

Responding to the Effects of Climate Change - Considerations for Public Company Boards

By Mark S. Bergman and Jean Rogers¹

It is becoming increasingly apparent that, given the range of climate crisis-related risks and both the gravity of the concerns and the urgency of mitigating the effects of the climate crisis, the responses to the crisis must be global, and they must be all-encompassing. Public companies have key roles to play, and there is a growing awareness that climate crisis-related risks will not be confined to energy and other companies that have direct exposure to the issues, but rather will affect broad swaths of the corporate landscape across the globe. As Larry Fink noted in his 2021 letter to CEOs,¹

There is no company whose business model won't be profoundly affected by the transition to a net zero economy - one that emits no more carbon dioxide than it removes from the atmosphere by 2050, the scientifically-established threshold necessary to keep global warming well below 2°C. As the transition accelerates, companies with a well-articulated long-term strategy, and a clear plan to address the transition to net zero, will distinguish themselves with their stakeholders - with customers, policymakers, employees and shareholders - by inspiring confidence that they can navigate this global transformation. But companies that are not quickly preparing themselves will see their businesses and valuations suffer, as these same stakeholders lose confidence that those companies can adapt their business models to the dramatic changes that are coming.

It is also becoming apparent that the necessary responses cannot be confined to ESG agendas, but rather should be viewed as impacting a range of corporate risks. As one research report noted, it is less likely that “climate risk will be treated by corporates as a separate risk category. Instead it is likely to be treated as a threat amplifier to existing risks.”²

Ultimately, boards of directors should, as part of their risk oversight responsibilities, consider climate crisis-related risks from a strategic perspective as well as from a disclosure perspective. It is important to bear in mind that, notwithstanding the magnitude of the steps needed to mitigate and adapt to climate change, the necessary initiatives present both opportunities³ as well as costs⁴.

The Risks

There are different ways in which commentators breakdown the climate-related risks that can impact businesses and their corporate strategies. The common elements are physical risks and economic risks, and the need to address (a) the transition/migration to a lower carbon future, on the assumption that policies and behavior lead to a more positive outcome, and (b) the risk of failure if policies and behavior do not shift quickly enough.⁵ As the UN Development Programme noted in its September 2019 report,⁶ while the “report finds many reasons for

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optimism, ... much work remains. It's clear that business as usual simply isn't good enough anymore. We must do more - much more - in areas related to mitigation, adaptation, and the finances to support all of this work. And we must do it quickly."

It is important to note that the landscape is by no means static. For example, while climate change and carbon emissions have tended to dominate the climate agenda, there is a growing focus by investors on the related threat of the loss of biodiversity, and the importance of pricing natural capacity given the ²extent to which the world's gross domestic product output relies on natural resources.

Physical risks. Physical risks encompass the consequences of an increase in both the frequency and the severity of extreme weather conditions that can damage assets, both physical as well as natural. Physical risks also affect humans through loss of life or injury. Physical risks can be triggered, for example, by hurricanes, tornadoes, wildfires, droughts or flooding. Physical risks can also be triggered by long-term shifts in climate, such as changes in precipitation and sustained higher temperatures, leading to retreat of glaciers, rise in sea levels and chronic heatwaves.⁷ In 2020 alone, there were 22 climate-related severe weather events in the United States with losses exceeding \$1 billion. These events included a drought, 13 severe storms, seven tropical cyclones and a wildfire.⁸

These risks disrupt business operations and can affect commercial and residential real estate, transportation, telecommunications and other infrastructure, and assets used throughout the supply chain (from factories to ports). Physical impairment of assets can, of course, indirectly adversely impact the value of other assets.

Financial risks. Closely connected to physical risks are financial or economic risks (also known as transition risks). Financial risks obviously depend on the extent to which the transition/migration to a lower carbon future occurs. The principal financial risk is "stranded assets," which refers to a decline in value of assets physically unimpaired⁹ due to a range of factors, such as changes in laws, regulations, tax regimes, demands/preferences of customers and consumers, technology, and prices of raw materials and other commodities. These same factors can have broader implications as well: regulation can increase the cost of energy, as can competition for minerals used in renewable energy solutions. And of course physical damage to assets - caused either by a specific event or by longer term weather trends - will have significant costs.¹⁰

While the replacement of old products by new products has always been a feature of modern economies, opportunities presented by climate-change driven responses can be far more fundamental. Clean cities can mean changes in where and how people work, where and how people live, the proximity of where people live to where they work, the physical layout of business districts and broader urban areas, with related changes to how people commute and travel more broadly. In short, the design of cities and the transportation and other links between cities are all candidates for transformation.

