2023 ESG Survey

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ESG Practice Co-Leader

Hello, I'm Kerry Berchem, co-chair of Akin's Environmental, Social and Governance or ESG practice, a corporate partner and member of the management committee.

It is my honor to introduce the firm's 2023 ESG Survey. Faced with new challenges from turbulent public markets, record inflation and rising interest rates, private credit once again proved its resilience as investors favored its timely characteristics of downside protection, floating rates, sizeable equity buffers and pragmatic credit selection.

Notably, in light of market demand and increasing disclosure requirements across multiple jurisdictions, we predict that asset managers will continue to significantly increase ESG-related investments and assets under management and product offerings in the coming years. We also expect more disclosure from issuers.

Simultaneously, however, we envision rising pushback against ESG, at least in the United States (U.S.), with some arguing that the ESG label is or has become "too woke," "too broad" or "too distracting." Others criticize ESG for being either inadequately or overly focused on data and metrics and, therefore, not scientifically quantifiable.

That said, while ESG, as a brand or label, will shift over time, it is clear to us that the underlying commitment to sustainability that undergirds the idea of ESG is here to stay and we fully expect ESG issues will remain front and center during the course of 2023. Accordingly, we continue our commitment to be "best in class" as we advise our clients on how to navigate these complex issues.

To that end, we have assembled a collection of articles that focus on what we believe are key ESG issues for 2023. In these materials, we touch on ongoing efforts to diversify our boardrooms and C-suites; examine the evolving landscape relative to greenwashing and green-hushing risks; consider the growing pushback against ESG and how to avoid attendant legal risks; and provide our thoughts on the recently concluded COP 27 in Egypt and some high-level expectations regarding what to expect for COP 28. We further identify key considerations in the opportunities to finance the global energy transition; discuss expectations for shareholder activism during 2023; examine the evolving world of ESG ratings; and provide insight into a new area of expertise that is likely overdue for a seat at the ESG table: corporate tax and compliance.

Obviously, these materials are not, nor are they intended to be, exhaustive. In an evolving and sometimes contentious landscape, we look forward to partnering with you to identify, address and implement your customized ESG needs. We hope you will enjoy this content and we look forward to working with you over the course of 2023.

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DEI Efforts

Challenges continue regarding expanding diversity in the boardroom and C-suites

As we have seen over the past number of years, and will continue to see throughout 2023, corporations are focused on expanding diversity. This is a laudable goal, but it does not come without legal risks. Legislatures and private citizens alike have taken action against certain diversity, equity and inclusion (DEI) initiatives. Programs seeking to boost representation of select demographic groups in executive ranks, boardrooms and the workforce more broadly have received backlash, particularly when the companies' goals have numeric targets attached to them[1].

DEI programming can come in many different forms. Some companies have focused on building the diversity pipeline by offering certain programming, such as fellowships or mentorships, to minority groups, often accompanied by scholarships or monetary grants[2]. Other companies have set multi-year, aspirational goals to increase their workforce diversity generally, or in specific roles[3]. Still other companies have focused on the power of the purse, looking for opportunities to increase spending with minority and women-owned businesses[4].

What CEOs think

90% of CEOs indicated that DEI was a personal strategic priority

94% agreed that their organization aspired to be a leader on the topic

Challengers to these programs allege that these initiatives discriminate against individuals outside of the protected group(s) at which they are aimed, in violation of applicable anti-discrimination law[5]. For example, last year an anti-DEI activist group backed a proposed class action against Amazon, alleging that its "Black Business Accelerator" program, which provides $10,000 grants to diverse delivery service entrepreneurs, unlawfully discriminated against non-black owned businesses in violation of Section 1981[6]. Disgruntled employees also have taken aim at their employers. A white male healthcare executive, for example, received a multi-million-dollar award after claiming his former employer fired him as part of its diversity efforts[7].

DEI initiatives are also being attacked by activist shareholders. In 2022 alone, the National Center for Public Policy Research (NCPPR), a foundation dedicated to advancing the "conservative movement," submitted proposals that resulted in 12 companies across various industries, putting the group's anti-DEI proposals to vote[8]. Most of these proposals requested that the board commission an audit analyzing the impact of DEI policies on the company's business, including, in some proposals, the impact on "non-diverse" employees[9].

The primary objective of the DEI incentives is to:

Source: PwC

Another avenue of attack is DEI policy retraction demands. Since 2021, the American Civil Rights Project (ACRP), a law firm that represents clients such as NCPPR, has sent at least seven retraction demand letters, threatening to sue companies if such companies refused to retract certain DEI policies[10]. These groups have also employed a strategy of sending requests to the Equal Employment Opportunity Commission to open civil rights investigations into companies' human resources and promotion practices[11]. Such requests can be problematic for employers, given the agency's ability to use a Commissioner's charge or a directed investigation to probe individual or, more commonly, systemic discrimination concerns without the need for an aggrieved party to first file a claim[12].

State legislatures are also taking aim at DEI initiatives. In April 2022, Florida Governor Ron DeSantis signed into law Hb7, the Individual Freedom Act.

The Individual Freedom Act, also known as the Stop the Wrongs to Our Kids and Employees Act (the "Stop W.O.K.E." Act)[13]. This Act amends the Florida Civil Rights Act of 1992 by adding a new section to define certain DEI programs as unlawful discrimination if mandated by employers, associations or certification organizations[14]. The Stop W.O.K.E. Act is drafted broadly, purportedly covering DEI programs that (i) involve training, instruction, or certain other enumerated activities; (ii) espouse, promote, advance, inculcate or compel an individual to believe any of eight identified discriminatory concepts[15]; and (iii) are a condition of employment, membership, certification, licensing, credentialing or passing an examination[16]. The Stop W.O.K.E. Act is the subject of numerous legal challenges[17].

The European Union (EU) and United Kingdom (U.K.) have not seen the same degree of activism challenging affirmative action as has occurred in the U.S. This may be partly a reflection of the law being more settled in this area than in the U.S. and partly that there seems to be less controversy amongst politicians over the issue. However, while DEI efforts have publicly been embraced by many organizations, implementation and progress in Europe has been mixed. A recent survey by PricewaterhouseCoopers (PwC) suggested that some EU organizations have struggled to translate commitments into tangible action plans. According to the survey, 60% of the companies surveyed use DEI initiatives to attract talent or to comply with

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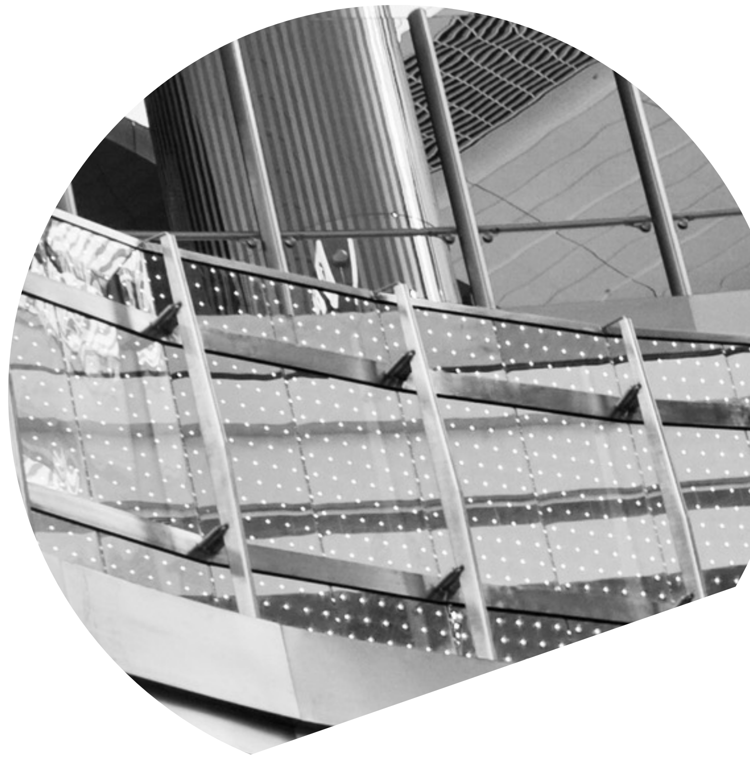
applicable legal requirements; however, only 19% link such DEI initiatives to actual business results or financial performance[18]. In the U.K., DEI efforts have likewise been embraced, including by the U.K. government, which recently announced a program to promote diversity within the civil service. Nevertheless, at least one report suggests that almost one-third of British companies have not adopted or developed strategic programs to support DEI efforts[19]. It is notable that the substance and focus of DEI varies across geographies.



