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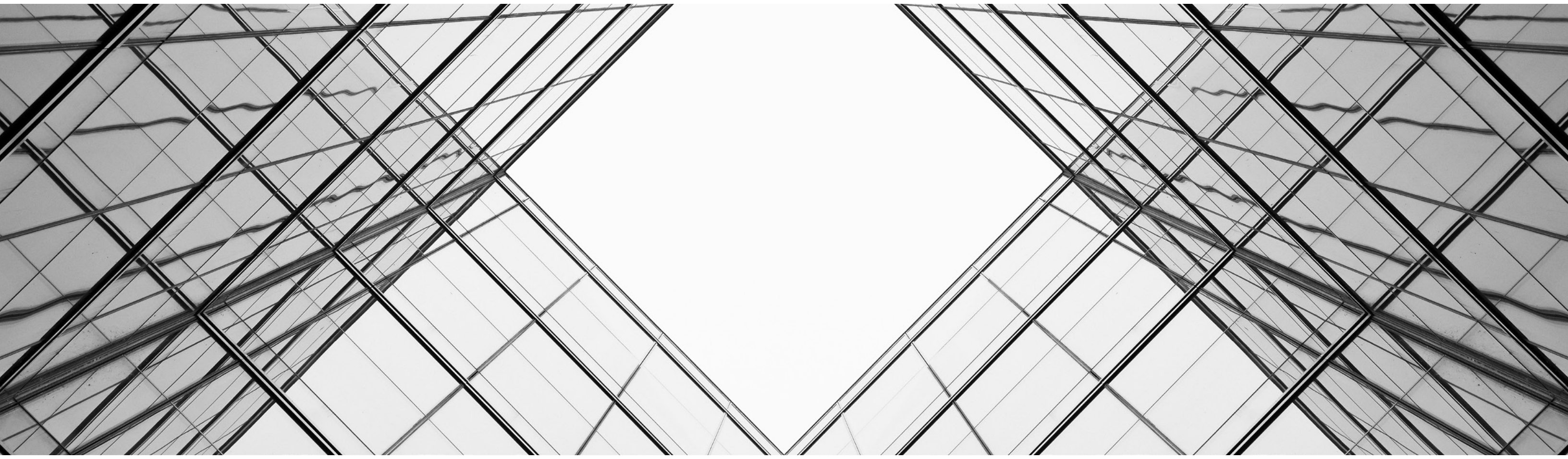

By William B. Jenkins

ESG Due Diligence: A New Class of Risk

The rapid rise of the Environmental, Social, and Governance (ESG) framework as a measure of corporate performance is remaking global business. Regulators around the world are rewriting the playbook for political and market demands that companies report their environmental and social impact. As finance houses rate—and nix—investments for their ESG credentials, retail investors are shifting and making new markets around ESG concerns. Regulation lags corporate communications and activity, but ESG's impact is already obvious in regulators' transformation. It has created a new class of risk for business.

Law is quickly codifying the movement's demands as major regulators build rulesets and task forces. The US Securities and Exchange Commission (SEC) has established an ESG enforcement team to hunt for "material gaps or misstatements in issuers' disclosure of climate risks." It is now warning public companies over the accuracy of their ESG disclosures, as firms are pressured to make ambitious statements to please investors. In the UK, key regulators plan to intensify supervision and regulatory action relating to ESG climate risks in 2022. Both the US and UK have various proposed legislation to standardize ESG rules and empower regulators to penalize misrepresentation and misconduct under them. The EU passed the far-reaching Sustainable Finance Disclosure Regulation (SFDR) in March 2021. In its global reach and broad definition of sustainability, it may become a "GDPR of ESG," similar in impact to the behemoth General Data Protection Regulation for commerce with an EU nexus. The EU and key member states have legislated human rights due diligence and "corporate vigilance" while securities and competition regulators are advocating for legislation to penalize greenwashing and ESG-related fraud.

Market perceptions of sub-par ESG performance are already materially and negatively impacting business. Insurgent investors and regulatory attention can turn hype and signals of corporate virtue into precipitous downside risk. Conversely, truly strong ESG practices can translate into market success at an "ESG premium." Companies that do not go far enough to find and mitigate risks in due diligence by digging into the reality behind ESG claims will increasingly expose themselves to new regulatory and reputational peril. In short, ESG is here to stay—and Nardello & Co. is here to help navigate it.

