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CORPORATE SOCIAL RESPONSIBILITY

Taking Advantage of the Intersection of ESG and Compliance

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With each day bringing new attention to the ways in which environmental, social and governance (ESG) issues are making their way into corporate board decisions and management philosophies, corporates – from multinationals to small- and medium-sized enterprises – may find themselves facing the question of how, from a practical perspective, they can begin to implement an approach to ESG management that helps to satisfy the multiple stakeholders who are increasingly interested in understanding how companies in which they have an interest are approaching such matters.

While there is no "copy/paste" solution to what should be an individualized and in-depth exercise, we believe that there are key lessons and strategies that companies can take from the development of a corporate ethics and compliance program that can help in establishing an approach towards ESG. This should allow them to identify ESG-related risks but also, critically, ESG-related opportunities that can help to differentiate them from their competitors.

Although there are certainly differences between compliance and ESG, this article focuses on the areas of intersection and overlap, and how companies can exploit those in a meaningful and productive way for their organization.

See "Five Steps to Establishing a Corporate ESG Policy for the Present Moment" (Oct. 28, 2020).

Launching an ESG Program

As with developing a compliance program, a good first step in establishing an ESG program is to convene a multi-viewpoint working group to set a framework for customized program development.

ESG Obligations

The working group should start by identifying ESG-related laws applicable to the company, as well as voluntary ESG commitments the company has made or might make in the future.

Hard Law

As its name would suggest, one of the roles of the compliance department is to ensure that the organization complies with laws and regulations that specifically apply to the company's business, or "hard law." These may include, but are not limited to, international anti-corruption laws, international economic sanctions and export control regimes, antitrust regulations, data protection and privacy rules, financial disclosure laws, workforce-related laws, insider trading prohibitions and other laws and rules regulating securities market participants. If violated, hard laws can result in civil or criminal fines and penalties being assessed against the organization and/or its employees.

Until recently, the sources of hard law that affected ESG would have been the subset of hard laws covered by the corporate compliance program that also reflect enforcement of non-commercial values, such as laws and regulations surrounding human rights, child labor, the environment and conflict minerals. However, lawmakers have begun adopting hard law based on policies to encourage or require companies to pursue ESG goals, or at least to be transparent and accurate about their efforts to do so.

In addition to broad efforts like the E.U. Taxonomy[1] and E.U. Sustainable Finance Disclosure Regulation,[2] some hard laws, particularly in E.U. countries, now target specific topics, such as human rights and data privacy. Although the E.U. is currently leading the world in hard law adoption in ESG, some of these laws will have extraterritorial application to U.S. and other non-E.U. companies that do business in Europe or with European residents.

See "The French Duty of Care Law: A First Assessment" (Jun. 12, 2019).

Voluntary Commitments

Beyond hard law, there are other areas where compliance obligations arise from "soft" sources, namely, the company's own policies and procedures. In some industries, these soft sources are similar to law, insofar as companies can be held responsible by regulators, enforcement agencies and stakeholders for failing to follow their own established policies and procedures.

Here, perhaps, launching an ESG program diverges from compliance program development. In corporate compliance matters, voluntary commitments are most likely to address practices around the edges of areas regulated by hard law in order to address the company's unique operating environment, disciplinary history or reputational concerns. Voluntary commitments around ESG may arise from these company-specific factors, but they are also likely to come from additional sources, like values established by management, the elements of voluntary accords and expectations of various stakeholders.

The rising attention to voluntary commitments is driving the current trend to combine ethics with compliance and risk under the supervision of a single "chief" officer. This busy chief may also find ESG added to those responsibilities for the same reason: these endeavors are coming to be viewed as so closely related that separation of them may yield undesirable gaps or competition between these allied concerns.

See "How CCOs Can Avoid Personal Liability for an Organization's Compliance Failures" (Jan. 6, 2021).

Narrow Focus Versus Broad Vision

The next step for the working group will be to define the scope of the ESG program. Depending on organizational structure and industry, the compliance department may have narrow, yet deep, focus on particular compliance topics that present the greatest risks to the company or it may have plenary responsibility over a litany of compliance practices mandated by applicable regulation. In either case, there is a tendency to view compliance professionals internally as subject-matter experts on anti-corruption, sanctions, or antitrust issues, and they can often spend the majority or entirety of their time helping the organization navigate these topics.