In the U.S. much of the focus is on race and gender, whereas in the U.K. social mobility also has significant prominence.

The DEI space is an evolving one, with many companies remaining committed to entrenching diversity, equity and inclusion in their corporate ethos. These efforts are not risk free, and we fully expect such efforts to remain subject to legal, public relations and other challenges as certain stakeholders continue to push back.

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“I thought you said this was ESG-friendly?!”

Risks associated with greenwashing/green-hushing

As ESG factors are integrated more and more frequently across industries and products, so too are risks associated with “greenwashing” and “green-hushing.” Greenwashing is the act of providing stakeholders (e.g., investors and consumers) with misleading or false information about whether a product was produced using sustainable practices or is itself sustainable. Greenwashing also can be deployed by companies in order to mask how certain business operations or practices may, in fact, adversely affect the environment, for instance. The term can apply equally to financial products and/or services (e.g., where the product is marketed as being environmentally friendly or its returns are linked to the achievement of certain sustainability metrics).

Relatedly, green-hushing occurs when a company opts to stay quiet or less vocal regarding its environmental, climate or other ESG goals and strategies. According to the Corporate Governance Institute, there are two primary reasons companies engage in green-hushing: first, they do not want to risk being exposed to negative publicity if they fail to achieve a publicly disclosed goal or target; and second, they do not want to risk greenwashing claims if it turns out their results are less than promised or suggested.

Over the course of 2022, there was a marked uptick in the attention stakeholders are paying to these issues. In response, regulators across the globe and all industries undertook extensive rulemaking initiatives that were, ostensibly, designed to protect investors, consumers and other relevant parties against greenwashing. In the United States (U.S.), these efforts were spearheaded primarily by the U.S. Securities and Exchange Commission (SEC) and other federal regulatory agencies. Indeed, the SEC proposed new disclosure requirements that are specifically intended to address greenwashing, including proposals related to climate risk, cybersecurity, investment managers and ESG more broadly[20].

Regulators in the EU and U.K. have, generally speaking, outpaced their U.S. counterparts. Lawmakers in the EU are reportedly preparing to put forward in the first half of 2023 a series of proposals that are intended to address greenwashing.

Consistent with past practice, regulators in the European Union (EU) and U.K. have, generally speaking, outpaced their U.S. counterparts. For instance, during 2023, lawmakers in Europe are reportedly preparing to put forward a series of proposals that are intended to address greenwashing across various products. In fact, just last month, the European Commission published the “Green Claims Directive,” which is intended, among other things, to set forth the first set of comprehensive rules to ensure that businesses do not engage in greenwashing when it comes to claims involving sustainability or ESG-related impacts. If adopted, these initiatives would require companies to ensure that any climate-related or environmental assertions companies make are backed by science. Similarly, in the U.K., regulators have proposed a series of rules that would, if adopted, attempt to prevent consumers from being misled. These proposals would require disclosures so that consumers can more clearly understand a product’s sustainability features and limit the usage of terms such as “ESG” and “green.”

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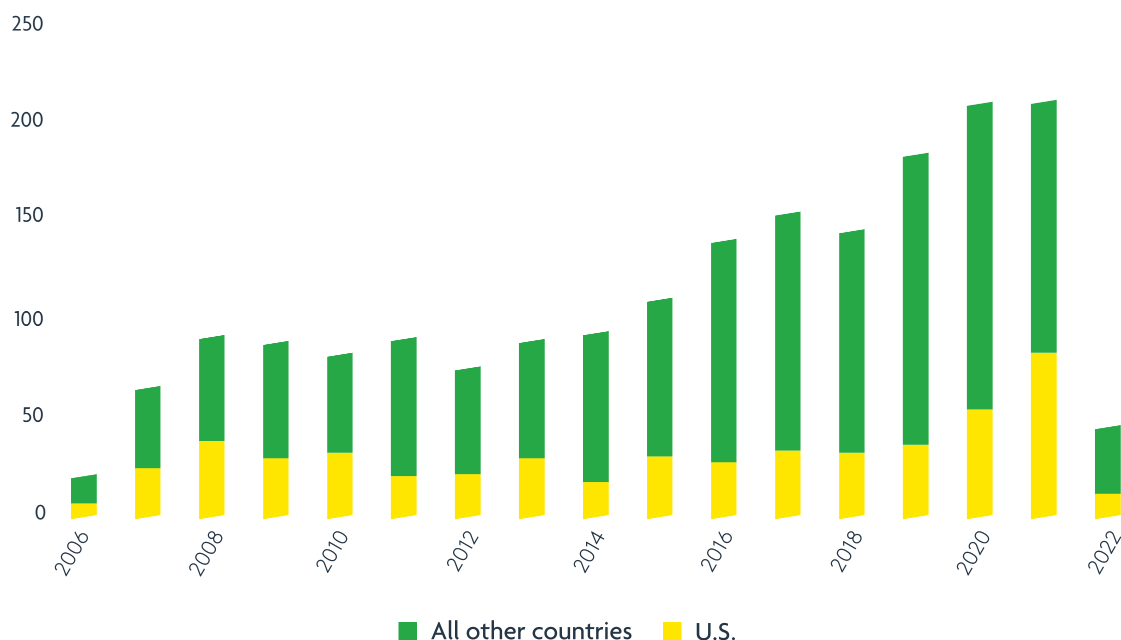
Regulators in Asia have likewise turned their attention to greenwashing, with regulators in Japan, Hong Kong and Singapore looking at various measures that can be used to combat greenwashing and protect consumers and investors. These efforts have included the adoption or development of green taxonomies by at least 13 countries, as well as the publication of a sustainable finance taxonomy by the Association of Southeast Asian Nations[21]. Similarly, progress has been made on disclosure requirements, including a new requirement proposed by the Monetary Authority of Singapore to require that asset managers make climate-related disclosures that align with standards promulgated by the International Sustainability Standards Board (ISSB)[22].

Greenwashing is the act of providing stakeholders (e.g., investors and consumers) with misleading or false information about whether a product was produced using sustainable practices or is itself sustainable.

Green-hushing occurs when a company opts to stay quiet or less vocal regarding its environmental, climate or other ESG goals and strategies.

Total climate change litigation cases over time, U.S. and non-U.S. (2006 to 31 May 2022)



Source: Authors based on CCLW and Sabin Centre data

Litigation and regulatory actions involving greenwashing claims increased during 2022 and are apt to continue to rise during 2023. Claimants are using a broad set of legal theories to advance these efforts including claims alleging violations of consumer protection laws (e.g., misrepresentation on product labels); claims challenging ESG-related statements, reports or other marketing materials (e.g., sustainability claims on company websites or on product labels); deceptive or unfair business practices claims (e.g., violations of the "Green Guides" issued by the Federal Trade Commission); and securities fraud claims (e.g., inadequate or misleading disclosures). Increasingly, claimants are alleging greenwashing claims across a company's supply chain, with litigants focused on human rights violations and trafficking and whether companies are adequately undertaking due diligence with respect to whether their suppliers are complying with applicable law and best practices in the procurement process.

As is usually the case, there are some practical steps companies can take in order to mitigate against greenwashing risks in their business operations.

