REIT Industry ESG Components: What to Know in 2023

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What is ESG?

- Environmental, Social and Governance (ESG) is an investment term that refers to the primary factors used to measure the sustainability and social impact of a particular company.
  - Environmental – Considers the environmental impacts of a company or organization and issues such as climate change, greenhouse gas emissions, sustainability and energy consumption.
  - Social – Considers social impacts of a company or organization and issues such as diversity & inclusion, human rights, and consumer protection.
  - Governance – Considers corporate governance and issues such as management structure, employee relations and compensation for executives and employees.
- Often, considerations for these factors may overlap, such as diversity on boards and in management positions, equal pay for men and women, compensation being tied to ESG.

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Environmental

Renewable fuels

Greenhouse gas (GHG) emissions

Energy efficiency

Climate risk

Water management

Recycling processes

Emergency preparedness

Social

Health and safety

Working conditions

Employee benefits

Diversity and inclusion

Human rights

Impact on local communities

Governance

Ethical standards

Board diversity and governance

Stakeholder engagement

Shareholder rights

Pay for performance

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Why is ESG Important?

- ESG issues have taken on broader significance, as environmental groups and activist groups use capital market participants to drive decarbonization and other social justice considerations, and governments set clean energy agendas with increased regulatory oversight of climate risk and other ESG factors.
  - See, for example, Exxon and Engine No. 1
- Effectively managing ESG issues is about more than risk mitigation and compliance. It also offers opportunities for a competitive advantage as sustainability and DEI become increasingly important factors in business transactions and partnerships.

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ESG Risks

- Annual rise in shareholder resolutions directed at climate change, sustainability and ESG, and proxy campaigns by activist groups to secure board seats advancing ESG agendas
- Annual rise in climate change litigation cases
  - Seeking liability for fraudulent disclosures to shareholders
  - Seeking liability for investment strategies that failed to adequately account for climate risks and/or relied too heavily on fossil fuels
  - Seeking to enforce constitutional rights to a clean environment
  - Seeking liability for contributing to climate change harms
- Activist campaigns
  - Divestment based on fossil fuel dependence or human rights issues, for example
  - It is the most effective way to motivate companies to be more proactive about addressing ESG factors
- Greenwashing
  - Government enforcement and consumer claims

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Growing Emphasis on ESG

- President Biden's Executive Order 14057 and accompanying Federal Sustainability Plan
  - 100 percent carbon pollution-free electricity (CFE) by 2030, at least half of which will be locally supplied clean energy to meet 24/7 demand;
  - 100 percent zero-emission vehicle (ZEV) acquisitions by 2035, including 100 percent zero-emission light-duty vehicle acquisitions by 2027;
  - Net-zero emissions from federal procurement no later than 2050, including a Buy Clean policy to promote use of construction materials with lower embodied emissions;
  - A net-zero emissions building portfolio by 2045, including a 50 percent emissions reduction by 2032; and
  - Net-zero emissions from overall federal operations by 2050, including a 65 percent emissions reduction by 2030.
- Consistent with this, we are seeing a holistic approach across federal agencies to address climate change
  - SEC recently proposed rules requiring enhanced disclosures regarding the management of climate risks and GHG emissions, including upstream and downstream emissions data for certain companies.
- Also seeing many states set clean energy agendas and emission reduction targets, and adopting (or proposing) environmental rights amendments

