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Research

ESG: The New Age Value Creator

Code of Governance for Start-ups

June 2023

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Introduction to ESG and Some Current Issues

The relevance of "**ESG**" or "**Environmental, Social, and Governance**" as a significant trend in the present market in the present time cannot be overlooked. The philosophy of corporations being mindful of, and responsive to their impact on society and environment has been growing a strong support. It is a new form of inclusive capitalism that recognizes the importance of creating long-term value for all stakeholders, alongside with providing returns for shareholders. There has been a paradigm shift in the approach of maximizing short term being from returns for shareholders as the primary objective of the institutional investor and the investee company, to one of being mindful of the impact of such business decisions on the environment and the stakeholders.

Countries are moving steadily towards inculcating ESG into their regulatory framework by amending or enacting legislation to include ESG regulations which require strict corporate compliance. As investors are becoming more conscious of their responsibility towards the environment and stakeholders, corporations are now increasingly becoming obliged to measure and disclose information of the negative impact of its actions on the environment and stakeholders. Investors have become responsible and now enquire about the ESG compliance reports to access the long-term viability of their investment. Such investor interest has prompted corporations to incorporate evaluation of ESG metrics into their due diligence processes.

The emerging ESG mandate in corporate governance presents a new challenge for companies in India. A stakeholder-driven approach, the ESG requirement facing each company is different and must be fine-tuned to suit the stakeholders with whom a company interfaces.[1] There cannot be a one-size-fits-all approach. Good governance is sacrosanct. It is no longer an option. Much like justice, not only must governance be done; it must be seen to be done. Whilst the applicable standards may differ from jurisdiction to jurisdiction and the nature of organization involved, the fact is that there is always room for improvement and more importantly, there is no room for consistent bad governance.

The business world is rife with stories of how promoters have lost their management positions due to one terrible incident, which forms the basis of an internal investigation and uncovers a series of incidents pointing to inappropriate behavior. ESG issues are becoming increasingly important for start-ups, as investors, customers, and employees demand more accountability and transparency from companies. Here are some of the current ESG-related issues facing start-ups:

i. **Climate Change:** Start-ups are under pressure to reduce their carbon footprint and develop sustainable business practices. Investors are increasingly looking for start-ups that have strong environmental policies and are actively working to reduce their greenhouse gas emissions.

ii. **Social Responsibility:** Start-ups need to demonstrate their commitment to social responsibility by taking steps to promote diversity and inclusion in their workforce and supply chains. They should also be taking steps to ensure that they are not involved in any human rights abuses or other unethical practices.

iii. **Data Privacy and Security:** Start-ups need to take data privacy and security seriously, particularly as more and more consumers are concerned about how their personal data is being stored/used. Start-ups need to implement strong data protection policies and ensure that their systems and processes are secure.

1 See: https://www.cfainstitute.org/en/research/esg-investing, last visited on April 20, 2023.

iv. **Ethical Governance:** Start-ups need to demonstrate strong ethical governance, particularly as they grow and scale. This means having clear policies and procedures in place for decision-making and ensuring that the company operates with integrity and transparency.

v. **Employee Welfare:** Start-ups need to ensure that their employees are treated fairly and have access to the resources they need to thrive. This includes providing fair wages, benefits, and opportunities for professional development.

vi. **Supply Chain Management:** Start-ups need to ensure that their supply chains are ethical and sustainable. This means working with suppliers who share their values and taking steps to ensure that they are not involved in any unethical practices.

Introduction to Start-ups

In recent years, the *start-up culture* has exploded around the world, with many entrepreneurs pursuing their dreams of building successful businesses. The rise of technology and the internet has enabled start-ups to reach global audiences and access funding from venture capitalists, angel investors, and other sources.

While the start-up journey can be rewarding, it is also filled with challenges and uncertainty. Many start-ups fail within the first few years due to lack of funding, market fit, governance or other factors. However, those that succeed can have a significant impact on society and the economy, creating jobs, driving innovation, and improving people's lives.

The startup sector in India has, over the last few years, become a key indicator of the economic growth of the country. A startup is primarily an entrepreneurial venture which is in its initial years of operations and backed by its founders.

A startup is faced with a number of issues that have to be dealt with in order for it to grow into a successful organization. Apart from planning the most effective business strategies, a startup needs to look at the regulatory, legal, governance and tax regimes of the country where it is proposed to be set up and carry on business.

'Startup India' is a flagship initiative of the Government of India intended to build a strong eco-system for nurturing innovation and start-ups in India that will drive sustainable economic growth and generate large scale employment opportunities.[1] Under this initiative, a full action for start-ups in India was launched on January 16, 2016 ("**Action Plan**"). This Action Plan set the stage for wide ranging reforms which are expected to give an impetus to the fast-burgeoning start-up culture in India.

