Why Does ESG Matter?

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ESG factors not only have the potential to directly affect a company's financial position, these factors may also significantly affect a company's reputation. Companies and investors now recognize the potential costs of not managing ESG risks.

With extraordinary access to information, a "new" regulator has emerged. Public scrutiny is at an all-time high, and pressure from the public, including customers, companies within the value chain, interest groups, employees, and shareholders, is influencing many companies to address ESG issues. Many consumers are demanding more sustainable products and more information about ESG issues.

Public pressure is also influencing how institutional investors make decisions. When considering why ESG matters from the investment perspective, there are two broad concepts. First, possibly in response to public perception, investors increasingly see themselves as more than financial advisors seeking the highest return. Some investors, in particular pension funds, charities, and endowment funds, seek investments that improve society and the environment.

Second, when analyzing companies to identify material risks, investors are increasingly applying non-financial ESG factors. These decisions are further influenced by the growth of ESG rating firms (more on that later), which are sometimes used by investors in their investment decisions. Investing in a company with a low ESG score (more on that later) could expose a portfolio to various risks, including work stoppages, litigation, enforcement, and negative publicity, ultimately affecting the value of the portfolio. These investment philosophies are not inconsistent with traditional investment advice; rather, by considering ESG factors, investors are seeking better risk-adjusted returns.

Some companies have increased their voluntary environmental disclosures in response to lenders and financial institutions using ESG risk assessments in their lending decisions, which could affect a company's access to financing.

Further, the regulatory environment is rapidly evolving and the "old" regulator (the government) is becoming more active with more resources. The U.S. Securities and Exchange Commission (the "SEC") recently proposed regulations, which, if adopted, would require public companies to disclose their direct and indirect carbon emissions and climate-related physical and transitional risks in their registration statements and annual reports. In March 2021, the SEC launched the Climate and ESG Task Force within the Division of Enforcement to proactively identify ESG-related misconduct consistent with increased investor reliance on climate and ESG-related disclosure and investment.

These trends are not limited to the SEC. Governments across the world have committed to reducing carbon emissions to mitigate global warming. The U.S. Environmental Protection Agency ("EPA") has ramped up its environmental justice initiative, increasing inspections in areas of environmental justice concern and developing initiatives to improve identification and resolution of persistent environmental violations that impact communities.

We strongly advise companies, both public and private (we will get to that later), to tell your ESG story to manage risk, build trust, and create a sustainable future.

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Kilpatrick Townsend partner Todd Roessler focuses his practice on a wide range of matters related to environmental litigation, regulatory counseling, and transactions. Mr. Roessler has nearly 30 years of diverse environmental experience.

Raleigh Partner **Todd Roessler** has created a multi-part series to help you navigate complex issues to start or enhance your ESG journey.

Read the second installment "Why Does ESG Matter?" below, or "Download PDF."

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