Companies should evaluate existing disclosures relating to ESG and sustainability and undertake due diligence to check whether such disclosures can be substantiated. When looking at the statements themselves, consider whether a more aspirational, less concrete statement may be advisable relative to referencing concrete statements or metrics. Relatedly, companies should review existing disclosure policies and practices to identify any gaps or areas for improvement, particularly if a company is making voluntary disclosures that are aligned with a third-party disclosure framework (e.g., Task Force on Climate-related Financial Disclosures (TCFD)). Also, consider whether any disclosures should be accompanied with appropriate disclaimers or caveats. A board of directors should carefully consider how to discharge its duty of oversight relative to ESG and related issues (e.g., vest an existing board committee with oversight responsibilities or create a stand-alone committee for that purpose). Finally, businesses should regularly review regulatory guidance and developments and, as always, consult with relevant professionals and attorneys to remain "on-side" relative to these issues.

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COP 27:

Political progress but transformative climate actions remain elusive

In November 2022, stakeholders gathered in Sharm el-Sheikh, Egypt, for the most recent meeting of the United Nations Framework Convention on Climate Change's (UNFCCC) 27th Conference of the Parties (COP 27). COP 27 concluded with an "historic breakthrough to help vulnerable countries deal with losses and damages from the impact of climate change"[23]. While COP 27 witnessed several notable moments, including the resumption of discussions between the United States (U.S.) and the Peoples' Republic of China with regard to climate issues, there was tangible disappointment on the part of various groups that wanted to see more significant progress in terms of curbing greenhouse gas (GHG) emissions. Nevertheless, publication of the Sharm el-Sheikh Implementation Plan supports the idea that actors can come together, cooperate and potentially agree on actions intended to address the dangers posed by climate change. What follows is our perspective on key takeaways and technical outcomes from COP 27.

Loss and Damage Fund

The parties agreed to the creation of a Loss and Damage Fund, a significant political outcome that allocates money to assist low and middle-income countries' efforts to respond to climate disasters. A transitional committee will make recommendations about how to operationalize the first tranche of these funds at COP 28. Initially, developed economies such as the U.S. and European Union (EU) will underwrite the Loss and Damage Fund, with higher-polluting, developing funds expected to make contributions in the future. Parties did not include admissions of liability in the finally announced framework for the Loss and Damage Fund and specified that loss and damage contributions were voluntary.

There was tangible disappointment at COP 27 on the part of various groups that wanted to see more significant progress in terms of curbing GHG emissions.

Climate Finance

Parties agreed to additional measures to support climate finance efforts for developing countries. These include the World Bank's Global Shield Financing Facility[24], which

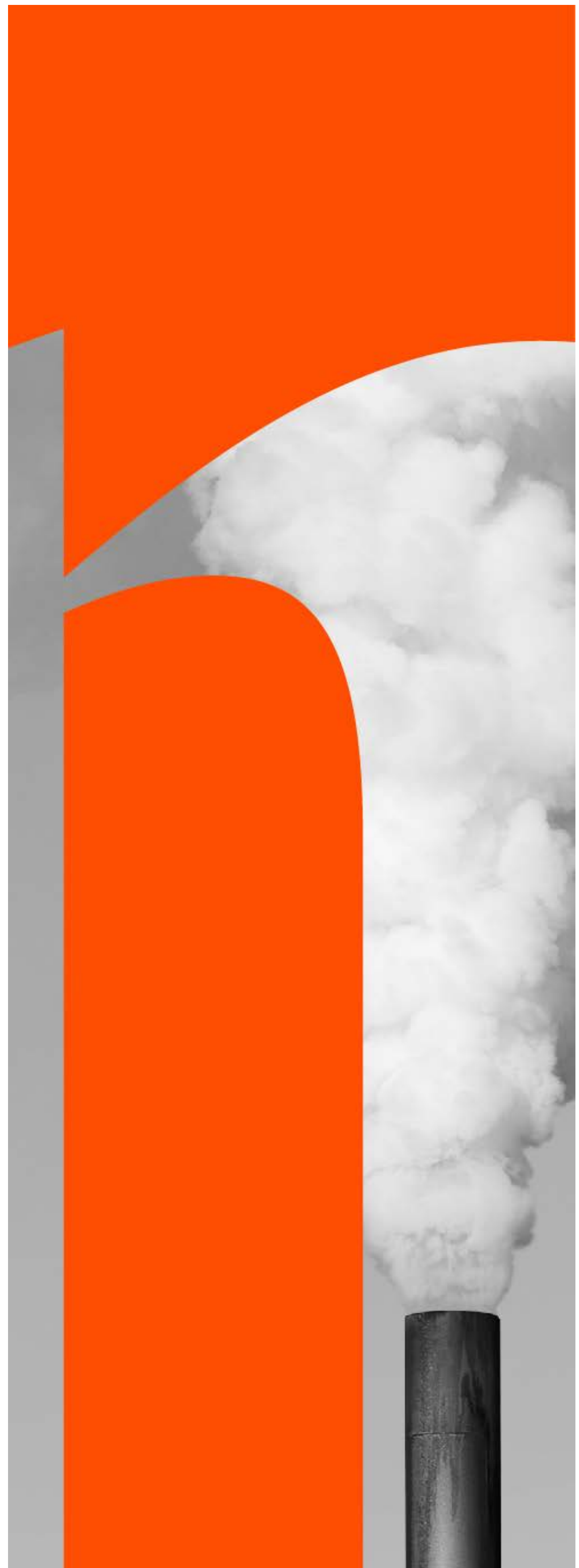
provides climate risk insurance to developing countries To recover from natural disasters and climate shocks, and a joint statement that proposed Multilateral Development Bank (MDB) reforms[25]. Developing countries noted that developed countries continue to lag behind announced commitments to fund these efforts. The U.S. initiated a new market-based financing mechanism, the Energy Transition Accelerator (ETA) program[26], which is intended "to retire unabated coal-fired power and accelerate the buildout of renewables." More broadly, parties also responded to the effects of GHG emissions on the maintenance of biodiversity. Several countries c ommitted to a 10-point Plan for Financing Biodiversity[27], which would increase financing for a variety of conservation-based activities.

Mitigation

The parties reiterated their call from COP 26 to accelerate efforts to "phase down" unabated coal power and "phase out" inefficient fossil fuel subsidies, thereby ensuring that the majority of governmental energy transition policies will concentrate on reducing emissions from unabated coal. Parties also concentrated on mitigation efforts through the Global Methane Pledge, which now counts 150 signatories following COP 27. The U.S. initiated the Carbon Dioxide Removal (CDR) Launchpad in partnership with Canada[28], the European Commission (EC), Japan, Norway and the United Kingdom (U.K.). The Launchpad will support public-private partnerships to build over 1,000 ton-a-year CDR projects by 2025, presenting new opportunities for direct air capture and other innovative removal technologies. The U.S. also announced the Green Shipping Challenge to spur the transition to clean energy across this sector[29].

1,000

The CDR Launchpad will support public-private partnerships to build over 1,000 ton-a-year CDR projects by 2025.



Sigantories of the Global Methane Pledge

Source: Globalmethanepledge.org

Article 6

Talks regarding the United Nations (U.N.) carbon market mechanism did not progress significantly at COP 27. Experts now predict that a global carbon trading mechanism will not be ready for launch until 2024 at the earliest[30]. That said, parties decided that countries would not be required to disclose confidential information about their internationally traded mitigation outcomes (ITMOs). However, at the same time, parties included a provision calling for further guidance on the issue for consideration at COP 28.

Environmental Integrity

The impact of civil society in holding parties and non-state actors accountable for pledges and commitments at COP 27 stood in stark contrast to the power that businesses wielded over the deliberations at COP 26 in Glasgow, Scotland. Several oversight organizations stressed the need for governments and businesses to strengthen the integrity of their emissions goals and reporting. The most important of these was the U.N. high-level expert group report that called for integrity in climate disclosure reporting for businesses, financial institutions, cities and regions[31].

COP 28 Preview

COP 28 will be hosted by the United Arab Emirates (UAE) in December 2023. Dr. Sultan Ahmed Al Jaber, UAE's Minister of Industry and Advanced Technology, has stated that he expects COP 28 to be a "COP of solutions that will follow inclusivity as a guiding principle." Other "key pillars" of COP 28 are expected to include implementation of existing climate commitments and pledges and a focus on concrete means by which to take credible and concrete actions on climate issues. Areas of focus for the U.S. are expected to include updates on some signature international climate initiatives, including the Green Shipping Challenge[32], the Global Methane Pledge[33] and the Energy Transition Accelerator (ETA)[34]. We expect to write in more detail on COP 28 in advance of the event.