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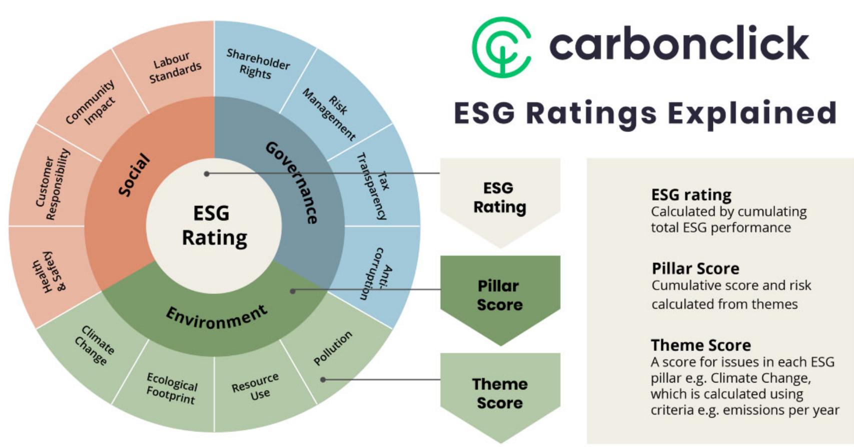

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What are REITS Doing to Raise ESG Ratings (Generally)?

- Enhancing ESG Data and Disclosure
  - In 2021, 80 of the largest 100 REITS issued stand-alone sustainability reports
- Factoring ESG and diversity into selection of suppliers and vendors
- Board-level ESG oversight and internal positions and committees dedicated to ESG
- Increased board independence, disclosure of political spending and alignment of political spending and lobbying with ESG strategies
- Enhanced ESG and climate change reporting

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What are REITS Doing to Raise ESG Ratings(Specifically)?

- "Science-based" emission reduction targets
  - 59% of surveyed REITS in 2021 had a greenhouse gas emissions goal for 2021
  - 70% reported on Scope 1, 70% on scope 2 and 40% on scope 3 emissions
- Commitments to energy efficiency, renewable energy and decarbonization technology
- ESG considerations in building design and construction
  - LEED certification
  - "Healthy" buildings (WELL and FitWel certifications)
  - Biodiversity commitments in building and design plans
- Deploying water conservation technology
  - Leak detection systems, retrofitting building fixtures and water-conscious landscaping
- Green bonds
- Sustainable waste management practices such as "circular economy" concept

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ESG Initiatives to Consider

- Conducting climate change risk assessments and setting GHG reduction targets for the portfolio
- Increased involvement in decarbonization solutions and feasibility studies
- Conserving or restoring green spaces to protect biodiversity and attract tenants and employees
- Investing in green certified and resilient buildings
- Improve DEI programs, identify gaps and establish goals and training programs
- Link compensation to diversity and improve diverse talent pipeline
- Integrate and coordinate ESG oversight at board and management levels
- Examine lobbying and advocacy to align with ESG commitments and strategies
- Disclosure and transparency for ESG strategies
- Incorporate ESG and sustainability into financing

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ESG Bonds

- Green Bonds - the proceeds are used to finance new and existing projects with positive environmental impacts.
- Social Bonds – the proceeds used to finance or refinance social projects or activities to achieve positive social outcomes.
- Sustainability Bonds- combination of social and green bond objectives, focused less on specific project and more on overall sustainability objectives.
- Sustainability-linked Bonds – bonds where performance (e.g., the bond coupon) is linked to borrower's achieving certain key performance indicators (KPI) or sustainability development goals (SDG)
- Increased focus on consistency and transparency of reporting of ESG bonds.
  - e.g., compliance with the Green Bond Principles (GPB) and/or the Social Bond Principles issued by the International Capital Markets Association (ICMA)
- Real estate examples of green bonds include renewable energy, energy efficiency, green buildings and wastewater management projects.
- Investing in ESG bonds provide institutional investors a way to assist in meeting their own ESG goals.

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SEC Proposed Rule on Climate Disclosures

On March 21, 2022, the SEC proposed rule amendments requiring public companies to include certain climate-related information in their public disclosure filings (the "Proposed Rule"). The Proposed Rule requires domestic and foreign issuers to include in their registration statements and periodic reports information including:

- Climate-related risks and the actual or likely material impacts on the issuers' business, strategy and outlook;
- Governance and risk management processes related to climate-related risks;
- GHG emissions, including third-party attestations for accelerated and large-accelerated filers;
- Certain climate-related financial statement metrics and related disclosures in the notes to audited financial statements; and
- Information about a company's climate-related planning, including targets, goals and transition plans, if any.

