Too Legit: ESG Won't Quit

U.S. ESG Trends for 2023

Teneo Insights / January 2023

Introduction

Spoiler alert: The focus on Environmental, Social and Governance (or "ESG")[1] topics in the corporate world is here to stay. The catch? We may not call it ESG ten years from now, but that won't matter.

Our view has long been that ESG will become ubiquitous, and that we will likely stop calling it ESG one day because its tenets – and the disclosure of non-financial ESG data – will simply become the way in which we do business.

There is an important distinction between ESG for funds vs. ESG for corporates. The media conflates the two all the time, which has exacerbated the confusion on ESG. This article is about sustainability practices and programs at public companies, not the labeling or marketing of ESG funds.

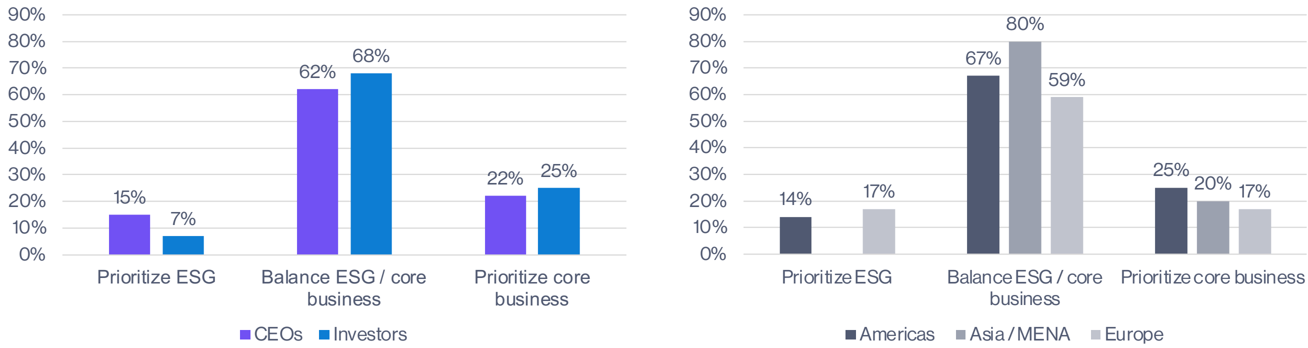
ESG's ultimate ubiquity is just one of our expectations for the future. This article covers 15 ESG trends that we believe are ahead.

Despite recessionary pressures, the ESG pushback from politicians and the underperformance of some ESG-focused funds, the results of Teneo's recent survey of global CEOs and institutional investors found that CEOs and investors are unwavering in their commitment to balance company performance and ESG commitments in 2023.

In fact, more than 60% of CEOs and investors indicated a commitment to balance both priorities, while 15% of CEOs said that they are prioritizing investment in ESG over business performance (Figure 1).[2] This percentage is even higher in Asia and Europe, where CEOs are more likely to balance ESG and business needs, while CEOs in the Americas lean toward refocusing on operations. As media coverage shows, some Americans believe ESG is a challenge to capitalism (which it is not).

ESG is simply misunderstood by most people.

Figure 1: Prioritizing Investment in ESG-Related Activities Related to the Core Business



[1] Teneo follows the guidance of The Sustainability Accounting Standards Board (SASB) and the Fundamentals of Sustainability Accounting (FSA) in the use of certain terms. "Sustainability" and "ESG" are used interchangeably when referencing information about environmental, social, and governance issues. In addition, while "disclosure" may imply regulatory-based reporting, the term does not refer to reporting requirements only. In this document, "disclosure" is used interchangeably with "reporting."

[2] Teneo Vision 2023 | CEO and Investor Outlook Survey

This piece explores key ESG trends finding traction in board rooms and headlines across the U.S. – While also seeking to clarify some common misconceptions about ESG:

1. Witnessing History: The Standardization of ESG is Coming
2. Surprise, Numbers Aren't Political: The Anti-ESG Movement, and Why Experts Will Push for ESG Objectivism
3. The Dawn of Sustainability Accounting: Tying ESG to Financial Impact
4. Formalizing Stakeholder Engagement to Support Strategy and Reduce Risk
5. "Activist Employees" and Increasing Unionization
6. Chief Political Officer and CEO? Deciding When CEOs Should Weigh in on Social Issues
7. Doubling Up: A New Focus on ESG Materiality Assessments
8. Tax Transparency: Country-by-Country Reporting
9. The Universal Proxy Card Has Arrived, with Major Implications for Shareholder Activism
10. Ushering in a New Era of "Shareholder Democracy"
11. Incentivizing Sustainability Progress: Linking All Employees' Compensation to ESG Goals
12. Climate Transition Plans: Growing Pressure for Net Zero Details
13. Biodiversity Takes Flight
14. International Debate Will Continue on the Largest U.S. Climate Legislation Ever
15. Rising Tides: The Level of Focus on Water Stewardship Will Increase

01 Witnessing History: The Standardization of ESG is Coming

There is a growing movement towards standardization in sustainability broadly – from the codification of ESG-related policies to efforts to create a universal ESG reporting framework.

