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Companies Should Follow ESG Rules Despite Hearing Mixed Signals

By Kahlil Williams

Ballard Spahr's Kahlil Williams shares guidance for companies trying to navigate shareholder ESG demands and shifting regulatory requirements for disclosure and metrics.

For the past several years, companies have faced enormous pressure to improve their environmental, social, and governance metrics to appease stakeholders that want firms to mitigate climate change, increase opportunities for underrepresented populations, and promote good corporate citizenship.

Businesses generally have responded by resolving to shrink their carbon footprint, improve workforce diversity, and divest from businesses or operations that could harm the environment or certain communities.

Federal regulatory signals have pointed the same direction. The Securities and Exchange Commission has demanded more disclosure from public companies on their environmental impacts and fined companies for improper branding of green investment vehicles and material misstatements relating to workplace harassment and misconduct.

The Department of Labor recently issued a final rule that permits fiduciaries to consider ESG factors in their investment decisions for retirement plans and in their exercise of shareholder rights.

Over the past few months, however, some state officials have argued that ESG investment and divestment requirements are headed the wrong way and at odds with the wishes of company shareholders. The House of Representatives has signaled similar sentiments.

Last November, Kentucky Attorney General Daniel Cameron launched an investigation into the ESG investment practices of several investment management companies and whether their portfolio strategies comport with their fiduciary duties owed to Kentucky pensioners.

In February, Oklahoma's treasurer sent questionnaires and letters to financial institutions to determine whether those firms were discriminating against energy companies in the state.

In February, Gov. Greg Abbott of Texas told state agencies and public universities that it's illegal to use diversity, equity, and inclusion initiatives and policies when hiring employees.

Rep. Patrick McHenry (R-Va), who chairs the House Financial Services Committee, recently announced a new ESG Working Group designed to "rein in the SEC's regulatory overreach" and "hold to account market participants who misuse the proxy process or their outsized influence to impose ideological preferences in ways that circumvent democratic lawmaking."

While large financial institutions have borne most of the scrutiny from these anti-ESG regulators, there may be more trouble ahead across all sectors.

For example, companies that set aggressive targets to increase workforce diversity may be stymied by upcoming rulings in the Harvard University and University of North Carolina affirmative action cases, which ostensibly relate only to admissions policies in higher education, but may be viewed as a green light by future litigants seeking to bar use of race in hiring.

Taken together, these trends have created a confusing roadmap, with punishments being meted out to companies whose words don't match their deeds on ESG, and to those that do precisely what they say they'll do on ESG.

But while companies may presume they're unsafe at any speed, the rules of the road have not changed dramatically for most. Here are a few markers that should continue to guide companies along their ESG journey.

Focus Goals on Long-Term Value

A company's ESG priorities should align with the firm's enterprise, where commitments on social and environmental issues relate to the company's mission and undertakings, and efforts are made to assess whether the company will be better off in the long term with those commitments in place. All ESG actions should account for potential short-term dips in favor of long-term gains.

Create Agile Strategies

Rigid goal-setting may attract headlines, but companies invite substantial risk if those goals are not attained, notwithstanding legal and regulatory shifts or changes in the political climate.

Companies should establish realistic ESG objectives that can be pursued even when circumstances change. For example, firms will always be able to improve workforce diversity through well-designed and appropriately resourced programs, even if those programs need to be adapted in the future.

Match Corporate Speech With Actions

The murder of George Floyd prompted an explosion of corporate speech on racial justice and equity. Shortly after, derivative lawsuits emerged alleging the corporations were liable under securities laws for touting the importance of racial equity in proxy statements and elsewhere, while lacking racial diversity on their boards of directors.

While courts generally have found those lawsuits lack legal merit, they extracted reputational costs from major corporations to prompt change.

To the degree that companies continue to speak out on sensitive political and social issues, they must have their house in order with ESG policies and a record of compliance that supports those positions.

The same is true of investments or projects purporting be environmentally friendly or socially beneficial—companies must ensure they develop and abide by clear and consistent policies for so stating.

The ESG landscape will remain uneven, with pro- and anti-ESG factions targeting different actors and creating some twists and turns. However, companies that follow the steps above can continue to set the pace on ESG without getting pulled over by regulators.

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