# 2024 Proxy Season: The Importance of Evaluating DEI, ESG, and Corporate Social Responsibility Disclosures

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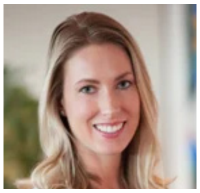

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In preparing for both the 2024 proxy season and publication of inaugural or refreshed corporate social responsibility or sustainability reports, as well as in anticipation of final climate disclosure rules from the SEC as of March 6, public companies should consider closely reviewing their policies, procedures, and disclosures related to diversity, equity, and inclusion (DEI) and environmental, social, and governance (ESG) statements and commitments.

When reviewing their DEI and ESG-related disclosures, public companies should consider the current and anticipated legal and regulatory regime, including the Harvard/UNC decision on race-conscious university admissions, the continued focus on climate change and greenhouse gas (GHG) emissions, state law, proposed rulemaking from the US Securities and Exchange Commission (SEC)—which is now expected to be finalized on March 6—stock exchange rules, and stakeholder interests, including those of shareholders, employees, and customers.

U.S. public companies find themselves seeking to satisfy existing and anticipated disclosure rules in an environment of sometimes conflicting stakeholder perspectives regarding the appropriate degree of focus on, and disclosure regarding, ESG and DEI issues. Even before the landmark US Supreme Court decision in *Students for Fair Admissions, Inc. v. University of North Carolina* and *Students for Fair Admissions, Inc. v. President & Fellows of Harvard College* that caused ripple effects through diversity, equity, inclusion (DEI) programs, companies faced shareholder proposals and demands to retract DEI statements or policies. There was similar pressure on climate-related policies and programs, as well as threats of litigation, investor relations concerns, and inquiries from regulators, including the SEC, due to ESG-related public statements.

At the same time, other constituencies (e.g., shareholders focused on socially conscious investing) are encouraging companies to continue to enact these policies and programs, and to provide disclosure about them. New California requirements that impose sweeping climate disclosure obligations on companies that do any sort of business in California, regardless of industry or current emissions levels, provide an additional component of pressure on many companies meeting certain revenue thresholds.

Against this backdrop, companies must closely scrutinize their DEI and ESG statements, including statements about GHG emission goals, to be able to defend against challenges from shareholders and the plaintiffs' bar and ensure their statements pass muster with state and federal regulators. At the same time, there are reputational and other investor-related risks if companies are perceived to be walking back diversity or climate-related goals.

# Recent Evolution of Board Oversight of ESG and DEI Initiatives

In the past several years, corporate boards have increased their oversight of ESG and DEI initiatives and refined their approach to risk oversight as companies continue to increase and enhance public disclosures of ESG and DEI initiatives and goals. This evolution is due to many factors, including changes that arose from internal board consensus and pressure, feedback from various stakeholders, including shareholders, employees and customers, and continuous shifting of the legal and regulatory landscape for ESG and DEI disclosure. For example, the SEC's adoption of human capital disclosure rules in 2020, Nasdaq's adoption of diversity disclosure rules in 2021, and soon-to-be-final SEC climate disclosure rules, all have contributed to the amplification of corporate boards' oversight of ESG and DEI initiatives and policies.

# Public Filings: ESG and DEI-Related Risk Factors

Given the ongoing transformation of the legal and regulatory landscape concerning ESG and DEI disclosure, the costs associated with gathering data, lack of standardized reporting, and potential lawsuits and shareholder proposals from both pro and anti-ESG and DEI stakeholders, public companies have been including in their annual reports new ESG and DEI risk factors or expanding their current risk factors.

For example, in light of the ongoing focus on climate change, companies have been ensuring that their climate-related risk factor disclosure specifically addresses how climate change may affect their business, financial condition, and results of operations.

# Considering DEI Disclosure Following Harvard/UNC Decision

The Court's decision on June 29, 2023, which struck down race-conscious admissions programs at Harvard University and the University of North Carolina (the Harvard/UNC decision), has had numerous ripple effects, including a rise in challenges to corporate DEI programs. The decision has not had any immediate legal impact on the validity of DEI programs in the private sector, but it emboldened the plaintiffs' bar to seek, in threatened and actual litigation, to extend the applicability of the decision beyond higher education to challenge corporate DEI programs.

Many of these challenges include allegations premised on statements in a public company's SEC filings and other public statements related to DEI efforts (such as human capital disclosure and ESG statements). There also have been shareholder actions aimed at preventing public companies from implementing their DEI programs and policies, such as aspirational representation goals, board diversity, and diverse supplier programs. Currently, courts have not ruled in favor of those shareholder actions, instead reminding shareholders they are free to choose different investments. Despite this, we do not expect these challenges to abate.

