ESG: 5 Trends to Watch in 2023

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Said simply, it might feel like ESG is everywhere in 2023. More companies and investment funds are adopting programs or policies that are keyed to various ESG measures as they look to drive profitability and improve access to capital. Regulators across the globe are busy writing and implementing new disclosure regimes. Investors are pushing for information as they develop and refine ESG-based investing strategies. Meanwhile, ESG-related issues in the United States have given rise to divisive political views.

Heading into 2023, the pressure will continue to build as a broader set of stakeholders (including shareholders, regulators, employees, customers and community members) expect companies across geographies and industries to take action on a wide set of ESG-focused concerns. Navigating risk and opportunity will require calibrated solutions that balance these competing priorities, and which are aligned with long-term sustainability and profitability. It will demand targeted, measurable and trackable action plans and—in some cases—tradeoffs.

If 2022 was the year that many ESG issues assumed a refined focus, then 2023 may be the year that corporate ESG efforts are seriously tested. Below are five emerging trends to watch—and our views about how to get (and stay) ahead of them.

1. The Regulatory Tsunami Looks to Hit Shore

The future ESG framework is coming into focus. Regulators across the globe have driven a rapid acceleration of complex, profoundly prescriptive ESG-related legal obligations. These rules are intended to drive disclosure, transparency and accountability relating largely to environmental concerns, but also covering human capital and other ESG-related issues. In some cases, international rules regimes are derived from a common standard, and so retain some similarities across countries. In other cases, the requirements relating to similar subject areas bear little common ground. As many companies confront the fact that they will be subject to at least a handful of different regimes, their compliance challenge grows.

To date, trends in ESG reporting and due diligence have largely been steered by developments, including reporting and compliance regulatory requirements, in the

EU and U.K. 2023 could be a watershed year for ESG-focused regulatory developments in the United States as well. Rules proposed by the Securities and Exchange Commission ("SEC") last year detailing new climate-related disclosure requirements (see chart in appendix) made quite a splash, garnering a staggering 14,000+ comment letters to the SEC. Given the level of attention and concern surrounding the rules, upon finalization, we would expect legal challenges to begin almost immediately, likely culminating in a review by the Supreme Court. To date, in the absence of finalized rules, the SEC taskforce established within the Division of Enforcement to address climate and ESG disclosures has pursued limited enforcement actions.

Other rules proposed by the SEC last year would enhance and standardize disclosures from registered funds and advisers with respect to ESG strategies. The SEC also adopted rules that require funds to disclose more information about their votes on ESG issues, executive compensation and other proposals at annual meetings. But the ESG-related SEC rulemaking didn't stop there. The agency has also proposed rules to address cybersecurity risk management, strategy, governance and incident disclosure by issuers, and finalized long-shelved executive compensation rules addressing clawbacks of erroneously awarded incentive-based compensation and pay versus performance, reflecting the relationship between executive compensation actually paid by a public company and the company's financial performance. Finally, based on the SEC's 2022 ESG agenda, there is wide speculation that the SEC plans to issue a new, expanded version of the 2020 rule on human capital management and recommend amendments to proxy rules to enhance corporate disclosures about the diversity of boards and nominees.

Key Takeaway

Companies will need to monitor regulations—those in force, impending and under consideration—closely to ensure that they are prepared for a new compliance regime. Synthesizing and harmonizing comprehensive global solutions will be appropriate in some cases and insufficient in others. Companies will need to implement action plans to address complex and, in some cases, conflicting sets of legal and disclosure requirements, and also identify risk areas, mitigants and areas of ESG best practice.

2. U.S. Politics Heat Up

Changes in disclosure practices around ESG really kicked off in the U.S. in response to investor demand. As money began to flow in a real way into ESG-focused funds, investors have pushed companies to be much more transparent about their activity and commitments in those areas, and to provide comparable and comprehensive information. Many large institutional investors in particular have used their powerful positions to advance the agenda in this area. They have collectively emphasized the need for companies to consider seriously their long-term growth and path toward sustainability by addressing issues that fall under the broad ESG rubric. While these ideas have not gained unanimous agreement among American investors and business leaders, they have certainly gained traction, though recently the tone among investors expanding into ESG strategies has shifted in response to political events.