Financial risks can capture a range of risks flowing from changing expectations not only of consumers and customers, but also of shareholders. And here shareholders can refer to not only shareholders of a company directly impacted by climate-change related risks, but also

² Mark S. Bergman is a former partner of Paul, Weiss, Rifkind, Wharton & Garrison LLP and a founding member of its Climate and ESG Practice Group. And Jean Rogers is the Founder and former Chief Executive Officer of the Sustainability

shareholders of other stakeholders. Shareholder activists and institutional investors can bring pressure to bear on the companies in which they invest, and they can also bring that same pressure to bear on insurance and reinsurance companies in which they invest that, in turn, invest in businesses associated with thermal coal mining or coal power generation or that insure/reinsure such companies.¹¹

The exposure of pension funds to sectors potentially affected by climate change adds another dimension to the issue due to the long-term nature of their investment horizon. Pressure can be in respect of divestment, or in favor of investing in renewable energy sources. Asset managers that are often employed to allocate capital on behalf of pension beneficiaries are now subject to a variety of disclosure obligations in the EU, including the carbon-intensity of their portfolios. This transparency obligation will further catalyze the shift away from investment in carbon intensive industries. Employees are another stakeholder that can also push for climate action to form a more prominent element of strategy or operations. Each of these constituent groups wields power to influence corporate behavior and have been successful in pressuring companies to take climate action more seriously.

Financial (or liability) risks also can arise as a result of liability claims seeking compensation for damages due to climate-change driven events. While the burden may fall on insurance and reinsurance companies (and those who invest in such companies), that burden will be a function of the extent to which the so-called "protection gap" closes. Certain assets and regions are becoming harder and more expensive to insure due to the perils of climate change.¹²

How Corporate Boards Should be Thinking About the Issues

The Global Risk Report 2021 is the 16th edition of the World Economic Forum's annual analysis of perceptions of threats facing the world. The Report lists the following among the top ten risks by likelihood and by impact:

- ***extreme weather events*** (#1 by likelihood and #8 by impact) - major property, infrastructure and/or environmental damage as well as loss of human life caused by extreme weather events;
- ***failure of climate-change mitigation and adaptation*** (#2 by likelihood and by impact) - the failure of governments and businesses to enforce or enact effective measures to mitigate climate change, protect populations and help businesses impacted by climate change to adapt;
- ***human-made environmental damage and disasters*** (#3 by likelihood and #6 by impact) - failure to prevent major human-made damage and disasters, including environmental crime, causing harm to human lives and health, infrastructure, property, economic activity or the environment; and
- ***major biodiversity loss and ecosystem collapse*** (#5 by likelihood and #4 by impact) - major property, infrastructure, and/or environmental damage as well as loss of human life caused by geophysical disasters such as earthquakes, volcanic activity, landslides, tsunamis or geomagnetic storms.

These perceptions of risk are over the next ten years. The 2020 list represented the first time in the WEF's 15-year history that environment-related risks filled the top five slots in terms of likelihood, and in 2021 these risks represented four of the top five, the fifth being infectious

disease. Over the past ten years, environment-related risks represented half of the annual top five, with another four related to climate change.

In a report¹³ submitted to the WEF in 2019, the authors noted that while good governance should include effective climate governance, it is not that simple. Climate change, in fact, is a complex issue that by its nature entails understanding “scientific, macroeconomic and policy uncertainties across broad timescales and beyond board terms. In short, general governance guidance is not necessarily sufficiently detailed or nuanced for effective board governance of climate issues.” In addition, the report noted that climate issues compete at the board and in the c-suite with a range of other pressing issues (including technology and business model disruption, changing global economic conditions and cybersecurity). And that was before the COVID-19 pandemic struck. Moreover, solutions to climate change require embracing long-term solutions to address long-term risks, which can be a challenge for businesses invariably facing pressure to meet investor expectations measured on a quarterly basis.

