January 26, 2023

ESG in 2023: Looking at the Year Ahead

While 2022 saw the rise of a vocal and politically charged anti-ESG movement, the coming year could prove to be a pivotal moment in the maturation of ESG discourse, disclosures and governance. The ongoing debate as to whether the integration of ESG-related considerations into investment decision-making and corporate strategy is merely "woke capitalism" will require companies and investors to confront the significant disinformation and disagreements surrounding what ESG means and the role it serves. Ultimately, the battles waged in boardrooms, legislatures and courts may bring much needed clarity to the role of ESG issues (and the role of management and boards) in creating and protecting shareholder value, particularly as companies continue to face myriad risks, including macroeconomic headwinds, geopolitical uncertainty, emerging nature and other resource-related threats, cybersecurity dangers, and competition for talent. Meanwhile, the alphabet soup of voluntary ESG disclosure frameworks looks set to further consolidate with the International Sustainability Standards Board (ISSB) expected to release global sustainability and climate reporting standards. Regulators are also moving ahead with mandatory disclosures: the U.S. Securities and Exchange Commission (SEC) is expected to release and/or finalize rules on climate, cybersecurity, human capital and board diversity, the European Sustainability Reporting Standards are expected to be finalized mid-year, and regulators in Australia, Canada, China, Hong Kong, India, Japan, and Singapore are also considering or mandating ESG-related disclosures. With inflows to ESG-oriented investment funds and products remaining robust throughout 2022 and outpacing investments that do not address ESG considerations, pressure and interest from investors, regulators and other stakeholders look set to continue in 2023 and be reflected in shareholder engagement, the coming proxy season, earnings and investor communications, and broader market discussions.

We set forth below some key trends and considerations for this year:

1. *The Anti-ESG Movement Will Force Companies and Investors to Crystalize What is ESG and Why it Matters*

In recent years, ESG has grown to accommodate a broad swath of interests ranging from climate activists to impact investors to institutional investors and active managers. ESG's nebulous boundaries, however, have made it a target of the anti-ESG movement which has questioned whether it is merely a manifestation of ideological interests. As we have noted previously, we view ESG to encapsulate the range of risks that all corporations must carefully balance, taking into account their specific circumstances, in seeking to achieve long-term, sustainable value. Oversight and management of material ESG-related considerations that may impact a company's performance and the creation and preservation of shareholder value lie squarely within the fiduciary duties of management and the board and are consistent with the board's obligations under *Caremark*. Materiality assessments conducted by companies in connection with voluntary reporting on ESG-related factors have already provided insight into issues likely to impact corporate performance as have risk factor disclosures in public filings. Forthcoming disclosures mandated by regulators will provide further clarity, including the quantification, of the scope and magnitude of such issues. Company reporting is being further supported by insurance data, which indicates that companies are finding it increasingly difficult and costly to obtain coverage for certain risks such as cybersecurity breaches, while 2022 saw

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record insured losses for severe weather incidents. As states such as Florida, Texas, Arizona, Indiana, North Dakota, Louisiana and others move to limit the consideration of ESG factors in investment decision-making, questions will inevitably be raised as to whether the pension plan fiduciaries of such states are fulfilling their fiduciary duties, particularly when companies have determined certain ESG factors to be financially material. The same questions may also arise in connection with lawsuits that seek to prohibit asset managers and pension plan fiduciaries from considering ESG factors in their investment decisions and efforts to reverse corporate policies designed to address identified ESG-related concerns, including in response to shareholder-supported proposals. It is perhaps notable that several of the tabled or enacted anti-ESG investment legislations do not prohibit the consideration of ESG factors outright or the ability of pension plans to provide ESG-oriented investments, but rather focus on eliminating the consideration of "non-pecuniary" factors. How companies and investors choose to respond to the public and legal challenges to the consideration of ESG factors by companies and investors may prove pivotal in crystalizing its value and purpose and addressing the criticisms of the anti-ESG movement. Ultimately, whether the concept of "ESG" matters or survives this debate may be secondary to the ability of companies and investors to continue addressing the range of risks and opportunities—many of which have been conveniently grouped under the "ESG umbrella"—that confront them in today's economy.