A "start-up" is defined as follows: An entity (i.e. a private limited company / limited liability partnership or a registered partnership firm) incorporated/ registered in India shall be considered as a "start-up" if:

1. It has been in existence for less than 10 years from the date of its incorporation/ registration,
2. Its turnover for any of the financial years has not exceeded INR 1,000,000,000 (Indian Rupees One Billion), and
3. It is working towards innovation, development or improvement of products, processes or services or it is a scalable business model with a high potential of employment generation or wealth creation.

The Government has further clarified that the mere act of developing the following would not be covered under the definition of 'start-up':

1. Products or services or processes which do not have a potential for commercialization; or
2. Undifferentiated products or services or processes; or
3. Products or services or processes with no or limited incremental value for customers or workflow.

1 See: https://www.startupindia.gov.in/content/dam/invest-india/Templates/public/Action__Plan.pdf, last visited on April 20, 2023.

Lately, there has been a growing interest in the intersection between start-ups and ESG. Start-ups, known for their agility and innovation, are increasingly being seen as a key driver of sustainable development, and ESG has emerged as a framework for measuring the impact of businesses beyond their financial performance. By integrating ESG considerations into their operations, start-ups can not only contribute to creating a more sustainable future but also attract investors and customers who prioritize socially responsible practices. In this context, it is becoming increasingly important for start-ups to understand ESG and how they can leverage it to drive long-term success while creating positive impact.

ESG — Inculcating the Trend of Governance by a Start-up from an Early Stage

ESG should be woven into the fabric of a company, not just something that is stacked on at the end. This means that companies need to integrate it into its investment and governance documents from the start.[1]

With the chances of failure so high for start-up companies, there is pressure for economic survival, and ESG compliance or strategies is typically not something investors or customers are determining as mandatory. Rather than needing to balance the demands for economic survival (finding product-market fit, signing first customers, attracting talent and investors) with deploying ESG strategies, it is the companies that had ESG considerations in their mission, problem statement or business model from the beginning which continue to have the most mature ESG strategies as they scale.[2]

An institutional investor such as a venture capitalist typically conducts a financial and legal due diligence on the start-up in order to uncover the risks pertaining to the start-up. Issues that come up often relate to corporate including governance, labour law and foreign exchange law compliances. In order to keep the start-up's valuation high, it is essential for the start-up to ensure that the start-up is managed in a manner compliance with applicable laws from an early stage.

The due diligence process has become even more relevant in recent times as both investors, and financiers have grown cognizant of potential risks involved in investing in a start-up — many investors having already suffered from issues in exiting their previous investments. It is therefore essential for any start-up anticipating investment to be financially and legally sound and to have the cleanest track record possible in terms of corporate governance.

As ESG practices, policies and regulations continue to evolve, founders and senior executives of start-ups are contemplating embarking on the ESG journey and asking several important questions like — Why move to ESG initiatives? When and where to initiate a formal ESG strategy? What are the associated rewards and risks? While most of the businesses including a few start-ups have taken ESG as their top business priority, only a few start-ups have established an ESG team or have taken steps to drive their strategic focus on ESG issues. However, with an increasingly demanding base of stakeholders and the awareness of long-term benefits, startups should also start demonstrating their commitment to making an environmental and social impact by adapting ESG into their corporate business strategy as soon as possible. Further, the ongoing expansion of ESG awareness, guidelines and processes, have created compelling options for startup companies to be early movers in this fast-pacing area.[3]

The Securities and Exchange Board of India, the Reserve Bank of India, the Ministry of Corporate Affairs have mandated several companies to integrate ESG framework, standards and disclosure requirements to further drive their ESG goals.

1 See: https://www.ringcentral.com/us/en/blog/esg-for-startups/, last visited on April 20, 2023.

2 See: https://www3.weforum.org/docs/WEF_ESG_Pulse_Check_2022.pdf, last visited on April 20, 2023.

3 See: https://www.timesnownews.com/opinion/why-when-and-how-should-startups-in-india-move-to-esg-article-95504803, last visited on April 20, 2023.

Below are few ways that start-ups can begin to develop a culture of ESG:

1. **Establish a diverse mix of Board of Directors:** Having a diverse board with a mix of industry expertise, business experience, and governance knowledge can help ensure that the company is making informed decisions that benefit all stakeholders.

2. **Develop Governance Policies and Procedures:** These policies should cover areas such as risk management, financial reporting, and ethical conduct. Having clear guidelines in place can help the organization stay on track and avoid potential legal or reputational risks. By adopting a values-driven strategy, companies can create an ESG governance framework that not only helps them achieve financial success but also contributes to solving some of the world's most pressing problems.