What has been described as an anti-ESG sentiment that seeks to challenge the field of ESG investing began in 2022 and continues to ramp up in 2023. Certain U.S. states and lawmakers are making their views known through the formulation of anti-ESG bills and by divesting from funds, with impacts felt by both U.S. and non-U.S. companies. Over the course of 2021 and 2022, 18 U.S. states passed legislation to limit ESG investing or prohibit state governments from doing business with financial institutions that adopt certain ESG policies. Among the more dramatic examples is Florida, which last August adopted a proposal preventing the state's pension fund and its investment management partners from making decisions based on ESG factors. In December, the state announced that it would pull $2 billion of the state's pension funds over ESG concerns in the largest anti-ESG withdrawal announced by a state, although a "truce" reported this month will apparently allow the asset manager to continue overseeing those funds provided that it stops applying ESG investing strategies with respect to the funds. Guidelines issued in Florida this month will exert further pressure by prohibiting state-run fund managers from considering ESG issues when making investments.

Other states are pursuing similar measures. Last January, the West Virginia State Treasurer announced that the state would pull assets from an investment fund, citing concerns over its ESG investing focus. West Virginia and Texas have both issued laws blacklisting financial institutions that "boycott" fossil fuel and, in the case of Texas, firearms companies.[1] More recently, a multistate coalition led by Texas sued the U.S. Department of Labor seeking to freeze a new rule that would allow retirement plan fiduciaries to consider ESG factors when making pension investment decisions, and to block regulators from enforcing it. The outcome of the case, which was brought in the U.S. district court for the Northern District of Texas—a jurisdiction historically associated with striking down significant employee benefit regulations—will be consequential given the state-led efforts described above and the Biden-Harris administration's longtime policy priority to remove barriers to considering ESG factors in retirement investing.

We expect further repercussions as the 2024 presidential election nears. And, given this political environment, many observers believe the Supreme Court would be eager to be take up a challenge to the climate disclosure rule.

So in addition to "greenwashing"—where companies may describe their strategy and programs in a way that makes them seem more environmentally or socially protective than they actually are—we are also now seeing the opposing phenomenon of "greenhushing." As ESG-related commitments, pronouncements and programs have started to garner negative attention from a portion of investors and lawmakers, some companies are choosing to downplay those statements to avoid this negative attention. A recent global study even showed that while many "sustainability-minded" companies are making net zero targets, with more science-based targets and more ambitious timelines, as many as one in four companies does not plan to talk about its science-aligned climate targets.

1. The Texas laws, which took effect in 2021, prohibit most state and local government agencies from contracting with financial institutions that restrict funding to the oil and natural gas and/or firearm and ammunition industries. The West Virginia law, which took effect last June, authorized the state treasurer to investigate and deny access to state contracts with financial institutions that are shifting away from fossil fuel investments.

Key Takeaway

The current political climate is creating minefields for investors and corporate leaders alike. Navigating conflicts and stakeholder sensitivities (including anti-ESG activist investors and shareholders) will require a renewed focus on and a commitment to corporate purpose, mission and values. Maintaining perspective on the ESG drivers that apply to a company now and in the future, and the rationales for developing and maintaining an ESG strategy, will be important. Companies should also maintain open lines of communication with stakeholders, and where a company decides to adopt an external position, ensure that communications are aligned with corporate purpose.

3. ESG Data Evolves

Investors are flocking to investments and transactions that are graded against ESG criteria—in part because comparable, or in some cases, higher investment returns globally, continue to advance the business case for ESG investing.[2] But in order to deploy that capital, investors need to be able to assess the connection between difficult-to-value ESG elements and enterprise value. This is, in turn, driving a push for new types of information and data on these elements. It's also motivating new ways of measuring corporate performance, including through ESG-focused indexes, ratings and industry-focused disclosure frameworks and standards,[3] and by reviewing corporate documentation.

The new slew of regulations (noted above and described in more detail in the chart below) underscores investors' need for comprehensive, comparable and reliable data related to ESG—and regulators' goal to help them get that information. In this way, the market, and the standard-setters, are trying to help guide investors to evaluate more closely how companies align their business purpose and strategic goals with the preservation of environmental and human capital—if at all.

