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Strategy and Operational Alignment are Interdependent Variables for Successful Compliance and ESG Performance

By Suz Mac Cormac

The results from our annual benchmarking survey are in. As we learned from the survey last year, it is heartening that in-house legal departments are increasingly becoming integral to—and often leading—corporate ESG initiatives. Our 2023 survey confirms that this trend has continued and is accelerating. However, I find it surprising that many lawyers, in-house and external counsel alike, do not understand the history of ESG. Understanding the genesis of ESG and how it has evolved is critical to the development of an ESG legal program that goes beyond compliance to see around corners and advance compliance, operational, and strategic goals.

A Little History

ESG is not "new" and has never been disconnected from the financial value of corporations. As a term, ESG was first used in 2004 in the United Nation's Global Compact Initiative's Who Cares Wins Report. Such report represented the culmination of efforts by major financial institutions and the International Finance Corporation's inquiry into the efficacy of certain environmental, social, and governance considerations in investments, which considerations were not reflected in a corporation's financial statements. The report, endorsed by 18 financial institutions from 9 countries with over $6 trillion in assets under management concluded that companies that perform better on certain ESG metrics could increase shareholder value and deliver better risk-adjusted financial returns by managing risks, anticipating regulatory action, or accessing new markets, while contributing to sustainable development of the societies in which they operate. The report highlighted ESG factors that could impact valuation, including climate change and related risks, human rights practices, executive compensation, and monitoring of corruption and bribery issues. Following this report, corporations accelerated the adoption of ESG policies, often blending them into existing corporate social responsibility (CSR) initiatives, thereby expanding ESG to include issues relevant to both stockholders and stakeholders following the Global Reporting Initiative (GRI) framework that had been introduced a few years earlier.

So, what does this mean for in-house counsel? It explains why ESG has a strong compliance component; there has been a sea of new government regulation adopted over the past two decades related to anti-corruption and bribery, privacy, sanctions, cybersecurity, and human rights, to name a few. And more regulation is expected, particularly in the areas of human rights, cybersecurity, and climate. However, it also means that there are many ESG factors that are not tied to compliance but instead touch on critical areas of focus for corporate strategy, operations, enterprise risk management, supply chain management, financial controls, and reporting.

Finally, because in many cases ESG was blended with CSR, there are also elements of ESG that may be "nice to have" but are actually not material to the financial performance or operations of a corporation. Typically, addressing this component of ESG goes a long way to mitigating some of the anti-ESG sentiment that exists in many jurisdictions in which corporations are operating in the United States

Trends and Developments

Back to the report. ESG is clearly now on the radar of every in-house legal department. Much of this is because of the rise in regulation of corporate action and disclosure. Compliance is increasingly shifting to cover overall operations with regulations driving accountability and disclosure on operational matters such as anti-slavery (e.g., the UK's Modern Slavery Act and the U.S. Uyghur Forced Labor Prevention Act, among others). ESG is also being driven by broad ESG reporting requirements that are moving from voluntary (following the Sustainability Accounting Standards Board now part of International Sustainability Standards Board) to mandatory. Even ahead of rules that are (eventually) expected to be published by the Securities and Exchange Commission, the European Union's Corporate Sustainability Reporting Directive (CSRD) will require measurement, benchmarking, and reporting (together with greater governance and internal controls) by most U.S. companies—companies meeting a particular revenue threshold, subsidiaries of covered U.S. companies, and, ultimately, companies not specifically covered by regulation that are counterparties of covered companies. The debate over whether or not to require reporting on Scope 3 in the United States is essentially moot.

Some of the increased focus of legal departments is driven by management teams that see the strategic value in establishing a leadership role around ESG—and the need to mitigate risks to operations (like climate risk) that were not as clear decades ago. Some of the attention is also the result of increasing scrutiny from stockholders and stakeholders, including consumers and regulators, forcing companies to pay closer attention to their actions and communications to mitigate risks from marketing and other strategies that embody greenwashing, greenrinsing,[1] greencrowding,[2] greenshifting,[3] and greenlighting,[4] to mention a few.

Room for Growth

As corporations navigate this economically significant year full of market gyrations, legal departments are encouraged to collaborate with all other departments and leadership across their organizations to ensure that ESG compliance and alignment are integrated into strategic decision-making as companies navigate risk management, compliance, and internal ESG innovations. ESG, if well pursued as a framework, should form part of a company's anatomy; blending overall strategy with material ESG considerations will deliver cost-effective and resilient results as posited by the group of institutional investors 20 years ago in the United Nations report.

We also hope to see more private companies and even start-ups rethink what ESG means for their organizations. Given the survey results, smaller companies and private companies (especially private companies looking to go public) are encouraged to consider what ESG factors are material to their operations to enable them to attract investors, achieve greater valuations and profitability as they grow, scale, and possibly contribute to a better world as a result.

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[1] Changing ESG targets before they are achieved.

[2] Greencrowding involves moving at a slow speed and hiding in a crowd to avoid discovery by relying on safety in numbers, for example, hiding in the crowd to adopt sustainability strategies slowly (e.g., hiding in industry groups without taking quick and meaningful actions).

[3] Shifting blames and implying that consumers, not the company, are responsible for ESG actions.

[4] Spotlighting a miniature green activity to draw attention away from environmentally damaging activities being conducted elsewhere.

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