3. **Hire Experienced Leaders:** Start-ups can benefit from hiring experienced leaders who have a track record of success in governance and business management. These leaders can help establish a culture of accountability, transparency, and ethical conduct within the organization. To gain valuable insights into how developments within the ESG ecosystem will impact their business models, top executives can start by familiarizing themselves with the fundamental ESG concepts, different standards and frameworks, as well as staying up-to-date with current industry trends and updates.

4. **Foster a Culture of Open Communication:** Start-ups should foster a culture of open communication that encourages employees to speak up when they see something that doesn't align with the company's values or policies. By creating a safe space for dialogue, the organization can identify and address potential issues before they become major problems.

5. **Conduct Regular Audits:** Start-ups should conduct regular audits of their governance policies and procedures to ensure they are meeting industry standards and best practices. These audits can help identify areas for improvement and ensure that the organization is complying with legal and regulatory requirements.

6. **Push from Investors:** There is a growing trend among investors towards responsible investments, with more and more of them choosing to invest in ESG funds or consider ESG factors when making investment decisions. Investors are increasingly prioritizing issues such as diversity and inclusion, human rights, climate change, business ethics, and corporate governance, and are insisting that these factors be considered when constructing their investment portfolios.

ESG — As a Tool to Deal with Issues Regarding Misgovernance in Start-ups

ESG can play a vital role in addressing issues of mis governance in startups in the Indian context. Startups in India have been facing challenges related to governance due to the lack of proper regulatory frameworks, weak institutional mechanisms, and inadequate disclosure norms. ESG practices can help startups mitigate these challenges and build a culture of transparency, accountability, honesty and responsibility (The four pillars of corporate governance) for building a strong corporate culture and establishing trust with stakeholders. In addition, having a healthy balance between the interests of different stakeholders, such as employees, customers, and shareholders, is also crucial for effective corporate governance. This balance helps to ensure that the company is not solely focused on maximizing profits for shareholders at the expense of other stakeholders.

The Indian Companies Act, 2013 ("CA 2013") is an example of how the principles of corporate governance can be enshrined in law to promote responsible business practices. The CA 2013 includes provisions for strengthening the role of independent directors, internal committees, enhancing transparency and disclosure requirements, and promoting responsible and sustainable business practices.

For start-ups, achieving effective corporate governance involves striking a delicate balance between rigid adherence to rules and regulations and the flexibility to adapt to changing circumstances. By implementing strong governance practices, startups can promote growth, transparency, and a strong organizational culture, making them more attractive and predictable places to work. To achieve this, it's essential to establish a shared vision among the founders, investors, and board of directors, and ensure that the board is actively engaged with the founders. Regular meetings with clear agendas can help keep everyone focused on agreed-upon plans and priorities.

The board of a start-up should also reflect on its role in dealing with emerging governance issues (e.g. corporate purpose, environmental, social and governance, human capital, and culture). Further, the board of a start-up should consider and manage all material risks facing their company, including ESG risks for effective board governance, contributing to shareholders value and creating the conditions in which sustainable long-term investment can prosper. Disclosing information on a range of ESG issues provides an opportunity for the company's board and management to demonstrate strategic thinking in relation to long-term financial sustainability beyond the achievement of short-term financial targets.

In addition, startups should set and regularly review Key Performance Indicators ("KPIs") to track progress and identify areas for improvement. Strategic planning, financial reviews, and other discussions should be conducted in a collaborative and fruitful manner to ensure that the company is on track to achieve its goals.[1]

By adopting ESG practices, start-ups can build a culture of good governance that will help them avoid mis governance issues and build trust with investors and other stakeholders. In addition, ESG practices can help startups attract investors who prioritize responsible and sustainable investments. Many investors are increasingly focusing on ESG factors when evaluating potential investments, and startups that adopt ESG practices are likely to be more attractive to these investors as start-ups can also reduce their cost of capital and improve access to financing.

1 See: https://www.edupristine.com/blog/indian-start-ups-need-to-start-taking-corporate-governance-seriously, last visited on April 20, 2023.

ESG — Duty of the Founders

A. Focus on the Basics

As a start-up founder in the early stages, what actions can you take to remain ahead of the curve? The brief response would be to begin with a modest approach and gradually develop your company's ESG capabilities as it expands.

i. During the early stages of your start-up, your focus will be on achieving the right product-market fit, and you are likely to iterate multiple times on both your product and business model. While speed is crucial in this process, it is important to take a step further and analyse the second and third-order impacts of your product and any changes to your strategy that could reveal new ESG risks and opportunities. Additionally, it is crucial to examine whether your start-up's product or service will have a positive overall impact on the world. For example, the value added by many tech start-ups may come at the expense of workers' rights.

ii. Even if your company doesn't appear to pose significant ESG risks initially, any ESG-related problems that go unnoticed can expand rapidly along with your start-up. As a result, it is crucial to identify ESG concerns that could impact your business, not just at present but also as it scales up

iii. As the founder, it should be your aim to establish a sturdy groundwork for constructing resilient ESG procedures. Similar to how you prioritize all feasible features and solutions during product development, you must also prioritize ESG concerns that offer high value and low complexity within your industry.

iv. Involve your customers in your sustainability discussions and be open about the fact that ESG is an ongoing effort as your business expands. Your transparency and connection with your customers will serve as your primary defense if an unintended sustainability problem arises. However, it's important not to overlook your investors as well. Include your ESG value creation narrative in documents targeted towards them. If you can provide specific stories backed up by data, that would be even more beneficial.