The demand from regulators and stakeholders for reliable information is also manifesting in the transaction context with requests for enhanced diligence, where increasingly it is no longer enough to understand what litigation a company faces. Companies must increasingly describe how they manage their consolidated corporate groups, including with respect to ESG issues, and in some contexts and depending on the transaction, undergo assessment and evaluation by technical experts focused on ESG risk and value creation.

2. According to a PwC report from October 2022, ESG-focused institutional investment will rise 84% to U.S. $33.9 trillion in 2026, making up 21.5% of assets under management. *See also* Barrons, "Future Returns: ESG-Related Ventures Are a 'Bright Spot' in Private Markets" (Jan. 17, 2023); and Morningstar, "ESG Investing Keeps Pace With Conventional Investing in 2022," (Jan. 12, 2023).

3. This includes but is not limited to the following ESG data and ratings providers and/or index providers: Bloomberg, Morningstar, MSCI, S&P and Sustainalytics.

Key Takeaway

In this environment, companies need to start evaluating their ESG-related reporting with a rigor akin to that applied to their financial reporting processes. This includes monitoring consistency across publications. To the extent that a company's ESG data originated in a corporate social responsibility ("CSR") or a sustainability report, and is now being leveraged in an offering document or regulatory filing, companies should evaluate seriously the internal systems and tools that are being used to collect, scrub, analyze, verify and report that data. Where appropriate, companies should consider enhancing the reliability of information (*e.g.*, greenhouse gas ("GHG") emissions data and other metrics and statistics) through external auditing or assurance.

4. Growing ESG-Related Allegations and Claims

ESG litigation of greater scale, scope and complexity is poised for launch. New SEC rulemaking requiring climate-related disclosures, disclosures by investment advisers, and disclosures related to greenwashing and cybersecurity, once finalized, will doubtless open the door to shareholder rights of action and fuel enforcement activity. Some major financial institutions reached settlements with the SEC during 2022 over their statements about ESG investment opportunities and alleged failures to follow policies and procedures that were established to ring-fence those investments.

Environmental and climate change litigation has historically accounted for the majority of ESG-related litigation.[4] Now, new subsets of climate litigation are emerging as countries work toward net-zero targets and companies pursue carbon-neutral or carbon-negative pledges. Securities litigation over climate change disclosures is also becoming more common, and claimants are ramping up tort and consumer protection lawsuits targeting fossil fuel companies.

Claims targeting social issues are also mounting.[5] Consumer-oriented lawsuits and court findings have examined companies' statements relating to their sourcing of materials and claims about the sustainability of their products. Litigants have also targeted corporations, individual directors and officers for their alleged direct or indirect involvement in the abuse of human or labor rights in the entity's supply chain, or at the community level.

Claims and settlements surrounding negative workplace culture (*e.g.* sexual harassment, discrimination) also continue to make headlines. Just last week, in its denial of a motion to dismiss a derivative lawsuit alleging that the former head of human resources for global fast food company McDonald's breached his fiduciary duties, the Delaware Court of Chancery made waves by stating that a duty of oversight extends to corporate officers, not just directors (described here). The case centered on claims that the defendant consciously ignored red flags regarding sexual harassment and misconduct at the company, while also personally engaging in that behavior. The decision is being described as a wake-up call for corporate executives. Delaware, as the leading state for the incorporation of publicly traded corporations listed on U.S. stock exchanges, is also considered the leading jurisdiction in U.S. corporate law, and the decision potentially opens the floodgates to these types of shareholder claims against officers for ESG failures.

The upshot is clear: emerging forms of ESG litigation risk and standards relating to board oversight of ESG issues and management's roles and responsibilities, and ESG governance more broadly, should shape the way that companies design, implement and report on the structural management and oversight of their ESG compliance programs. Officers with oversight of ESG implementation should take a critical look at the scope of their responsibility to monitor and oversee corporate ESG risk, scrutinize existing procedures, resources and reporting lines, and take steps to ensure effective operationalization and the fulfillment of their mandates. For companies, there could be implications related to how officers' employment, indemnifications and D&O insurance coverage are structured.