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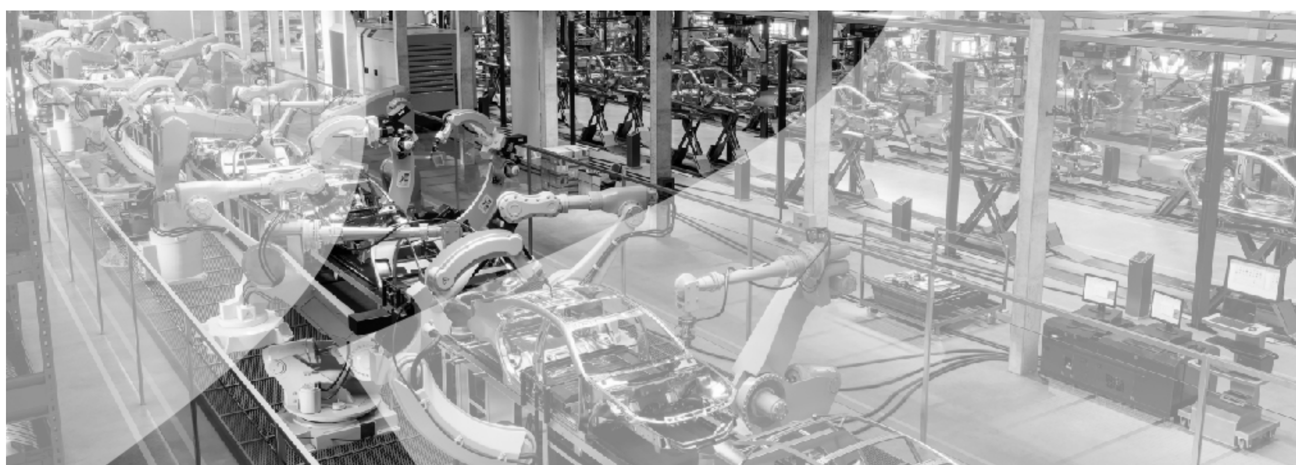
The evolving role of ESG in shareholder activism

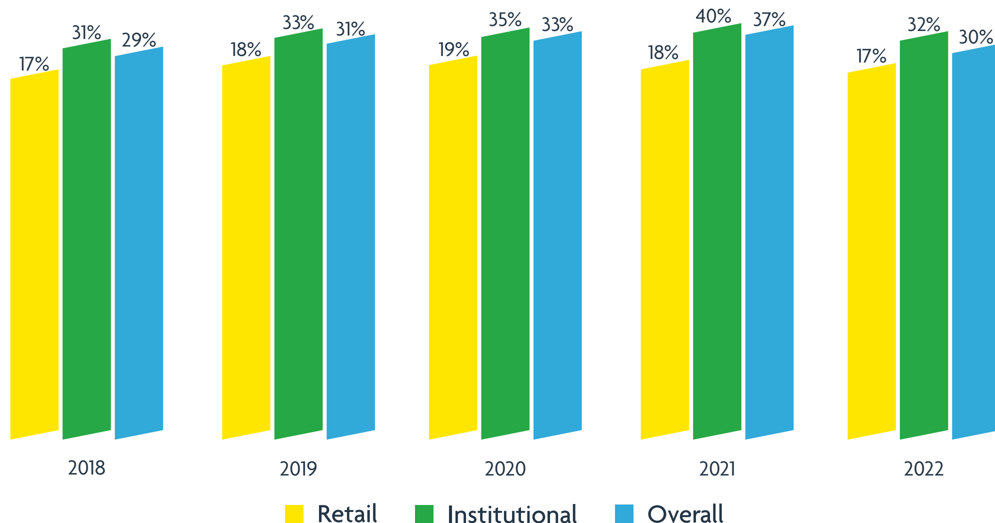
Shareholder activism continues to play a critical role in capital markets and we see no reason to think 2023 will play out any differently. Traditional activists are expected to continue pushing for issuers to implement changes that they believe will generate enhanced economic returns, such as modifications to a company's capital or governance structures and changes in strategic and operational direction, capital expenditures and other items. The overall political and macroeconomic environments, coupled with investor fears regarding a potential recession and ongoing inflationary pressures are expected to result in activists continuing to aggressively push for companies to be responsive to their agendas. Additionally, companies across all sectors find themselves responding to demands for ESG-focused financial and consumer products and services, with such demands being made in a regulatory environment that is focused squarely on protecting stakeholders against greenwashing and other manipulative practices.

Broadridge indicated that ESG-related proposals increased by 25% in 2022

Within this context, activists are increasingly focusing on ESG considerations as they develop and promote their agendas, with some observing that attention to ESG issues can be linked with operational resilience, long-term competitiveness and enhanced financial returns. An analysis published by Broadridge indicated that ESG-related proposals increased by 25% in 2022[35], with the increase primarily attributable to proposals involving climate and social issues. These proposals can focus on both financial (e.g., measures aimed at enhancing long-term sustainable growth) and non-financial agendas (e.g., advocating for increased boardroom diversity, broader DEI and social justice initiatives) and do so using a growing variety of tactics and strategies[36]. ESG shareholder activism is sometimes justified by the financially driven thesis that more progressive companies will ultimately deliver greater shareholder returns as they move in alignment with consumer demands. Other shareholders may simply see it as the right thing to do. Whatever the rationale, ESG shareholder activism increasingly represents an external pressure from shareholders on issuers to adapt. Even investors that have purchased relatively small percentages in issuers have demonstrated their ability to corral sufficient support to impact the way in which significant businesses are run.



Support for environmental and social shareholder proposals (%)



Source: PwC

Traditionally, activist shareholders (e.g., institutional investors, hedge funds and other investors) have deployed a handful of tools to push their agendas. Typically, these tools have included pushing for greater shareholder engagement, sponsoring shareholder proposals, "vote no" campaigns and proxy contests. More aggressive activists may turn to threatening or actually engaging in litigation to pursue a particular goal. Obviously, a tactic that works for one activist may not be effective, or even an option, for another, depending on the facts and circumstances. Nevertheless, over the last few years, activists pushing ESG-focused agendas are increasingly leveraging these tools in both traditional and new ways in an effort to compel companies to pursue objectives that are consistent with ESG principles. To date, ESG-focused activists have focused primarily on the environmental and social aspects of ESG. That said, addressing governance issues (e.g., seeking changes to board composition and governance structures, protecting shareholder rights, or tying executive compensation to ESG-related metrics), is becoming a more significant tool.

For example, in December 2020, the hedge fund Engine No. 1 invested $40 million in ExxonMobil Corporation, representing a stake of just 0.02%. The fund's founder immediately published an open letter to the board of directors calling for radical strategic change in order to adapt to a low-carbon economy. Engine No. 1 argued that ExxonMobil had no strategy for navigating the carbon transition and that $170 billion of shareholder value had been destroyed by poor capital allocation. This letter garnered support from multiple institutional investors, who agreed with the premise that long term board members were not as sensitive as they should be to environmental issues and, ultimately, led to the appointment to the board of three activist-nominated directors with more experience in alternative fuels and energy. This example demonstrates that even with a small percentage shareholding, proactive investors can generate significant change where their campaign resonates with and receives support from major institutional investors that have an eye on their portfolio companies' ESG strategies.

Even with a small percentage shareholding, proactive investors can generate significant change where their campaign resonates with and receives support from major institutional investors.

