ESG AS SEEN BY BOARDS AND DISCLOSURE COMMITTEES: A VIEW LARGELY AT ODDS WITH THE GOP "ANTI-ESG MOVEMENT"

It undoubtedly is a challenging time to be a director of a publicly listed company. A recent report by Heidrick & Struggles, Boston Consulting Group and INSEAD, "The Role of the Board in the Sustainability Era," posits that a series of highly disruptive changes "are driving the most profound business transformation in 50 years" and are having a fundamental impact on how boards exercise their risk oversight and other functions. These changes are all too familiar to those who track the issues of the day: the potential impact of generative AI on how businesses operate; geopolitical uncertainty and the attendant consequences for the global economy; trade risks and regulatory changes, as well as the impact of sustainability on corporate strategy, supply chains and economies.

The Board Role report highlights the results of a global survey of directors that was designed to assess how sustainability is impacting boardroom discussions and actions. It is a complex landscape and, unhelpfully, that landscape in the United States is now also being blighted by the weaponization, for political gain, of broader culture war wedge issues.

If one were just following the headlines reporting on the culture war battles being fought over ESG as part of the broader assault against "woke capitalism," one would miss completely the reality on the ground when it comes to sustainability. Whether it is board focus or corporate disclosure, companies are well past debating whether or not to embrace sustainability. The direction of travel for business is clear.

Political Posturing …

The reality on the ground notwithstanding, sustainability is one of the key themes driving the fraying of the traditional relationship between the GOP and business, with Democrats all too happy, and comfortable, to surface in their place as the champions of business and the markets. The attacks against Disney, Bud Light and Target are just the more prominent examples of the frayed relationship.

In February, House Republicans formed an ESG Working Group, not to promote ESG, but to kill it (or its practical consequences) off. In the words of the Chair, the working group is intended to "combat the threat to our capital markets posed by those on the far-left pushing environmental, social, and governance (ESG) proposals." According to the Chair, Biden's regulators have gone "rogue." Not much left to the imagination as to intent.

The Chair of the House Financial Services Committee, the Chair of the House Subcommittee on Oversight and Investigations and the Ranking Member of the Senate Committee on Banking, Housing, and Urban Affairs launched a broadside against the SEC's proposed climate-related disclosure rulemaking, prompting a House Democrats Response, particularly to urge the SEC to not dilute or scrap Scope 3 disclosure requirements. The Republican lawmakers' letter seeking information from the SEC claims that the climate disclosure rule exceeds the "SEC's mission, expertise, and authority and, if finalized in any form, will unnecessarily harm consumers, workers, and the U.S. economy."

The battles will continue. In late June, the ESG Working Group issued its preliminary report, which sets out a number of goals, including reducing proxy access, "ensuring the accountability of proxy access firms," rolling back SEC ESG efforts, and protecting US companies from "burdensome EU regulations."

In a related action, in early June, the Ranking Member of the Senate Committee on Banking, Housing, and Urban Affairs and the Chair of the House Committee on Oversight and Accountability requested the SEC to provide information relating to SEC "activities taken in connection or coordination with the European Union" on ESG and climate-related matters, including EU climate-related disclosure requirements. The authors of the letter allege that the Biden administration is seeking to circumvent US courts and "our democratic process" by collaborating with the European Union to ensure desired outcomes of the EU ESG agenda reaching the United States through extraterritorial application. Never mind that the EU climate-disclosure efforts predate the SEC effort by some years and that extraterritorial effect of EU rules has a significant precedent (the GDPR) and justification (and never mind that the US securities laws likewise have extensive extraterritorial reach).[1] But never let facts get in the way.

Expect to hear more. As Zachary Warmbrodt and Eleanor Mueller, writing in POLITICO earlier this month, noted, "Republicans who lead the House Financial Services Committee plan to spend the next few weeks holding hearings and voting on bills designed to send a clear signal: Corporations, in particular big investment managers, should think twice about integrating climate and social goals into their business plans. Committee conservatives will target the process in which advocates pressure public companies to adopt environmental, social and governance (ESG) goals using the shareholder voting process." And, per the GSA website in October, we will likely have final SEC rulemaking on mandatory climate-related disclosure, which no doubt will unleash a new wave of right-wing attacks, not to mention legal challenges.

