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Skadden Discusses ESG in 2022 and Predictions for 2023

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Comment

Following another year of increasing focus on environmental, social and governance (ESG) considerations by companies, investors and regulators alike, ESG appears to have cemented its position in the corporate landscape. As set out in our 28 July 2022 client alert "H1 2022 — ESG Trends and Expectations", although the invasion of the Ukraine highlighted the need to accelerate the green energy transition, the unforeseen event did not slow progress on a number of other key ESG themes.

In this article, we examine the key ESG topics impacting businesses in the second half of 2022, which included the green energy transition, the performance of ESG funds, the role of ESG matters in disputes and the ongoing development of the ESG legislative and regulatory landscape in the U.K., the U.S. and Europe. We also identify key topics to track in 2023: the interplay of ESG matters and competition law, the continuing importance of executive remuneration and the possibility of a decrease in interest in ESG matters.

Reflecting on 2022

Rise in Sustainability Advice[1]

As predicted in our July 2022 article, companies are increasingly seeking advice and consulting services to meet their ESG obligations and improve their ESG credentials. Given the rapidly changing legal and regulatory landscape, companies are looking to law firms, consulting firms and other service providers to assist them in gathering data and producing reports to satisfy disclosure requirements arising from new regulations or investor demand for greater transparency in relation to their ESG policies and objectives. A report by research firm Verdantix forecasts that investment in ESG and sustainability consulting will reach $16 billion by 2027. With the continuing introduction of new legislation, the growth of this market is not expected to slow in 2023.

In addition to seeking advice externally, general counsels increasingly find themselves included in a wide variety of ESG discussions across their internal teams to address, for example, cybersecurity, work-from-home policies and more "social" concerns such as vaccine mandates and diversity, equity and inclusion (DEI) initiatives. In 2023, companies will continue to build these capabilities in-house to successfully integrate handling of ESG concerns throughout the business.

COP27 and COP15[2]

On 20 November 2022, the Conference of the Parties 27 (COP27) ended after two weeks of intense negotiation of international climate action. The meeting produced some historic agreements on climate-related funding; however, it fell short in advancing global mitigation commitments and fossil fuel reductions.

At COP27, the nearly 200 countries assembled agreed to launch a fund to cover the loss and damage that particularly vulnerable nations are suffering from droughts, floods, rising seas and other acute and chronic impacts of climate change. The new fund structure will be established by the next annual summit in 2023. However, despite the agreement reached at COP26 on the tapering of coal use, the COP27 agreement did not significantly increase commitments and pledges to reduce the use of coal.

Though COP27 did not set any new firm targets, the private sector has long been aware of the goal to halve emissions by 2030 and reach net zero emissions by 2050. The COP27 agreement did highlight the importance of private sector accountability and action and launched the new International

Organization for Standardization Net Zero Guidelines (Net Zero Guidelines). These guidelines provide companies with guidance on how to set and meet climate targets that are authentic, measurable and will withstand charges of greenwashing. The Net Zero Guidelines note that companies should complement long-term net-zero targets with interim objectives, and that companies can only claim to reach net zero emissions after they have taken all possible actions to reduce carbon emissions.

Following COP27, the UN Biodiversity Conference (Fifteenth Meeting of the Conference of the Parties (COP15)) took place in December 2022 and culminated in the Kunming-Montreal Global Biodiversity Framework (the GBF). The GBF aims to address biodiversity loss, restore ecosystems and protect indigenous rights and includes a commitment to, by 2030, conserve at least 30% of the planet's lands and oceans and to establish effective restoration programmes for at least 30% of currently degraded land and ocean ecosystems. However, the GBF is not legally binding and does not set country-specific targets. It has been criticised for not including stronger language about halting extinction or using concrete language in setting targets.