In the United Kingdom (U.K.), Bluebell Capital Partners, a London-based activist, began in February 2022 to push Glencore plc to demerge its coal mining business, on both financial and environmental grounds, but to maintain voting control via a dual-class share structure so Glencore can ensure mines are properly decommissioned once extraction ceases[37]. In April, Bluebell Capital then voted against approving Glencore's 2021 Climate Progress Report[38]; with shareholder dissent of almost 24%, the approval of the 2021 Climate Progress Report was the least-supported resolution at Glencore's 2022 annual general meeting[39]. While Glencore has not adopted Bluebell Capital Partners' plans, it did commit in December 2022 to closing 12 coalmines by 2035 in order to meet emissions targets[40]. Nevertheless, this may not be enough to satisfy investors, with Legal & General and HSBC subsequently filing a resolution (to be voted on at the company's annual general meeting in May 2023) requesting more detail on Glencore's coal production plans[41].

It is important to acknowledge that ESG activist investing is no longer an area where only smaller, ethically-driven investors are moving the needle. This has resulted in some significant backlash at the state and federal levels. Such backlash notwithstanding, asset managers continue to see significant capital inflows into, and demand for, ESG- or sustainability-linked products and such demand is not expected to recede for the foreseeable future.

Relatedly, proxy advisory firms, such as Institutional Shareholder Services Inc. and Glass Lewis, also are increasingly playing an important role in shareholder voting decisions as they publish more and more detailed and goal-oriented proxy voting guidelines. Reportedly, some investors have criticized asset managers and the proxy advisory firms for publishing guidelines that are overly prescriptive, while other investors may complain that such guidelines are not sufficiently aligned with particular ESG-related goals. In response, some asset managers have adopted pass-through voting programs so that investors can bypass voting guidelines they view as inadequate or lacking sufficient alignment with their broader goals[42]. This relatively new development may inject additional complexities into how companies manage shareholder votes in the future and will necessitate robust shareholder engagement programs so that companies understand which guidelines or procedures are guiding a particular shareholder vote or campaign.

At the more aggressive end of the spectrum, some more combative activist groups have resorted to aggressive litigation to pursue their goals, particularly in relation to environmental matters. For instance, the successful claim by almost 2,000 Zambian villagers against Vedanta Resources plc[43] based on environmental pollution has paved the way for group litigation[44] against parent companies whose subsidiaries are alleged to be causing environmental damage. Such class actions are often funded and driven by specialist litigation funders who also may be working with activist investors. Similarly, activist ClientEarth has taken French food producer Danone to court in Paris[45] based on its failure to sufficiently reduce its plastic footprint in packaging.

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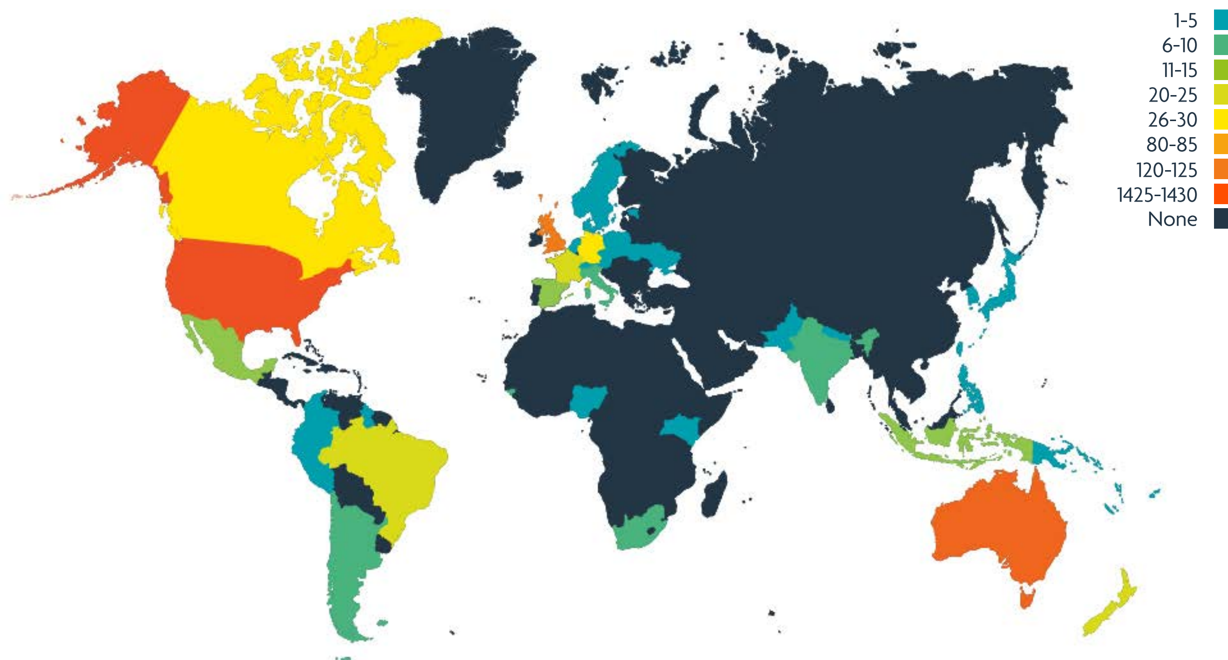
In a development arising primarily outside of the U.S., ESG litigation also can come from within a company itself. In May 2021, the Hague District Court ordered Shell to reduce emissions by 45% from 2019 levels by 2030 (currently under appeal by Shell[46]), in line with the Paris Agreement. Subsequently, in March 2022, ClientEarth took a derivative action on behalf of Shell plc against Shell's board of directors[47], alleging that the board's failure to adopt and implement an adequate climate strategy to comply with this previous judgement was in breach of the directors' duties under section 172 of the U.K. Companies Act 2006 to promote the success of the company. A pre-action letter of claim was sent by ClientEarth to the board in March 2022. There have been no public updates since then.

Number of climate litigation cases around the world, per jurisdiction (up to 31 May 2022)

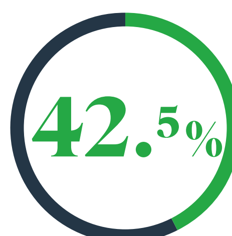


Source: Globalmethanepledge.org

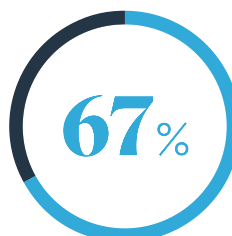
Despite the increasing influence of ESG factors in the activist space, there has been a recent trend from certain institutional investors not to support shareholder-proposed ESG resolutions. Non-profit campaigner ShareAction, which tracks the ESG voting performance of institutional investors, found that asset managers (including The Vanguard Group, Inc. and State Street Corporation), supported fewer ESG shareholder proposals in 2022 than in 2021, despite overall shareholder support growing from 60% to 66% during the same period.

One reason for this may be boards reacting in a proactive, defensive manner to the waves of ESG activist activity seen in recent years by adapting their strategies to take into account some of the activists' usual concerns. However, one anonymous asset manager has expressed concerns that these proposals are becoming increasingly prescriptive, ignoring financial performance and, in some cases, targeting issues on which the company in question has already made notable progress. Meanwhile, political opposition to ESG-based investment in certain U.S. states has served to discourage institutions from supporting shareholder proposals, with the same anonymous asset manager suggesting that it would have lost its license to operate in the U.S. had it supported all ESG resolutions[48].

Nevertheless, for investors with an appetite to drive change, ESG-focused activist opportunities still abound. In the first half of 2022, activist campaigns at S&P 500 companies increased 42.5% percent over the same period in 2021[49], and in Europe, they increased by 67%[50]. There are also various predictions for more opportunities for activist investors through ESG-focused campaigns in 2023[51]. Prudent investors will no doubt bear these issues in mind when planning investment strategies for the year ahead.



In the first half of 2022, activist campaigns at S&P 500 companies increased 42.5% percent over the same period in 2021,



and in Europe, they increased by 67%.

