significant changes to executive compensation deductibility after the Tax Cuts and Jobs Act eliminated the exception for performance-based compensation under IRC section 162(m). Whereas previously qualified performance-based pay had been tax deductible, under the new rules, all compensation over $1 million is deemed non-deductible.
- Biden Administration: As it is unlikely that a Biden administration would pursue similar Department of Labor investigations, the trend toward companies tying diversity to pay will continue, having gained momentum due to the increased focus on racial justice after the death of George Floyd. Tax reform under a Biden administration may affect executive pay. A restoration of the performance-based pay exception under 162(m) is unlikely; however, Biden's campaign website describes potential changes to certain individual and investment income tax rates that could affect executive take-home pay. Any such changes would not take effect for several years.

Proxy Advisors: From Being Caught in Irons to More Wind to Their Sails?

- Trump Administration: Earlier this year, the SEC, by a 3-2 vote along party lines, adopted a regulatory regime for further proxy advisory firm oversight. The new rules were opposed by Democratic Commissioners, and some governance watchers expect these regulations will not survive a Biden presidency, particularly given that Republican Commissioner and SEC Chairman Jay Clayton has announced his departure by the end of 2020. ISS filed a lawsuit against the SEC challenging the rules and recently terminated the ability of S&P 500 companies to review and comment on a draft of their research report prior to publication (though the ISS data verification portal remains open).
- Biden Administration: A reversal of this rule by a newly constituted SEC may further embolden proxy advisory firms to adopt more progressive policies on issues such

as climate change and diversity. It may also free-up resources currently dedicated to litigation and compliance towards more detailed coverage of companies on ESG issues. For example, ISS has steadily increased the amount of ESG information included in research reports (including its own ESG ratings), and this could continue to increase in the future.

What Does This All Mean for Companies?

Overall, we expect that a Biden Administration will enable the further acceleration of the ESG investing trend with increased disclosure requirements and corporate scrutiny, therefore also accelerating the impact ESG ratings are already having on a company’s access to ESG capital. A Biden Administration is also likely to roll back the newly adopted SEC rules that arguably limit shareholder proposals and proxy advisor recommendations. And while some maintain that a Biden Administration lessens the need for investors to pressure companies on ESG issues, we believe investors will continue to do so given that they are increasingly competing for global capital on an ESG basis. As a result, we believe that companies should continue their heightened focus on ESG initiatives and transparency and stay very engaged with their investors in 2021, which perhaps will be a watershed year for ESG investing with the new administration.

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