The WEF report on guiding principles for corporate boards to address effective climate governance¹⁴ sets out the following principles:

Board accountability. Notwithstanding the uncertainties around the impact of climate change on businesses, maintaining resilience in the context of different policy and financial outcomes posed by climate change should be elevated, if it is not already, on boards’ risk oversight agendas. The focus should have both an offensive component (how to capture the opportunities) and a defensive component (how to minimize the impact of the panoply of risks and ensure the short-, medium- and long-term resilience of the enterprise).

Board awareness and understanding. In recent years there has been a greater awareness of the value of diversity on boards. One measure of diversity is the breadth of experience, expertise and perspectives in relevant areas. The potential impact of climate change on a company's business is of necessity one such area. It is up to the board to set the tone for the company and promote greater responsiveness, as well as engagement, by management on the issue. But, to do that, the board needs a level of understanding of the potential impact of climate change on the enterprise, and this is where diversity can play an important role.

Board structure. Boards should embed climate change-related issues in board and committee structures to ensure proper risk oversight of the issues. Boards should consider where lead responsibility for these issues should reside, which, given the breadth of the potential effects, may not at first blush be self-evident. If responsibility is spread across board committees (typically audit, compensation and risk), are the efforts coordinated? Should a new committee or sub-committee be appointed?

Risk management can be compromised by organizational silos. Effective communication about common corporate goals and vision, including responses to climate change-related challenges, and the sharing of resources among business units and departments are likely to be critical to ensuring that the enterprise can respond effectively. Cross-functional training and cooperation across the enterprise can mitigate the inherent tendency to default to silo mentalities that so easily can undermine coherent responses to external threats.

Assessment of the material threats and opportunities. Boards should be mindful that climate change-related business disruptions may occur over a time horizon that is far longer than typical budgeting and reporting cycles. Boards should consider different climate scenarios to

facilitate an understanding of the potential impact under different time horizons and different climate outcomes. Short-term decisions may have profound, long-term implications for resilience, and long-term resilience may require fundamental shifts in business model and strategic direction.

The challenge for boards is to develop a comprehensive understanding of the risks and opportunities across various time horizons, and then focus on what to do about them. The first step of necessity is to assess the materiality of the risks and opportunities.

Management incentives. Boards, as they did following the financial crisis, should re-examine management incentives, this time though through a lens designed to ensure that climate and other sustainability targets are integrated into management incentive arrangements and tied to resilience of the enterprise. At the same time, boards should also consider whether existing compensation arrangements promote conduct that heightens climate-related risks for the enterprise.

Disclosure and other communications. It is important to note that corporate disclosure and the attendant transparency has a variety of drivers. For a range of market participants and other stakeholders, disclosure and its attendant transparency provides a wealth of information about the resilience of the enterprise. Disclosure is also about accountability – to prompt action and achieve sustainable outcomes. Communications on climate-related issues can include:

- external disclosure of how climate change impacts strategic decisions, perhaps as part of the corporate long-term strategy or a standalone sustainability report;
- external risk factor disclosure mandated under applicable securities laws for purposes of reports or offering documents;
- external disclosure of the financial impact of climate change and transition/mitigation efforts;
- external disclosure against voluntary climate-related reporting benchmarks (for example, the recommendations of the Task Force on Climate-related Financial Disclosures, which cover governance, strategy, risk management and metrics/targets);
- shareholder engagement efforts, particularly with institutional investors;
- internal communications to employees on priorities and vision; and
- external communications with other stakeholders, such as suppliers, vendors, lenders and the markets.

Despite efforts over the past decade to encourage public companies to report on the steps they have been taking, and intend to take, to reduce greenhouse gas emissions and their carbon footprint, and the related impact on their financial statements and operations, the quality of disclosure generally does not begin to approach the level contemplated by the TCFD recommendations.

Net Zero commitments

The Paris Agreement is driving climate action by countries and companies. The number of commitments to reach net zero emissions by businesses has roughly doubled in less than a year, as many prioritize climate action in their recovery from Covid-19. Companies with combined revenue of over \$11.4 trillion (equivalent to more than half of the US GDP), are now pursuing net zero emissions by the end of the century,¹⁵ according to the New Climate Institute. In fact, the recent wave of net zero pledges has put the Paris Agreement's 1.5°C within striking distance. Global warming could be as low as 2°C by 2100 assuming carbon neutrality in the United States by 2050, as proposed by President Biden. The UN has launched a Race to Zero campaign advocating for science-based targets and aiming for zero emissions by 2050. Signatories now include 1,101 businesses and 45 of the largest investors.