Yet, if compliance is isolated from the business as keepers of knowledge in an ivory tower, regulators have indicated that they are unlikely to find the compliance culture satisfactory. Compliance needs to be expressed in business practices and businesspeople need to understand the value of and reasons for compliance requirements.

This tension is likely to recur with ESG programs. The universe of possible goals and approaches is sometimes frustratingly broad and, depending on the organization, can literally encompass hundreds of topics across the E, the S and the G.

Companies with corporate compliance programs will have had some experience studying the broad array of possible compliance approaches and then customizing a set of policies and procedures more narrowly drawn to the firm's actual business. A similar approach is needed for ESG. Using a multi-disciplinary working group and outreach to stakeholders, companies can drill down to the specific areas and practices that will make the biggest difference in ESG outcomes for their specific business.

Enforcement Versus Engagement

Compliance departments are often viewed as the part of an organization that is responsible for enforcing particular rules or standards. This is for good reason since, in the context of a corporate misconduct event such as a violation of the FCPA, companies will be evaluated at least in part on (i) how the misconduct was identified; (ii) the response that the company undertook to investigate the misconduct; and (iii) the remedial measures taken (including disciplinary ones) to ensure it does not recur.

If ESG practices are based on voluntary commitments or voluntary choices or interpretations under hard law, this is an area where it may be useful to approach policies and procedures differently than in the corporate compliance program. Care may be taken so that ESG policies are expressed in a manner that allows for exploration and evolution. It may be possible to take the view, in some parts of the ESG program, that challenges or even failures are best met with openness to change and bottom-up engagement, including with customers, employees or other stakeholders, to improve future outcomes, rather than disciplinary action.

See "30 Creative Ideas for Compliance Messaging" (Mar. 4, 2020).

Key Considerations for ESG and Compliance Cross-Pollination

Recognizing that there are important, and justifiable, distinctions between a company's compliance program and its approach to ESG, there are lessons that companies can take from the development of a robust compliance program to apply to the ESG context. After all, the most successful compliance programs are not those which seek to simply enforce rules; they are ones that take a more holistic view of what it means to act with integrity or in an ethical manner.

The objective is not to force compliance for the sake of compliance, but to bring about a compliant culture within an organization by embedding the topic and considerations of compliance into day-to-day decision making. The best compliance programs are also those that look not just at risk, but also at opportunities for the organization to use its compliance program to differentiate itself from its competitors and ultimately drive business success.

When evaluating the effectiveness of a corporate compliance program, the DOJ asks itself three questions:

- Is the corporation's compliance program well designed?
- Is the program being applied earnestly and in good faith? In other words, is the program adequately resourced and empowered to function effectively?
- Does the corporation's compliance program work in practice?

These questions should be kept in mind as companies navigate their approach to ESG. Integrating seemingly disparate elements under one roof and taking a holistic approach to ESG will not happen overnight and will take significant time, effort and fine-tuning for organizations to develop the approach that makes the most sense given their activities and profile. As with compliance, it should be thought of as a process, not as something that is decided by the board or C-suite and implemented overnight.

With this in mind, here are five useful lessons that companies can consider as they build an ESG program.

1) Tone From the Top Is Critical …

A clear "tone from the top" is as critical to effective corporate compliance as it will be to integrating ESG factors into the organization's business activities. As the DOJ indicates in its Evaluation of Corporate Compliance Programs (ECCP), "[t]he effectiveness of a compliance program requires a high-level commitment by company leadership to implement a culture of compliance from the middle and the top." This must go beyond messaging that compliance and ESG implementation are important. It must include creating a culture in which people feel comfortable speaking out about concerns, as well as creating incentives for desirable behaviors, and avoiding incentive systems (particularly in sales teams) that elevate self-concern above important compliance goals.

See ACR's two-part series on updates to the ECCP: "Encouraging Companies to Make Compliance a Positive Feedback Loop" (Jun. 24, 2020); "Providing More Nuance on Training, M&A and Third-Party Management" (Jul. 8, 2020).

2) … But So Is Building From the Bottom

As important as is tone from senior levels of the organization, it is equally important to build up the company's approach to ESG from the operational levels. In the context of a compliance program, rules and procedures can be meticulously drafted with the best intentions, but they will have limited effectiveness if they are made without consideration of how they will be applied in practice, and how they will impact daily operations of the company. This is why, in the context of the development of a compliance program, the DOJ considers that the starting point is an effective risk assessment, designed to "understand the company's business from a commercial perspective, how the company has identified, assessed and defined its risk profile, and the degree to which the program devotes appropriate scrutiny and resources to the spectrum of risks."