Financing the energy transition

The global energy transition has moved well beyond its initial focus on decarbonizing our electricity systems by significantly reducing our reliance on legacy fossil fuel resources, adding renewable energy sources to the grid and accelerating rail and passenger car electrification to take advantage of the lower carbon footprint in the energy mix. Importantly, we are beginning to embrace the challenges of reducing emissions in "hard to abate" sectors such as heavy road transport, maritime, aviation and heavy industry. Indeed, the energy transition now encompasses the full spectrum of solutions that seek to:

- Decarbonize our electricity and gas networks;
- Decarbonize our transportation system (road, rail, maritime and air);
- Decarbonize energy- and carbon-intensive industrial processes (such as steel, aluminum, ammonia/fertilizer and cement production);
- Improve energy efficiency, reduce unnecessary energy consumption and optimize our energy systems;
- Offset residual emissions that cannot be reduced (with a key focus on "Scope 3" emissions, such as the emissions associated with the use by consumers of the products sold by a business); and
- Embed ESG factors in corporate governance, investment and lending processes, facilitate the disclosure and reporting of ESG data and support the authenticity of corporate ESG claims.

The breadth of energy transition solutions, across the globe, now includes:

Renewable electricity (e.g., offshore and onshore wind, solar, hydro, energy from waste/biomass and geothermal)

Battery and energy storage (at utility scale, to provide grid or behind-the-meter flexibility and for power resilience)

Biofuels and biogas/ biomethane

Carbon capture utilization and storage & direct carbon-capture technologies

Clean hydrogen and green ammonia

Sustainable aviation fuel and other sustainable synthetic or liquid fuels

Electric vehicle (EV) charging infrastructure

Extraction and processing of energy transition metals and the development of a wider value chain

Digital & other process solutions that optimize energy use & energy efficiency, support asset flexibility and navigate system constraints

Mandatory and voluntary carbon and emissions trading and offsets

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Importantly, ESG factors and considerations also are playing an increasingly important role in this space. In particular, stakeholders recognize that ESG considerations such as focusing on sustainable product development and risk management issues (e.g., avoiding greenwashing and developing processes to support substantiation of sustainability claims); developing credible and consistent ESG-related reporting and disclosures and compliance procedures; and embedding ESG factors in investment, lending, corporate governance and regulatory oversight of governance processes and procedures will be critical as the energy transition continues across all sectors of the global economy. These issues will be of particular importance as regulators increasingly look at developing and deploying integrated disclosure requirements as well as enforcement tools to ensure compliance with such requirements.

This very broad spectrum of energy transition solutions has different capital and financing requirements and different risk profiles. There is no "one size fits all" approach to developing and scaling a solution, and we expect that most stakeholders will implement energy transition strategies that involve a combination of available solutions, depending on geography, sector requirements and stakeholder-specific facts and circumstances.

We therefore expect all of the financing solutions below to play a significant role in delivering the energy transition:

- Bank project finance or limited recourse finance, which has been a dominant form of financing for the sector and will continue to play a critical role, particularly for assets with well-understood construction risks and long-term cost and revenue certainty;
- Bond capital markets, which have played a key role in financing (or refinancing) projects with stable, operational, lower-risk profiles (or greenfield construction assets that have been structured to replicate an operational risk profile due to the presence of government support providing protection for cost overruns and/or construction delay or failure), and innovative delayed-draw structures have evolved to offer project bond solutions for more construction projects;
- Common debt platforms, which will continue to be attractive for projects with very large financing requirements and the need or desire to pre-wire their ability to continue to access further finance over time from a mix of the bank, private placement and public bond markets;
- Green, sustainable or impact finance (including green bonds, green loans and sustainability-linked loans), using any of the above lending structures, but which are specifically targeted at lending to qualifying energy transition or ESG projects, businesses or activities or are designed to incentivize a broader sustainability or decarbonization agenda;
- Development finance institutions (DFI) and export credit agencies (ECA), which will remain key to mobilizing additional commercial capital, reducing the overall cost of capital, promoting the export of domestic supply chain solutions and/or bringing additional rigor to project due diligence and debt terms and conditions, particularly for projects in emerging sectors or with new technology risk;
- Sovereign infrastructure banks, loan guarantees and other blended-finance solutions, which provide support for innovative technologies, critical infrastructure and demonstration projects that are not yet served by commercial lenders;
- Streaming or royalty financings, which attract a different and complimentary category of financier, and enable companies to monetize their assets with greater flexibility than traditional debt terms (and which may play an even greater role as carbon credits develop);
- "HoldCo" or fund financings, which provide indirect funding solutions or funding projects on a portfolio basis;
- Private credit and institutional direct lending, which we expect to play an increasingly significant role in financing the transition as it may be able to offer more attractive financing solutions for energy transition projects with, for example, higher technology, construction, cost overrun, revenue or political/regulatory risks; and
- Special situations lending, which may be well suited to projects or businesses in, or close to, distress and looking at rescue or restructuring options.

In addition, many energy transition projects, solutions and businesses will continue to rely on balance sheet and/or traditional corporate financing, with energy, automotive, industry and technology majors alongside investment funds, likely to play a pivotal role in driving the sector forward.

The key to selecting the right capital structure and optimizing cost of capital and debt terms and conditions will be understanding and matching the underlying risk profile of the asset, project or business to the best available source(s) of capital.

We therefore expect all of the financing solutions below to play a significant role in delivering the energy transition:

Funding need and project life

Geography

Perceived political and regulatory risk

Likely construction and technology risk

Cost and revenue stability versus exposure to feedstock and offtake availability/uncertainty and merchant price risks

The extent of available government credits or support mechanisms that can reduce costs or de-risk the financing

The extent to which a secondary market for the relevant debt instrument exists

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The politicization of ESG: What's next?

By all accounts, stakeholder demand for ESG-related products, disclosures and metrics across all sectors of the economy continued to grow over the course of 2022, and this is expected to continue unabated during 2023. A recent forecast by PwC projects that assets managers are expected to "increase their ESG-related assets under management to more than $34 trillion by 2026, from $18 trillion in 2021" as demand for ESG-related products – financial and otherwise – continues its recent growth trajectory. Nevertheless, there has been a growing and increasingly vocal anti-ESG sentiment that stakeholders must prepare to confront and address, particularly in the United States (U.S.).

Estimated ESG-related assets under management by 2026:

U.S.

$10.5tn

Europe

$19.6tn

Asia-Pacific

$3.3tn

Overall

$33.9tn

Source: PwC

Stakeholder demand for ESG-related products, disclosures and metrics across all sectors of the economy continued to grow over the course of 2022, and this is expected to continue unabated during 2023.

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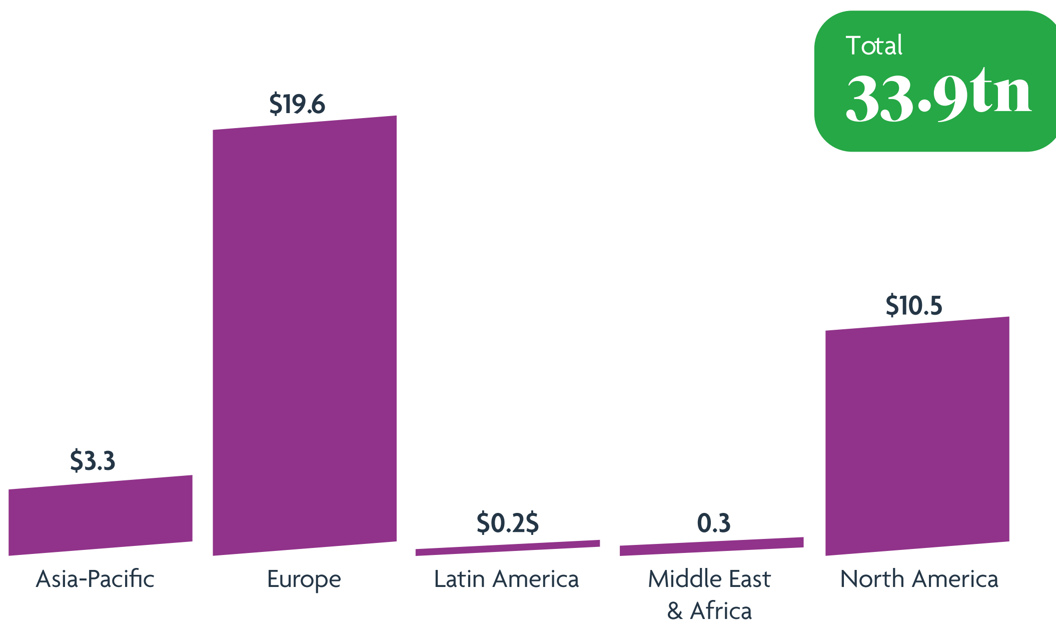
Indeed, skeptics have voiced doubts whether ESG actually facilitates long-term value creation or that adherence to ESG principles delivers results consistent with its promise. In some quarters, ESG-focused investing has been called a "scam" that has been "weaponized by social justice warriors"[52]. An opinion piece in The Wall Street Journal from October 2022 referred to a new $100 million energy index fund that will, in part, use "proxy measures to persuade companies to pursue…maximizing return to shareholders" in lieu of what is described as "politicized investment"[53].

