The key to embedding ESG in your DNA

The fight against climate change is no longer only within the purview of environmental activists. As the deleterious effects on the environment become more apparent, more actors in the public and private sectors – including governments and businesses – are taking practical steps to protect the environment.

Temps de lecture : minute

---

3 March 2022

Making environmental, social and governance (ESG) factors part of a company's mission is no longer a "nice to have" and has become a "must" for a business. Holistically embedding ESG in a business' DNA is integral as companies face increasing scrutiny from multiple stakeholders.

ESG at the centre of focus

Many factors are contributing to the focus on ESG. One of the primary factors is increased media and public attention to climate change, sustainability and social issues. Additionally, new generations of stakeholders – including investors, employees and customers – are seeking to hold companies accountable for their direct and indirect impact on the environment.

Governments are also taking matters into their own hands and an increasing number of countries have introduced legislation to address climate change and promote a myriad of ESG matters. This includes regulations intended to make corporations and financial institutions more accountable for environmental and social impacts through the adoption of robust sustainable disclosure regimes.

In March 2021, aspects of the European Union's *Sustainable Finance Disclosure Regulation* (SFDR) came online. The SFDR, among other things, makes regular ESG public reporting mandatory for asset managers. Then, in April 2021, the European Commission adopted the proposed *Corporate Sustainable Reporting Directive*, which would introduce a mandatory ESG reporting regime for certain businesses.

In June 2021, the German Parliament approved a draft bill on corporate due diligence in supply chains, making it mandatory for companies from a certain size (3,000 employees as of 2023 and 1,000 employees as of 2024) to identify and assess human rights and environmental risks as well as establish effective risk management systems to tackle them. This new law is not exclusive to German companies and extends the duty to all businesses with an office on German soil and a certain size.

> *Incorporating ESG factors into a company's mission is also becoming an increasingly important factor in attracting investment.*

In 2021, a record $649B was invested in ESG-focused funds (through 30 November 2021), which now account for 10% of fund assets worldwide. VCs and investors who prioritise ESG are increasingly looking to invest in businesses with strong ESG practices.

The risks of leaving ESG behind

Today's focus on ESG is here to stay and businesses face risks by not making ESG a priority. In addition to the regulatory and legal issues that might arise following governments’ introduction of ESG-related legislation – including mandatory ESG reporting – companies risk losing commercial opportunities and customers. For example, asset management companies have come under scrutiny by regulators recently for alleged greenwashing.

Investors are not the only stakeholders looking at *ESG* practices to decide whether or not to engage with a business. Companies seeking commercial partners, such as suppliers or joint venture partners, are also taking sustainability practices into consideration during vetting processes. Third-party ratings or certificates assessing and verifying a business’ ESG strategy and practices – such as ESG rating agencies and the B Corporation Certificate – are increasingly in demand, as they provide stakeholders with assurance that a business “walks the walk” when it comes to ESG.

Embedding ESG

For many businesses, embedding ESG into their DNA can seem daunting due to the complexity and proliferation of ESG regulations and reporting frameworks. While efforts are being made to adopt uniform ESG reporting standards (such as the IFRS Foundation’s *sustainability reporting project*) to act as a single reference point for businesses, such efforts are slow going. The spectre of different ESG regulatory and reporting regimes – for example across the EU, UK and US – poses significant risks for companies with global operations.

Given that ESG covers a broad range of topics, businesses seeking to adopt ESG policies must first undertake an internal “materiality assessment” to determine which ESG factors are important and most relevant for its internal and external stakeholders and operations. Once a company’s ESG strategy has been identified and adopted, its board of directors and senior management must take an active role in ensuring that ESG practices are adopted on a company-wide basis. ESG teams should be interdisciplinary, composed of members from finance, operations, human resources, investment relations, marketing and legal, to ensure comprehensive and entrenched ESG practices.

Moving forward

It is advisable for boards of directors to monitor internal procedures and controls—and adjust when needed—with the aim of setting up robust structures that are integrated in, or work hand-in-hand with a company’s compliance management system. Such a management system will support a company’s efforts to embed ESG in its DNA, while preserving the business’ opportunities for growth, providing lasting access to financial markets and better protecting the business from external scrutiny from investors, regulators and clients.

Simon Arlington, Matthew Dunlap, Angela Kerek and Patrick Spaeth are partners at *Morrison & Foerster*.

Article by Morrison & Foerster