But who will ensure that these targets are met, if most CEOs and board members will not be around in 2050?¹⁶ Governance will play a critical role in determining which companies invest in climate programs and make a sustained, long-term effort to achieve climate goals, and which ones allow short term earnings pressure to scuttle climate investment necessary to achieve long term goals. How climate commitments will be financed is an important question for any board. Ensuring the company's climate strategy is cost-effective and that adequate resources are allocated to achieve climate targets aligns with a board's fiduciary duty.

A Place to Start

We set out below a set of questions Directors may wish to consider asking as part of their risk oversight efforts. The answers will be relevant to shaping strategy and should equally help think about appropriate corporate disclosure.

Material Threats and Opportunities - Threshold Questions

- What physical and financial risks and opportunities are most material to the business and long-term strategy?
- How material are the risks to the enterprise under different time frames and scenarios of global warming, and what are the probabilities and magnitudes of the impacts?
- How resilient is the overall business model and strategy to the climate change challenges, and which areas of the business and supply chain are most exposed? How is that resilience tested?
- What are the potential implications of current or future regulations?
- Which operations present the most attractive strategic opportunities?
- For each of the foregoing how does the answer differ across different climate scenarios and time horizons?

Enterprise Risk Assessment Processes

- How are climate considerations embedded in the enterprise risk management framework?
- How are climate considerations taken into account in setting budgets and in operational planning?
- How does climate change factor into the assessment of the long-term viability of the industry? Is this assessed across the entire value chain of the enterprise?
- What systems and processes are in place to operationalize the assessments and update annually?

- To what extent are time horizons and different scenarios stress-tested, and how often? Are the assessments constrained by self-imposed temporal limits?
- What materiality analysis has been undertaken in respect of the current and anticipated exposures to climate-related risks and opportunities? The impact of climate change on financial condition and operating performance should be assessed against physical risks, market and technology shifts, changes in policy and laws, investor preferences, stakeholder concerns, and reputational risks
- How vulnerable is the enterprise to interruptions in its supply chain? What contingency plans are there to address supply chain interruptions?
- What would the impact be of stricter limits on emissions, energy consumption or implementation of a carbon pricing mechanism?
- Are sufficient resources being allocated to the separate phases of the effort?

Board Awareness and Understanding

- Is board oversight of climate-change related issues appropriate and effective? Are any of the board committees involved in the review and assessment of climate-related issues? Is the allocation of committee responsibility producing the best oversight outcomes?
- Does the board have the awareness and understanding of potential effects of climate-related issues on the enterprise?
- Where are the gaps in internal knowledge and skills, both at the board level and among members of senior management? Is there awareness that that competition for talent with the requisite experience and expertise will become more pronounced?
- What external advice would be most useful to the board? Are external experts engaged?
- Which management function is taking the lead on forming an integrated view of the risks and the opportunities?
- What information and metrics does the board consider necessary or particularly helpful to properly evaluate relevant climate-related issues, goals and targets? How frequently?
 - How is the information and how are metrics monitored?
 - Is this the appropriate information? How was it identified?
 - Are these the appropriate metrics? How were they identified?
 - How often is the information or are the metrics evaluated?
 - What does the information and what do these metrics suggest in terms of potential impact on the business and operations?
 - How are the metrics integrated into operations and reporting?
 - What assurance processes (internal or external) are applied to the information and metrics?

Management Incentives

- What climate change-related key performance indicators and targets are appropriate and are they embedded in compensation metrics?
- How should performance against targets be measured and monitored given the long-tail nature of the risks and opportunities?

- How are the metrics referred to above integrated into compensation decisions?

Long-Term Climate Commitments

- Are carbon targets and/or climate commitments integrated into long-term strategy and updated on the same cycle?
- Is the timeframe reasonable given the state of technology and resources that can be allocated?
- What are the milestones to achieving net-zero or other targets and how will progress be assessed?
- Has the cost-effectiveness of meeting climate targets been evaluated as part of the implementation plan?
- Have no- to low-cost measures (*e.g.*, conservation, energy efficiency) been exhausted prior to implementation of more expensive measures (*e.g.*, renewable energy, carbon removal technology)?
- Does the strategy maximize actual carbon reduction in the atmosphere, and rely on offsets only as a last resort?
- How will the plan be financed and how will resources be earmarked and allocated for climate programs over decades of sustained effort?