The politicization of ESG has been particularly evident in several states in the U.S. For instance, Florida and Texas, among others, submitted letters to major asset managers and pension administrators questioning whether ESG commitments are coming at the expense of shareholders, with several states pulling back billions of dollars that were invested with such asset managers. A handful of states have gone as far as prohibiting the consideration of ESG factors in connection with the investment of state pension and retirements funds. Criticism of ESG issues has not been limited to asset and investment managers – 21 Republican state attorneys general recently submitted letters to the two largest proxy voting advisory firms raising questions with respect to how those firms push ESG principles when making proxy-voting recommendations. Additionally, the most recent form of pushback has come from Republican members of the U.S. House of Representatives who have established an "ESG Working Group" to "combat the threat to our capital markets posed by those…pushing environmental, social, and governance (ESG) proposals"[54].

We expect the pushback against ESG to continue over the course of 2023 and that these efforts will ramp up significantly as we head into the 2024 presidential election season. That said, global demand for ESG-focused products and services may simply be too large to ignore or for anti-ESG proponents to gain material traction. In addition to PwC's ESG-related growth projection noted above, jurisdictions outside of the U.S. have not seen any meaningful pushback relative to ESG issues. For example, and by comparison, in the EU and U.K., the politicization of ESG has been less prevalent, but as the Russia-Ukraine war continues, the energy crisis ceases to wane and political parties gear up for both local and national elections, it is expected that there will be similar issues brought to the forefront in a manner not dissimilar to the U.S. Relatedly, although asset managers have acknowledged that certain states have pulled back funds under investment, they are quick to note that divested funds are more than offset by capital inflows.

Global ESG AUM by region, 2026 base ($tn)



Source: PwC

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As stakeholders seek to navigate these complex issues, it is worth acknowledging that there are legitimate concerns related to ESG that need to be addressed. At a high level, we all will benefit from continuing to strive toward developing consistent and integrated disclosure frameworks, encouraging robust and credible public and private oversight structures for ESG-related issues and embracing efforts to guard against greenwashing and encouraging corporate transparency when it comes to the evolving issue of “green-hushing”.

In addition, there are practical steps companies and other stakeholders can take to mitigate against legal and other risks in this space. Boards of directors and management teams, for instance, should review and evaluate ESG-related programs and policies regularly against broader long-term strategic growth strategies and initiatives to ensure alignment. Disclosure processes and procedures should be assessed to ensure that public disclosures and statements can be substantiated and hold up against greenwashing claims. Regulatory and rulemaking initiatives should be evaluated periodically with counsel and other professional advisors, particularly for companies that have operations in multiple or cross-border jurisdictions with potentially inconsistent approaches to these issues. Finally, all stakeholders will surely benefit from regular and open communications so as to ensure alignment of purpose and to avoid unnecessary conflict where possible.

At a high level, we all will benefit from continuing to strive toward developing consistent and integrated disclosure frameworks, encouraging robust and credible public and private oversight structures for ESG-related issues and embracing efforts to guard against greenwashing and encouraging corporate transparency when it comes to the evolving issue of “green-hushing”.

ESG ratings: An update

As ESG financial products and metrics increase in the market, so too does the demand for comparability, transparency and oversight. ESG ratings have the potential to meet that demand, but come with their own set of challenges. ESG rating agencies and/or services, which operate similarly to credit rating services, create independent reports on ESG opportunities and risks facing a company or a product, ostensibly allowing that company, its stakeholders and investors to better understand ESG elements, risks or impacts – whether negative or positive. Yet discrepancies among rating systems; aggregated "E," "S," and "G" calculations; and differing methodologies and data bring a lack of clarity to the ESG rating market.

The ESG rating industry is largely self-policed and unregulated. Services develop proprietary methodologies, which creates incomparable results and fuels a general debate regarding the usefulness of the ESG rating system altogether. Even basic elements of ESG ratings can vary between providers, including whether the rating agency uses a numerical scale (e.g., 98 out of 100) or assigns a letter grade. In response to market confusion and a lack of comparable metrics, many have called for transparency, disclosure requirements and standardization. In fact, the International Financial Reporting Standards Foundation (IFRS) created the International Sustainability Standards Board (ISSB) in November 2021 to address that very issue and released a proposed standard for General Sustainability-Related Disclosures in March 2022[55].

As consumers of ESG rating services work to understand the system, companies also face concurrent, mounting pressure to ensure all ESG statements, actions and marketing efforts are clear and accurate. Errors or misstatements regarding a company's ESG metrics, advancements and goals will increasingly be subject to scrutiny by investors, the public and regulators.

Even basic elements of ESG ratings can vary between providers, including whether the rating agency uses a numerical scale or assigns a letter grade.

A growing number of governing bodies and international organizations have entered into the ESG ratings sphere and are considering whether further regulation is necessary. The International Organization of Securities Commission (IOSCO) published a November 2021 report that included recommendations for ESG product ratings and identified that "there is little clarity and alignment on definitions, including on what ratings or data products intend to measure" and that there is "a lack of transparency about these methodologies underpinning these ratings"[56]. The Securities and Exchange Board of India (SEBI) announced in January 2022 that it would begin to regulate ESG ratings, thereby becoming the first country to do so. SEBI's regulatory framework includes SEBI accreditation of ratings providers, but does not go so far as to propose a standardized ratings measurement. Japan recently took action as well, through its draft Code of Conduct for ESG Evaluation and Data Providers[57], and financial regulators across Africa are beginning to incorporate ESG factors into state-sponsored investment programs[58].

In the United Kingdom (U.K.), the Financial Conduct Authority (FCA) expressed its support for regulation of ESG ratings agencies and recently announced the formation of a group to develop a Code of Conduct for ESG data and ratings providers[59]. In a step toward standardization, the FCA will "coordinat[e] as far as possible with other jurisdictions" in the development of any regulatory approach[60]. The international Taskforce on Climate-related Financial Disclosures (TCFD) has been adding to the developing set of available guidance as well, including its most recent Status Report that provides an overview of current disclosure practices and reports key themes and findings from the Taskforce's disclosure review[61].

Most recently, the SEC proposed a rule in May 2022 to enhance and standardize disclosures related to ESG factors considered by funds and advisers, and to expand the regulation of the naming of funds with an ESG focus[62]. The SEC is currently considering public comments on its proposed ESG disclosure rules (the public comment period closed November 1, 2022), and the agency will likely implement the disclosure rule, or a version of it, in 2023. The status quo places the onus on those relying on third-party ESG rating providers to complete proper due diligence. Even after due diligence, however, the lack of standardized ratings criteria leaves companies with questions about the reliability of the ratings and rating systems themselves. To ensure reliability, some investors and companies choose to conduct their own assessment and analysis of ESG data. Those that use third-party ESG ratings providers would be well advised to take time to understand the data and methodology the provider uses, both at the outset of the process and regularly while the ESG rating is used. Taking either, or both, of these approaches will provide a greater level of protection and assurance that their ESG rating is defensible.

In the U.K., the FCA expressed its support for regulation of ESG ratings agencies and recently announced the formation of a group to develop a Code of Conduct for ESG data and ratings providers.