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Enhanced Disclosures on Climate Risks, Governance and Planning

The Proposed Rule required enhanced disclosures at granular levels:

- It would require the issuer to identify climate-related risks and disclose how such risks have had or are likely to have a material impact on the issuer's business and financial statements.
- It would require the issuer to indicate its mechanisms and processes at the management and board level for assessing climate-related risk.
- The issuer would be required to disclose its processes for identifying, assessing, and managing climate risks and whether and how such processes are integrated into the issuer's overall risk management system.
- Disclosure would be required regarding how the changing regulatory environment affects their assessment of climate-related risk as well as changes in consumer preferences, market prices and evolving technology.
- It would require disclosures regarding the impact of climate-related events (such as severe weather events and other natural conditions) and transition activities on the line items of an issuer's consolidated financial statements, as well as the financial estimates and assumptions used in the financial statements.
- Issuers would be asked to discuss their climate-related planning efforts, if any, including whether and how they set targets and goals for climate-related matters, and whether they have adopted a climate-related transition plan, along with details regarding such plans and goals and progress made.

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GHG Disclosures Under the Proposed Rule

- Issuers would be required to disclose quantitative information about their own direct GHG emissions (Scope 1) and indirect GHG emissions (Scope 2). Scope 1 and Scope 2 disclosures would need to be made separately, expressed both aggregated and disaggregated by constituent greenhouse gasses, and in absolute terms, not including offsets and in terms of intensity (per unit of economic value or production).
- Accelerated and large accelerated filers would be required to include with their public filings an attestation report covering the issuer's disclosed Scope 1 and Scope 2 emissions.
- Issuers would also be required to disclose quantitative information about indirect emissions from upstream and downstream activities in the issuer's value chain (Scope 3) if either (i)material, or (ii) the issuer has set a GHG emission target goal that includes Scope 3 emissions.
  - Scope 3 disclosures, if required, would also need to be disclosed in absolute terms, not including offsets and in terms of intensity.
  - Attestations are not required as to Scope 3 disclosures.
  - The materiality of Scope 3 emissions cannot be determined solely quantitatively.
  - Proposes an explicit safe harbor for Scope 3 disclosures, providing that they could only be considered fraudulent statements if shown to have been made "without a reasonable basis" of "other than in good faith."

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Will the Proposed Rule Survive?

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Statutory Challenge to Proposed Rule

- Objectors to the Proposed Rule will argue that the proposed mandatory climate disclosures are neither "necessary" nor "appropriate" to ensure investor protection and fairness in the securities markets, and therefore exceeds the SEC's rule-making authority pursuant to Section 13(a) of the Exchange Act, 15 U.S.C. § 78m(a).
  - There is no explicit statute authorizing the current Proposed Rule.
  - "When an agency claims to discover in a long-extant statute an unheralded power to regulate 'a significant portion of the American economy,' we typically greet its announcement with a measure of skepticism. We expect Congress to speak clearly if it wishes to assign to an agency decisions of vast 'economic and political significance.'" *Util. Air Regulatory Grp. v. EPA*, 573 U.S. 302, 324 (2014).
- The Supreme Court may be asked again to apply the "major questions doctrine," which provides that regulatory initiatives with significant economic or societal impacts must be explicitly articulated by Congress.
  - *West Virginia v. EPA* is currently pending before the Supreme Court to determine whether the Clean Air Act gives the EPA broad authority to implement industry-wide GHG emissions regulations affecting the power sector, or if the Act only allows more narrow authority to regulate GHG emissions "inside-the-fence" on a facility by facility basis, and will examine the major questions doctrine.
  - A decision limiting the EPA's authority to regulate GHG emissions under the Clean Air Act would raise similar questions about the SEC's authority to mandate climate-related disclosures.

