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The Future of ESG: Materiality, Good Governance, and Data Will Shape Success

By Suz Mac Cormac

ESG is currently front-page news in America—for all the wrong reasons. Considerable financial support has been funneled to the "anti-woke" movement, primarily from China and Russia, attempting to discredit U.S. businesses, as well as to the "anti-climate change" campaign, primarily from entrenched traditional energy companies and related interests. What does this mean for in-house counsel at U.S. and multinational companies? Survey results indicate that in-house counsel continue to prioritize ESG for a variety of reasons and that ESG, with a particular focus on its individual environmental, social, and governance components, is here to stay for the long term.

Why In-House Counsel Remain Focused on ESG

First, we are witnessing a rapidly rising tide of regulation. When the term "ESG" was introduced in 2004, there was minimal regulation and most of the disclosure by companies and investors was voluntary, set forth in glossy CSR or ESG marketing pieces separate from financial reports. However, over the past decade, an increasing number of jurisdictions have passed legislation focused on both corporate action and corporate and investor ESG disclosure. Further, the regulations that have been promulgated so far are extra-jurisdictional, requiring compliance and disclosure not only from the company that operates (or is listed) in the jurisdiction that has passed the regulation, but also from all companies within its "value chain": suppliers, partners, and customers. For example, the EU's Corporate Sustainability Reporting Directive (CSRD) and Corporate Sustainability Due Diligence Directive (CS3D) implicate companies outside the EU, and value chain requirements expand disclosure requirements beyond large EU-issuers companies to small suppliers around the world. Nevertheless, compliance is only one piece of the ESG puzzle for in-house counsel.

Many in-house lawyers are also focused on ESG as a result of findings from their materiality assessments, particularly given the direct correlation between certain ESG risks and opportunities and shareholder value. However, the survey confirms that more companies need to conduct these assessments. To ensure that ESG initiatives are tailored to a company's needs and contribute to valuation, it is important for more companies to identify material topics that will inform initiatives; in fact, certain regulations require materiality assessments to frame the required disclosure. Understanding material topics that are critical to valuation and important to stakeholders will inform the most effective ESG initiatives, which will provide the best results.

Finally, because of the rapid pace of change in the natural environment, in technology (including AI), in the investment climate, and in business operations expected over the next decade, there will be an even greater need for ESG strategies that are tied to operations, including strategies to navigate the energy transition, accurately assess risk, and identify business opportunities. Therefore, in-house counsel will continue to focus on the elements of ESG—from cybersecurity to privacy to human rights to climate change—for tactical as well as compliance reasons.

Leveraging Existing Compliance and Governance Programs

While companies focus on the individual elements of ESG—specifically climate, diversity, equity, and inclusion, anti-money laundering, anti-bribery and corruption, cybersecurity, human rights, and sanctions—there are benefits to considering them all under a broader ESG umbrella. In-house counsel are discovering that the compliance programs adopted to address regulations,

such as the Foreign Corrupt Practices Act, are very similar to what is required under the regulations for “newer” ESG compliance areas, such as cybersecurity, climate, and human rights. In addition, the process of ensuring compliance with, and receiving data from, suppliers and customers needs to be coordinated across ESG subject areas, or there is risk of, at best, overwhelming the participants in a company’s value chain or, at worst, sending conflicting signals to, and possibly alienating, counterparties that are driving value to the corporation.

In terms of a compliance program, smart in-house counsel are (i) identifying the most arduous regulation and then adjusting for nuances in regulatory requirements and (ii) determining what data and information are required by their key suppliers and customers, as opposed to guessing at what they may need over the duration of the contract. It may seem at first glance that regulatory requirements are consistent around the world (most generally following the International Sustainability Standards Board’s IFRS S1 and S2 standards), but MoFo conducted an analysis of the global climate regulations and found that there are more nuances than synergies across the regulations. Fortunately, data can be replicated. To make the best use of corporate resources, we recommend that companies identify the most robust applicable regulation or requirement, replicate data across other regulations, leverage existing internal policies (since most companies have established policies on the crosscutting material topics, *e.g.*, cybersecurity), and adjust for different requirements where necessary.

Internal ESG Coordination

So how can companies continue to focus on ESG from a compliance perspective **and** beyond? First, in-house counsel can help shape and lead consistent and coherent programs through collaborative efforts that touch on all business lines of the organization. Avoiding a siloed approach, each team and function should take ownership of ESG as it impacts their business or operational area while communicating with other functions in the organization. This ensures that companies develop uniform strategy and representations.

Second, in addition to the internal coordination, ESG ownership should remain at the “C suite” level, as our survey indicates there is an evolving trend of placing ESG leadership in the CEO and CFO functions. However, there remains a need for board oversight that is also not siloed in a specific ESG or CSR committee but is shared by the entire board and examined from a finance, audit, compensation, and governance perspective, and the CEO and CFO need a strong coordinated team to whom they can delegate. There is a critical need for ESG leadership to be tailored to subject matter expertise and decentralized across functions. For example, assurance and data management may be well suited to the audit function, but compliance direction and strategy are better handled in the legal department, and both functions must be aligned on strategy and direction.

Third, priorities and strategy must be coordinated across the entire organization. In this report, we identify a dissonance between the board’s and the legal department’s priorities. For example, while climate emerged as a top *legal* priority, boards of directors appear to place less emphasis on climate than other strategic initiatives. This dissonance is risky and opens doors to both legal and reputational risks, particularly with respect to greenwashing claims made to shareholders and customers. Internal alignment on priorities, as well as coherent and consistent strategy, is key to mitigating risk and maximizing opportunities.

Looking Ahead

ESG—and particularly its environmental, social, and governance components that are material to assessing risk and opportunities—is here to stay, although there will likely be a shift to the use of different language, such as Sustainability and Risk Management. Further, both new technology and data will play an increasingly critical role in mitigating the attendant risks that are inherent in all ESG programs. Companies must ensure that both their internal programs and their disclosures are backed by quality data. Disclosure to investors, customers, and counterparties must be properly scoped to ensure that all recipients understand the extent and limitations of corporate representations.

The need for strong internal systems—similar to the policies and procedures underlying financial reporting—is even more important as we anticipate the outcome of this year’s U.S. presidential elections. Policy direction on ESG may be impacted, and there will likely be more fuel added to the already hot anti-ESG fire, regardless of who wins. Therefore, companies must be able to support their representations, and those that do it well will find themselves with a competitive advantage not only in reduced litigation and compliance costs, but also in greater attractiveness in the market for their goods, services, and securities.

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