The threats are not limited to those emanating from Capitol Hill. Pleiades Strategies tracks 165 anti-ESG bills proposed in 37 state legislatures during 2023. Most, according to their report, are based on models circulated by right-wing organizations targeting a range of state financial regulations, including limiting state contracting authority, restricting pension management, forcing disclosures under threats of liability and countering federal investment rules. The report notes as well that "[t]his coordinated legislative effort, commonly referred to as the anti-ESG movement, generated massive backlash from the business community, labor leaders, retirees, and even Republican politicians. It is not an issue that resonates with the public. Despite all the hype, the vast majority of anti-ESG bills failed to progress through legislative chambers, including in ten states fully controlled by Republicans."

… Versus Reality

An analysis undertaken by Ceres of comment letters submitted by 320 institutional investors (including both asset owners and asset managers, who collectively own or manage more than $50 trillion in assets) in response to the SEC climate-related disclosure rulemaking proposal

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1 For an overview of EU sustainability disclosure initiatives, *see* two of my prior briefing notes, available here and here.

found overwhelming support for the proposed disclosure rules. This is not surprising given, as Ceres notes:

- asset managers are bound by fiduciary duty to manage investment risks, including those arising from climate change;
- company financial performance will be affected both positively and negatively by material climate issues, over different time horizons;
- climate disclosures contribute to informed capital allocation and business decisions by investors, resulting in improved value creation, risk mitigation and effective portfolio design; and
- investors need to understand the magnitude of company-specific risk exposures to prioritize engagements and inform proxy voting.

I examine briefly below the view from the boardroom and the broad disclosure trends, in each case relating to climate matters.

Board focus

Although sustainability is not deemed by surveyed directors to have a significant financial impact on business today, boards nonetheless are taking sustainability very much into consideration. The key factors motivating boards to act on sustainability were found to be:

- It is the right thing to do – 52%
- Increasing legislative and regulatory requirements on sustainability - 51%
- Expectations of investors, insurers and lenders – 41%
- Attracting and retaining talent – 41%
- Customer demands – 36%
- Community pressure – 20%
- Sustainability severely impacts business today – 19%
- Threat to medium- or long-term survival – 13%
- Impact on medium- to long-term financial results 10%

Interestingly, the Board Role report notes that in roundtable discussions, directors often expressed a lack of confidence in their abilities to understand the long-term implications of the global shift to sustainability and stakeholder demands. While directors generally felt (79%) they understood the strategic risks and opportunities around sustainability, far fewer (29%) felt they had sufficient knowledge to effectively challenge management in respect of sustainability plans and to exercise risk oversight in respect of the execution of sustainability plans.

Admittedly, while the sector-specific knowledge gap is broad, the range of sustainability/ESG issues that any one sector faces is also broad. The report sets out the following broad priorities, as examples:

Industry	Priority 1	Priority 2	Priority 3
Consumer	DEI	Raw material scarcity	Pollution and waste Employee engagement
Industrial Goods	Carbon emissions	Environment as a competitive edge	Pollution and waste
Energy	Carbon emissions	Environment as a competitive edge	Public policy Climate change vulnerabilities

			Health and safety
Tech	Employee engagement	Carbon emissions	Product liability Environment as a competitive edge Climate change vulnerabilities Social as a competitive edge DEI
Financial services	Climate change vulnerabilities	Financing environmental impact	DEI Employee engagement
Materials	Water stress	Carbon emissions	Health & safety Climate change vulnerabilities
Healthcare	Health & safety	Employee engagement	DEI
Utilities	Carbon emissions	Public policy and regulations	Climate change vulnerabilities

As for sources of knowledge, 62% of directors believe they do not spend enough time hearing directly, or reading material, from outside experts. Directors also feel that sustainability is still not fully integrated into board selection criteria and see room for improvement in integrating sustainability into decision-making. When asked about the gap between the extent to which sustainability *is* integrated versus *should be* integrated, across a range of functions (board agenda, compensation, stakeholder engagement, asset allocation, risk appetite, business strategy and business opportunity assessments), the largest split affected business strategy – 38% felt sustainability *was fully integrated today* in setting strategy, while 66% felt *it should be fully integrated*. Over half felt sustainability *should be* a standing agenda item, while only 29% felt *it was* today. As for obstacles to spending more time reflecting on sustainability, 35% report that they do not know enough about the long-term strategic implications to have a meaningful discussion.