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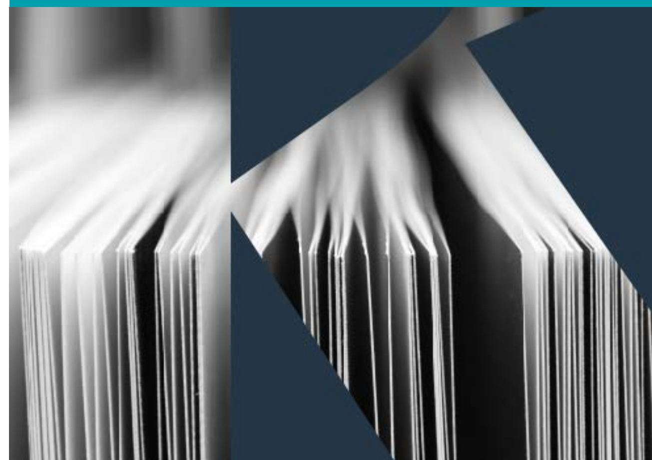
The forgotten “T” in ESG

Driven by a perceived link between ESG factors and financial performance, and a desire to promote their own values, the general public and investors are increasingly interested in ESG investments. One aspect of ESG that has, to date, seen less of a focus than it arguably deserves, is tax.

Tax considerations permeate all ESG considerations. Taxation (as a mechanism for wealth redistribution) is inherently socially driven, with measures such as research and development reliefs, charitable exemptions, and the United Kingdom’s (U.K.) diverted profits tax and off-payroll working rules, intended to benefit broader society through incentivizing or discouraging certain behaviors. However, these regimes typically develop organically within their respective spheres rather than being introduced to further an “ESG objective.”

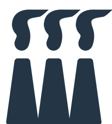
Environmental taxes and tax incentives present a powerful tool to drive a globally concerted effort to significantly reduce carbon emissions.



Tax governance, presenting both financial and reputational risk, is a growing concern for increasingly well-informed investors. Companies are now facing additional disclosure requirements, as well as scrutiny with regard to where and how much tax is paid, driven both by legislative change and investor pressure.

Generally speaking, domestic environmental tax legislation is piecemeal and consists of sector or energy-specific measures designed to discourage certain behaviors and draw funds from profitable industries. Notably, the U.K., following a "the polluter pays" policy, has historically imposed significant additional taxes on "bad" energy sources (largely gas, petroleum and solid fuel sources). There are also additional taxes on plastics, the exploitation of aggregate and landfill operations. Although there are enhanced capital allowances for investments in environmental technologies, intended to operate as a green energy tax incentive, these are largely overshadowed by the impact of the U.K.'s blanket energy levies.

Indeed, the recently introduced electric generator levy and energy profits levy, imposing windfall taxes on energy profits, apply to both "good" and "bad" sources of energy, thereby significantly reducing the commercial incentive to invest in green and sustainable energy.



The recently introduced electric generator levy and energy profits levy in the U.K., imposing windfall taxes on energy profits, apply to both "good" and "bad" sources of energy, thereby significantly reducing the commercial incentive to invest in green and sustainable energy.

With further uncertainty as to the appropriate tax treatment of transactions involving emissions credits and woodland carbon credits, there is clearly much potential for progress in this area.

The proposed European Union (EU) Carbon Border Tax, the "biggest climate law ever in Europe, and some say the world," shows promise in driving a concerted global effort to reduce emissions. Although still in its infancy, the tax, if implemented as proposed, would significantly raise the price of importing certain classes of goods with high manufacturing emissions into the EU, with the burden to reduce the tax by showing low manufacturing emissions placed on the exporter. While draconian and far from actual implementation, the tax has the potential to lead the reshaping of global trade in an environmentally beneficial manner.

Investors are showing an increasing interest in tax strategy. In addition to financial concerns, whereby companies face penalties and fines for tax evasion or avoidance, there is a developing reputational concern for investors.

Globally, reporting obligations and transparency measures have been spearheaded by the United States (U.S.) Foreign Account Tax Compliance Act (FATCA) and the Organization for Economic Cooperation and Development (OECD) Common Reporting Standard, requiring greater tax transparency from companies. In addition, in the U.K., with the introduction of the Code of Practice on Taxation for Banks and (more recently) the mandatory publication of tax strategies for large businesses, larger companies face increasing tax reporting obligations. Obligations in respect of potentially aggressive tax structures have been broadened by implementation of select "DAC6" hallmarks in the U.K. (soon to be replaced by the mandatory disclosure rules).

The proposed EU Carbon Border Tax shows promise in driving a concerted global effort to reduce emissions.

Global tax transparency measures:

March 2010
FACTA enacted as part of the Hiring Incentives to Restore Employment Act in the U.S.

June 2016
Inclusive Framework on Base Erosion and Profit Shifting (BEPS) established by OECD

July 2016
EU adopts the Anti-Tax Avoidance Directive, building on the OECD's BEPS initiative

May 2018
DAC6 introduced across the EU

January 2020
International Tax Enforcement (Disclosable Arrangements) Regulations 2020 implements DAC6 into UK law

March 2023
Mandatory disclosure rules (MDR) come into force in the U.K. to replace DAC6

October 2023
Transitional phase begins for EU's Carbon Border Adjustment Mechanism

These reporting obligations have been backed up with substantive legislative change, such as the EU Anti-Tax Avoidance Directives, sparked (primarily) by the OECD Base Erosion and Profit Shifting Project. This ties in with investors' increasing concern with the manner in which, through taxation, a business contributes to the international community. To this end, some investors favor investments deemed to be paying tax in "appropriate" jurisdictions. Viewing legislatively mandated standards as insufficient, such investors turn towards a number of voluntary metrics to measure and report on ESG tax performance, including the Sustainability Accounting Standards Board (SASB) industry-specific standards, the Global Reporting Initiative (GRI) 207 tax standard and the International Financial Reporting Standards' (IFRS) proposed Sustainability Disclosure Standards. These metrics can, however, be problematic to the extent they fail to provide a consistent benchmark for performance and reporting standards. Some investors, such as Google, have started relying on internal ESG metrics owing to the inconsistent external approach. The reluctance to use what could be considered "aggressive" tax structuring is therefore only partly driven by legislation – it is also heavily influenced by investor concerns and reputational risk regarding appropriate governance and social contribution.

In the U.S. context, despite political backlash, investors' enthusiasm for ESG products and business strategies, at least from an environmental perspective, is apparent in the fact that major asset managers have not yet opted out of the Net Zero Asset Managers Initiative. A handful of asset managers have also taken steps to implement and enforce SASB standards, with State Street having developed its own "R-Factor" score. However, the extent to which tax governance ESG measures are implemented will largely depend on the underlying rational for prioritizing ESG products.

The U.S. approach to ESG is largely premised on the principle of ESG products' profitability, seeing State Street proclaiming that investment in stocks as a potential solution to climate change is a "matter of value, not values." However, aggressive tax strategies inherently involve minimizing social contributions. ESG commitment to a tax strategy with greater social contribution, and implicitly a larger tax bill, would necessarily reduce profits. Ultimately, the extent of asset managers' ESG commitment in both the U.S. and Europe is driven by investor enthusiasm – material nonlegislative commitment to ESG tax strategies would likely form part of a broader ESG commitment and need to be driven by a matter of values, not value. Although European investors seem more focused on ESG values than their U.S. counterparts, it remains to be seen whether such enthusiasm will translate into material differences between U.S. and European tax planning.

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COP 27: Political progress but transformative climate actions remain illusive

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The evolving role of ESG in shareholder activism

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The politicization of ESG: What's next?

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ESG ratings: An update

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4 - SHRM, 12 Ways Companies Are Boosting Their DEI (March 9, 2022) https://www.shrm.org/resourcesandtools/hr-topics/behavioral-competencies/global-and-cultural-effectiveness/pages/12-ways-companies-are-boosting-their-dei.aspx

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15- Concepts involving unlawful discrimination include those espousing forms of racial superiority and privilege. Additional detail can be found here.

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