Institutional investors have shown growing interest over the past few years in natural capital finance, which involves the conservation of nature and biodiversity and is still an emerging subsection of green finance. The area is now the fastest developing ESG theme in global capital markets, according to the Association for Financial Markets in Europe (AFME). AFME identifies debt products as the most common form of natural capital finance, and the instruments share similar characteristics with other green finance debt products. In particular, AFME highlights natural climate solutions (NCS), which include conservation, restoration and land management initiatives that increase carbon storage and avoid greenhouse gas emissions, as an effective but underfunded means of mitigating climate change. AFME estimates that NCS currently attracts only 2-3% of public climate financing being invested in climate-related projects provided by governments, philanthropy and public development institutions. This leaves a large space for private finance to invest in NCS, which is one area in which increased activity is expected in 2023.

Green Energy Transition Following the Invasion of Ukraine[3]

In our H1 2022 article, we considered the initial impact of the war in Ukraine on the ESG movement in the first six months of 2022. Our analysis focused on the global need to decrease reliance on Russian oil and gas and to accelerate the transition to green energy. Six months later, the impact of soaring energy prices and risk of energy blackouts in winter are among the many challenges countries face in achieving these goals. Further complicating the transition is the need to balance the opinions and recommendations of the numerous stakeholders involved in the transition process, with financial institutions increasingly adopting cautious approaches to their ESG commitments due to the dual concerns of fiduciary duties owed to their investors and rising anti-ESG sentiments from certain sectors.

European nations shifted focus from climate change-related discussions to energy security as they looked to curb rising gas prices and reduce energy poverty during the winter months, leading to short-term responses including an increased use of coal and the search for local or other imported sources of natural gas. Further, the EU has struggled to reach consensus on energy policies among member states, with southern and eastern European states being more vulnerable to cost increases than the richer, northern nations that have more resources to commit to the transition to green energy. For example, in October 2022, following efforts from Poland to protect its use of coal, the EU agreed to delay updating its Nationally Determined Contributions toward its target to cut emissions under the 2015 Paris Agreement. In the U.K., the government has drawn criticism for its approval of a number of new projects that appear to contradict its green energy commitments. For example, in October 2022, despite criticism from climate protection campaigners, the North Sea Transition Authority overturned a "climate compatibility" review by the U.K. government to open a new licensing round to award more than 100 licences to oil and gas companies looking to extract fossil fuels in the North Sea. In December 2022, the U.K. government also granted approval to operate a coal mine in Britain for the first time in 30 years, defending its decision on the basis that the mine would provide coking coal for the steel industry that would otherwise need to be imported (rather than provide coal for burning in power stations). However, the former chief executive of British Steel, Ron Deelan, has stated that the mine is "completely unnecessary" because enough coal is available on the free market, and that investment in greener sources such as electric arc furnaces and hydrogen would be more beneficial for the energy industry.

ESG in the US

In the U.S., ESG matters have continued to become highly politicised, as some officials have found that attacks on "woke capitalism" generate traction. For example, some state officials banned the consideration of social or political interests when making investment decisions for state pension funds or have redirected state funds away from large asset managers because these officials claim the companies are prioritising political and social agendas over duties to clients. Recently, 21 state attorneys general sent a letter to proxy advisory firms Institutional Shareholder Services (ISS) and Glass Lewis asserting that these firms may be violating their contracts with the states' investment vehicles and federal and state laws by adopting voting policies and making voting recommendations that take into consideration climate change and DEI matters.

With the Republican party now holding a slim majority in the U.S. House of Representatives, the party is expected to hold committee hearings further criticising ESG efforts by companies, asset managers, proxy advisory firms, the Securities and Exchange Commission (SEC) and others.

Underperformance of ESG Funds[4]

For the first time in five years, ESG funds are set to underperform their non-ESG counterparts. Given the industry's exposure to the technology sector, the ongoing war in Ukraine and the broader economic climate characterised by soaring inflation and interest rates, ESG funds have become vulnerable to investors prioritising their need for financial returns and portfolio performance above their environmental concerns. Based on Refining Lipper data, in 2022, ESG funds experienced an 18% loss, compared to a 15.8% loss in non-ESG equity funds; and only 31% of actively managed ESG equity funds had surpassed their targets in the first half of 2022, compared to 41% of non-ESG funds.