It finally bears noting that, when it comes to ESG, even for claims that are not ultimately successful, or that result in relatively minor financial penalties, the reputational penalty associated with a suit can have an outsized impact on a company.

4. This includes claims to enforce climate-related laws, policies and mitigation targets, meet the cost of climate-related damage, halt cross-border GHG emissions, projects or investment in fossil fuels, or in respect of environmental licensing and permitting, as well as environmental and climate change disclosure-based claims.

5. This includes claims brought under general principles of tortious liability, provisions of new legislation requiring companies to exercise due diligence on and to address business-related human rights and environmental risks, international human rights proceedings, and quasi-litigation before mechanisms such as OECD National Contact Points.

Key Takeaway

As the legal risk to taking certain ESG-related positions comes into focus, companies would be wise to drill down on governance—the "G" in ESG. Appropriate solutions and strategies when it comes to ESG (whether that's expressed through disclosure, policy implementation, lobbying activities or other expressions of a company's ESG strategy) cannot be crafted without oversight. Public statements need to be ticked and tied. Practices need to be funneled through compliance or audit functions. And most of all, companies' boards of directors need full, complete reporting and comprehensive oversight on corporate activity.

5. Proxy Season Brings Issues Into Focus

For shareholders in the public equity markets, proxy season is prime time. While lines of communication between investors and companies have morphed from quarterly earnings calls into year-round engagement on top investors' priorities, proxy voting continues to be the primary forum where shareholders exert real influence. And many of the topics driving investors' votes fall directly under the broad ESG umbrella.

In the wake of the SEC staff's 2021 change in approach to issuers' ability to exclude shareholder proposals (which the SEC continues to refine), as expected, we saw a spike in the overall number of proposals going to a vote last year. In particular, environmentally-focused proposals have increased almost 50% over 2021 numbers. Socially-focused proposals were voted on 231 times, with those submissions focused on racial equity audits and reports being most likely to pass.

Within the environmental and social proposals, we observed a clear trend. While the number of proposals going to a vote was up, and while most of the largest institutional investors (who are also the holders most likely to exercise their vote at annual meetings) generally advocated for companies' need to think about their environmental and societal impacts and future-looking commitments as a part of a sustainable business model, the percentage of environmental and social proposals passing was down significantly. In part, this is due to the fact that proponents have been refining their approach, and offering more targeted resolutions and, according to investors, overly prescriptive proposals that may not support long-term shareholder value.

We predict that this bifurcation trend will grow in 2023. Proposals are becoming more prescriptive and specific, and perhaps less likely to garner widespread support. Proponents are also taking a broader approach to the types of requests they make, including for example what are termed "anti-ESG" proposals targeting racial justice and corporate political activity. These types of proposals doubled in 2022 over the prior year, and are also likely to increase as the political climate continues to shift.

Beyond shareholder proposals, investors and proxy advisors are updating proxy voting guidelines and implementing policies to promote director accountability for the perceived ineffective oversight of ESG issues, emphasizing the need for companies to assess carefully the impact of these changes, and to engage with major investors on their policy positions in the off-season.

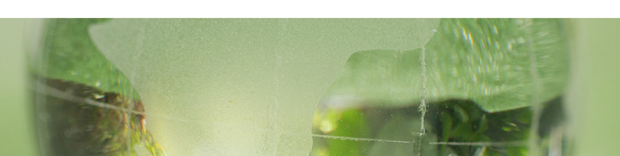
Key Takeaway

Shareholder proposals focused on environmental and social issues this year will be subjected to even greater scrutiny from investors, as many move both to reject overly prescriptive proposals, and also to evaluate proposals in more detail against the steps the company may have already taken. This could lead to continued declines in support for many ESG-related proposals. But ESG concerns will play out in other ways this proxy season, as proxy advisors and investors adopt stricter director voting policies to hold companies accountable for their action (or inaction) in ESG-related areas.

Conclusion

Given the fluid landscape and scope of issues, the ESG mandate can seem overwhelming. But overlaying all is an emerging recognition that ESG extends well beyond normal issues of compliance or corporate social responsibility—it is a core issue of business strategy that requires significant board and C-level engagement and robust internal controls appropriately scaled to address known and unknown risks.