The Board Role report sets forth some recommendations. In particular, corporate boards should consider:

- seizing the opportunity to refresh their membership based on a more forward-looking succession plan that takes account of the strategic direction of the business;
- expanding the knowledge of their members on sustainability and seeking more information from independent, external experts;
- spending more time, as a matter of a standing agenda item, focused on long-term sustainability issues; and
- improving transparency around director selection, board evaluation and board practices, to send a message that the board is committed to addressing the changes facing the company longer-term, rather that focused on historical trends and performance.

Drilling down on sustainability, the report posits that, in setting strategic ambitions, boards should be mindful of the tendency to underestimate the demands and scale of new and renewed technology, infrastructure, facilities and resources needed to successfully transition to a sustainable economy. Boards should:

- challenge management's ambitions;
- address the scarcity of talent, resources, capacities, skills, technologies and appropriate assets to successfully navigate the requisite transitions; and

- recognize that sustainability transformations will cut across value chains and industry sectors, necessitating changes to the business proposition to "drive cross-sector innovation, scale new technologies, structure and deploy transition solutions, work around missing market infrastructure and compensate for scarcities." This will likely involve adapting to new means of capital raising and collaboration, and will mean transforming at scale and at speed.

Disclosure

The title of a March article in the Wall Street Journal sums up the corporate disclosure landscape, "The SEC's climate disclosure rule isn't here, but it might as well be, many businesses say." In particular, companies are assessing GHG emissions in their supply chains (for purposes of Scope 3 disclosure) as if the proposed SEC rules were in place.

A March PwC-Workiva study found that 70% of companies are prepared to proceed with climate-related disclosure regardless of when the SEC rules are finalized and effective, and almost all (96%) say their companies are prepared to proceed with third party assurance regardless of whether or not the SEC mandates it. The study found many companies are prioritizing climate reporting, with 95% of business leaders reporting their companies are prioritizing ESG reporting more since the SEC proposed its rules in March 2022, with almost half reporting their companies have prioritized climate disclosure *significantly* more. That same 95% also report taking proactive, compliance-related measures in respect of ESG reporting.

According to the Governance & Accountability Institute (GAI), sustainability reporting by the largest US public companies reached all-time highs in 2021. In its 11th annual survey of S&P 500® and Russell 1000® companies, GAI found that 96% of S&P 500 companies published sustainability reports or disclosures in 2001, up from 20% in 2011. Only 21 of the S&P 500 did not publish a report or make sustainability disclosures. Among the Russell 1000, 81% published a sustainability report in 2021 (68% of the smaller half by market cap of the Russell 1000 publish reports, somewhat offsetting the 96% of the larger half). The 81% figure represents a 68% increase over 2020 (49% of companies).

As for standards, for the first time, SASB was the most-used reporting standard in 2021 among the Russell 1000, with 67% of sustainability reports aligning with SASB compared to 54% aligned with GRI. The adoption of TCFD recommendations doubled in 2021, with 34% of sustainability reports aligning with TCFD recommendations compared to 17% in 2020. An increasing number of companies are embracing external assurance of disclosures, with 36% obtaining external assurance for non-financial ESG disclosures (49% among the largest half, and 18% among the smallest half), an increase of 47% overall over 2022. Of these, 57% extended the assurance only to Scope 1 and Scope 2 GHG emissions disclosures.[2]

Globally, according to KPMG's 10th annual report published in 2022, 96% of the world's 250 largest companies (G250) reported on sustainability. A significant number (77%) of the G250 break out material impact disclosure by topic (impact on company (8%), impact on company

[2] UCLA's Anderson School of Management provides an interactive guide to US corporate sustainable disclosure, available here.

and stakeholders (39%) or impact on company, stakeholders and broader society (30%)). Interestingly, 64% of the G250 acknowledge climate change as a risk to their business and 49% acknowledge social elements as a risk to their business, particularly companies in Western Europe. Within two years of the establishment of the TCFD in 2015, 67% of the G250 were reporting their carbon targets. In 2022, that had increased to 80%. The top three sectors reporting on carbon targets are TMT, retail and oil & gas, while the bottom three are industrials, financials services and healthcare.