In contrast to the significant investment in ESG funds throughout the pandemic era, 2022 also saw a withdrawal of $13.2 billion from ESG stock, bond and mixed-asset funds — the first net outflows in a decade. Political backlash against ESG strategies in some U.S. states, as discussed above, compounded the effect of these withdrawals.

Despite the underperformance of ESG funds and the political battles faced by asset managers, interest in this sector remains high. Although ESG funds may continue to experience difficulties in 2023, there is a general consensus that in light of increased environmental and energy security concerns, the demand for new ESG products will continue to outweigh supply. Institutional investors in particular are eager for asset managers to embed ESG matters more deeply into their investment decision-making processes.

ESG and Disputes

While climate litigation has grown significantly over the past decade, 2022 featured some particularly ambitious environmental claims.

Globally, climate litigation most commonly targeted energy companies, with proceedings including threats of litigation for underreporting carbon emissions and, for U.K. companies, derivative claims by activist shareholders. This latter development has placed further pressures on U.K. company directors across industries to both incorporate environmental concerns within the exercise of their duties to promote the success of their companies and to carefully consider the realistic prospects of their climate pledges. These developments ultimately may be counterproductive, making companies more hesitant to publicise climate change targets that may later require justification regarding performance. Another example of ambitious environmental litigation is a potential class action against U.K. water companies alleging that the treatment of sewage discharge appears to be linked to anticompetitive overcharges.

Public bodies have also been under heightened scrutiny. In July 2022, two environmental NGOs succeeded in their judicial review case of the U.K. government's Net Zero Strategy.[5] As a result, the U.K. government is required to republish its Net Zero Strategy by March 2023, providing more information about how the government proposes to achieve the net zero emissions target under the Climate Change Act 2008. Also, at the end of 2022, the Austrian government joined environmental organisations in the legal battle against the European Commission for its labelling of gas and nuclear power as "green" in its EU Taxonomy framework. Challenges to governments and regulators may increase in 2023 given the growing scrutiny of greenwashing and the rising demand for clear, transparent and achievable targets.

Furthermore, now that ESG matters are considered real and important factors when evaluating a business, environmental concerns are emerging in damages calculations. In particular, the environmental assets and liabilities of a company may become increasingly relevant when considering the forward-looking valuation of a company.

The Growing Legislative and Regulatory Landscape of ESG

As set out in our H1 2022 article, a wide range of ESG-related rules and regulations across the globe occurred during the first half of last year, and this trend continued into H2 2022.

ESG and Sustainability Disclosure[6]

In the U.S., disclosing ESG and sustainability information remains a voluntary practice, undertaken by many companies in response to calls from investors and other stakeholders. The SEC, however, has an ambitious agenda to establish mandatory reporting requirements. The agency has previously proposed for public comment an extensive and prescriptive set of requirements relating to climate change disclosure and indicated its hope to approve final rules by April 2023. The SEC has also indicated that in the coming months it may propose for public comment new disclosure requirements relating to human capital management and corporate board diversity. Whether the Republican-controlled U.S. House of Representatives will have any impact on the SEC's upcoming agenda remains to be seen.

Meanwhile Europe introduced a number of important pieces of ESG legislation, as well as the proposal of the groundbreaking "carbon border tax".

A decade after the "Women on Boards" Directive was first proposed, the European Commission adopted the directive in November 2022. It aims to improve the gender balance on the boards of listed companies and requires that at least 40% of nonexecutive director positions or 33% of all director positions on a listed company's board are held by members of the underrepresented sex by 30 June 2026. Each listed company must also set individual quantitative objectives to improve the gender balance of its executive directors. Member states will be responsible for introducing persuasive and proportionate penalties for companies that fail to meet these targets. A 2021 study reported that only 30.6% of board members in the EU's largest listed companies are women, with considerable disparity in percentages among member states. As a result, some have queried the viability of the directive.