To navigate this area, and to do it well, requires that companies put the "G" first, and focus on the governance supporting it all. Numbers and statements relating to ESG measures or topics need to be viewed with the same rigor as any other statement upon which investment decisions might be made. Decisions cannot be made in silos or by isolated ESG professionals—but should be made in concert with company leaders to ensure alignment with strategy, values and the long-term business plan.



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Appendix

Significant Newly-Enacted and Upcoming Regulation[6]

Regulation	Issuing Authority	Requirement	Subject Companies	Timing
United States				
Climate Risk Disclosure Rule (link)	SEC	Would require companies to provide certain climate-related information and GHG emissions insights (Scopes 1 and 2, and Scope 3 if material or company has set a target)[7] in annual reports and registration statements, including in the footnotes to financial statements (see here for additional information)	Public companies (issuers), domestic and foreign	Proposed March 21, 2022; expected to be finalized in first four months of 2023 When finalized, phased implementation based on SEC filer status
ESG Disclosure Requirements for Funds and Advisers (link)	SEC	Would require investment funds and investment advisors to provide more specific disclosures on ESG strategies in fund prospectuses, annual reports and adviser brochures	Investment advisers and investment companies that market themselves as having an ESG focus	Proposed May 25, 2022
ESG Disclosures and Naming Rules (link)	SEC	Would require funds whose names suggest a focus on one or more ESG factors to invest at least 80% of their assets in that factor(s) Would prevent a fund that considers ESG factors alongside but not more centrally than other factors from using ESG in its name	Registered investment companies, business development companies, registered investment advisers and certain unregistered advisers	Proposed May 25, 2022
Enhanced Proxy Voting Disclosure Requirements for Investment Funds and Required Disclosure of "Say-on-Pay" Votes for Institutional Investment Managers (link)	SEC	Requires enhanced reporting from registered funds concerning proxy votes (including Say-on-Pay); funds will also be required to categorize votes related to the environment or climate, among others, to help investors identify votes of interest and compare different funds' voting records	Mutual funds, exchange-traded funds, and certain other registered funds; institutional investment managers	Adopted Nov. 2, 2022; effective July 1, 2024, covering votes occurring on or after July 1, 2023

6 We note that additional, significant regulations have recently been passed or proposed in other countries. This includes, but is not limited to, the German Act on Due Diligence in Supply Chains (entered into force on Jan. 1, 2023), the Uyghur Forced Labor Prevention Act (key provisions took effect on June 21, 2022), and the European Commission proposal to ban goods made with forced labor (issued Sept. 14, 2022).

7 Scope 1 emissions consist of direct GHG emissions from operations owned or controlled by an issuer. Scope 2 emissions consist of indirect GHG emissions from the generation of purchased or acquired electricity, steam, heat or cooling that are being consumed by operations owned or controlled by an issuer. Scope 3 emissions consist of all other GHG emissions from the upstream and downstream activities of an issuer's value chain, which includes sources as varied as suppliers, transport of goods, employee travel and commuting, consumption of a product and investments of the issuer (a nonexclusive list of activities in the value chain is set forth at Item 1500(r) of the proposed rule).

