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The Future of ESG: Thoughts for Boards and Management in 2024

The term "ESG" has steadily faded from the investor and corporate lexicon over the past year in the wake of cultural and political clashes over its meaning and purpose. "Anti-ESG" legislation adopted by several states has created legal and financial hurdles around the term. Institutional investors have gone quiet on ESG amid public criticism and congressional subpoenas. BlackRock has publicly disavowed the term for having become too politicized. The use of "ESG" in earnings calls has dropped precipitously.

For boards and management seeking to navigate today's environment, the declining use of the term "ESG" likely signals its evolution rather than its demise. ESG was conceived with the purpose of focusing global attention on risks and opportunities that were not captured in financial statements or investment analysis. But no single term could ever accurately capture the range of issues that can materially impact any particular business and its pursuit and achievement of long-term value maximization. Without the hype and polarizing effect of the ESG mantle, companies and investors alike may have more flexibility to take a surgical approach to issues such as climate, sustainability, human capital and diversity, equity and inclusion, and pursue tailored strategies that are firmly rooted in the creation of long-term sustainable value.

Many of the risks and opportunities that were previously lumped together under the ESG umbrella remain important to both businesses and investors and will need to be unbundled, assessed and addressed. Despite the recent outflow in sustainable funds, record sums are being invested into renewable energy and infrastructure projects. The accelerating capabilities of artificial intelligence will inevitably create new ethical, social and regulatory dilemmas. And regulators globally have continued to impose demands for disclosure and accountability on sustainability, human capital and environmental risks.

As boards and management navigate toward a post-ESG era, we have summarized below some key principles and practical considerations to keep in mind:

- **Prioritize Issues of Highest Value to the Business**: ESG is not a monolithic concept but rather a composite of disparate matters that are not all equally important to a business. Boards and management should periodically assess whether resources are being allocated to address matters that are

most likely to have a material impact on the operations and financial results of the business. The purpose of a corporation, as articulated by Professor Colin Mayer in his recently published book, *Capitalism and Crises*, is " producing profitable solutions for the problems of people and planet, not profiting from producing problems for either," and the measure of a company's success is superior performance and long-term value creation. In addition, to the extent ESG-type metrics are incorporated into executive compensation, those metrics should align with a company's broader strategy and be weighted to reflect its overall impact on returns and performance.

- **Focus on Responsive Actions to Risks (and Opportunities)**: Regardless of terminology, boards and management need to develop and disclose strategies to address business risks (and opportunities). In addition to the SEC's pending and forthcoming rules on climate, human capital and board diversity, the International Sustainability Standards Board has established global baseline reporting standards that are pending adoption in over 60 jurisdictions globally. The clampdown on greenwashing has also accelerated: the SEC has continued to issue climate comment letters, while the "Names Rule" amendments, California's AB 1305 and the FTC's pending revisions to the "Green Guides" will further tighten standards for how and when investors and companies may make "green" claims. Whatever the fate of the term "ESG," investor and regulatory expectations of board and management action and accountability on the underlying issues have not abated.

- **Seek to Balance, Not Equalize, Stakeholder Priorities**: Many of the individual issues that were shoehorned under the ESG umbrella will continue to be important to a range of stakeholders. While boards and management should pay attention to stakeholder perspectives, it is the responsibility of boards and management to balance, not equalize, stakeholder priorities, all in the service of the pursuit and achievement of superior performance and long-term value creation. How a business responds to stakeholder interests should be commensurate with the magnitude of the stakeholder's impact on the business and the anticipated time horizon of such impact. Stakeholder interests with large magnitude, high certainty and longer-term impact should be accorded greater weight in a corporation's strategic decision-making.

- **Expect and Prepare for Criticism**: It is likely that businesses will continue to face public pressure on ESG issues. Businesses that are household names may be particularly vulnerable targets, but no company is immune from

stakeholder agitation. Consequently, boards and management should prepare for public pressure and scrutiny. Advance preparation includes proactive engagement with stakeholders, maintaining a record of deliberate and thoughtful board oversight, adopting consistent and well-reasoned policies that can be demonstrably linked to better performance and long-term value creation, paying attention to how the company's policies and practices are communicated, and ensuring that company leadership is fully prepared to face public scrutiny when it arises.

- **Stay Close to Your Investors**: While the largest U.S. investors may have steered away from prescriptive mandates on environmental and social issues, a record $6 trillion in cash is currently sitting on the sidelines. Consequently, efforts should be made to communicate to the markets the steps the company is taking to enhance business performance, including, where relevant, the initiatives to address specific ESG issues. The fact that stewardship teams at institutional investors may be taking a more deferential approach to their guidance for companies, and are less inclined to use the term "ESG," is not necessarily a green light to move material social and environmental issues – on which superior performance and long-term value creation may hinge – to the backburner.

The recent conflicts and confusion over ESG suggest that the term may have outlived its usefulness. However, the need to address the environmental, social and governance issues that may materially impact long-term performance and value creation, as outlined in our New Paradigm memo, remain as relevant as ever. The onus is on boards and management to continue developing strategies that promote superior performance and long-term value creation and to ensure the public markets appreciate these efforts.

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