Currently, non-financial ESG data has many of the same challenges that financial data had about 100 years ago when the stock market crashed in 1929, with the Great Depression ensuing in its wake. In the U.S., the precipitous drop in stocks' market value by the summer of 1932 and subsequent public outcry resulted in investigative hearings, in which national legislators uncovered dubious practices, including "bankers and companies that failed to fully disclose information about the companies whose securities were being offered for sale, creating widespread securities sales using false or misleading information."[3] The 1929 stock market crash and global economic downturn it sparked are one of the most poignant examples of how a lack of transparency can have dire consequences and fundamentally erode investor confidence.[4]

We are now seeing the consequences of inaccurate, incomparable and unreliable non-financial ESG data play out in front of us. And although the International Sustainability Standards Board (ISSB) is currently working on a universal ESG reporting framework aimed at streamlining ESG disclosures, some naysayers argue this will never work.

We disagree. Accounting standards for U.S. GAAP and IFRS weren't developed overnight. These efforts take years, and even if the U.S. forges out on its own again like it did with GAAP, and we end up with a couple of standards, we see the broad consolidation of the current multitude of ESG reporting frameworks and standards as inevitable.

Related to this, one of the most significant ESG developments in 2022 was the creation of a single set of ESG reporting standards for the European Union, the Corporate Sustainability Reporting Directive (CSRD). This is the most far-reaching sustainability disclosure legislation ever, around the world. The CSRD aims to improve the quality of non-financial data and make sustainability reporting more consistent, reliable, comparable and useful. In short, it seeks to make ESG disclosures more akin to financial accounting and reporting.

As part of ESG's broad standardization and CSRD's requirements, there will be a rapidly accelerated move towards third-party assurance of ESG reporting, which will help with some current data integrity issues.

Takeaway: As the standardization of ESG continues, U.S. companies must have data collection, controls and internal audit procedures in place for non-financial data in addition to financial data to promote accurate ESG reporting and avoid potential legal risks.

[3] SASB Fundamentals of Sustainability Accounting citing Senate Banking and Currency Committee, Stock Exchange Practices (Fletcher Report), S. Rep. No. 73-1455 (1934)

[4] "Speech by SEC Staff: Quality, Transparency, Accountability," by Lynn E Turner, April 26, 2001.

ESG regulation gains traction around the world – with significant impacts on U.S. companies

Despite the U.S. SEC's delayed decision on climate disclosures, many countries have marched ahead on ESG regulation, which has implications for U.S. companies. Europe's CSRD rules will apply to corporations outside Europe, too – including U.S. companies of a certain size with at least one subsidiary or branch in Europe. The gridlock in Washington and any U.S. regulatory delays on climate disclosures will likely be usurped by the private markets (again). Many points raised by the government may end up largely moot given the influence of the largest U.S. asset managers, who we anticipate will continue to encourage issuers to approach environmental and social issues responsibly and transparently through ESG disclosures.

Takeaway: While companies aren't required to adopt the new CSRD this year, management teams should familiarize themselves with the requirements as soon as possible to understand what new information they may be required to report and begin making internal changes now to ensure a smooth transition.

Integrated reporting will increase – combining financial and non-financial data reporting

Lastly, investors are increasingly asking our clients to explain how ESG fits into their investment proposition and commercial strategy. Under CSRD, companies will have to publish sustainability information in the management report, so implementing the guidelines of the International Integrated Reporting Council (IIRC)'s <IR> Framework is very relevant given its incorporation of intangibles, including social, human and intellectual capital.

Like IIRC's multi-capital approach, the CSRD "recognizes the importance of intangible assets and relationships for value creation, putting sustainability disclosure on an equal footing with financial information."[5] With intangible assets like culture, goodwill, intellectual property and brand comprising an increasing portion of market value, combining financial and non-financial reporting makes sense.

It is worth noting that at the WEF Forum in Davos, IFRS Chair Erkki Liikanen announced that the finalized versions of the first global standards for sustainability and climate-related reporting will be released in June of this year. Quoting the Chair of IOSCO, Liikanen said, "the aim should be that in 2024, financial reporting and sustainability reporting will go together."

Takeaway: As we know, when it comes to ESG, developments in Europe are often a harbinger of what will eventually play out in the U.S. and elsewhere. Integrated reporting like that in the IIRC's <IR> Framework and the CSRD are examples. The SEC has already been evaluating cybersecurity and more human capital disclosures; U.S. companies should prepare for a future in which the SEC will combine more ESG information than just climate reporting with the Form 10-K or other filings.

[5] "IIRC Welcomes Multi-Capital Approach Outlined in European Commission Corporate Sustainability Reporting Directive (CSRD) Proposals," IIRC, April 23, 2021

02 Surprise, Numbers Aren't Political: The Anti-ESG Movement, and Why Experts Will Push for ESG Objectivism

In many ways, ESG became a four-letter word in 2022 as the politicization of ESG reached unprecedented levels. Terms like "woke" took on new meaning and were used to describe companies and investment firms that supported certain environmental and social causes – or in some cases, "ESG" itself.

The exercise below seeks to correct misconceptions about ESG – simply and clearly.

Figure 2: Comparison of Two Companies on Financial and Non-Financial Metrics

ESG Considerations: Comparing Two Companies

Company A

$1.5B in annual revenue

$500m in net income

+1.5% in stock performance in FY 2022

15% employee turnover

$2m in fines for discrimination lawsuits

5% reduction in emissions in past 2 years

5 cybersecurity incidents

8 fatalities

Company B

$1.4B in annual revenue

$450m in net income

+2.1% in stock performance in FY 2022

6% employee turnover

$100k in fines for discrimination lawsuits

30% reduction in emissions in past 2 years

1 cybersecurity incident

0 fatalities

Which company would you invest in?

Companies A and B are in the same industry and have similar business models. Take a moment to compare the metrics of Company A vs. Company B (Figure 2). What are your observations?