Significant Newly-Enacted and Upcoming Regulation *continued*

Regulation	Issuing Authority	Requirement	Subject Companies	Timing
Cybersecurity Disclosure Rules (link)	SEC	Would amend Form 8-K to require disclosure of "material" cybersecurity incidents within four business days, with trigger date keyed to date of the materiality determination Would impose new periodic reporting requirements with respect to previously reported material cybersecurity incidents, risk management and strategy, governance, and board of directors' cybersecurity expertise, if any, and oversight of cybersecurity incidents	Public companies (issuers), domestic and foreign	Proposed March 9, 2022
Pay Versus Performance Disclosure Rules (link)	SEC	Requires registrants to disclose the relationship between executive compensation actually paid compared to the financial performance of the company Requires additional, specified disclosures in annual proxy statements	U.S. registrants that file proxy and information statements requiring executive compensation disclosure under Item 402 of Regulation S-K for fiscal years ending on or after December 16, 2022	Adopted Aug. 25, 2022
Clawback Rules (link)	SEC	Directs U.S. stock exchanges and securities associations to adopt listing standards requiring listed companies to adopt and enforce policies for the recovery of erroneously awarded incentive compensation received by current or former executive officers in the event of an accounting restatement (see here for additional information)	Public companies (issuers), domestic and foreign, with limited exceptions	Adopted Oct. 26, 2022
EU and U.K.				
EU Sustainable Finance Disclosure Regulation ("SFDR") (link)	Pillar of EU Sustainable Finance agenda introduced by European Commission as core part of its 2018 Sustainable Finance Action Plan[8]	Requires sustainability disclosures covering a broad range of ESG metrics at both the entity and product level All financial products (including funds) must disclose their approach to the integration of financially material "sustainability risks," even if they do not have an outward ESG focus Funds that promote ESG characteristics (Article 8) or that have a sustainable investment objective (Article 9) must make detailed additional disclosures about their approach and commitments to ESG integration, and disclose the proportion of their assets that qualify as environmentally sustainable investments	All financial market participants and financial advisers based in the EU, and investment managers or advisers based outside of the EU who market or intend to market their products to clients in the EU	Entered into force March 10, 2021; SFDR regulatory technical standards apply from Jan. 1, 2023 Detailed pre-contractual disclosures for products promoting environmental or social characteristics or with a sustainable investment objective required from Jan. 1, 2023. June 30, 2023: final date to report for first time for financial year 2022 on principle adverse impacts of investment decisions; and detailed annual reporting of non-financial performance for ESG-focused funds

8 The 2018 Sustainable Finance Action Plan also includes the EU Taxonomy Regulation and the Low Carbon Benchmarks Regulation. The EU Taxonomy Regulation, which became effective from January 2022, established specific environmental criteria related to economic activities for investment purposes and forms part of the enhanced disclosure obligations required by the EU SFDR. A social taxonomy and extended environmental taxonomy are expected to follow.

Significant Newly-enacted and Upcoming Regulation *continued*

Regulation	Issuing Authority	Requirement	Subject Companies	Timing
U.K. climate-related disclosure regime (link) and (link)	Financial Conduct Authority ("FCA")	Requires Task Force on Climate-Related Financial Disclosures ("TCFD")-aligned disclosure by certain financial institutions, including asset managers, as well as certain U.K. listed companies	All FCA-authorized investment managers in relation to their TCFD in-scope business, including U.K. PE advisors	Asset managers with >£50 billion AUM, Jan. 1, 2022 with first publication of reports due by June 30, 2023 Asset managers with >£5 billion AUM but less than £50 billion AUM, Jan. 1, 2023 with first publication of reports due by June 30, 2024
Corporate Sustainability Reporting Directive ("CSRD") (link)	Formally adopted by European Parliament and Council of European Union; EU Member States must transpose into national law	Requires companies to report on governance, policies and due diligence processes covering environmental and human rights-related risks from a "double materiality" perspective (similar to the Global Reporting Initiative), in line with detailed disclosure standards developed by the European Financial Reporting Advisory Group	Large EU undertakings with two of the following: EUR 40m+ turnover, EUR 20m+ balance sheet and 250+ employees All companies with securities admitted to trading on EU Regulated Markets (including SMEs and non-EU companies)	Entered into force Jan. 5, 2023; must be implemented into national legislation; phased implementation based on category of company (2024-2028)
EU Corporate Sustainability Due Diligence Directive ("CSDDD")	Commission Proposal (link); Council General Approach (link) EU level legislation pending; Final Directive would be subject to national implementing legislation	Would require companies to integrate due diligence into policies, conduct diligence to identify and address actual and potential adverse impacts on the environment and human rights, implement measures to prevent/mitigate impacts, adopt processes to evaluate the effectiveness of such measures, and issue disclosures; specific duties for corporate directors of EU companies	EU companies with > 500 employees and > EUR 150m worldwide net turnover; or > 250 employees and > EUR 40m worldwide net turnover with 50% or more of their revenue from high risk sectors Non-EU companies with > EUR 150m net turnover in the EU; or > EUR 40m net turnover in the EU and > 50% of their worldwide net revenue from high risk sectors	Not close to finalization; significant political issues will need to be resolved Predictions are that a final text will not be agreed before the end of 2023