B. Define Purpose

Defining a clear purpose is critical for start-ups to identify the unique problem they are solving and the strengths that set them apart from competitors. The purpose encapsulates the essential need that the start-up aims to address and the distinct value it provides to its customers. It answers the question of whether the start-up's disappearance would cause a significant loss to the world, and whether competitors can easily replace it. Purpose goes beyond branding and public relations, and its importance lies in inspiring employees, guiding the company's efforts, and helping it make crucial decisions in challenging situations. Start-ups typically benefit from a strong sense of purpose that stems from the founder's passion to solve a problem.

While Purpose is critical, it should be complemented with ESG frameworks that provide a roadmap for implementing Purpose and guide the start-up's decision-making processes. ESG frameworks offer a systematic approach to running a business while delivering on its Purpose and strategy and minimizing risks. Purpose without ESG is not strategic or measurable and lacks the necessary anchoring in the business. Conversely, ESG without Purpose fails to focus on the crucial areas that underpin the start-up's strategy and becomes a mere checklist. Therefore, Purpose and ESG go hand in hand, with Purpose helping founders to identify the critical areas to focus on to achieve their goals, and ESG providing an implementation framework to guide the start-up's decision-making processes.[1]

C. Emphasize Culture

In today's world, the significance of corporate culture, which refers to the principles and conduct that shape a company, has amplified. Companies are confronted with the challenge of attracting and retaining skilled employees, and cultivating an enticing culture is one approach to achieve both goals. Furthermore, the recent incidents of employee harassment, which brought about the "Me Too" movement, highlight the dangers of having a negative culture. Therefore, the topic of corporate culture has become more pertinent to investors, whether financial or strategic. As the existence of a healthy culture can influence the level of risk associated with a potential investment/acquisition.

Successful implementation of ESG requires time and dedicated effort, which is why many companies struggle to accomplish it effectively. Our culture of prioritizing quick victories is deeply ingrained and heavily incentivized, causing immediate outcomes to take precedence over decision-making processes.

Founders need to ensure that management walks-the-talk on culture and values. Cultures can also change more rapidly than Founders think. They sometimes underestimate the influence the CEO has on the culture. The CEO's behaviour is quickly copied throughout the organization. One other area of culture where the board can be really powerful is around lifelong learning. One of the critical success factors, both for individuals and institutions, is having a thirst for learning and an external orientation.[2]

D. Focus on Risk Management

It is a well-known fact that companies need to undertake significant risks to achieve success. However, the overall responsibility for managing risks rests with the board of directors including the founders. Unfortunately, boards / founders often tend to overlook existential risks, which can be harder to comprehend, especially for executives who are primarily focused on the present. These risks can cause severe harm to companies and have a far more significant impact than more easily identifiable business risks.

Instead of only discussing competitive risks, boards / founders should put in place a well-functioning crisis management system. Yet even the best systems will not identify all the risks, and boards and management must somehow try to grasp the unthinkable. The best way may be to tap into the concerns and observations of middle management, the group most likely to be aware of bad practices or rogue behaviour in any company.[3]

To mitigate risks effectively, founders must first identify and prioritize the critical risks that are relevant to their start-up's specific sector or business. Attempting to tackle every potential risk at once can be overwhelming and may lead to failure. Hence, it's essential to start with the most material risks and avoid

1 See: https://hbr.org/2022/11/startups-need-an-esg-strategy, last visited on April 20, 2023.

2 See: https://www.mckinsey.com/~/media/mckinsey/featured%20insights/leadership/the%20board%20perspective/issue%20number%203/the-board-perspective-number-3.pdf, last visited on April 20, 2023.

3 See: https://www.mckinsey.com/~/media/mckinsey/featured%20insights/leadership/the%20board%20perspective/the-board-perspective.ashx, last visited on April 20, 2023.

attempting to address all risks simultaneously. The failure to manage material risks can prove to be detrimental to a start-up's success.

- On **E:** startups must have a target on carbon/natural resource footprint
- On **S:** Startups must build a strong social contract with employees and other stakeholders; including 'living' wages, an inclusive culture, and support for mental health
- On **G:** startups need diverse boards and rock-solid data security rules[4]

E. Tendency to Grow Too Big, Too Fast at the Cost of Governance Issues

Corporate governance is a critical aspect of every company's operations, regardless of its size, nature, or ownership structure. The purpose of corporate governance is to establish a framework of policies, procedures, and practices that ensure the company is managed in a responsible and ethical manner, and its stakeholders' interests are protected. However, the nature of corporate governance for large, established companies differs from that of start-ups and private companies.

