BRC
BOARD RISK COMMITTEE
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The Climate of Contradiction

Simple Steps for Boards to Successfully Navigate ESG Issues During the Current Election Cycle

By Gary S. Roboff

On its face, the summer of 2023 is turning out to be a season of massive ESG (Environmental, Social and Governance) contradictions as climate issues in particular loom large and anti-ESG efforts simultaneously accelerate.

U.S. businesses seem to be at a tipping point. The coming months leading up to the November 2024 elections (and, of course, those election results) will determine how effectively companies in the United States can address a rapidly evolving set of critical sustainability challenges and maintain or accelerate the progress of recent years.

In this climate of contradiction, board directors also face varying headlines potentially muddying their strategic oversight. The politization of climate data has made directors' work more of a challenge. For example, just last week the *Wall Street Journal* ran an opinion piece titled "Climate Change Hasn't Set the World on Fire; It turns out the percentage of the globe that burns each year has been declining since 2001" [1]. Unfortunately, that piece was based on what scientists have concluded was bad data; in fact, the National Interagency Fire Center data on which the *Journal* opinion piece was based was officially withdrawn long before the article was published [2].

Directors, as always, must survey the landscape and serve as a bellwether for the enterprise. This report will examine today's ESG landscape with the aim of providing directors useful context for improved navigational clarity.

Anti-ESG simmers; Wildfires Spread; Boardrooms Heat Up

On July 10th, the National Association of Manufacturers (representing 14,000 companies) asked the House of Representatives to rein in SEC efforts to require public companies to disclose climate metrics increasingly common in other parts of the world [3]. On July 6th, Reuters reported that ESG equity funds suffered a "large loss of investors in the second quarter, triggered by economic and regulatory worries in Europe and an anti-ESG backlash in the United States." [4]

To date this year Republicans have proposed more than 165 pieces of legislation in 37 states designed to counter ESG investment practices [5]. In a May 2023 letter, 23 state Attorneys General accused the Net Zero Insurance Alliance, a UN convened membership organization, of illegally collaborating to advance an activist climate agenda to the detriment of residents in their states [6] part of an ongoing effort that is now stifling

independent efforts to price climate risk, harming policy owners and local economies [7].

And yet, this summer has seen some of the warmest days globally in 125,000 years [8] and July has been widely branded the hottest month, globally, on record. Catastrophic floods hit parts of Vermont and New York State when more than nine inches of rain fell on Sunday July 9th. In June of this year skies in the Northeast and Midwest turned an apocalyptic orange as millions of Americans found it difficult to breath because of smoke from Canada's wildfires. *The New York Times* reported that "Climate research suggests that heat and drought associated with global warming are major reasons for the increase and a contributor to bigger fires" [9]. On July 11, a Northwestern publication highlighted the ability of underground climate change to cause deformations and displacements and compromise critical urban infrastructure (in Chicago the ground between the city surface and the bedrock has warmed on average by 5.6 degrees since 1950) [10]. A UK meteorologist labeled Phoenix "one of the first places in the world to be deemed uninhabitable without air conditioning" [11] in a city where the temperature exceeded 110 degrees Fahrenheit for 31 consecutive days.

ESG Under Attack

Elements of ESG have been under attack for years, sometimes for good reasons. Greenwashing issues, for example, have plagued climate disclosure and carbon neutrality pledges casting doubt about whether organizations were serious about reducing the impact of climate change. In the last few years, with the increasing visibility of the Black Lives Matter movement, ESG has become increasingly politicized in the United States. SEC climate guidance has been delayed after charges of overreach from Republican State Attorney Generals and members of Congress.

During the last year organizations have begun to think about ESG related reputational risk in broader terms. Twenty-four months ago, most companies were concerned about reputational risk resulting from environmental missteps or from human rights violations, and most firms still are. However, nonstop anti-ESG campaigns have opened the door to woke reputational risk. For example, Pride Month backlash hit Budweiser parent Anheuser-Busch InBev hard with double digit market share loss for one of its leading brands in a very short period. Disney, Target, Kohls and others lost market value in the increasingly polarized marketplace as political campaigns in the United States continue to weaponize climate, diversity and other ESG activities. Today it seems as if there is very little room to hide no matter an organization's sustainability perspective.