In December 2022, the European Commission's long-awaited Corporate Sustainability Reporting Directive (the CSRD), also came into force. The CSRD will apply to both EU and certain non-EU companies, with a phased introduction. Building on the EU's Non-Financial Reporting Directive, the CSRD extends the scope of reporting for companies and specifies both the disclosure format and standards that companies must use. (See our 9 January 2023 client alert "Q&A: The EU Corporate Sustainability Reporting Directive" for further information on which companies the CSRD will apply to and a discussion of the implications for subject companies.)

Also in December 2022, the European Council and European Parliament reached a political agreement on the implementation of a Carbon Border Adjustment Mechanism (CBAM), also known as the carbon border tax. The policy targets perceived "carbon leakage" — the moving of carbon-intensive production outside of the EU to countries that have less comprehensive climate policies and/or the import of more carbon-intensive products to replace products produced in the EU. The CBAM will add a cost on embedded carbon emissions generated in the production of certain imports into the EU, examples of which include cement, iron, fertilisers and hydrogen.

The scheme will be introduced during a transitional phase beginning in October 2023, during which importers will be required to report carbon emissions (but not yet pay the tax). The permanent system will start to be phased in during 2026. The CBAM has been praised as a global first in policy, although some have criticised the policy as incompatible with World Trade Organization rules or argued that the CBAM should not impose additional costs on developing countries without using those funds for climate finance in those countries.

Although no new major legislation was adopted in the U.K. in the second part of 2022, the Financial Conduct Authority (FCA) has continued to advance its proposed ESG sourcebook through consultations and guidance.

Following the introduction of new climate-related financial disclosure rules for premium listed companies, the FCA published a summary of its findings from the first annual reports that complied with these rules in December 2022. Though the FCA was encouraged by the content of these reports, it also highlighted some areas for improvement. Importantly, the FCA urged companies to ensure that any net zero emissions commitments are clear, warning that some of these commitments have been vague and "in some cases risked being misleading as a result".

In recognition of the difficulties companies face in preparing information for their climate transition plans, in April 2022 the U.K. chancellor established the Transition Plan Taskforce (the TPT) to aid the private sector in establishing these plans. The TPT is currently consulting on its proposed disclosure framework and implementation guidance with the aim that these documents will help entities disclose credible, useful and consistent transition plans. The consultation will close in February 2023 and the FCA intends to build on the TPT's framework to strengthen disclosure rules for listed companies and financial firms. Companies should therefore be particularly cautious when presenting their transition plans and net zero emissions commitments in their 2022 annual reports and consider reviewing the TPT framework and guidance currently available.

Preventing Greenwashing[7]

The FCA also published its consultation on sustainability disclosure requirements and investment labels in October 2022. CP22/20 includes an anti-greenwashing rule that would apply to all FCA-regulated firms and require them to ensure that the naming and marketing of financial products and services in the U.K. is clear, fair, not misleading and consistent with the naming and marketing of the relevant product or service elsewhere. The FCA is also proposing the introduction of a classification and labelling regime for sustainable investment products, which would apply to financial products manufactured or marketed in the U.K. How these rules will affect overseas firms and products is not yet clear. Authorities envisage that the rules relating to the labelling, naming and disclosure requirements will become effective by 30 June 2024.

Other agencies have also continued to escalate actions against greenwashing. In the U.K., both the Competition and Markets Authority (CMA) and the Advertising Standards Authority launched a number of investigations into greenwashing in 2022, and further action is expected this year. The European Commission has also proposed a new directive intended to ban various greenwashing practices. The prevention of greenwashing will continue to be a key theme in 2023, and regulators will need to contend with possible divergence of global measures as different jurisdictions adopt different measures.