With this backdrop, some companies have opted to reduce the scope of their human capital management disclosure in their 2024 filings, while others have taken the opportunity to reaffirm their commitment to DEI and explain why DEI continues to be tied to long-term corporate strategy and shareholder value. Regardless of approach, any discussion of demographic employee data or DEI goals or initiatives in an annual report, proxy statement, or other public disclosure should be reviewed in close coordination with counsel.

Companies should seek to balance their risk mitigation goals against the possibility that dialing back or eliminating DEI efforts could result in shareholder derivative suits, pay equity and disparate impact enforcement and class actions, and other negative repercussions, including to personnel, employee morale, and financial results.

## Shareholder Proposals

In the past several years, ESG and DEI issues have been the subject of a significant number of shareholder proposals, both in favor of and opposed to efforts in these areas, and this is likely to continue in the wake of the Harvard/UNC decision.

The most common type of DEI-related shareholder proposal received during the 2023 proxy season concerned racial equity and civil rights audits and included requests for companies to produce reports to shareholders explaining the effectiveness of their DEI efforts, the existence of gender and/or race or ethnicity pay disparity in their workforce, the presence of structural racism in their company culture, and the specific actions being taken to improve gender, racial, and ethnic board diversity.

Likewise, as expected, public companies also continued to see an abundance of environmental and climate change shareholder proposals concerning GHG reporting and emission reduction targets during the last proxy season.

At the same time, the number of shareholder proposals that, essentially, take the other side of the argument on many of these matters has sharply risen in the past several years. The proposals often are predicated on the premise that DEI efforts are in themselves discriminatory, or that a company's focus on ESG efforts, rather than purely on financial performance, is inappropriate.

Obtaining no-action relief from the SEC's Division of Corporation Finance generally has gotten more challenging in the past several years and many of these shareholder proposals go to a vote. As recently as late February 2024, the SEC declined to grant no-action relief on a procedural basis to three companies seeking to exclude DEI and ESG proposals. Despite this, support for ESG and DEI-related proposals generally remains low. Crafting a statement in opposition that challenges the substance of the proposal or articulates why management already is addressing the subject matter of the proposal can help encourage shareholders to vote with the recommendation of the board.

Early 2024 indications are that companies are continuing to receive a significant number of these proposals.

## Disclosing Executive Compensation ESG and DEI Performance Metrics

During the past several years, shareholders have remained focused on the connection between executive pay and performance. Many public companies recently have included goals tied to ESG and DEI performance as executive compensation performance metrics, in particular for annual incentive compensation plans.

According to a 2023 FW Cook report[1], the most common DEI goals relate to diverse leadership representation, promotion and hiring of diverse employees across the entire organization, and improvement in diverse representation across the entire organization. However, in light of the Harvard/UNC decision, incentive compensation tied to DEI goals is attracting scrutiny and can create litigation risk.

Legally, companies are not prohibited from continuing to use DEI performance metrics in their executive compensation programs. However, there is increased risk in tying performance and compensation to specific DEI metrics or numeric targets, as doing so could incentivize race or gender-conscious decision-making. Companies should carefully review DEI performance metrics and consider using qualitative measures rather than quantitative ones.

Companies also should ensure that the executive compensation disclosure in their proxy statements communicates these metrics in a way that underscores the tie to the company's business and future success, such that there is meaningful alignment between that metric and the company's key strategic goals. Examples include (1) ensuring the company hires the best talent by broadening the pipeline for prospective employees, (2) cultivating a diverse and inclusive workplace to attract and retain employees, and (3) eliminating bias across the workforce and supply chain. Companies should take care that their programs are not construed to utilize protected categories to determine employment outcomes.

As with any other performance metric, companies also should ensure that their proxy disclosures are clear as to how an ESG target was attained. Goals related to metrics, such as achievement of GHG emissions reductions, may be easier to quantify and should be, where possible. If it is challenging to quantify an ESG metric—or undesirable to do so, owing to litigation risk—then the company should include robust qualitative disclosure explaining how the goal ultimately was achieved.

# Disclosure's Potential Impact on Proxy Advisory Service Voting Recommendations

Both Institutional Shareholder Services Inc. (ISS) and Glass Lewis, the leading proxy advisory services firms, consider DEI and ESG issues in various ways as they formulate their voting recommendations. Both organizations use a variety of company sources, including proxy statements, annual report filings, ESG reports, and sustainability reports published on a public company's website to determine the company's ESG profile.

## DEI

For Russell 3000 index companies, Glass Lewis's current policy guidelines provide that it will generally recommend voting against the nominating committee chair if the board is not at least 30% gender diverse or against all members of the nominating committee if there are no gender diverse directors.

However, Glass Lewis may refrain from recommending that shareholders vote against directors if the company's board gender diversity disclosure provides a sufficient rationale for the lack of gender diversity or a plan to address the lack of diversity, including the timeline for appointing additional gender diverse directors.