Beginning in 2022 many U.S. based companies have reduced the socialization of their corporate climate agendas, a practice that has come to be labeled "green hushing." The *Wall Street Journal* has documented the extent to which companies have quieted diversity and sustainability talk amid increasingly frequent culture war boycotts:

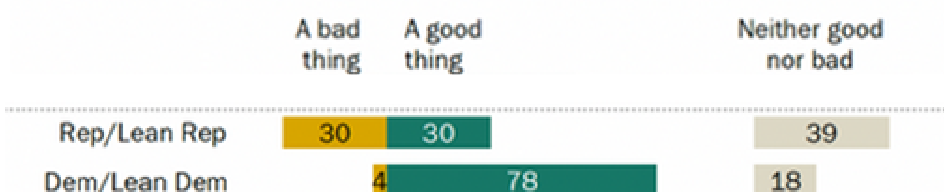
Executives at U.S.-listed companies mentioned "environmental, social and governance," "ESG," "diversity, equity and inclusion," "DEI" or "sustainability" on 575 earnings calls from April 1 to June 5, down 31% from the same period last year, according to data from financial-research platform AlphaSense. That is the largest such year-over-year decline and the fifth consecutive quarter of year-over-year drops, following a pickup in these discussions and corporate social efforts in the wake of the police killing of George Floyd in May 2020. [12]

In another report, the *Journal* reported that the number of Chief Diversity Officer searches is down 75% in the last twelve months, with one executive search firm CEO reporting that demand is at the lowest he's seen in many years [13].

And there is increasing polarization among employees on the value of DEI initiatives [14].

Views of DEI in the workplace vary along demographic and partisan lines

% of employed adults saying that in general, focusing on increasing diversity, equity and inclusion at work is mainly ...



*Estimates for Asian adults are representative of English speakers only.
Note: Based on workers who are not self-employed and work at a company or organization with 10 or more people. Share of respondents who didn't offer an answer not shown. White, Black and Asian adults include those who report being only one race and are not Hispanic. Hispanics are of any race.
Source: Survey of U.S. workers conducted Feb. 6-12, 2023.
"Diversity, Equity and Inclusion in the Workplace"

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In some organizations there has been a significant gap between intellectually understanding various ESG issues and making appropriate commitments to address them. For example, in 2020 a London based asset firm and the New York State Retirement Fund asked U.S. based S&P 500 companies to voluntarily disclose the location of key physical assets where loss or impairment would impact their financial results. Only 13 percent of the companies responded, and only three of those firms had seriously considered their potential asset (and financial) impacts from climate related damages [15].

Questions for Boards:

- Has your organization developed and vetted a set of ESG principles that align with your strategic plan? How often are the principles reviewed?
- How are ESG issues handled at the board level? Is there a specific board committee that's charged with ESG oversight?
- Does your organization understand its own sustainability ratings?
- If your organization fundamentally discounts the importance of related ESG goals, is it equipped to defend its point-of-view?
- Has your organization considered, and is it prepared to address, the increasing set of ESG reputational risks?

What a Difference Geography Makes – The Emergence of Curative ESG Regulations Outside the United States

Organizations that operate on a global scale are likely aware of divergent ESG regulatory paths in the European Union (among other jurisdictions) and the United States. As of early July, 29 states had some form of anti-ESG regulation in place while 15 states had pro-ESG regulation [16]. A June HSBC survey found that the recent rise in anti-ESG sentiment "falls along mostly political lines and is isolated to the U.S." [17]

Regulations that require companies to understand the human rights and environmental activities of their suppliers are emerging and are likely to increase outside of the United States. On May 11th Canada adopted "An Act to enact the Fighting Against Forced Labour and Child Labour in Supply Chains Act and to amend the Customs Tariff" [18] which requires Canadian firms to report annually:

(a) [its]...activities and supply chains;
(b) its policies and its due diligence processes in relation to forced labour and child labour;
(c) the parts of its business and supply chains that carry a risk of forced labour or child labour being used and the steps it has taken to assess and manage that risk;
(d) any measures taken to remediate any forced labour or child labour;
(e) any measures taken to remediate the loss of income to the most vulnerable families that results from any measure taken to eliminate the use of forced labour or child labour in its activities and supply chains;
(f) the training provided to employees on forced labour and child labour; and
(g) how the entity assesses its effectiveness in ensuring that forced labour and child labour are not being used in its business and supply chains

Across the Atlantic, the new German Supply Chain Due Diligence Act [19] entered force on January 1, 2023. This regulation is focused on human rights protection and the impact of environmental issues on the health of individuals and requires outsourcers to take remedial action when issues are discovered. Passage of the act was motivated by a series of audits (2019, and 2020) commissioned to determine compliance with the National Action Plan (NAP) for Business and Human rights. These audits determined that less than 20% of firms monitored their foreign subsidiaries and contractors for human rights violations [20].