Disclosure and Communications

- Does the enterprise disclose climate-related risks and opportunities? To what audiences? Against what metrics and frameworks is the enterprise reporting?
- To what extent is disclosure of climate risks tied to the financial implications of identified risks? Are risk and finance teams also involved in the disclosure process?
- To what extent is there a process in place to track public commitments on climate and other ESG themes relative to actions actually taken? Are all relevant management functions, including legal, compliance, investor relations, legislative affairs, human resources, sustainability and the c-suite, aligned as between climate-related communications, including commitments, and corporate actions.
- To what extent is management tracking emerging disclosure standards?
- To what extent is management tracking possible changes in applicable accounting frameworks?
- Which disclosure standards and metrics are achieving consensus within the industry or among investors?
- Is assurance obtained for climate-related disclosures to investors? Are internal controls established for data published in a regulatory filing or otherwise made publicly available?

Stakeholder Considerations

- What is the stakeholder landscape in terms of pressure to act on climate change: clients/customers; board/management; regulators; employees; civil society; institutional investors/other shareholders; lenders/insurance providers; competitors.¹⁷
- What is the nature of shareholder engagement on climate issues and how are those interactions integrated into decision-making and investor relations?

Concluding Thoughts

The global business community has multiple roles to play in responding to climate change. This effort is as much about measuring, anticipating and responding to risks, as it is about incorporating analysis into growth strategies. Boards should be at the forefront of the response, and pressure is only likely to increase - from consumers, shareholders, other stakeholders, government policy-makers, securities regulators and the financial markets. To date, most efforts call for voluntary action; however, industry norms and the direction of travel by regulators could well mean mandatory action. Incorporating oversight of climate risks and opportunities into essential board committees and governance processes aligns with fiduciary duty and ensures optimal outcomes for the company and society as the urgency of climate action continues to increase.

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- ¹ Available [here](#).
 - ² *Citi Global Perspectives & Solutions*, Managing the Financial Risks of Climate Change” (October 2019), citing Lawrence Hababbeh, “Avoiding climate chaos” (*The Actuary*, 6 June 2019)(available [here](#)). See also Climate Risk Financial Forum, “Climate Risk Financial Forum Guide 2020 – Risk Management Chapter” (June 2020) (available [here](#))
 - ³ A 2018 report by the Global Commission on the Economy and Climate entitled “*Unlocking the Inclusive Growth Story of the 21st Century*” (available [here](#)), estimates that climate change adaptation and mitigation could generate investment opportunities between 2018 and 2030 of up to \$26 trillion. See also CDP, Major risk or rosy opportunity – Are companies ready for climate change (available [here](#)); Morgan Stanley, “Risks and Opportunities of Climate Change” (February 2021) (available [here](#)).
 - ⁴ In 2018, the Economist Intelligence Unit, in a report entitled “The Cost of Inaction: Recognizing the Value at Risk from Climate Change” (available [here](#)), concluded “The potential impact of climate-related change on the assets owned and managed by institutional investors is significant. Our estimates indicate that asset managers can expect present-day losses of US\$4.2trn to the US\$143trn of current manageable assets as a result of climate change by 2100 at a private-sector discount rate, equivalent to the entire GDP of Japan. It is important to recognize that this is not a risk of volatility or temporary price movements but of permanent impairments and capital losses. Perhaps more seriously, the expected losses would more than triple (US\$13.8trn) should global warming reach 6°C. Few institutional investors have addressed this risk to date; only a modest minority are even able to measure the carbon footprint of their own portfolios. ... Climate risks need to be assessed, disclosed and, where feasible, mitigated.”
 - ⁵ See, generally, Financial Stability Board, “The Implications of Climate Change for Financial Stability” (November 2020) (available [here](#)).
 - ⁶ United Nations Development Programme, “The Heat is On: Taking Stock of Global Climate Ambition” (available [here](#)). See also World Economic Forum, “The heat is on businesses to respond to climate change” (15 January 2020) (available [here](#))
 - ⁷ See, e.g., *New York Times*, “How Scientists Got Climate Change So Wrong” (available [here](#)). The Intergovernmental Panel on Climate Change reported in 2018 (available [here](#)) that “a number of climate change impacts could be avoided by limiting global warming to 1.5°C compared to 2°C, or more. The report finds that limiting global warming to 1.5°C would require “rapid and far-reaching” transitions in land, energy, industry, buildings, transport, and cities. Global net human-caused emissions of carbon dioxide (CO₂) would need to fall by about 45 percent from 2010 levels