Unlike large, publicly listed companies, start-ups and private companies typically consist of founders and investors as board members, who have a vested interest in the company's success. These board members' primary responsibility is to safeguard their investments and ensure the company's value and growth potential remain high. This focus on valuation often leads to cut corners and questionable practices, driven by both the promoters' greed and investors' appetite for higher valuations.

Many start-ups are focused on achieving profitability quickly, which can lead to decisions that prioritize short-term gains over long-term sustainability and governance. Promoters of start-ups often seek faster growth and capital, which can lead them to take shortcuts and engage in unethical practices. This approach can lead to governance failures and, in some cases, bring down the company and its promoters. In such scenarios, promoters and key management personnel may not be transparent and could resort to falsifying books of accounts with fake bills and invoices to make a quick profit.

While the focus on valuation is important for start-ups, it should not come at the expense of good governance practices and ethical conduct. Investors must prioritize responsible governance practices and hold promoters and management accountable for their actions to ensure the long-term success of the company and protect their investments. This pressure to perform can lead to a focus on rapid growth at the expense of governance and ESG considerations.

Start-ups often have a culture that values risk-taking, innovation, and disruption. While these values can be beneficial for growth, they may not always align with ESG considerations. Further, Start-ups may not fully understand or comply with the complex regulatory requirements related to ESG.

Overall, start-ups may prioritize growth and profitability over ESG concerns due to investor pressure, lack of resources, short-term thinking, cultural values, and regulatory compliance issues. It is important for start-ups to address these challenges and prioritize responsible governance practices and ESG considerations for long-term sustainability and success.

4 See: https://hbr.org/2022/11/startups-need-an-esg-strategy, last visited on April 20, 2023.

F. Is the Reputation of The Indian Start-up Ecosystem, so Painstakingly Built, at Risk?

While India has witnessed a significant surge in start-up activity over the past few years, the ecosystem is facing several challenges that could impact its reputation. One of the primary concerns is the recent wave of corporate governance failures, which have brought several high-profile start-ups under scrutiny. These failures have raised questions about the overall integrity of the Indian start-up ecosystem and its ability to sustain its growth in the long run.

Start-ups that do not regularly review and address governance issues may be ignoring them at their own peril. For many businesses, governance remains a less discussed area of vulnerability, in part because it involves internal systems, controls, and procedures, which in many cases are less visible to stakeholders and the broader public.

With recent stories of corporate mis governance spilling over to the mainstream, there is a genuine outcry that corporate governance needs to be strengthened in start-ups. It is a serious issue that needs to be addressed not just by the founders alone but by everyone so that the reputation of the Indian start-up ecosystem, so painstakingly built, is not hampered in anyway.

However, it is also important to note that India's start-up ecosystem has demonstrated resilience and the ability to overcome challenges in the past. With the right support and regulatory environment, the ecosystem can continue to thrive and maintain its reputation as a hub for innovation and entrepreneurship.

ESG — Duty of the Investor / Shareholder

There has been a growing recognition of the role that investors can play in driving change in the companies in which they invest. Investors are increasingly using environmental, social and governance (ESG) metrics within their investment processes to not only assess risks but also to identify potential real-world impacts — both positive and negative — of corporate operations and future investment opportunities. They are using this information to push for changes in business strategies and models that support the shift to a low carbon economy, a fairer society and numerous other goals as outlined by the UN Sustainable Development Goals (SDGs).[1]

Effective engagement by the start-ups with investors and other stakeholders is key to developing long-term relationships, understanding stakeholder perspectives, communicating board practices and priorities and the start-up's commitment to long-term value creation, and cultivating stakeholders' understanding of the start-up's point of view, particularly with respect to investments that have a long-term horizon.[2]

This involves a mutual exchange of information, with investors carefully reviewing company communications about strategy, governance, and long-term objectives, and communicating their own expectations and policies for engagement. By engaging with companies in this way, investors can gain a deeper understanding of a company's governance and long-term strategy beyond just financial metrics. When investors are satisfied that a company has a thoughtful board, adheres to good governance principles, and has a reasonable long-term strategy, they will support the corporation against short-term pressures. The goal of this engagement is to move beyond mere check-the-box governance mandates and quarterly financial metrics towards a more comprehensive understanding of a corporation's long-term prospects.