- Based on the information given, if you were planning to invest in one of these companies, which one would you choose?
- If you were planning to accept a job at one of these companies, which one would you choose?
- Now, look at the data again. As you likely noticed, the numbers above the dotted line represent financial data, and the numbers below the dotted line represent non-financial ESG factors.
  - Do any of these numbers reflect a political view?

The answer is no.

Over the past few years, a common theme echoed by ESG experts and thought leaders is that they increasingly emphasize the objectivism that guides ESG principles and standards. This includes a desire to improve the quality of ESG data and a focus on the development of best-in-class ESG reporting frameworks, which seek to uphold standards that are data-driven, evidence-based, verifiable and neutral – similar to financial reporting.

As Cyrus Taraporevala's quote conveys, the difference is value vs. values. Importantly, ESG does not seek to assert a certain kind of values or beliefs, nor does it strive to push a Republican or Democratic agenda. It simply examines how responsibility across environmental, social and governance areas can lead to better risk management and support long-term value creation for companies.

The concept of ESG objectivism will eventually become second-nature, and the disclosure of non-financial ESG metrics will be no more politically charged than the announcement of quarterly earnings. For now, investors are simply asking companies to disclose their relevant data (emissions, diversity, etc.) and let the market – and society – decide from there.

"We approach these [ESG] issues from the perspective of long-term investment value, not from a political or social agenda (aka 'values')."[6]

Cyrus Taraporevala, State Street Global Advisors

[6] "2019 Proxy Letter — Aligning Corporate Culture with Long-Term Strategy," by Cyrus Taraporevala, State Street Global Advisors, January 15, 2019

In an effort to educate people on ESG, Bob Eccles has published a plethora of articles in recent months as part of a personal crusade to dispel misinformation and educate others on what ESG really is.

"We focus on sustainability not because we're environmentalists, but because we are capitalists and fiduciaries to our clients."[7]

Larry Fink, CEO, BlackRock

When writing about the dramatic feuds in Washington and ESG being dubbed "a pernicious strategy...that empowers an unelected cabal of bureaucrats," Eccles comments, "[ESG] is nothing nearly as exciting as that. It's simply about companies and investors managing material risk factors to ensure long-term value creation."[8]

In a run-up to the November 2022 midterms, many Republican Governors attacked BlackRock and decided to boycott the firm by pulling out their money.

This made a huge splash, with thousands of articles on the topic. Unfortunately, both Republicans and Democrats in some cases were misguided in their understanding of ESG. We expect – and hope – the future of ESG will bring more understanding to our society about what ESG is, and how it can decrease risks and support long-term value creation.

Takeaway: ESG is about risk management and long-term value creation; it is not meant to convey a political view or "values" of any sort. More education on ESG is needed among a corporation's many stakeholder groups, as well as among our society more broadly.

The roughly $3 billion Republicans have pulled from BlackRock so far is a proverbial drop in the bucket. To be precise, it's 0.035% of BlackRock's total AUM of $8.59 trillion at the end of the fourth quarter of 2022. For BlackRock, this is more of a legal headache than anything else.

[7] "Larry Fink's 2020 Letter to CEOs: The Power of Capitalism," by Larry Fink, BlackRock, January 16, 2022
[8] "My New Year's Resolution to Republican Politicians Regarding ESG," by Robert G. Eccles, Forbes, January 1, 2023

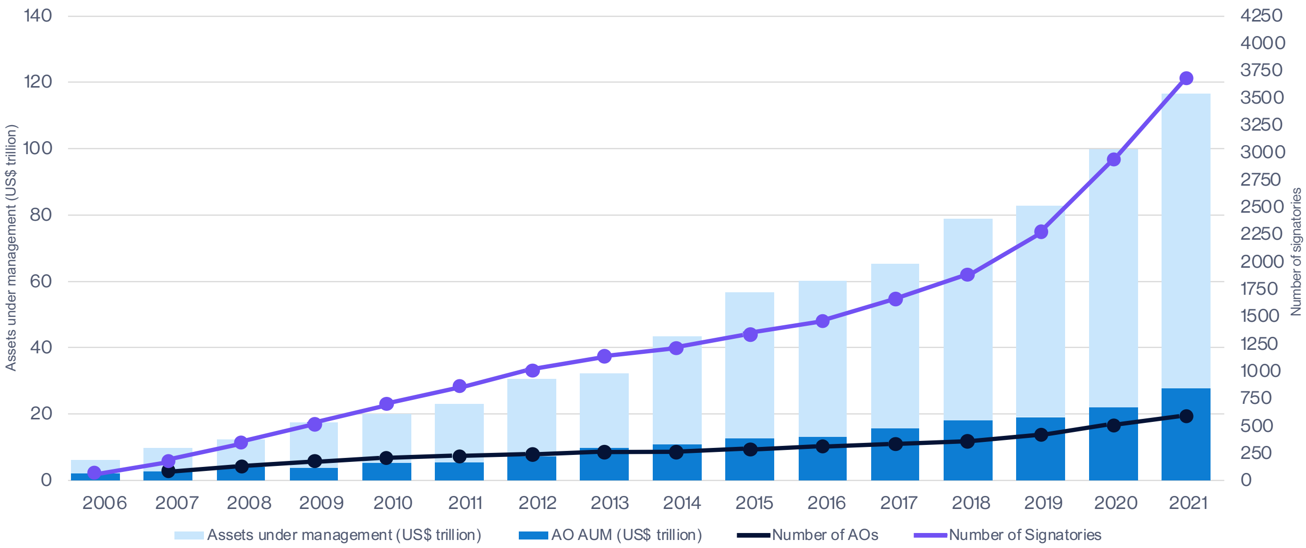
PRI signatory growth continues

The United Nations-supported Principles for Responsible Investment (PRI) initiative represents an international network of financial institutions working together to implement six Principles for Responsible Investment. PRI's goal is to understand the implications of sustainability for investors and support signatories in incorporating these issues into their investment decision-making and ownership practices.