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Constitutional Challenge to Proposed Rule

- Opponents have also raised First Amendment concerns regarding compulsion of statements by issuers.
  - The SEC previously sought to require that issuers using certain minerals from the Democratic Republic of the Congo ("DRC") (*i.e.*, gold, tantalum, tin, and tungsten) file a statement that the minerals were not "DRC conflict free" both on their websites and in filings with the SEC.
  - That particular compelled statement—despite the explicit statutory authorization from the Dodd-Frank Act—was deemed to be unconstitutional by the U.S. Court of Appeals for the D.C. Circuit. *Nat'l Ass'n of Manufacturers v. S.E.C.*, 800 F.3d 518, 553 (D.C. Cir. 2015).
  - The court concluded that, even assuming the government had a sufficient interest in requiring companies to make the compelled statement (*i.e.*, to lessen the humanitarian crisis in the DRC), the SEC failed to carry its burden of proving that the compelled statement was effective in achieving that objective. Furthermore, the court concluded that even if the government interest were sufficient, and even if the chosen means to achieve the objective was effective, the statement was still not "purely factual and uncontroversial."
- Given that the Proposed Rule would require disclosures and attestations regarding GHG emissions and climate change risks and impacts – without express statutory authorization such as found in the Dodd-Frank Act for the DRC conflict free rule – there are questions as to whether the Proposed Rule will survive judicial review.

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West Virginia v. EPA and the Major Questions Doctrine

- The Supreme Court concluded that the EPA had exceeded its authority under the Clean Air Act by establishing emission caps in the Clean Power Plan (CPP) that would have required a shift in electrical generation from coal to cleaner sources such as natural gas, wind and solar.
- The "major questions doctrine" provides that "decisions of vast economic and political significance" cannot be assigned to an agency absent clear Congressional intent. To overcome a major questions dispute, an agency must point to "clear congressional authorization" for the power it claims, which the Court held EPA could not do in this instance.
- By interpreting Section 111(d) of the Clean Air Act to allow generation-shifting emission caps that would "substantially restructure the American energy market," the Court concluded that the EPA was "'claiming to discover in a long-extant statute an unheralded power' representing a 'transformative expansion in [its] regulatory authority.'"

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What If SEC Rules Do Not Survive?

- Still shareholder resolutions
- SEC already prioritizing ESG enforcement under existing regulatory framework
  - Recently settled charges by ESG task force
  - Will continue whether or not rules are adopted / survive legal challenges
- Also enforcement by state attorney generals and consumer claims

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Greenwashing

- Securities Fraud Claims
- Consumer Protection Claims
- Focus on materiality and misleading the public
  - Even puffery if repeated can be actionable
  - Safe harbor for forward-looking or aspirational language with substantive cautionary language

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Evolving Regulatory Framework

- There is considerable uncertainty on the rules relating to measuring and disclosing emissions and climate risks right now.
  - Proposed SEC Rule
  - FERC GHG Policy
  - CEQ Regulations
  - EPA Rules
  - IFRS Sustainability Disclosure Standards
- And the rules are not necessarily consistent.
  - GHG emission reporting to the EPA and state agencies is not necessarily consistent with disclosures required under SEC's Proposed Rule or under international standards.
  - Different and additional data needs to be tracked and reported differently for different agencies.

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What Can Companies Do Now?

- Determine whether sufficient resources are dedicated to monitoring and evaluating climate-related risks, and whether sufficient management and board expertise exists to assess climate-related risks.
- Determine whether financial and audit teams have sufficient expertise to provide guidance and management of the changing financial statement presentations that would be required under the Proposed Rule.
- Review internal controls and processes to ensure consistency and coordination of reporting across regulatory filings, corporate social responsibility (CSR) reports and company statements on climate related-risks and GHG emissions.
- Determine whether appropriate processes and controls are in place to monitor and evaluate performance against sustainability or ESG plans and targets, both qualitatively and quantitatively.
- Consider whether and how to collect emissions data from private companies both upstream and downstream in the value chain and engage with key suppliers, vendors and customers regarding that process. Consider adding provision in vendor/supplier contracts regarding emissions data.
- Carefully vet all public statements regarding climate risk to avoid material misstatements or material omissions that could elicit either government enforcement action or private securities litigation.

