ENVIRONMENT AND CLIMATE
ESG

ESG: a blueprint to better business

Hogan Lovells lawyers unravel the actionable steps that companies should be taking to better integrate ESG into their business strategies

Businesses are becoming increasingly intertwined with ESG concerns which presents a unique opportunity for leaders to become game changers within their own organisations and the wider business community.

While each business, industry and region will have nuances to consider when applying best practice, there are actionable steps that businesses should be taking.

Act, and act fast

Society is making progress, but not fast enough. Earth Overshoot Day, the date when humanity's demand for ecological resources and services in a given year exceeds what Earth can regenerate in that year, is falling earlier and earlier annually. Society needs to ramp up action and make commitments to reach net-zero in the nearer term.

In the coming years, more new policy and legislation in this already complex and fast-moving area can be expected. Boards should ensure that they are aware of legislative developments, align their legal frameworks with any public statements and protect themselves against accusations of greenwashing. In a world of "crowd-reg" and increasing stakeholder activism, governance structures should promote transparency, diversity, confidence and integrity. Preparing and getting ahead will help businesses avoid potential costs and disruptions, which will become progressively challenging the more businesses wait to take action.

Investors and consumers expect companies to set ambitious targets, particularly relating to climate and diversity & inclusion strategies. Companies must meet these expectations while not over-reaching and failing to deliver on their promises. Accusations of greenwashing or lack of authenticity can disrupt a company, so businesses should ensure that they have robust systems which produce reliable, science-based data become an essential part of their target-setting and reporting processes. Additionally, stakeholder activism and class actions can lead to significant reputational harm, distract management and limit investment. Companies should therefore be proactive in engaging with stakeholders and managing the understanding of their commitment to ESG.

Acting in a meaningful and impactful way is increasingly becoming a key differentiator in the market, not only contributing to the wider societal goals associated with net-zero but also helping those who get it right to succeed. It is no longer sufficient for a company to consider solely its own corporate commitments to environmental and social issues. These issues should be integrated into the wider legal and governance framework, including its supply chain, contractual relationships and recruitment, retention, incentivisation and promotion practices. Companies need to act fast in order to be able to meet market expectations.

Beyond making commitments to help reach net zero, businesses must shift their focus on the growing threats to nature and biodiversity. The Taskforce on Nature-related Financial Disclosures (TNFD) calls nature loss "a planetary emergency" and aims to create a framework for corporates and financial institutions to assess, manage and report on their dependencies and impacts on nature. The World Economic Forum estimates that $44 trillion of economic value generation, representing more than half of world GDP, is moderately or highly dependent on nature. Companies must develop nature-positive solutions as part of their operating practices and should expect reporting requirements to expand to include disclosure on the impact of their activities on land and under water.

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There are a number of business reasons why efforts to act in a sustainable way are so important. For example, many new opportunities in the capital markets space have emerged. In Europe, 30% of the €750 billion ($769 billion) pandemic recovery fund is dedicated to green and sustainable finance. With so much government-issued debt that will be allocated to sustainability, and significant interest from private markets, the already booming sustainable finance market is set for even greater growth. In order to access this finance, businesses must evidence a credible transition plan which includes suitably ambitious targets and is innovative in its approach to tackling climate change and biodiversity loss. To meet the demands of investors, stakeholders and regulators, companies must consider nature-based solutions, their use of technology and their role within economies.

Rethink the role of business within society

Society is moving towards a transition phase, whereby businesses are rethinking their purpose and how they can contribute positively to wider society. Business counterparties and regulators want performance, not just compliance. Soft law will continue to drive further hard law and regulation but compliance should be viewed as a framework for enhanced performance – not an end in itself. Businesses should no longer see themselves solely as money making machines, and should instead try to unlock their potential to become a driving force for sustainable growth.

There is a big lever to pull as businesses must reimagine their purpose so that they can become net positive contributors to society. It is vital that their business purpose shines through what they do, and is not just seen as a marketing tool. In fact, increasingly, spending habits are being influenced by ESG disclosure and considerations. Consumers want to spend money on brands that focus on improving their commitment to sustainability and society. This is all the more important given the fact that younger generations are increasingly driven by ethics when making investment and career decisions, as not only do they represent a big portion of consumers in the market, but they are also moving up the ranks to one day lead these organisations.