Incoming Regulation and Legislation[8]

Even after robust regulatory development in 2022, ESG will remain a priority in 2023, with investors, employees and other stakeholders continuing to call for climate change and diversity policies and disclosures. (See our 13 December 2022 client alert, "ESG Momentum Remains Strong but May Face Headwinds in 2023".)

One area in which both regulators and investors seek improvement in 2023 is in the quality and presentation of ESG data. In September 2022, the FCA published a "Dear CEO" letter specifically addressing its strategy for supervising benchmark administrators. The letter states that to address concerns about the subjective nature of ESG factors, companies need to provide more information about how they put together ESG benchmarks. Given the increasing demand for such information, practitioners in the U.S. and Europe have raised similar concerns about the need to standardise and detail ESG data.

From a company perspective, the International Sustainability Standards Board (the ISSB) continued to draft a new comprehensive set of sustainability-related disclosure standards in 2022: The ISSB intends for these to meet investor demand for high-quality, transparent, reliable and comparable reporting from companies on ESG matters. The board has said that it may be able to publish the final form of standards in early 2023. Publication of these standards will have far-reaching implications across the globe as regulators look to minimise the divergences between jurisdictions and aid companies in meeting investor expectations. As a result, 2023 could see the proposal of amendments to existing ESG legislation to incorporate the ISSB standards.

What to Watch For in 2023

ESG and Competition Law[9]

The tension between antitrust laws and ESG objectives continued throughout 2022 and the debate about whether industry-wide initiatives to address ESG concerns constitute a breach of antitrust rules will persist in 2023. A growing number of competition authorities, particularly in Europe, have in recent years taken steps to encourage private sector collaborations that pursue legitimate sustainability objectives. For example:

- The Dutch competition authority was among the first to adopt draft guidance to help businesses self-assess whether their sustainability initiatives may violate antitrust laws and has proactively published its opinions that apply these guidelines.
- Austria amended its antitrust laws to include a sustainability-related exemption, and the Austrian competition authority adopted final guidelines on how it intends to apply this new provision.
- The Greek competition authority set up a "sandbox" to evaluate proposed sustainable business solutions.
- Antitrust laws in some jurisdictions, such as Australia, already permit the competition authority to authorise certain competitor collaborations that are in the public interest, and the Australian authority has granted authorisations for sustainability measures in a number of cases.

In contrast, the U.S. has signalled a more sceptical approach to sustainability collaborations within markets. Five Republican U.S. senators wrote to law firms in November 2022, reminding them to "fully inform clients of the risks they incur by participating in climate cartels and other ill-advised ESG schemes", and some state attorneys general have launched antitrust investigations into ESG initiatives.

The lack of a consistent global approach has led to calls for competition authorities to provide more practical help to businesses seeking to cooperate with their competitors to meet sustainability targets. In November 2022, the International Chamber of Commerce published (and presented at COP27) a white paper that called on governments and competition authorities "to do everything possible within their own legal systems to reduce or eliminate the disastrous inconsistency between the imperative of fighting climate change and competition law or policy". One example cited in the white paper is the organisation Glasgow Financial Alliance for Net Zero, which reportedly abandoned the requirement that member organisations enroll in the UN's Race to Zero initiative in late 2022 because of antitrust concerns.

In 2023, practitioners hope that additional antitrust guidance on collaborative ESG initiatives will provide businesses with greater clarity. The Japan Fair Trade Commission released its draft antitrust guidelines on environmental sustainability-related business conduct on 13 January 2023 and the EU's revised guidelines on cooperation agreements between competitors, which now include a specific section on sustainability agreements, are due to come into force by mid-2023. In the U.K., the CMA is preparing to publish more detailed sustainability guidance for consultation in early 2023. However, the potential for authorities to take divergent views on the legality of ESG initiatives may result in companies continuing to take a cautious approach to those initiatives, particularly on cross-border ESG projects.