Despite all of the anti-ESG pushback, the PRI has continued to gain momentum, including 5,179 signatories globally, representing $121tn of AUM as of the end of 2022 (Figure 3).[9]

Figure 3: PRI Growth Since 2006

The PRI now has 5,179 signatories, representing $121tn of AUM



Source: Principles for Responsible Investment

[9] "Quarterly Signatory Update," by David Atkin, United Nations Principles for Responsible Investment

03 The Dawn of Sustainability Accounting: Tying ESG to Financial Impact

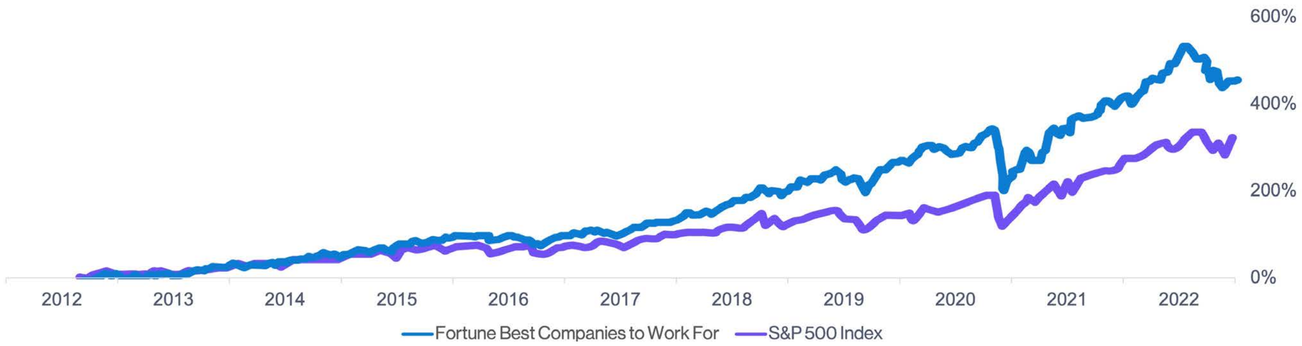
Can a good culture and strong ESG platform create value?

Data suggests that the answer is "yes." And although a robust ESG program does not guarantee value creation especially in the short term, companies with leading ESG programs tend to outperform companies without them over the long term. For example, companies included in Fortune's "100 Best Companies to Work For" list have consistently outperformed the market over the past decade (Figure 4). It makes sense that companies with strong cultures and happy employees will fare better over time, likely having better outcomes, such as these: higher retention rates and therefore less money spent on training and retraining people for the same position, lower fines and settlements relating to issues like sexual harassment and discrimination, and "free marketing" by employees who love their job and employer and consequently who pass that positive sentiment along to potential recruits, customers and others throughout their tenure and beyond.

Figure 4: Performance of Fortune 100 Best Companies to Work For

Top Employers Outperform

Companies that are rated top employers exhibit stock outperformance



Source: Bloomberg data; Fortune 100 Best Companies to Work For rankings

Note: Based on total return; considers public companies that were listed on Fortune's list in 2011 and are still there in 2021; method roughly adapted from Alex Edman's study on job satisfaction and firm value

ESG risks are business risks that can impact stock price and enterprise value

Companies broadly recognize that financial information alone does not provide a complete picture of a business. For decades, investors have increasingly recognized the need to account for non-financial value drivers, externalities and other performance measures that influence enterprise value creation and thus help investors make more informed decisions.

The field of sustainability accounting is born

Recognitions like those outlined on the previous page reflect a growing movement driven by a body of ESG experts, influencers, investors and other stakeholders to recognize and validate the connection among material ESG factors, enterprise value and investment performance. This has given birth to the field of "sustainability accounting," bringing the rigor of finance and accounting to sustainability. Similar to financial reporting's evolution over decades, sustainability accounting will continue to evolve.

ESG's impact on financial performance can be seen in many instances. Some examples include:

- New revenue streams created when a company introduces a sustainable product, such as automotive companies' introduction of electric vehicles
- Lower interest rates awarded to ethical and responsible companies for their strong risk management practices
- Lower operating expenses for a company that decreases its emissions in a country that has introduced a new carbon tax

According to Bank of America's Savita Subramanian, ESG factors are the best signal for fundamental risk as traditional financial metrics like earnings quality, leverage and profitability are not nearly as useful as ESG metrics when it comes to anticipating future earnings risk and volatility of U.S. corporations. A few years ago, she published research on how controversies involving ESG issues wiped $500 billion off the value of large U.S. companies over the 5-year period from 2015 to 2019.[10]

We will continue to see more and more connections between ESG and financial performance.

Takeaway: Increasingly, investors are asking how companies' ESG efforts impact their financial performance. U.S. companies need to get up-to-speed on sustainability accounting and evaluate if – and where – it might fit into the investor relations narrative.