On June 1st of this year the EU Parliament approved (by a vote of 366-225) a groundbreaking measure that would require larger firms to undertake comprehensive due diligence to determine whether their suppliers were violating human rights or environmental statutes. This regulation would go beyond the German Supply Chain Due Diligence Regulation (see table 1 below) and requires both systematic supply chain due diligence and steps to cure identified issues. It will mandate that when firms discover violations, they must take appropriate actions to mitigate and prevent potential adverse effects and bring actual adverse effects to an end.

TABLE 1
German and EU Supply Chain Due Diligence and Remedy Obligations

German Due Diligence Act Obligations	EU Due Diligence Proposal Obligations
(1) Enterprises are under an obligation to exercise due regard for the human rights and environment-related due diligence obligations set out in this Division in their supply chains with the aim of preventing or minimizing any risks to human rights or environment-related risks or of ending the violation of human rights-related or environment-related obligations. The due diligence obligations include: 1. Establishing a risk management system 2. Designating a responsible person or persons within the enterprise 3. Performing regular risk analyses 4. Issuing a policy statement 5. Laying down preventive measures in its own area of business and vis-à- vis direct suppliers 6. Taking remedial action 7. Establishing a complaints procedure 8. Implementing due diligence obligations with regard to risks at indirect suppliers 9. Documenting and reporting	Member States shall ensure that companies conduct human rights and environmental due diligence as laid down in Articles 5 to 11 ('due diligence') by carrying out the following actions: 1. Integrating due diligence into their policies and risk management systems; 2. Identifying actual or potential adverse impacts; 3. Preventing and mitigating potential adverse impacts and bringing actual adverse impacts to an end and minimizing their extent; 4. Establishing and maintaining a complaint procedure; 5. Monitoring the effectiveness of their due diligence policy and measures; 6. Publicly communicating on due diligence in accordance

See references [21] and [22].

In late July 2023 the UK's Prudential Regulatory Authority (PRA) released its revised approach to banking supervision and stated:

> *Climate change, and society's response to it, present financial risks which are relevant to the PRA's objectives. While the financial risks from climate change may crystallise in full over longer time horizons, they are also becoming apparent now. We expect firms in scope of SS3/19, which detailed our supervisory expectations for firms' management of climate-related financial risks, to be able to demonstrate how they are responding to our expectations and set out the steps being taken to address barriers to progress. The PRA is aware of the need to be proportionate, and smaller firms should determine how these capabilities might map to the nature, scale, and complexity of their business. [23]*

On the same day the European Commission released its long awaited, final European Sustainability Reporting Standards (ESRS) [24] for use by all companies subject to the Corporate Sustainability Reporting Directive (CSRD) [25]. This reporting standard is effective on January 2, 2024, and will eventually cover 50,000 firms who operate within EU boundaries.

For firms operating internationally the future is here.

Questions for Boards:

- Does your organization understand its current and future ESG obligations throughout the jurisdictions in which it operates?
- Has your organization optimized its ESG socialization efforts? Can it respond effectively and consistently to today's heightened political ESG rhetoric?
- Is your corporate culture aligned with its ESG goals?
- Has your organization properly scaled its workforce to address increasing ESG challenges? Are management resources properly aligned?

Planning for the Inevitable

ESG efforts will continue to build momentum even in the face of heightened election cycle rhetoric. As one observer noted, that outcome is an inevitable consequence of "the stubbornness of facts and the prevalence of recurring events" [26]. U.S. based businesses will continue to make sustainability progress because boards and executives understand that advances will ensure the best long term economic and social outcomes for all stakeholders (shareholders, employees, customers and communities) they touch.