2. *The Long-Awaited Moment of Global Disclosures is Here, But…*

This year will likely see the culmination of multi-year efforts to consolidate voluntary global ESG reporting frameworks. The International Sustainability Standards Board (ISSB) is expected to complete the consolidation of existing voluntary frameworks including the Sustainability Accounting Standards Board (SASB) and the Task Force on Climate-related Financial Disclosures (TCFD) into new sustainability and climate-reporting standards to be released in the first half of this year. The new standards (both drafts were released in March 2022) will include Scope 3 emissions (subject to certain safe harbor protections) and climate-related scenario analysis disclosures. Nature-related disclosures and standards drawn from the Taskforce on Nature-related Financial Disclosures (TNFD), which will be finalized in September 2023, will also be reflected in ISSB's forthcoming standards. While the ISSB frameworks are not legally binding until formally adopted by a jurisdiction, it is expected that the UK will adopt the standards and Australia and China are among the countries considering adoption. A number of large asset managers, including BlackRock, State Street and Vanguard, have also voiced general support for ISSB's proposed frameworks.

In parallel with the consolidation of voluntary global reporting, the SEC is expected to finalize its rulemaking on climate and cybersecurity disclosures and adopt new rules on human capital metrics and board diversity. These rules come after the European Union last year adopted the Corporate Sustainability Reporting Directive (CSRD), which will, among other things, require public and private non-European companies with qualifying EU subsidiaries and which meet certain net revenue thresholds to comply with the EU Sustainability Reporting Standards, which are expected to be adopted mid-year. While the disclosure requirements for non-European companies will not be required until 2028, they are currently expected to be more expansive than that proposed by the SEC, covering, among other things, Scope 3 emissions, pollution, water, resource usage and biodiversity. Importantly, the disclosure standards will also apply "double materiality," meaning that companies will need to disclose material impacts to both investors and

stakeholders—in contrast to the investor-centric materiality standard used by the SEC. Looking ahead, multinational companies will need to carefully manage such policy divergences to avoid creating confusion and potential litigation risks over its sustainability disclosures.

3. *Greenwashing and Fraud Risks Will Refocus Attention on Governance*

Last year saw several enforcement actions on misstatements and omissions made by companies and asset managers on sustainability-related disclosures. The SEC has already indicated that it plans to continue stepping up enforcement actions on greenwashing and has proposed amendments to enhance and modernize the Investment Company Act "Names Rule," which would require funds whose names suggest a focus on a particular type of investment (e.g., sustainability) to adopt a policy to invest at least 80% of the value of their assets in those investments. Regulators in the European Union have also proposed new consumer protection legislation designed to target greenwashing, requiring companies to provide evidence backing up their green claims. Activists have also begun taking matters into their own hands through public social media campaigns.

As companies prepare for more rigorous and expansive disclosures, care will need to be taken to ensure that ESG reporting, particularly disclosed metrics, are subject to a similar degree of internal oversight and controls as are applicable to financial reporting. For U.S. issuers, the new SEC rules may require a reassessment of the allocation of oversight responsibilities for ESG reporting at the board level, including whether the board committee(s) tasked with oversight on reporting have sufficient bandwidth and current knowledge of best practices and regulatory and market expectations. In the M&A context, closer attention to due diligence and post-transaction integration processes can help mitigate the spread of ESG-related risks among companies, particularly the identification of internal controls and reporting weaknesses that could create heightened risks of reputational, legal and financial losses.

4. *Emerging Resource Risks—Biodiversity and Water—Are Coming to the Fore*

As we recently noted, new nature-related risks are quickly gaining focus among investors and regulators. In particular, focus has accelerated on resource loss, particularly biodiversity loss. Investor and regulator efforts to address biodiversity loss—estimated to lead to a $2.7 trillion loss to global GDP annually by 2030—have accelerated since the COP 15 summit last year and will be reflected in new disclosure standards being finalized by the Global Reporting Initiative (GRI), TNFD, ISSB, and the Science Based Targets Network. Notably, the recently launched Nature Action 100 initiative, comprising institutional investors working in partnership with Ceres and other advocacy groups, may herald the start of a new wave of shareholder engagement echoing the approaches taken by Climate Action 100+.