Collaboration and partnership

Progress will not be made if businesses work in siloes. The private and public sectors need to find workable solutions that address the Sustainable Development Goals. In practice, this means that while businesses, investors, government and civil society may all be aligned in their vision and end-goals, the ways in which they will each set out to achieve those goals may vary. For example, for business to truly partner with government, they need to understand, engage and act with regard to policy.

When businesses work together, they can achieve far more, often much more effectively that when working alone. Combining resources, expertise, and ideas will be key to our success in making progress.

Consumers and employees also have to feel like that they have a say. The concept of enfranchising indirect investors is becoming an increasingly hot topic. In particular, there is focus around the fact that the majority of people are investing in companies that influence the world through their pension funds but do not exercise any direct influence over them. Typical investors therefore feel disconnected from the economy and that they have no say over how these companies are run. Society, and governance structures, need to evolve so that indirect investors' influence on ESG matters is brought to the forefront, with businesses and institutional investors increasingly looking to engage with individual savers and pensioners to decentralise shareholder voting rights.

Being accountable and transparent

The world needs leaders who are committed to taking responsibility by making public commitments to hold themselves accountable. By being transparent with progress, companies can build trust with their stakeholders at all levels.

A huge part of this accountability and transparency is reporting and disclosure of data. This goes beyond climate-related reporting but incorporates wider environmental and social factors. There is a growing body of law and regulation governing disclosure of environmental and

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climate-related data which increasingly aims to scrutinise green claims and requires the true integration of sustainability into investment decision-making.

These hard-law requirements are strengthened with market best-practices, investor expectations, and "soft law" voluntary reporting standards, such as the UN Global Compact, the Extractive Transparency Initiative and UNPRI.

Whether required by law to disclose, or encouraged to do so by investors and stakeholders, boards must ensure they are in a position to manage ESG disclosures. As disclosure requirements become more involved, current ESG policies should be reviewed, responsibility for ESG performance should be clearly delegated and boards should determine whether their current reporting practices sufficiently support legal obligations, branding and wider ESG commitments.

Policies alone are not sufficient; best practice is now for clear key performance indicators, reporting and auditing of this information. The increase of data collection and disclosure has a correlative effect. Companies and governments are using data-driven technologies like artificial intelligence, the internet of things and machine learning to oversee and improve environmental compliance, while also increasing operational efficiency.

Improved transparency and investor-grade, high-quality ESG disclosure will influence asset allocation decisions, consumer spending habits and regulatory compliance, making companies more accountable. This data is crucial not only to access finance and ensure regulatory compliance, but reliable data will also highlight companies' risks and opportunities and allow them to facilitate a robust business strategy focusing on ESG risk-management.

Focusing on long-term goals

Rather than focus purely on short-term reporting and financial incentives, companies and financial institutions need to focus on a longer-term, sustainable approach. Stakeholders are increasingly expecting companies to set and meet long-term, sustainable, scientifically-backed targets and goals. Whether it be customers expecting long-term value, employees wanting long-term impact, or investors expecting more from their investments than just a profit – companies will not be meeting expectations if longer-term thinking does not form part of the board discussions. Thinking short-term when finite resources will ultimately run out will lead to both planetary and business disaster unless society prepares in advance.

Legislation and regulation in the UK are starting to address these risks. Earlier this year the UK became the first G20 country to enshrine into law mandatory climate-related financial disclosures. The disclosure requirements, which apply to listed companies and large private companies, require their boards to cover the business's long-term risks and opportunities, the entity's resilience, and mitigation plans.

Directors need to think about the whole picture, by thinking of 'holistic' returns instead of just financial returns. This thinking does not just stem from wanting a better planet – it is also better for businesses. Well planned, long-term strategies which are effectively executed can help companies outstrip competitors, create jobs, build public trust, benefit the environment, improve the communities they are operating in, and reward shareholders.

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Adrian Walker
Partner, Hogan Lovells


Patrick Sarch
Partner, Hogan Lovells


Nicola Evans
Partner, Hogan Lovells