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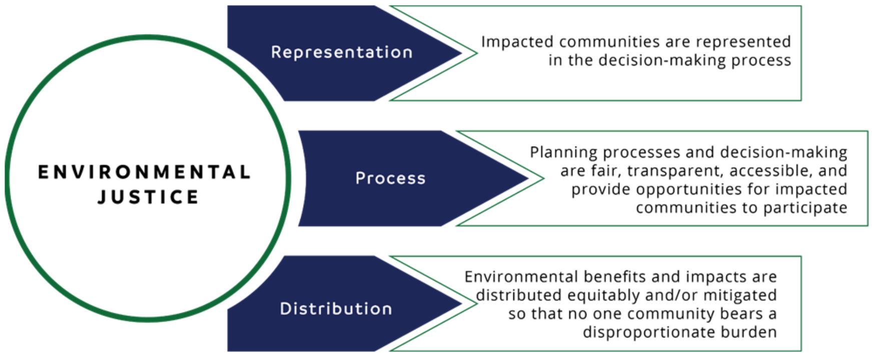
Environmental Justice



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Environmental Justice Has Been Priority of Biden Administration

- On first day in office, January 20, 2021:
  - Executive Order 13985: "Advancing Racial Equity and Support for Underserved Communities through the Federal Government" ordered executive departments and agencies to work to redress inequities in their policies and programs that serve as barriers to equal opportunity.
  - Executive Order 13990: "Protecting Public Health and the Environment and Restoring Science To Tackle the Climate Crisis" announced that his Administration "must advance environmental justice" and the
  - Memorandum "Modernizing Regulatory Review" called for recommendations to "ensure that regulatory initiatives appropriately benefit and do not inappropriately burden disadvantaged, vulnerable, or marginalized communities."
- Executive Order 14008: "Tackling the Climate Crisis At Home and Abroad" issued on January 27, 2021.
  - *"To secure an equitable economic future, the United States must ensure that environmental and economic justice are key considerations in how we govern. . . . Agencies shall make achieving environmental justice part of their missions by developing programs, policies, and activities to address the disproportionately high and adverse human health, environmental, climate-related and other cumulative impacts on disadvantaged communities, as well as the accompanying economic challenges of such impacts."*
  - Climate and Economic Justice Screening Tool that will "highlight disadvantaged communities."
- On May 5, 2022, the Justice Department and EPA launched a Comprehensive Environmental Justice Enforcement Strategy and restored the option for Supplemental Environmental Projects to help disadvantaged communities.

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Environmental Justice for Redevelopment Projects

- EPA is encouraging companies to get familiar with the Climate and Economic Justice Screening Tool and to engage with communities early and often.
- States environmental permitting agencies are also expanding or implementing EJ policies.

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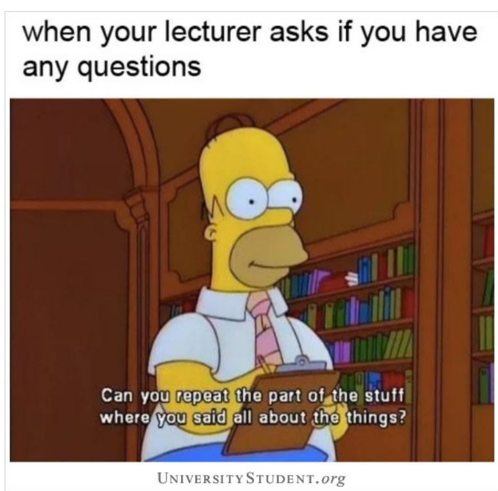
Questions?



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