Furthermore, in its current policy guidelines, Glass Lewis notes that it will generally recommend voting against the nominating committee chair at Russell 1000 companies with no disclosure of individual or aggregate racial/ethnic minority information and with no directors from underrepresented communities. Glass Lewis in 2024 tweaked its guidelines to confirm that a director who self-identifies as a member of the LGBTQIA+ community is an "underrepresented community director."

ISS also will generally recommend voting against the chair of the nominating committee—or other directors on a case-by-case basis—of companies without at least one racially or ethnically diverse director, and without at least one woman director. However, an exception will be made in the latter case if there was at least one woman on the board at the preceding annual meeting and the board discloses a firm commitment to return to gender diverse status within the year.

## ESG

Glass Lewis will examine a company's overall governance practices and identify which directors or board-level committees are responsible for overseeing ESG issues. For Russell 1000 companies, Glass Lewis will generally recommend voting against the governance committee chair if the company does not provide explicit disclosure relating to the board's role in overseeing ESG related issues.

Further, Glass Lewis may recommend voting against the chair of the committee or board charged with oversight of climate risk in certain circumstances. This may include certain companies operating in industries such as energy and transportation, among others, and where Glass Lewis believes emissions or climate impacts represent an outsized financially material risk, and if the company hasn't produced certain climate related disclosures.

A clear understanding of these voting recommendations and thoughtful disclosure in response can directly impact voting recommendations and thus voting outcomes.

# Climate Related Disclosures

Based on a Sunshine Act notice published on February 28, the SEC on March 6 is expected to vote on the long-awaited climate disclosure rules. While many public companies appreciate the reassurance of timing with respect to final rules, the remaining uncertainties as to phase-in dates for compliance and the ultimate impact of legal challenges to the final rules remain significant areas of concern.

If the prediction that Scope 3 will be omitted from the final rules proves to be true, companies also will need to consider how to comply with other, potentially more stringent regulatory requirements, including the recent California climate legislation (which is itself under legal challenge).

Even in the absence of finalized rules, the SEC continues to address climate-related disclosures. In September 2021, the SEC's Division of Corporation Finance published sample letters to companies that sought to elicit more information on how companies publicly disclose climate-related risks and the material impact those risks had on their business operations, results of operations, or financial condition.

In 2023, the SEC sent additional comment letters to companies that further highlighted the SEC's focus on climate disclosures and climate-related risks. In particular, these comment letters focused on disclosures pertaining to (1) the physical risks and transition risks related to climate change disclosures, (2) the physical impacts of climate change on operations and results, (3) the purchase, sale, and use of carbon credits or offsets for carbon reduction, and (4) the impact and indirect consequences of pending or existing climate-related legislation, regulation, and business trends.[2]

Similarly, in Europe (EU) and the United Kingdom (UK) there are more extensive reporting obligations on companies to meet stakeholder demands for increased sustainability transparency and accountability. Both the EU and UK laws no longer focus only on listed companies or public-interest companies (such as banks and insurers), but rather, the new laws will be triggered if certain revenue or employee thresholds are met on an individual or consolidated basis. Notably, under the phased-in rules, starting in 2025, large private EU companies will need to be compliant with the EU Corporate Sustainability Reporting Directive (CSRD).

These regulations differ from the SEC's proposed climate-disclosure rules in various aspects. For example, the European Sustainability Reporting Standards (ESRS) include social and governance aspects and not just environmental aspects. Notably, the need to report is preceded by a double materiality assessment, requiring companies to report on sustainability matters if a topic is material either from a financial and/or impact perspective.

Although multinational companies will not be subject to the new EU reporting requirements until 2025 and global reporting until 2028, US companies should begin preparing for the CSRD now by conducting an analysis to determine whether and, if so, when they will be subject to the CSRD reporting requirements and preparing for a double materiality assessment.

# Expect Continued Challenges and the Need for Balance

Companies should expect the level of scrutiny and risk associated with their ESG and DEI programs to increase in the near term. Companies could choose to view this environment as an opportunity to clarify their ESG and DEI strategies and to ensure their disclosure aligns with that strategy.

Although we may see tempered ESG and DEI disclosure this year, rather than retreat from the discussion, the most effective response to the current environment is to ensure that the company's approach aligns with its core business strategy and to use the 2024 proxy season to thoughtfully communicate that alignment to its stakeholders.

More information can be found on ESG and sustainability trends and how to navigate the changing DEI landscape, as well as on our Morgan Lewis Global Public Company Academy programs, Navigating ESG and DEI Disclosure Issues in 2024 and 2024 Proxy Season: A Recap of 2023 and Trends to Watch.