When it comes to ESG, having a similar vision of the issues that are most relevant to the company from employees at various levels of the organization, as well as other stakeholders, will help to provide a more realistic view of the ESG focus points that the company should prioritize and the manners in which it can track progress in such areas.

In ESG, as in compliance, inevitably, measuring progress will land on operational and middle management teams. These teams should be empowered to be creative in thinking about what sources of data are available, through statistics, but also through surveys and qualitative evaluation, to (i) give a genuine picture that distinguishes real progress from superficial counting, (ii) diagnose causes where violations or shortfalls occur, and (iii) offer insight in to how to improve in creating sustainable, desirable outcomes.

In fact, there is already consensus among those focused on ESG measurement that this need for proficiency, creativity and elegance in data collection be more essential for improving diversity, equity and inclusion outcomes than it has been for any other ESG or compliance endeavor.

3) Actions Speak Louder Than Words

Both compliance programs and ESG suffer when companies "talk the talk" but do not "walk the walk." As important as tone is, it is not alone sufficient. In the compliance context, this is referred to as having a "paper program" – well-drafted statements, codes, policies and procedures that exist on paper but are not applied in practice. In the ESG context, there is increasing concern over "greenwashing" – making bold net-zero goals or statements about diversity and inclusion without taking the steps necessary to implement change.

More robust standards and disclosure requirements – such as the E.U. Taxonomy and widely anticipated new guidance and rulemaking out of the SEC – will help to mitigate these overstatements somewhat, but it is also up to companies to ensure that ESG, just like compliance when done successfully, becomes a reflexive part of the decision-making process throughout the organization.

See "Insights From Jimmy Chatsuthiphan of Uber on Compliance and Culture in APAC" (Sep. 2, 2020).

4) Country Risk Is Just One Data Point

In many compliance risk assessments, the generalized corruption risk of a country – typically as reflected in the most recent version of the Corruption Perception Index released by Transparency International – often serves as a starting point and initial risk factor. As those of us who have performed such corruption risk assessments can attest, however, generalized country risk is only one data point, and can often be misleading if not combined with a more granular assessment of the type, size and manner of activities and operations that a company has in a particular country.

Country risk may also be one point of assessment in the ESG context, and at least one third-party ratings provider (MSCI) has released an ESG Government Ratings Assessment to help companies assess generalized ESG risk points in 198 countries and regions. But just as is the case in the compliance context, granularity will be key in determining whether the types of activities that a company has in certain countries are susceptible to risks and opportunities.

See "TI's 2020 CPI Lowers U.S. Ranking and Links Corruption to Healthcare Spend" (Feb. 17, 2021).

5) Third-Party Risk Management Is Critical

Compliance programs tend to focus significant attention on the risks associated with different types of third-party relationships. This is for good reason, since 20 of 28 corruption-related settlements and prosecutions in the U.S. in 2019 and 2020 involved the conduct of third parties or other intermediaries – such as commercial agents, consultants, distributors or joint venture partners.

Robust compliance programs thus tend to have risk-based mechanisms to assess the likelihood that a third party acting on the company's behalf will engage in improper conduct. These practices – generally referred to as third-party due diligence – increasingly encompass "soft law" issues such as human rights, labor practices and environmental compliance.

The expertise and experience, as well as the tools and metrics, that the compliance program has established to help mitigate such third-party compliance risk may therefore be useful in evaluating third party ESG risks and opportunities. For corporates, this may involve including ESG factors into third party pre-qualification assessments; for investment companies and asset managers, this may take the form of assessing their portfolio companies to see how such companies are assessing their own risk in their supply chains.

See "Tough Times and Lax Third-Party Oversight Lead to Second Deutsche Bank FCPA Settlement" (Jan 20, 2021).

Strong and Proactive Approach

Investors, consumers, employees, suppliers, customers and other stakeholders are increasingly looking for corporates, investment managers and private actors to develop solutions for societal issues, including strong and proactive approaches to better integrate ESG-related issues into their activities.

As they do so, corporate leaders should consider lessons they have learned from the implementation of other large-scale corporate programs, such as corporate compliance programs, to leverage their existing resources and accelerate and optimize ESG programs capable of producing real results and evolving to meet future challenges and opportunities.

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[1] Regulation (EU) 2020/852, 2020 O.J. (L 198) 13.
[2] Regulation (EU) 2019/2088, 2019 O.J. (L 317) 1.