[10] "ESG Controversies Wipe $500bn Off Value of US Companies," by Chris Flood, Financial Times, December 14, 2019

04 Formalizing Stakeholder Engagement to Support Strategy and Reduce Risk

When the Business Roundtable (BRT) redefined the purpose of a corporation in 2019, it initiated a tectonic shift in the global business landscape. Not only did it catalyze the stakeholder capitalism movement, but it also highlighted the need for accurate and credible assessments to validate whether or not companies are fulfilling their promise and ambition to “benefit all stakeholders – customers, employees, suppliers, communities and shareholders” (Figure 5).

Figure 5: Prior to the Business Roundtable Announcement in 2019, the Purpose of a Corporation was Focused on Creating Value for Investors

Before the Business Roundtable Announcement in 2019...

Stakeholder engagement is not exempt from the shift to standardization in ESG. Since the BRT’s 2019 announcement, the stakeholder capitalism movement has gained momentum globally. As a result, there is a magnified focus on companies’ engagement with their stakeholders.

Companies are now increasingly implementing parameters to guide engagement, including formal policies, official company statements on key social issues and formal models / frameworks to guide and measure stakeholder engagement. Best-in-class companies report not only the methods of engagement, but also details on the key issues raised and the follow-up actions taken.

Takeaway: The AccountAbility (AA1000) Standards were developed to put guard rails in place for stakeholder engagement. Companies are encouraged to review AccountAbility’s detailed guidance in the AA1000 Standards and assess what parts of it make sense for implementation at their own company.

05 "Activist Employees" and Increasing Unionization

In 2021, hundreds of employees at one of the largest U.S. tech companies created one of the first "white-collar unions" in Silicon Valley. Notably, organizers were motivated by a desire to have a voice on moral issues, not an increase in salaries or other standard requests in these instances.

In 2022, worker strikes across a wide variety of sectors increased by 39% year-over-year.[11] Similar to the tech company above, at the end of last year salaried workers at one of the largest U.S. financial institutions went on broadcast news and said the formation of a union would help them join together and speak out against unethical practices pushed down from management.

With Millennials comprising the majority of the U.S. workforce today and moving into middle and senior management roles, an increased focus on social responsibility and a more civic-minded workforce makes sense. So does the willingness to speak out against employers.

Millennials grew up in the height of social media's rise, many of them using social media from an early age to post their opinions and pictures for the world to see – every day. We should not be surprised that this generation is not afraid to speak up in the workplace and, in fact, thrives on publicly expressing themselves.

Importantly, ESG's rise in the corporate world would never have been possible without social media. Why?

The creation of social media ushered in a revolution that transformed history as it permanently altered the corporate conversation, shifting it from a monologue to a dialogue. Stakeholders could suddenly talk back – and with – an audience.

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[11] "Worker Strikes Surged in 2022," by Emily Peck, Axios, December 19, 2022

This heralded a seminal disruption: the corporate conversation morphed from a series of one-way communications pushed down from companies to employees and other stakeholders, to a true exchange of ideas between corporations and their stakeholders. In short, social media gave a voice to the formerly voiceless in the workplace and beyond, from the #metoo movement to Black Lives Matter and countless other movements, forcing a new level of accountability for companies and institutions that had never been seen before.

Importantly, this change will not revert. When future generations look back on this century, social media will be etched in history for this reason: it sparked a digital revolution that democratized communication – and influence. This is the foundation on which the ESG movement is built, and it is how recordings, pictures, videos and information posted on social media by employees and others necessitated a new level of transparency and responsibility for companies. The power returned to the proverbial "people," pitting the word of the masses on major issues against previously unopposed C-suites, boards and industry titans.

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We expect employees to continue to exert their power. According to a Gallup poll released last summer, approval of labor unions among the U.S. public is at its highest level since 1965, yet a majority of non-union workers in the U.S. (58%) say they are "not interested at all" in joining a union.[12]

A spokesman for Gallup explained the contradictory results as stemming from the fact that Americans want to give some power back to employees and improve the overall workplace experience and environment, rather than join the unions themselves.

We will continue to watch this evolving balance of power in corporate America.

Takeaway: Do not expect "activist employees" and unionization efforts to abate in 2023. Companies should proactively conduct desktop exercises and ensure they have a playbook to help them prepare for any potential risks ahead. Now, more than ever, employee engagement is a critical way to regularly take the pulse of a company's culture and people.

[12] "The American Public is Back in Love with Labor Unions, So Why Aren't Workers?" by Eric Rosenbaum, CNBC.com, August 31, 2022

06 Chief Political Officer and CEO? Deciding When CEOs Should Weigh in on Social Issues

In the past few years, activist employees have been on the rise, and there has been more pressure for CEOs to publicly respond to employees and other stakeholders' demands on environmental and social issues. While we have also seen examples of how that can backfire, younger generations increasingly want to work at companies where they know leadership's values align with their own. The correlation makes sense: the more activist employees there are, the more activist CEOs employees expect.

Today, "more companies feel pressure to weigh in on fraught political, social and moral issues, from voting rights in the U.S. to human rights in China or Russia's invasion of Ukraine, in what some dub a new era of 'corporate political responsibility.'"[13]

In Teneo's recent Vision 2023 CEO and Investor Outlook Survey, our research team found that nearly one in five large-company CEOs believe they are not well prepared to respond to the next controversial social issue that emerges.[14] Related to this, the results showed that only 28% of CEOs indicate that they believe their current executive teams represent the perspectives of future generations.

When asked what internal pressure points may inhibit their ability to manage disruption, both CEOs and investors surveyed agreed (more than 50% of each data set) that external stakeholder pressure is a material consideration, raising the question of how much influence external stakeholders exert in how priorities are set internally.

