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Client Alert
Commentary

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Voluntary ESG "Materiality" Assessments — Legal Considerations and Dos and Don'ts

This Client Alert probes the ESG "materiality assessment" process, why it is a misnomer, when and how the assessment can be conducted, and legal and practical tips for conducting the assessment.

Companies have been conducting ESG "materiality" assessments in support of their ESG disclosures for a number of years now. An ESG materiality assessment can serve as a useful tool to identify areas of priority from the perspective of a company's internal and external stakeholders, including shareholders, employees, customers, vendors, and community members. With ESG regulatory requirements on the rise and in light of the need to reduce the risk of blurring between regulatory definitions of "materiality" and so-called "ESG materiality assessment," this Client Alert provides an overview of the ESG materiality assessment process and why it is a helpful tool, as well as tips for conducting the assessment.

ESG and Legal Liability Risks

As ESG continues to grow in importance, regulators, investors, and other stakeholders have increasingly sharpened their scrutiny of companies' ESG actions and reporting. ESG-related disclosures have already triggered claims based on public reporting (or the absence of public reporting) in both formal and informal venues. Additionally, public watchdog groups will likely double down on their attempts to bring about ESG reform via litigation geared towards marketing and other representations. A well-conducted ESG materiality assessment serves as a key step in a company's process of understanding the ESG risks and opportunities relevant to its business and stakeholders, and in managing possible ESG-related legal liability risks.

While "ESG materiality assessment" has become a term of art, companies should take care to clarify that the term materiality in this context is intended to reflect priority ESG issues, and specifically flag that the term does not carry the same meaning as it does under securities and other laws in the US or other jurisdictions.[1]

Why ESG Materiality Assessments Are Helpful

A growing number of companies are looking to establish, or continue to develop, their ESG strategies, whether due to pressures from stakeholders, regulations requiring more ESG disclosure, or a desire to capitalize on the current opportunities available to ESG-leading companies. Given the number of issues that fall under the ESG umbrella and the vast differences in reporting between industries and jurisdictions, determining the most relevant ESG factors for a company can be daunting. Materiality assessments have become popular tools to inform and prioritize ESG factors based on a company's key stakeholders and their expectations. By focusing on key priorities, a company can build a more effective ESG strategy.

Even companies that have formed ESG strategies and regularly publish ESG disclosures find that materiality assessments are useful tools for prioritizing, reaffirming, or refreshing their ESG approaches. Current best practice is to refresh the ESG materiality assessment at least every two years.

Finally, companies looking to attract investors that see ESG as an advantage find that materiality assessments can facilitate the development of ESG key performance indicators (KPIs) to measure and track their progress in high-priority areas.

Structuring an ESG Materiality Assessment

The process of conducting an ESG materiality assessment typically entails the following:

1. ***Defining*** the company's approach to materiality, including what definitions of materiality will be used and how they will be used. Increasingly companies are expected to address both the qualitative and quantitative aspects of their definition(s) of materiality

2. ***Benchmarking*** against peers, competitors, ESG-leading companies, regulatory requirements, and/or prevailing disclosure frameworks, such as relevant industry standards from the Sustainability Accounting Standards Board (SASB, now administered by the IFRS Foundation), the Global Reporting Initiative (GRI), the United Nations Sustainable Development Goals (SDGs), and the Task Force on Climate-related Financial Disclosures (TCFD)

3. ***Identifying*** ESG issues relevant to a company by reviewing internal and external sources

4. ***Prioritizing*** ESG risks and opportunities by consulting with internal and external stakeholders

5. ***Finalizing*** the prioritization of ESG topics by sharing with internal leadership

6. ***Developing*** an ESG strategy, plan, or approach

Typically, a third-party expert is retained to develop and/or conduct the assessment. A third-party expert can add credibility to the process, reducing the likelihood or perception that the company is focusing on the issues it already manages sufficiently, and thereby mitigating possible allegations of greenwashing. An ESG expert can also assist in interviewing internal and external stakeholders, as some stakeholders may be hesitant to share their views openly and honestly directly with the company.

A company's approach to materiality, both within the context of ESG and outside of it, can have significant legal implications. Therefore, companies should also have their materiality assessment process reviewed by their outside ESG counsel, or consider having ESG counsel assist in the initial conducting of the assessment.

Must-Do Items

Clearly define or confirm the company's mission, vision, values, and/or strategy before conducting a materiality assessment. This will facilitate centering the materiality assessment on key issues that drive business strategy and corporate purpose — what issues hit the bottom line.

Update the materiality assessment periodically (e.g., every two years) so that the company's ESG strategy is evolving to address the most salient ESG risks and opportunities. To that end, house any disclosure of the materiality assessment in a document that is updated regularly, such as a voluntary CSR or ESG report and/or on the company's ESG webpage.

Identify the team members that need to be included in the process and at what stage. Consider creating a dedicated ESG task force composed of a cross-functional team of key executives, board members, and employees. Senior leadership should be involved in finalizing the key ESG topics the company plans to focus on and the resulting ESG strategy to make sure it is aligned with the overall business model.