# Related Content

## Prior Legal Developments & Analysis

- U.S. Supreme Court: Affirmative Action in College Admissions Must Come to an End

## Resource Kits

- Climate Change Resource Kit
- Executive Compensation Disclosure and Governance Resource Kit
- Proxy Statement and Annual Meeting Resource Kit

## Practice Notes

- CD&A Drafting
- Item 402 of Reg. S-K Compliance When Drafting the Proxy Statement

**Laurie A. Cerveny, Managing Partner, Morgan, Lewis & Bockius LLP**

Laurie A. Cerveny is an accomplished mergers and acquisitions (M&A) and securities lawyer. She has more than 25 years of experience counseling on M&A, ongoing disclosure and reporting requirements, corporate governance matters, annual meeting and proxy-related issues, securities laws, rules under the US Securities and Exchange Commission (SEC), stock exchange listing requirements, executive compensation, and various other matters affecting US and multinational public and private companies and their officers, boards, and directors. With the economic and regulatory climate becoming increasingly complex, Laurie is a trusted advisor to boards and management teams on the disclosure, compliance, and regulatory challenges they face daily.

**Justin W. Chairman, Partner, Morgan, Lewis & Bockius LLP**

Justin W. Chairman, a senior member and former head of the firm's capital markets and public companies practice, counsels both public and private companies on issues that arise in capital raising, mergers and acquisitions, securities compliance and corporate governance activities, and contract, finance, securities, and general corporate matters. Justin specializes in working with real estate investment trusts and also represents clients in various other industries, including life sciences, retail, technology, automotive, media, staffing, and consulting, among others. Justin has led numerous teams in representing several clients in defending against shareholder activism, and routinely counsels clients in preparing for such activity.

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Gina L. Lauriero advises clients across the spectrum of employee benefits and executive compensation matters. Her practice encompasses designing, implementing, and administering equity, incentive compensation, nonqualified deferred compensation, employment, and severance plans and agreements for public and private companies. When clients undertake mergers, acquisitions, and other corporate transactions, she offers advice on all employee benefits and compensation-related aspects. Gina's recent work has included advising a credit ratings agency on its acquisition of a leading provider of analytical tools and data.

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W. John Lee focuses his practice on complex employment litigation, representing employers in class and collective actions across the United States involving allegations of race and gender discrimination, wage and hour claims, as well as challenges to employer background check practices. He also litigates claims under the Sarbanes-Oxley and Dodd-Frank Acts, as well as state law whistleblower actions, in courts and before the US Department of Labor (DOL).

**Sharon Perley Masling, Partner, Morgan, Lewis & Bockius LLP**

Sharon Perley Masling, a leader of Morgan Lewis's Workplace Culture Consulting and Training practice, helps companies and organizations create safe, respectful, diverse, and inclusive workplaces. Sharon also leads the firm's DEI and Affirmative Action Task Force, and developed and led the firm's Reproductive Rights Task Force and COVID-19 Task Force. Having previously served as chief of staff and senior counsel to a commissioner at the Equal Employment Opportunity Commission (EEOC), Sharon provides insight on the enforcement of all employment civil rights laws and advises employers on employment discrimination issues.

**Dr. Veronika Montes, Of Counsel, Morgan, Lewis & Bockius LLP**

Veronika Montes counsels companies, boards, and investors on capital markets transactions, mergers and acquisitions (M&A), and German stock corporation law. She advises on public takeovers, initial public offerings (IPOs), rights issues, and debt offerings, as well as post-listing obligations (including voting rights notifications, insider trading, ad hoc publicity, managers' transactions, and other Market Abuse Regulation (MAR) matters), corporate governance matters, and executive compensation. Veronika also counsels corporates, funds, and multinational businesses on the impact of environmental, social, and governance (ESG) matters and sustainability laws and regulations.

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Celia A. Soehner is co-leader of the firm's capital markets and public companies practice and co-leads the firm's ESG and sustainability advisory practice. She focuses her practice on counseling public companies and their boards with respect to corporate governance, federal securities, stock exchange, shareholder engagement, ESG, and executive compensation matters. Drawing on her previous tenure as an attorney-advisor with the US Securities and Exchange Commission (SEC) in the Division of Corporation Finance, Celia has experience with securities disclosure issues that impact public companies' ongoing reporting obligations and proxy-related matters that impact public companies and their officers and directors. She also advises companies in connection with public capital raising transactions, including through IPOs, secondary offerings, and debt offerings.

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Shabeena Sharak advises clients on a broad range of corporate and transactional matters, including mergers and acquisitions involving both public and private companies, capital markets, debt and equity financings, and other general corporate matters. While in law school, Shabeena was an extern at Alnylam Pharmaceuticals, Inc. and a volunteer for the non-profit organization Lawyers for Civil Rights.