Takeaway: Advance preparation for addressing high-likelihood/high-risk issues will improve a company's ability to navigate or mitigate impact. Teneo's Diversity, Equity and Inclusion team (co-headed by Senior Managing Directors Lisa R. Davis and Faten Alqaseer) works with executives to establish a customized strategic framework for determining what a company will and will not address and how it will respond.

[13] "When Should Business Take a Stand?" by Sarah Murray, The Financial Times, March 8, 2022

[14] "Global CEOs and Investors Have Diverging Views on Economic Outlook, Preparing for Deglobalization in 2023, Teneo Survey Finds," by Teneo, December 20, 2022

07 Doubling Up: A New Focus on ESG Materiality Assessments[15]

Since the Business Roundtable's announcement in 2019, stakeholder capitalism took hold in the U.S. Over the same period, ESG materiality assessments have grown in frequency and importance, and they will continue to climb in significance throughout 2023 for many reasons. In short, these assessments embody the tenets of stakeholder capitalism as they involve interviewing or surveying a company's many stakeholder groups to help ensure that the company's ESG priorities are aligned with its stakeholders' views.

Recent examples of a growing interest in ESG materiality assessments are as follows:

- A prominent activist investor using an ESG materiality assessment in the materials for his highly publicized ESG activism campaign.
- New questions on a company's materiality assessment surfacing in ESG ratings scorecards, with potential impacts to a company's score and thus, potentially, its access to capital.
- The Principles for Responsible Investment (PRI) submitting a consultation response to the ISSB's drafts for a new global ESG reporting framework last July; in it, PRI encouraged ISSB to require corporates to provide more details on their materiality assessments.[16]

When it comes to ESG materiality assessments, regulation in the U.S., Singapore and Japan has focused on disclosures specifically relevant to financial materiality, or "single materiality." Meanwhile, the EU, UK, and Hong Kong explicitly include disclosures on broader societal impact, in addition to financial materiality (referred to as "double materiality").

With the approval of CSRD in Europe, double materiality will be required – again, not only for companies in the European Union but also for U.S. companies of a certain size with a European subsidiary or branch. The Global Reporting Initiative (GRI) standards are based on double materiality as well, while SASB and the new ISSB framework are based on single materiality.

Takeaway: In 2023, disclosure and reporting complexities for multinational companies will be exacerbated further. U.S. companies should be prepared to refresh – or in some cases, begin – their ESG materiality assessments through the double materiality lens as well.

[15] Note: The term "materiality" in this case refers to priority ESG topics and should not be confused with the meaning of the term "materiality" under U.S. securities laws

[16] PRI Consultation Response - DRAFT: IFRS S1 General Requirements

08 Tax Transparency: Country-by-Country Reporting

Some companies are now publishing supplemental reports outlining tax payments by country. Increasingly, investors also are pushing for public country-by-country reporting (PCbCR), while other companies have proactively adopted the voluntary standards for tax reporting under the GRI standards. Companies that are raising their hands to disclose this information often highlight how their tax payments contribute to the communities in which they operate.

Looking back, a prominent energy company published its first PCbCR tax report in 2019, with reporters then heralding it as the beginning of the demise of tax secrecy. This kind of detailed reporting is required by tax authorities in about 100 countries, including the U.S., since 2017 based on rules agreed by the Organization for Economic Cooperation and Development, but it is rarely made public. The energy company hoped to entice other corporations to follow its lead when it published the report four years ago, and while some have, many corporations only have done so begrudgingly after facing a shareholder proposal.

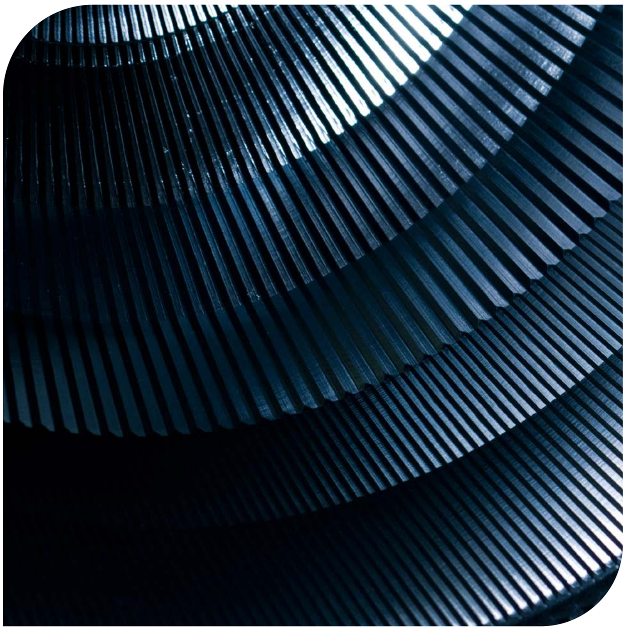
Takeaway: Regardless of whether companies are pushed to do this or pursue country-by-country reporting on their own, we expect attention on this topic to gain speed. C-suites and boards should review what is required in PCbCR and any implications for their companies if they must one day disclose this information.

09 The Universal Proxy Card Has Arrived with Major Implications for Shareholder Activism

The implementation of the universal proxy card (UPC) and the increasing use of ESG as a “hook” for a contentious conversation have multiplied the threat of shareholder activism.

With the cost of a proxy contest decreasing exponentially and a wider spectrum of issues to defend, including environmental and social issues, having a robust activist preparedness plan and defense strategy at the ready is critical to protecting companies against potential activist intervention. It also ensures corporates can mobilize quickly and effectively in the event of a fight.