- **Consistent Support for Long-Term Strategies** — To ensure long-term growth, it is important for an investor to provide consistent support for reasonable strategies and speak out publicly against short-term demands that could be disruptive.
- **Integrated Long-Term Investment Approach** — An investor should establish a culture of long-term thinking and patient capital, discourage over-reliance on short-term performance metrics and promote stewardship principles are also crucial. It is important to consider sustainability, citizenship, and ESG factors when developing investment strategies and designing employee compensation to discourage sacrificing long-term value for short-term gains.
- **Engagement** — Investors should be active listeners and, where appropriate, they should be proactive in engaging in dialogue with a corporation as part of a long-term relationship. Engagement is key for a shareholder, as it involves actively listening to companies and reviewing their communications about strategy, long-term objectives, and governance. Communicating preferences and expectations for engagement and providing candid feedback on strategy, performance, management, board, governance, and engagement is important.

1 See: https://assets.ctfassets.net/bxxzjfpinfqw/2hljRz6upSUo3bpeQ6fRSm/56747d739f374665196fc01109bda19b/ESG_conundrum_report.pdf, last visited on April 20, 2023.

2 See: https://www.wlrk.com/webdocs/wlrknew/AttorneyPubs/WLRK.25960.16.pdf, last visited on April 20, 2023.

- **Collaboration and feedback** — Collaboration and feedback are also essential, and if an investor is concerned about a company's strategy or performance, prompt notice should be given to the corporation and an opportunity to engage should be provided. If negative opinions are publicly disclosed, it is important to state whether the corporation was given an opportunity to engage.
- **Voting decisions** — Voting decisions should be made on an informed basis, and shares should be voted or refrained from voting in a manner consistent with the best interests of all stakeholders.
- **Integrate ESG matters into Investment Strategy** — Just as companies should take into account relevant ESG and sustainability factors when developing their long-term strategies, investors should likewise consider such factors in their investment strategies.

ESG's Crystal Ball: Anticipating Some Potential Future Issues

A. Cyber Security

There has been a rise in cyber-attacks targeting critical infrastructure, financial networks, healthcare, and other interconnected systems in recent months. However, investors and boards who prioritize Environmental, Social, and Corporate Governance (ESG) tend to concentrate on environmental and social justice issues, leaving cybersecurity concerns to regulators and insurance companies.

Cybersecurity has gained wider attention as the global workforce has pivoted to working from home and as data breaches occurred to companies in various industries. Companies can be fined and/or suffer reputational damage if they do not adequately protect their information networks. The sectors most relevant to this theme are Information Technology, Consumer Discretionary, Financials, and Communications Services. It could also have material impact on industries which have conventionally spent lower budgets on cybersecurity issues.[1]

It is crucial for companies to view cybersecurity as a crucial aspect of ESG. Cyber risk is the most pressing and financially significant sustainability risk that businesses confront today. Companies that do not implement effective cybersecurity governance, along with proper tools and metrics, will have lower resilience and sustainability. This can ultimately impact other organizations they depend on, as well as the stability of companies, communities, and governments.

Despite being traditionally perceived as an IT problem, cybersecurity breaches, malicious use, and social engineering can have far-reaching consequences beyond the realm of IT. The impact on society as a whole can include identity theft, vulnerabilities to disadvantaged groups, exploitation of marginalized communities, and the aftermath of geopolitical instability. We are already seeing technology innovation shifting from digitization to broader goals, such as democratization, decentralization and decarbonization.

Companies that fail to recognize these changes and don't integrate their ESG and cybersecurity strategies risk a whole lot more than a breach or costly insurance claim.

B. Human Rights

As companies increasingly prioritize Environmental, Social, and Corporate Governance (ESG) initiatives, human rights issues are becoming an increasingly important area of focus. While progress has been made, there are still potential future issues that companies need to be aware of and address.

One potential issue is the increased scrutiny of supply chains. Companies are under pressure to ensure that their supply chains are free from human rights abuses, including forced labour and child labour. As a result, companies may need to invest in additional due diligence and monitoring of their suppliers to ensure that their products are not tainted by human rights violations.

1 See: https://www.jpmorgan.com/insights/research/why-is-cybersecurity-important-to-esg, last visited on April 20, 2023.

Another potential issue is the impact of emerging technologies on human rights. As technology continues to evolve, there is a risk that it could be used to violate human rights. For example, facial recognition technology could be used for mass surveillance or discrimination against certain groups of people. Companies need to be aware of the potential risks and work to mitigate them as they develop and implement new technologies.

Finally, the ongoing COVID–19 pandemic has highlighted the need to protect the human rights of employees and customers. Companies may need to invest in additional health and safety measures to protect their employees, while also ensuring that their customers are not subjected to discriminatory policies or practices related to the pandemic.

In summary, while progress has been made in addressing human rights issues as part of ESG, there are still potential future issues that companies need to be aware of and address. These include supply chain risks, emerging technology risks, and the need to protect human rights in the context of the ongoing pandemic.