Water resource management is another issue that is emerging as a consequence of ongoing focus on climate risks. Ceres, in partnership with the Netherlands government, launched the Valuing Water Initiative in August 2022 with 64 institutional investor signatories representing $9.8 trillion in assets under management. The initiative has set forth key expectations for issuers, including commitments to avoid negative impacts on water availability and water quality across the value chain and board oversight and public policy engagement aligned with sustainable water resource management. In March, the UN will host the UN Water Conference, the second such conference in 50 years. Like COP 15, the conference agenda will

seek "commitments, pledges and actions, across all our sectors, industries and interests, uniting nations, stakeholders and professionals" with a focus on "accelerated implementation and improved impact" in meeting Sustainable Development Goal 6 (Clean Water and Sanitation).

5. *Effective Cybersecurity Risk Management Will Demand More Expertise and Controls*

Cybersecurity risks will likely continue to escalate in 2023 fueled by growing geopolitical instability, remote work, innovations in artificial intelligence (AI) and machine learning, shortages in technical expertise and increasing regulatory and investor expectations, all of which has prompted many to regard cybersecurity as an ESG risk, rather than just a technology challenge. IBM's recent report on the costs of cybercrime reported a 13% surge in data breach costs from 2020 to 2022 alone. U.S. companies are bearing the brunt of the losses, with companies suffering losses on average of $9.44 million per incident, more than double the global average. A report by the National Association of Insurance Commissioners (NAIC) released late last year also highlighted significant increases in insurance premiums (direct written premiums increased 75.3% year over year) as well as growing hurdles in underwriting policies with insurers becoming increasingly cautious when examining a company's risk profile, including risks presented by third parties with whom they work and contract as well as the robustness of internal security controls and cyber-risk procedures. Just this past week, the World Economic Forum published a new report highlighting trends in cybersecurity risks in which it noted that "cyber leaders still struggle to clearly articulate the risk that cyber issues pose to their organizations in a language that their business counterparts fully understand and can act upon." The SEC's proposed cybersecurity rules set to be finalized this year will further probe into the robustness of strategies and controls designed to mitigate and respond to cyber threats as well as the role and expertise of management and the board in overseeing and managing the organization's cybersecurity risks. To that end, organizations will need to continue to evolve and improve their efforts to equip their boards with the knowledge and tools to properly oversee risks, build a security-focused culture and recruit and retain skilled cyber professionals.

6. *Human Capital Management and the Competition for Talent Will Remain a Long-Term Challenge*

While the Great Resignation appears to be petering out, the talent war does not yet appear to be over. Recent reductions in force among the largest companies belie a labor market that continues to remain relatively tight. With the Covid-19 pandemic easing into the rearview mirror, a key legacy impact will be felt in the workplace where norms have shifted dramatically and could determine how talent is won or lost. The advent of remote work has created new opportunities to access and retain talent, while also creating challenges for training and integrating new employees. Companies will also need to prepare for a new generation of employees who are entering the workforce with heightened priorities regarding corporate purpose and employee wellness and mental health. The skills companies require today are also rapidly changing, and perhaps faster than the current workforce is able to adequately accommodate: ongoing innovations in AI and machine learning will render many roles obsolete while creating new roles that may require hiring or upskilling of employees. And companies will also need to address existing DEI commitments and targets, including how to address the impacts of reductions in force on workforce demographics and targets.

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The coming year presents new challenges and opportunities in the evolution of ESG. A global reporting regime looks to finally come into place, albeit with transatlantic divergences that will need to be carefully managed. Increased regulatory efforts at addressing greenwashing may again refocus attention on governance. Meanwhile, multiplying risks will continue to increase the responsibilities of boards and management. As in previous years, ESG continues to evolve rapidly, sometimes taking unexpected turns. Perhaps the biggest surprise of 2023 may be how the anti-ESG movement's efforts to unwind the consideration of ESG factors by companies and investors ultimately end up providing much needed clarity on the purpose and value of addressing the myriad of risks and opportunities that have fallen under the broad ESG canopy.

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