Takeaway: The activism game has changed in a monumental way with the universal proxy card. Companies need to evaluate their position in this rapidly evolving landscape and proactively prepare for potential activist threats, including challenges to a company’s decisions on sustainability topics.



10 Ushering in a New Era of "Shareholder Democracy"

2022 introduced a new era in "Shareholder Democracy," one in which asset managers increasingly share and transfer voting power to stakeholders (hence the term "pass-through" voting). Last year, BlackRock announced Voting Choice, an initiative to give institutional investors and some individual investors options for voting at annual shareholder meetings. The asset manager has expanded the program significantly since. "The next generation of investors will increasingly demand to be heard," Fink wrote.[17]

With State Street and Vanguard announcing similar initiatives, there are significant consequences for companies, as Teneo's Governance Advisory Team (led by Dr. Martha Carter, Vice Chairman and Head of Governance, and Senior Managing Director Matt Filosa) outlined in a recent piece Be Careful What You Wish For: Four Potential Consequences of Pass-Through Voting for Companies.

Among those listed are potential impacts from retail investors, with the piece noting that, "Activist investors may also see an opportunity to gain the support of the newly empowered retail investors in their proxy campaigns, especially those relating to ESG issues where individual investors may have a more populist view than institutions (e.g., executive compensation)." Overall, engagement with retail investors will likely become much more significant for issuers, as will companies' ESG strategy and communications.

Takeaway: Pass-through voting has major potential repercussions and brings a much wider set of stakeholders and views to the mix. One important consideration for ESG is how pass-through voting may amplify the voice of retail investors on environmental and social topics. At a minimum, companies should prepare for a very different dynamic.

[17] "BlackRock Sees a 'Revolution' Coming in Corporate Governance," by Andrew Ross Sorkin, Ravi Mattu, Bernhard Warner, Sarah Kessler, Stephen Gandel, Michael J. de la Merced, Lauren Hirsch and Ephrat Livni, The New York Times DealBook Newsletter, November 3, 2022

11 Incentivizing Sustainability Progress: Linking All Employees' Compensation to ESG Goals

Over the past decade, executive compensation has increasingly been linked to progress on specific ESG initiatives. In 2022, some companies took this concept to a new level, incorporating progress against ESG goals as a factor in compensation for all employees.

A growing number of companies are beginning to factor corporate ESG targets into rewards – not just for executives, but increasingly for all employees. This marks a sea change in the ESG and compensation conversation.

One such company explains its decision to integrate ESG goals into all employees' compensation simply as: "our responsibility, and our success, is shared."

Takeaway: Companies need to monitor the efficacy of these measures throughout 2023 as they consider adjustments to their own compensation models in relation to ESG goals and incentives.

12 Climate Transition Plans: Growing Pressure for Net Zero Details

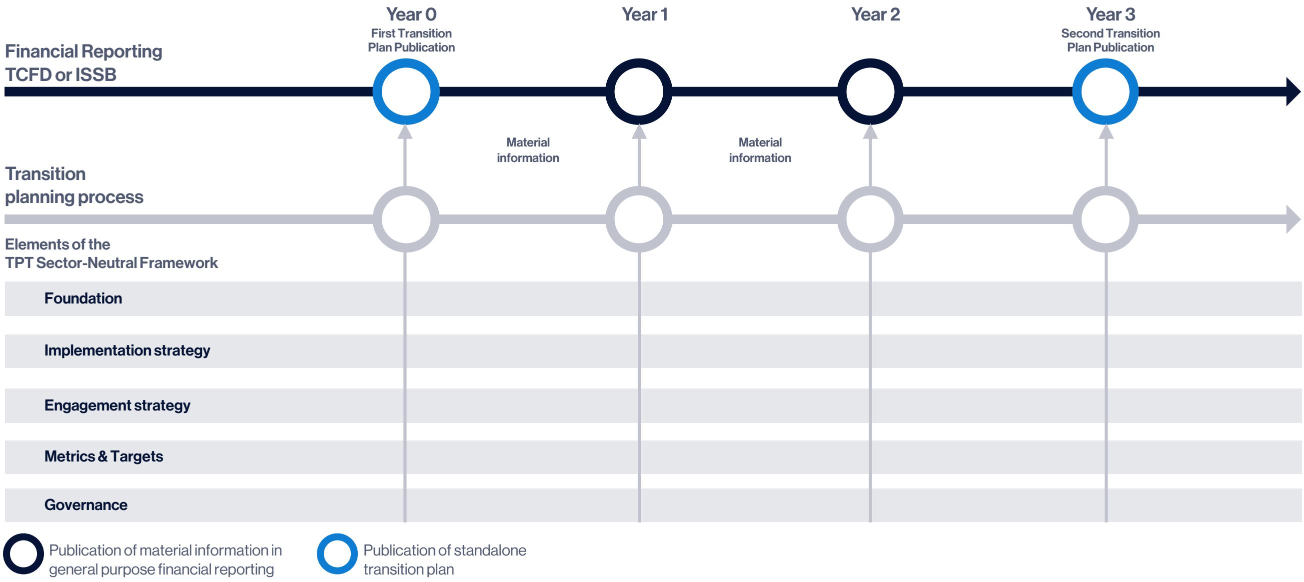
After a company announces a net zero target, the subsequent publication of a Task Force on Climate-related Financial Disclosures (TCFD) report is now considered standard practice – and an expectation by investors. Increasingly, investors and others now expect companies to communicate how they will meet their climate goals in the short-, medium-, and long-term by issuing a climate transition plan.