In environments outside of the United States there has been more consistent pressure to reduce carbon emissions as the alphabet soup of climate reporting standards has rationalized. Progress in the United States will continue to be incentive based (following the model set by the Inflation Reduction Act of 2022). [27]

In its May 24th communique, the G7 affirmed support for the internationalization of climate reporting standards, essential to track climate change progress:

"We support the International Sustainability Standards Board (ISSB) finalizing the standards for general reporting on sustainability and for climate-related disclosures and working toward achieving globally interoperable sustainability disclosure frameworks. We also look forward to the ISSB's future work on disclosure on biodiversity and human capital, in line with its work plan consultation." [28]

The most controversial component of the ISSB standard (released in June 2023) is inclusion of Scope 3 emissions data when material. It's important to note that Scope 3 data inclusion has broad international

support. In fact, the G20, International Organization of Securities Commissions (IOSCO), the Financial Stability Board, and Finance Ministers and Central Bank Governors from over forty jurisdictions (among others) have increased pressure on the U.S. to follow suit. This most recent communique from G7 leadership – with support from the Biden administration – leaves little doubt that Scope 3 disclosure requirements in the U.S. will move forward. Watch for likely inclusion in the new SEC climate reporting mandates now expected this fall, likely phased in over time and targeted so that smaller firms will be exempt from the requirements. [29]

Remediating issues identified in sourcing chains and standardized ESG metrics reporting will emerge more broadly as a front burner priority during the next five years. As ESG activities have increasingly become part of daily business reality, organizations will be able to leverage industry specific efforts to help ensure good hygiene in their supply chains. One good example is the Alexandria, Virginia based Responsible Business Alliance (RBA), which claims to be the world's largest industry coalition dedicated to corporate social responsibility in global supply chains. The RBA fields four major initiatives, focused on minerals, labor, factories and the environment. It operates a metals and minerals downstream assessments program, monitors corrective action plans of companies committed to improving their sustainability practices, and provides a range of monitoring templates.

Simple Steps for Boards to Successfully Navigate ESG Issues During the Current Election Cycle

Noise generated during the current election cycle should not cause firms to deviate from the thoughtful sustainability paths they've evolved over time. Corporate boards and executive management should:

1. Update climate and other ESG targets based on long term business outcomes and climate science, not politics.
2. Consider the new International Sustainability Standards Board (ISSB) standards as your reporting mechanism going forward. The ISSB standards incorporate and will effectively replace TCFD sustainability disclosures. [30]
3. Ensure that adequate resources are in place to meet ESG expectations.
4. Communicate sustainability values consistently, both internally and externally.
5. Engage with value added partners.
6. Ensure progress transparency, even when targets are not met.

Questions for Boards:

- Does your organization attempt to remediate environmental and human rights issues when found in your value chains? If so, how?
- Does your organization participate with, and support, organizations dedicated to improving environmental, human rights and corporate governance outcomes?
- Does your ESG program support long term value creation?
- Is your organization examining (and, where appropriate, adopting) best ESG reporting, due diligence, and remediation practices from within and outside of the United States?

REFERENCES

All works cited are [numbered in brackets] throughout the report - click on any of the numbers to access a hyperlink to the cited material. To view all works cited in one document, click here to download a PDF.

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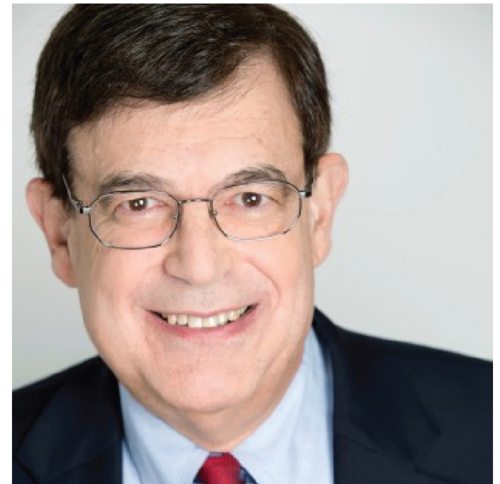

Gary has more than four decades of experience in financial services sector planning and management, including 25 years at JPMorgan Chase where he retired as Senior Vice President of Electronic Commerce. Gary has served on the Board of Directors at multiple companies and organizations including ISTPA, the NYCE network, and the Electronic Funds Transfer Association. Gary served on the Board of Trustees at Clark University for 12 years, nine of them as Board Vice Chair and Chair of the Board's Strategic and Financial Oversight Committee.

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