C. Climate Change

While climate change will continue to be a primary concern, the ESG discourse will become more intricate due to the growing emphasis on other environmental issues like biodiversity, and environmental and energy justice. The world's efforts to reduce the effects of climate change will persist in 2023 as many public and private entities respond to the urgent need for change. As a result, some of the more challenging aspects of the energy transition could come under closer inspection.

Climate change has the potential to profoundly change the physical world in which we live. Indeed, some of these changes are already taking place. Summers around the world are already hotter; wildfires are more frequent and more devastating; sea levels have risen around the world, increasing instances of coastal flooding; rainy seasons are rainier; droughts are longer; and extreme weather in general is more frequent. Climate-related risks to our economies and investments are already here, and they will grow in severity depending on global responses to climate change in the coming decades. Climate change risks are usually divided into two categories: physical risks and transition risks.[2]

Physical risks: The physical risks are likely the first aspects that come to mind when talking about the impacts of climate change. The majority of us are aware of the rise in extreme weather conditions related to climate change, such as more frequent and severe hurricanes, hotter and dryer conditions leading to forest fires, and so on. These environmental modifications will impact all businesses to some degree. Even if companies don't directly produce goods or services that emit greenhouse gases into the atmosphere, these gases may still be present in the supply chain of firms that do.

Transition risks: Economies around the world will attempt to decarbonize (i.e., dramatically reduce or eliminate CO_2 emissions) in the coming decades. How successful they will be is an open question. Efforts to decarbonize economies are already underway by countries and companies alike. Currently, about 20% of the world's emissions are covered by some kind of carbon market to put a price on CO_2 emissions, with more expected to come in the future. The quicker the transition to a low-carbon or net zero emissions economy, the more jarring that transition will be for companies and the more disruption it will cause to economies and markets.

2 See: https://www.cfainstitute.org/-/media/documents/article/industry-research/climate-change-analyis.ashx, last visited on April 20, 2023.

All industries will undergo some transition to a lower carbon world. Some will be rapid, some will be slow, and the level of disruption will vary due to government action, consumer preferences, as well as company and investor engagement on these issues.

D. Bribery / Corruption

One of the most pressing challenges facing ESG compliance is corruption in its various forms, which poses a significant material risk for investors, particularly during times of crisis. These forms include bribery of public officials, embezzlement, fraud, money laundering, nepotism, and the lack of adequate control structures, which can lead to unfair dealings and illegal private arrangements. In some cases, corruption can even become institutionalized, causing entire jurisdictions to be viewed unfavourably. When governmental institutions lack integrity, the consequences can be severe, ranging from lost business and public trust to environmental destruction, wildlife trafficking, money laundering, terrorist financing, and even human trafficking and modern slavery.[3]

Bribery and corruption can undermine good company and state environmental and social policies and processes, if standards are ignored by bribed officials. Furthermore, the fear of these illegal practices can erode trust in a company, particularly among investors and shareholders who may question the effectiveness of its systems and processes in preventing bribery and corruption.[4]

This in turn calls for companies to have a robust Anti-Bribery and Anti-Corruption program that will reflect positively on a company's ESG compliance. This is particularly crucial in international environments, especially in countries where there is a high risk of both state and private sector corruption. While some countries and industries appear to be more exposed to corruption risks than others, none has escaped the financial fallout associated with acts of corruption. As a key indicator of corporate financial health, it is essential that investors understand the corruption risks in their portfolio.

Investors and standard-setting organizations should not lose sight of the corrupt conduct that frequently enables environmentally and socially corrosive corporate behaviour. Corruption is intricately intertwined with financial, environmental, social and governance risks alike. Moreover, corporate integrity is fundamental to ethical ESG performance and reporting. Screening and mitigating corruption risks should therefore be integral to investor frameworks, metrics and ratings across the board.[5]

3 See: https://www.msg-compliance.de/en/blog-item-en/esg-in-the-tension-field-of-corruption , last visited on April 20, 2023.

4 See: https://abacgroup.com/the-importance-of-esg-with-relation-to-anti-bribery-and-anti-corruption/, last visited on April 20, 2023.

5 See: https://www3.weforum.org/docs/WEF_Investing_in_Integrity_GFC_2022.pdf, last visited on April 20, 2023.

ESG Conundrum: Examining the Role of a Corporate Entity in Civil Society

Large corporations are increasingly taking into account the interests of various stakeholders, including the environment and society, due to their significant impact and accountability to civil society. The separation of ownership and control in corporations has contributed to this shift. Many companies have voluntarily integrated social and environmental policies into their operations and report on their performance. This is justified by the belief that meeting the needs of stakeholders leads to improved financial performance and not doing so can harm shareholder value. This trend has created opportunities for further research on the role of corporations in society.