Overall, in spite of intentions to provide robust climate-related disclosures, executives are concerned that their companies are not prepared to move from the voluntary reporting environment to mandated climate-related disclosure. The PwC-Workiva study found that 39% of leaders surveyed are concerned that their companies are not yet prepared to comply with the proposed disclosure standards, because of technology, talent and budgetary constraints. Close to half the executives report that their companies have not invested in the technology needed to provide the SEC disclosures.

Relatedly, executives express concerns around data, and, in particular, around the consistency (19% report this as a big concern), accuracy (19%), and quality (17%) of data they are collecting and reporting. Executives are worried about data that may not be comprehensive or up-to-date enough to accurately reflect current climate performance. Another challenge is the perceived difficulty in gathering data from disparate systems and understanding what should be included and what should not be. Not surprisingly, these factors mirror the responses from directors about board involvement.

The extent of the change in corporate mindset is also evident in the findings of the Committee of Sponsoring Organizations of the Treadway Commission (COSO). In March COSO announced the release of a study with supplemental guidance for organizations to achieve effective internal control over sustainability reporting (ICSR), using the globally recognized COSO Internal Control Integrated Framework. The COSO effort responds to its perception of "a sea change in attitudes" since 2017.[3] "With sustainability and ESG reporting now having become a top area of focus for CEOs, senior management, boards, investors, regulators, customers, and other stakeholders, we find that many more companies are now in various stages of implementing controls and governance processes over the collection, review, and reporting of sustainability information, including creating multifunctional teams that bring together a company's sustainability, finance and accounting, risk management, legal, and internal audit professionals." Just as companies following Sarbanes-Oxely Act mandates developed internal control over financial reporting (ICFR) processes, COSO is now seeing the emergence of ICSR.

Concluding Thoughts

It would have been beneficial just to highlight the agenda items faced by businesses as they embrace sustainability. The gap between aspiration and reality underscores that much remains to be done, and the challenges should by no means be underestimated. For so many, though, the clarity that SEC climate-related disclosure rulemaking should bring should be a welcome development across the broad ecosystem that has a stake in sustainability.

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[3] In 2017, COSO conducted interviews for its first paper on sustainability. It found at the time that its "overall sense was that most companies had not yet begun the journey" to embrace ICSR.

That said, it is regrettable that some powerful voices have lost sight of, or never understood, what ESG is intended to do. Simply put, ESG is a proxy for metrics, and in the context of the "E," the myriad initiatives loosely termed ESG are designed to provide a basis to measure the material risks and opportunities associated with climate change. This ultimately is about profitability and shareholder value.

The "ESG" regulatory responses are designed to bring order to the chaos that has resulted from multiple ESG regimes – lawmakers and regulators are, at the end of the day, responding to a range of wholly rational and justifiable demands for a set of comprehensive, consistent, comparable and decision-useful metrics for measuring the risks and opportunities presented by climate change.

The European Union and the United Kingdom have embraced, with relatively little opposition, the imperative of drawing up these metrics. There may be disagreement over details, but the regimes are moving forward. For example, reporting under the EU Corporate Sustainability Reporting Directive (as transposed into national law across the European Union) will (as summarized here) be required beginning in 2025 in respect of 2024 data, and will have tailored extra-territorial effect.

We are about to find out if the United States is able to do the same thing. The mood music on Capitol Hill and in certain state capitals is not promising, as we face a potential legislative backlash against transparency. It is hard to comprehend opposition to transparency, when both the underlying threats and the underlying opportunities are so transformational. Conservative politicians have embraced an anti-ESG movement that flies in the face of the sentiments of institutional investors and other shareholders, as well as other stakeholders, including lenders and insurers.

As highlighted above, that movement also flies in the face of the direction of travel of the business community. Boards are embracing sustainability and companies are embracing climate-related disclosures. Admittedly, there are concerns, particularly around Scope 3 disclosures, but those concerns should not doom, or delay, the entire disclosure regime. Those same concerns surfaced in the European Union, and have been addressed via consultation. Similarly, in the United States, there is a recognized process for airing disclosure-related concerns in the context of corporate disclosure, which is the public comment process that was made available.[4] We should hope that the SEC minimizes the dilution of its rules, and that the business community stands behind the efforts.

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July 31, 2023

[4] A comment letter signed by 72 Republican members of Congress was submitted to the SEC. It was, as these letters go, shall we say, on the light side. Their one comment: rescind the proposed rulemaking.