by 2030, reaching ‘net zero’ around 2050. This means that any remaining emissions would need to be balanced by removing CO₂ from the air.” *See also* S&P Global, “The Big Picture on Climate Risk” (2020) (available [here](#))

- ⁸ See NOAA National Centers for Environmental information, Climate at a Glance: Global Times Series, published September 2020 (available [here](#)).
- ⁹ Stranded assets are defined as assets that have suffered from unanticipated or pre-mature write-downs, devaluations or conversion to liabilities and can also refer to an asset that has become obsolete or non-performing.
- ¹⁰ According to a 2019 report issued by CDP (formerly, the Carbon Disclosure Project, an NGO that supports companies and cities in the disclosure of environmental impact) entitled “Major Risk or Rosy Opportunity: Are companies ready for climate change?” (available [here](#)), in an analysis of 500 of the world’s largest companies (by market capitalization), where 215 companies provided estimates of the financial implications for a portion of their reported risks, just under one trillion dollars is at risk – over half of which are likely/very likely/virtually certain, and will materialize in less than five years. The top four reported drivers were increased operating costs (such as compliance costs and insurance premiums); write-off or early retirement of assets due to damage or location in high risk areas; reduced demand of goods/services due to shifts in consumer preferences; and changes in policy leading to asset write-offs, asset impairment and early retirement.

Approximately \$250 billion is attributed to stranded assets, as a result of both transition/migration risks and physical risks. The majority of companies that identified these risk as relevant to them indicated that both had an impact, while the balance indicated that either one or the other was relevant. A high proportion of companies in the apparel, food, beverage, agriculture and infrastructure sectors identified only physical risks, while a high proportion in the fossil fuel and materials sectors identified only transition risk. The top physical risks identified were increased severity of extreme weather; changes to precipitation and weather patterns; and rising mean temperatures. The top transition risks increasing pricing of greenhouse gas emissions; mandates on and regulation of existing products and services; enhanced emissions-reporting obligations; and changing customer behavior.

- ¹¹ A growing number of insurance and reinsurance companies have announced incorporating sustainability goals in their investment and underwriting policies. *See* The Geneva Association, “Climate Change and the Insurance Industry: Taking Action as Risk Managers and Investors Perspectives from C-level executives in the insurance industry” (January 2018) (available [here](#)). *See also* “Insuring Coal No More: the 2018 Scorecard on Insurance, Coal and Climate Change (December 2018) (available [here](#)); BCG, “Insurers Take Up the Climate Fight” (19 August 2020) (available [here](#)).
- ¹² *See* S&P Global Market Intelligence, Certain perils becoming pricier, harder to cover as climate risks grow (January 2020) (available [here](#)).
- ¹³ *See* World Economic Forum, “How should corporate boards respond to climate change?” (January 2019) ([available here](#)); International Corporate Governance Network, “The Board of Directors & Climate Change” (July 2020) (available [here](#)); National Association of Corporate Directors and Marsh McLennan, Climate Change – Implications for Boards (Article Series 2020) (available [here](#)).
- ¹⁴ World Economic Forum, “How to Set Up Effective Climate Governance on Corporate Boards – Guiding principles and questions (January 2019) (available [here](#)).

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- ¹⁵ See Climate Action Tracker (available [here](#)). While 2050 net zero targets are commendable, governments must now adopt stronger 2030 targets (nationally determined contributions or NDCs) to deliver on their net zero goals, and close the remaining emissions gap to 1.5°C.
- ¹⁶ See Andrew Edgecliffe-Johnson, “Climate plans for big companies need substance” (March 2021)(available [here](#)).
- ¹⁷ See, e.g., Deloitte Insights, “Feeling the Heat? Companies are under pressure to act on climate change and need to do more” (2019) (available [here](#)).