

ESG Investments and Disclosures in Today's Corporate World: A Q&A with Christianna Wood

Christianna Wood, **Andrea Okie**, and **Anne Catherine Faye** — 7 MIN READ

Investors are increasingly putting their money where their values are. How should they measure the risks and opportunities?

In recent years, there has been a burgeoning movement among institutional and retail investors to direct more of their investments toward companies whose values go beyond the single traditional aim of maximizing shareholder returns. While investors have long considered a wide variety of non-financial criteria in their investment decisions, environmental, social, and governance (ESG) factors have most recently come to the fore as areas of growing investor concern and regulatory scrutiny.

Investors are increasingly using ESG criteria to assess risk and make targeted investments. Yet questions remain regarding what information companies should disclose about ESG factors, and whether these disclosures should be voluntary or required.

To better understand this development, Analysis Group Managing Principal **Andrea Okie** and Vice President **Anne Catherine Faye** spoke with affiliate **Christianna Wood**, an expert in institutional investment and corporate governance. Among her extensive experience, Ms. Wood led the investment team overseeing $150 billion in global equity assets for the California Public Employees' Retirement System (CalPERS), the largest public pension plan in the US, as well as its ESG activities. She was chair of the board of both the **International Corporate Governance Network** (ICGN), which advocates for global standards of corporate governance, and the **Global Reporting Initiative** (GRI), which offers a framework for ESG reporting applied by a majority of Fortune 250 companies. Ms. Wood has also served as a board member of the **International Integrated Reporting Council** (IIRC), a global coalition of institutional investors, regulators, and companies working together to integrate financial and non-financial corporate reporting. In addition, Ms. Wood has served as a board member of public and non-public companies.

Is ESG a new concept in the investing world?

Not really, because investors have been concerned about sustainability issues for decades. For example, if you were deciding whether to invest in a brewery, you would want to know whether that brewery had access to a sustainable source of water. Similarly, when considering an investment in a company involved in oil and gas exploration and production, you'd want to understand the company's safety protocols and track record.

Some non-financial factors – for example, a company's commitment to customer satisfaction – aren't tied particularly closely to ideas of social justice or corporate societal responsibilities. So, what I think is new is the push to tie non-financial criteria to specific environmental sustainability or social equity goals, and to tie management compensation to those goals as well. Examples of these factors include a company's commitments to sustainability (environmental), or to diversity, equity, and inclusion (social). This effort seems to dovetail with the social justice movements that have arisen over the last several years, both in the US and globally, as well as with increasing concern over climate change.

How do ESG issues arise, and how are they relevant for investors?

There are two distinct but related ways in which ESG issues come up. The first is in the broad question of how a corporation should conduct itself. How important are issues such as sustainability or diversity to business goals? Furthermore, what are a company's multistakeholder commitments, and how are they tied to corporate strategy, both financial and non-financial?



Because there's no bright line in this area [ESG reporting] – or, if there is, it's constantly shifting – determining whether a particular corporate action was or was not sufficient, or whether a particular disclosure was likely material to investors, can end up being debated in court by various parties, including economic and financial experts."

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The second relates to the question of how much information a company should disclose to the public or shareholders. Should it reveal how much of its energy comes from renewable or non-renewable sources? Or how robust its cybersecurity protection is? Some investors may use this information not only to determine value alignment but also to assess risk.

In both cases, problems can arise when the company's public statements don't align with its actions – or, more accurately, when shareholders and investors have the perception that they don't align. That's when the dispute may end up in court to decide whether any of the parties have breached their fiduciary responsibilities, whether it's brought as an ERISA claim or as a securities case concerning allegations of securities fraud.

So how do companies make decisions about what information to disclose? Is any of it mandatory?

In the US, there are virtually no mandatory requirements for ESG disclosures. One of the few exceptions is the Dodd-Frank Act's provision requiring companies that report to the SEC [Securities and Exchange Commission] to disclose the use of minerals sourced from conflict-affected countries such as the Democratic Republic of the Congo. Another is the **SEC's interpretive guidance**, issued in 2010, on the disclosure of climate change-related risks to investors.

Earlier this year, the SEC introduced several proposed rules that would, among other things, require public companies to provide investors with more detailed disclosures on greenhouse gas [GHG] emissions and require certain investment funds to disclose information on their ESG strategies. But these SEC rulemakings are currently only proposals, and the vast majority of ESG disclosure over the last 25 years has been voluntary, which means that there are no broadly accepted standards that companies are required to follow in reporting (or not reporting) this information. This can be frustrating to companies trying to do the right thing, as well as costly when disagreements over whether a company has disclosed too much or too little information end up in shareholder litigation.

What standards do exist for ESG reporting?

Several sets of guidelines are available for reference through NGOs [non-governmental organizations], although they're not binding in the way that, for example, the Dodd-Frank Act's provision is. The **Sustainability Accounting Standards Board**, or SASB, has developed US-centric standards for the disclosure of a broad set of sustainability key performance indicators and information, while the **GRI's standards** are more of a globally focused framework. There is also the **Task Force on Climate-Related Financial Disclosures**, which was created in 2015 by the Financial Stability Board. Other frameworks include those of the **GHG [Greenhouse Gas] Protocol** and the **Climate Disclosure Standards Board**, or CDSB.

But because the reporting is voluntary, companies need to make their own judgments as to what constitutes material, or even pre-material, information relevant to investors. Those factors have changed over time, and they will also vary by industry and according to the judgment of individual company officers. Because there's no bright line in this area – or, if there is, it's constantly shifting – determining whether a particular corporate action was or was not sufficient, or whether a particular disclosure was likely material to investors, can end up being debated in court by various parties, including economic and financial experts.

You've been discussing this topic from the issuer side. What about the investor side? How did ESG disclosures and non-financial information more generally play into your work at CalPERS?

Most institutional investors follow a fundamental research process: discounting forecasts of future cash flows, comparing predicted value to current security pricing, and making investment decisions. Where they differ, as relevant to this discussion, is how to factor in non-financial information, including potentially material ESG risks, when calculating the probability that future value won't be realized. Investment time horizons also differ among institutional investors, and risk factors are assessed accordingly.



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It helps to remember that, as the largest public pension fund in the US, CalPERS is what's known as a "universal owner," meaning that it is large enough that it effectively owns every company in perpetuity and is unable to diversify away system-wide risks. That means that our risk evaluation has to operate on the longest timeframe where ESG factors could be more profound sources of risk.

One example was when we faced public pressure at CalPERS to divest our holdings in companies that operated in a conflict-affected developing country. As an investment manager, though, you don't want to narrow the pool of potential investment choices unless you have an overwhelming reason to. But it's not just a yes/no decision. In that instance, before making a divestment decision on a particular investment, we first engaged companies operating in that country in an attempt to encourage them to be part of the solution for creating positive change.

Can Europe's experience with ESG reporting provide any clues for what the future holds in the US?

Europe has had longer experience with ESG reporting, and many of the disclosure issues that are voluntary in the US are mandatory there. While I don't expect that to happen overnight in the US – remember that the SEC's proposal to require ESG reporting on greenhouse gas emissions and ESG fund strategy has been met with significant pushback – I do expect that the introduction of some kind of mandatory ESG disclosure standards in the US is a question of when, not if. In time, I wouldn't be surprised to see most disclosure criteria in Europe ultimately find their way to the US. ■