During the COP26 conference in 2021, the UK government announced that asset managers, regulated asset owners and public companies will be required to publish net zero transition plans by 2023, which should outline how companies will decarbonize to meet the UK's national 2050 net zero targets.

A Transition Plan Taskforce was created and launched a Disclosure Framework and Implementation Guidance, both of which are intended to serve as a gold standard for transition plans; both are also currently open to public consultation through the end of February. These are meant to help companies develop a transition plan step by step (Figure 6). The public's reception of these ambitious efforts will likely have important implications for how corporations broadly approach these plans.

Takeaway: We have moved from aspiration to action. Publicly announcing a net zero target is no longer enough. For those that don't already, companies should have a roadmap outlining the specific steps they will take between now and the year chosen as a deadline (2040, 2050, etc.), as well as the abatement levers they will use to successfully achieve their climate goals.

Figure 6: Excerpt from "Consultation: The Transition Plan Taskforce Implementation Guidance"



13 Biodiversity Takes Flight

At the end of 2022, the COP15 UN Biodiversity Conference in Montréal secured a major win with a pact by 195 nations to fight nature loss and restore at least 30% of the Earth's land and water by 2030. In addition, wealthy countries vowed to fund an estimated $30 billion per year by 2030 to help less fortunate countries in part through a new biodiversity fund.

The traction at COP15 was accompanied by accelerated momentum and support for an ESG reporting framework focused on natural capital and biodiversity topics, The Task Force on Nature-Related Financial Disclosures (TNFD). According to the TNFD website, "more than half of the world's economic output – $44 trillion of economic value generation – is moderately or highly dependent on nature," yet we currently don't have the information we need to evaluate "how nature impacts an organization's immediate financial performance, or the longer-term financial risks that may arise from how the organization, positively or negatively, impacts nature."[18]

The TNFD has garnered the support of major financial institutions and industry groups from the start, and one of the changes in BlackRock's newly released 2023 Voting Policies is their encouragement for "companies to consider reporting on nature-related factors, given the growing materiality of these issues for many businesses,"[19] citing the TNFD in the document's accompanying footnote.

Takeaway: It will be important for companies to understand what additional information they will be asked to disclose based on the TNFD framework, which is set to have final recommendations published in September of this year.

[18] The Task Force on Nature-related Financial Disclosures website

[19] "BlackRock Investment Stewardship: Global Principles 2023"

14 International Debate Will Continue on the Largest U.S. Climate Legislation Ever

In the late summer of 2022, U.S. President Joe Biden and a slim Democratic majority in Congress successfully passed the Inflation Reduction Act, which included within it the most significant U.S. climate legislation ever, despite no mention of climate in the title.[20] With approximately $370 billion earmarked for climate spending, the Inflation Reduction Act ensures that billions of dollars will be put towards the energy transition over decades and will include a just and inclusive transition to net zero. Energy experts have estimated that the legislation ultimately will eliminate 4 billion tons of greenhouse gas emissions.[21]

However, the U.S. legislation has received sharp criticism overseas. The sticking point? The subsidies pertain to producing goods incorporating green technologies on American soil only. Detractors have said it penalizes international producers and does not respect World Trade agreements, while some have said that other countries can learn from Biden's Inflation Reduction Act.[22] Certain countries have floated the idea of proposing their own version of the U.S. legislation to fight back.

In this case, stiff competition may not be the worst outcome, at least for the planet.

Takeaway: Expect to hear more international debate on the structure of the climate portion of the U.S. Inflation Reduction Act – and more from other countries as they rethink plans in reaction to it.

[20] "The Inflation Reduction Act Is a Climate Bill. Just Don't Call It One," by Eric Roston and Brian Eckhouse, Bloomberg, August 15, 2022

[21] "How the Senate's Big Climate Bill Eliminates 4 Billion Tons of Emissions," by Zahra Hirji, Bloomberg, August 4, 2022

[22] "Europe can learn from Biden's Inflation Reduction Act, Spain's PM says," by Matt Clinch and Silvia Amaro, CNBC, January 16, 2023

15 Rising Tides: The Level of Focus on Water Stewardship Will Increase

In 2022, we saw both the paradox and the power of water clearly: the fatal consequences of too much water – and the deadly impacts of too little of it. From the catastrophic floods in Pakistan and Germany to the recurring droughts plaguing the western U.S., we are observing increasing efforts by both investors and issuers to help solve the water crisis.

Notably, on March 22, 2023, the UN will host its first water event in almost five decades.

Teneo clients are asking more questions about peers' water stewardship programs, their Net Zero Water initiatives and involvement with groups like the CEO Water Mandate. There has also been a spike in investors' focus on water, with the formation of coalitions like the Valuing Water Finance Initiative, which launched in August with the support of investors representing roughly $10 trillion in AUM. The coalition provides companies with clear, science-based steps to prioritize water risk and opportunity, as well as resources to engage and take actions to reduce water-driven biodiversity loss.[23]

[23] "Corporate Expectations for Valuing Water," by Ceres, August 2022

Takeaway: Discussions on "water, water" are suddenly everywhere (and time will tell whether there is a drop to drink, as the literary classic posits). Water stewardship will continue to quickly climb up the list of ESG priorities. Management teams at U.S. companies need to start evaluating their organization's water-related risks and opportunities, targets and other initiatives related to this resource.

Author

Kensey Biggs
Managing Director
kensey.biggs@teneo.com

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