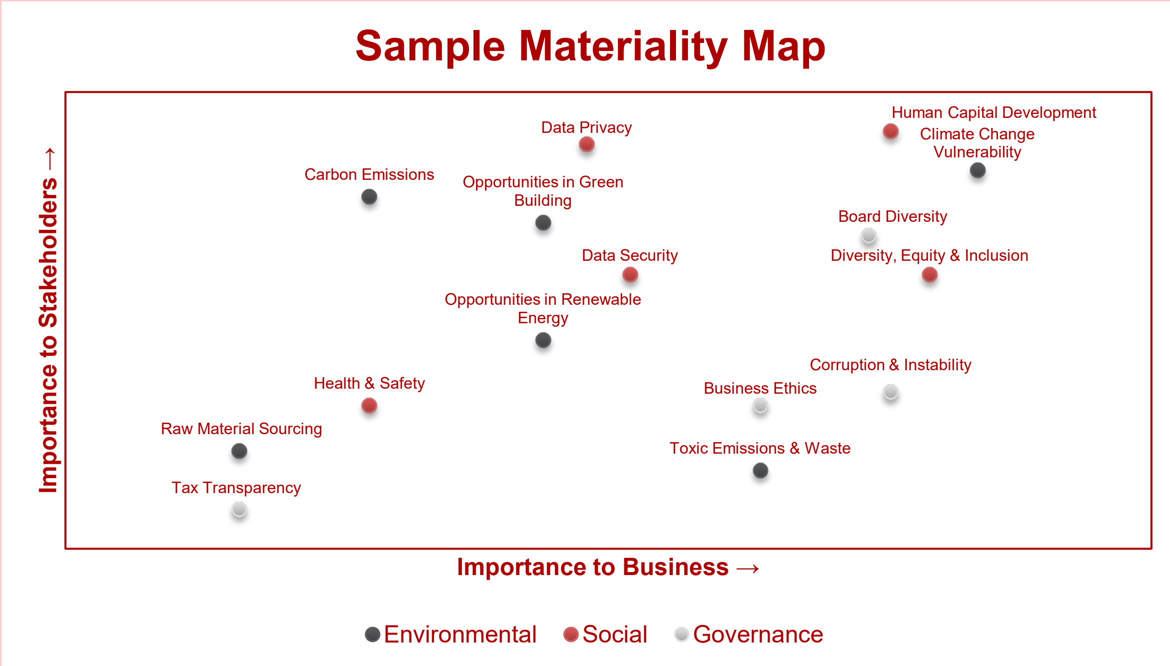
Things to Avoid

Don't focus solely on the risks and other negative outcomes associated with a certain ESG action, but also on the opportunities it could create.

Don't ignore existing ESG policies and initiatives. Leverage existing learning, strategies, and initiatives when developing and conducting the materiality assessment, and use the assessment as an opportunity to validate the impact of existing policies and initiatives.

Appendix A: Sample Materiality Map

The example below illustrates the deliverable of a materiality assessment: a materiality map. A materiality map, also known as a materiality matrix, highlights the results of a materiality assessment by displaying the relative importance of priority ESG topics to the company's business and stakeholders. A materiality map typically only shows the most relevant topics identified through the ESG materiality assessment, and the topics presented along with their prioritization will be unique to each company. The sample materiality map below is for illustrative purposes only, and is not based on any specific industry or company.



Appendix B: Sample ESG Roadmap

The example below illustrates a sample ESG roadmap. Informed by its existing vision, culture, business strategy, and enterprise risk management, a company can determine the key ESG topics that will drive its strategy and mission, develop programs and policies and collect data that is tailored to the outcome the company wishes to achieve. The ESG roadmap below is for illustrative purposes only and an effective ESG roadmap is the result of a company-specific evaluation.

1. Define or refine the company's values, mission, and culture

2. Set up a structure and strategy for the ESG program

3. Establish a board-level ESG committee or overall board ESG oversight and report to it on a quarterly basis

4. Establish a cross-functional management-level ESG committee or team

5. Conduct an ESG materiality assessment (for the rest of this roadmap, assume that the ESG materiality assessment highlighted emissions reduction; diversity, equity, and inclusion (DE&I); and supply chain management as priority topics)

6. Build out and publish a series of policies and statements relevant to ESG

7. Evaluate ESG ratings and consider whether to provide responses to any ESG raters

8. Conduct assessments of priority topics identified in the ESG materiality assessment to understand baselines and set short-, medium-, and/or long-term targets or goals. Depending on the areas identified as priority ESG items in the materiality assessment, this could include:

   - creating a greenhouse gas (GHG) emission reduction strategy;

- establishing a DE&I council or team and create a DE&I strategy; and/or
- assessing critical suppliers, vendors, and other third-party relationships on their ESG performance and creating a supply chain management strategy.

9. Work with internal and external auditors to create data control processes for ESG
10. Consider the approach to reporting ESG information, including whether to align to recognized reporting frameworks such as TCFD, SASB, or GRI, and which stakeholders to share ESG information with (for example, through the development and publishing of an ESG Report)

As ESG considerations continue to become more important, companies can consider using ESG materiality assessments to inform and prioritize ESG factors based on the expectations of key stakeholders and to manage possible ESG-related legal liability risks.

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Endnotes

[1] Note: This Alert is limited to ESG issues and trends of companies operating in the US. This Alert does not discuss double materiality considerations impacting many companies operating in other jurisdictions. For a discussion on ESG materiality, *see* Sarah E. Fortt, "It's time to really talk about ESG materiality," *Reuters* (June 3, 2022), available at: https://www.reuters.com/legal/legalindustry/its-time-really-talk-about-esg-materiality-2022-06-03/.