ESG Activism and Executive Remuneration in the UK

U.K. listed companies and their remuneration committees continue to face scrutiny from investors, the public and politicians regarding executive pay practices, reflecting the ongoing tension between demands for moderation in executive pay (which focus on the perceived gap between the executive and employee/wider stakeholder experiences) and the business need to effectively incentivise executives and senior management (particularly after several years of restraint during challenging times for businesses and management). While the COVID pandemic is no longer dominating headlines, the Investment Association (IA) specifically notes in its recently released 2023 Principles of Remuneration that remuneration committees should be mindful of the current cost-of-living crisis, the inflationary environment and continuing economic uncertainty in determining 2022 pay outcomes and in setting 2023 remuneration policy.

A priority for investors is how companies are using incentive arrangements to support their ESG strategy, with previously divergent investor group expectations starting to converge. The IA notes that companies are increasingly incorporating the management of material ESG risks and opportunities into their long-term strategies, and therefore remuneration committees should consider the extent to which these goals should be reflected as performance metrics in variable remuneration. According to its 2023 U.K. Principles on Executive Pay, Legal & General Investment Management (LGIM) expects companies to incorporate managing ESG matters into the strategy of the business, and where companies are exposed to high levels of ESG risk, to establish relevant targets that are meaningful, measurable and aligned with the company's strategy, with environmental and social targets subject to third-party verification. Further, LGIM recommends companies within sectors that have significant effects on climate change link a portion of executive pay to delivering the companies' climate change mitigation goals, and link environmental targets to approved plans by the Science Based Targets initiative (SBTi) to achieve net zero emissions by 2050 at the latest. Companies should design these targets not only to improve revenue, but also to positively impact the environment. Starting in 2025, LGIM will expect to see climate-related targets in long-term incentive plans (LTIPs) for companies in certain sectors before the firm will support a new remuneration policy, with the targets (ideally SBTi approved) serving stated transition goals to accomplish net zero emissions across the value chain. The weighting for delivering climate-related targets should represent at least 20% of the overall LTIP award or, for restricted share plans, companies should specifically link one underpin to achieving carbon reduction targets. Glass Lewis has set out that, where environmental and social targets are not explicitly included as targets in incentive plans, it expects a company to provide additional disclosure explaining how the company's compensation strategy is aligned with its sustainability strategy.

In the past, ESG targets may have been considered easier to achieve than financial targets. Investor guidance is increasingly clear that ESG metrics should set suitably stretching goals and should not be used to reward business-as-usual activity. The IA notes that ESG performance conditions should be quantifiable, explainable and clearly linked to a company's overarching sustainability goals. Remuneration committees should also be able to explain how progress is measured and how performance will be disclosed. The Financial Reporting Council in its 2022 Review of Governance Reporting (FRC Report) emphasises that, as companies do with any other performance metric, they should clearly link ESG measures to strategy, explain the weighting of ESG metrics and report the degree to which the related targets are achieved, and detail how the achievement links to granted awards. Companies are likely to receive increasing pressure for remuneration committees to take focused and specific action to use relevant ESG metrics in performance awards.

End of the Rise and Rise of ESG?

Given the backlash to ESG considerations seen in some U.S. states toward the end of 2022 and the uncertain economic outlook for the coming year, some believe that the "ESG bubble" may burst in 2023 as companies and institutional investors focus on investor returns over ESG policies. However, this seems unlikely from our perspective given the ongoing focus on ESG and in particular sustainability by governments, consumers and activists who show no sign of waning interest. Our H1 2023 article later this year will assess how ESG considerations are positioned on board agendas in the first six months of the year.

ENDNOTES

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This post comes to us from Skadden, Arps, Slate, Meagher & Flom LLP. It is based on the firm's memorandum, "ESG in 2022 and Predictions for 2023," dated February 1, 2023, and available here.