Digging Under the Surface

ESG topics have marched under many banners for years, but old approaches like the triple bottom line, Corporate Social Responsibility, sustainable/responsible investing, and stakeholder engagement have had only limited effect. ESG gathers formerly separate corporate reporting elements (e.g., sustainability, diversity, labor rights, *etc.*) under one banner that poses associated reputational and commercial risk by drawing investor, media, and regulator attention.

The temptation of companies to "greenwash" is therefore substantial, but ESG credential inflation or misrepresentation is a major concern of investors. In fact, the International Organization of Securities Commissions (IOSCO) and the International Financial Reporting Standards (IFRS) Foundation—not toothless bodies—have set up a new watchdog to combat it. For this reason, proper ESG diligence, whether performed in self-examination or in anticipation of a transaction, requires going beyond tick-box assessments and turning to experienced, sophisticated, and ethical investigators to pierce the veil of PR messaging, jargon, and trendy metrics.

The breadth and number of new required disclosures are themselves risks. While some businesses have objected to ESG reporting burdens, many have moved to adapt quickly and claim ESG virtue—even as they are still assessing what it means and as legal liabilities remain undefined and untested. As the SEC admitted in setting up its task force: "ESG is at the same time very broad, touching every company in some manner, but also quite specific in that the ESG issues companies face can vary significantly based on their industry, geographic location and other factors." To ward off risk and thrive in the brave new ESG world, firms should deploy veteran investigators to uncover the ecological, political, and social realities of supply chains, financing, and operations whether in emerging or established markets.

Modern ESG due diligence must assess a growing landscape of risk considerations. Often, it requires bespoke political risk insight to find and contextualize threats hidden within a company's operations. Broad stakeholder interests are crucially important, be they the concerns of local indigenous communities, activists in mining regions, advocacy groups, unions, or others along complex global supply chains. Rosy corporate pronouncements of sustainability and good governance can be undone within a news cycle by questionable environmental or labor practices or allegations of corruption or other misconduct.

Effective ESG due diligence must analyze not only policy, pronouncements, and counterparty questionnaires—where most ESG risk-rating stops—but also concrete commercial realities and the impact of a business' physical, political, and social footprint. This calls for expert sources and sometimes on-the-ground operatives who can make site visits to identify hidden risks—whether it be farming waste and migrant rights in Arabia, toxic mine tailings in Africa or Australia, forced labor in Xinjiang, or the ecological after-effects of drilling for gas in Indonesia. It invariably requires expert analysis of the political context of each situation. Whether talking to unionized employees making demands, distant suppliers, or dealers at the end of a supply chain, or identifying the reality behind the grievances of activists who agitate for media attention, thorough investigative due diligence finds the specific risks that questionnaires and ratings cannot. In comparison, the proliferating tick-the-box, one-size-fits-all ESG approach invites danger.

An ESG investigation shares much with typical integrity due diligence, but re-orients and re-weights the risks. Astute ESG investigation focuses on broader political considerations as much as on obscured control, financial misconduct, or unexplained wealth. It prioritizes employee and labor rights, sexual or other ethical misconduct, and consumer and politico-social concerns such as diversity, equality, and ecology. But the typical risks remain: third parties can bribe officials; a violation of labor rights can betray a company's track record; and community concerns can generate media coverage, especially when fueled by activists.

Aldous Huxley wrote, "A love of nature keeps no factories busy." ESG calls for a different world view, one in which firms take clear stock of the ecological, political, and social realities of their global operations. In the end, regulators, investors, consumers, and the media are looking for actual ethical practices, not just headline ratings and black letter compliance. To get there, most firms will likely need a little help.

About our firm

Nardello & Co. is a global investigations firm whose experienced professionals handle a broad range of issues including due diligence, anti–corruption & fraud investigations, civil and white collar criminal litigation and arbitration support, asset tracing, activist defense, political risk and strategic intelligence, digital investigations and cyber defense, monitorships and independent investigations, and compliance.

Our clients include the world's leading law firms and financial institutions, Fortune 500 and FTSE 100 companies, high–net–worth individuals and family offices, governments, NGOs, sports organizations, and academic institutions.

With offices in New York, London, Washington DC, Hong Kong, Tokyo, and Dubai, Nardello & Co. maintains a professional staff that includes former US federal prosecutors, US and international lawyers, former law enforcement personnel and intelligence operatives, licensed investigators, research analysts, former journalists, financial crime specialists, forensic accountants, and computer forensic experts.

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