A. Instances of Promoter Greed and Investor Appetites for Higher Valuation as a Cause for Governance Failures

Corporate Governance is important to all companies whether start-ups, mature companies, private companies, public companies, listed companies etc. However, there is a difference between corporate governance for large companies and corporate governance for start-ups. Unlike a listed company which has independent directors who may call out instances of mis governance or poor practices, start-ups and private companies consist largely of investor board members, whose job is to protect their investment and interests and the value of their shares.

In most start-ups, Board is generally guided by one major event 'valuation'. Promoters look for faster growth and capital and therefore, cut the edges, while non-promoter investors look for higher more valuations, so as to multiply their investments and make a profitable exit. These instances of promoter greed and investor appetites for higher valuation has been a major cause for governance failures and brought down the companies and the promoters as well.

One of the main reasons for corporate governance failures in start-up entities is "Greed". Sometimes, the promoters and key management personnel are not transparent and tend to lie lest the valuation falls. They could even resort to falsifying books of accounts with fake bills, invoices, so that first the promoters make good slush money and then take care of the company if possible. All these happen under the very nose of Investors.

B. Need for Regular Training Programs for the Board of Directors and Key Management Personnel (KMPs)

With sustainability and corporate responsibility taking centre stage, businesses worldwide are integrating Environmental, Social, and Governance (ESG) practices into their operations. As the governing body cance of ESG and its impact on the business.

Regular training programs provide an opportunity for the Board of Directors and KMPs to stay informed and up-to-date on the latest developments in ESG practices, regulations, and trends. A well-designed training program can cover a wide range of topics such as climate change, social responsibility, diversity and inclusion, ethical business practices, and corporate governance.

Furthermore, regular training programs can help the Board of Directors and KMPs identify potential risks and opportunities related to ESG issues and develop strategies to mitigate risks and capitalize on opportunities. It can also help the Board of Directors communicate the company's ESG initiatives to stakeholders, including investors, customers, employees, and communities. It can also improve the overall reputation of the organization and attract socially responsible investors and customers.

C. Climate Change as the New Driver

S&P Global Market Intelligence reports that 80% of the world's largest companies acknowledge exposure to physical or market transition risks stemming from climate change. Shareholder and activist pressures have resulted in divestments from carbon-intensive industries. As a response to the physical climate risks or transition risks, many ESG initiatives focus on evaluating material climate change issues, such as greenhouse gas emissions, which are likely to be important to more than 50% of industries in the transportation and extractives sectors.

Some suggest that climate action has outgrown the ESG mandate, and climate risks must be addressed separately from other social and governance concerns, given their unique nature. Immediate adaptation or recovery efforts related to climate events can directly impact safety and physical assets, thereby overshadowing long-term sustainability goals. Additionally, grouping sustainability goals based on ESG criteria may dilute the awareness of specific climate risks. Furthermore, as climate risks affect all market segments and businesses, the macro nature of exposure is a source of concern.

Apart from regulatory mandates, incentivizing corporate performance can also aid in addressing the risks associated with climate change. The correlation between corporate performance and dedication towards ESG matters, particularly those related to climate change, has been the subject of much research. While there is ongoing debate due to the limited history of various ESG-centered strategies, preliminary data indicates that companies with strong ESG awareness and investments in climate-related solutions may reap benefits.

D. Web3 Technologies, Enabling a Fresh Approach to Corporate Governance

Corporate governance refers to the processes put in place to oversee the functioning of corporations, ensuring they operate in a fair, transparent, and responsible manner while striking a balance between all stakeholders involved. However, corporate structures in their existing form tend to concentrate decision-making power in a few top officials, which can lead to malfeasance. To solve this agency problem, corporate governance focuses on tightening the noose.

But Web3 offers an alternative, tech-based solution. Web3 is a group of technologies, including blockchain, crypto-assets, smart contracts, and decentralized autonomous organizations (DAOs), that advocates for an intermediary-free, decentralized ecosystem. This core concept of decentralization enables a fresh approach to corporate governance, addressing the root cause by decentralizing power instead of vesting it with a few individuals.

By leveraging blockchain and smart contracts powered by crypto-assets, Web3 can minimize discretion and allow for the conduct of operations in a transparent, auditable, and fair fashion. In this way, Web3 offers a promising new path towards more effective corporate governance.

In order to achieve sustainability targets, it is important to incentivize carbon reduction through the use of blockchain technology. Blockchain and Web3 have the potential to deliver a wide range of innovative, positive, social, and environmental solutions that can complement or provide alternatives to traditional solutions.

For instance, Distributed Ledger Technology (**DLT**), the platform from which crypto tokens are built, is already being used to solve environmental challenges. Carbon offsets can be tokenized on blockchain, offering greater transparency and assurance that offsets are reaching the intended projects. A decentralized approach enables distributed ledgers and smart contracts, eliminating the need for negotiations, manual intervention, and mediation. This strategy reduces costs, eliminates power centralization, and ensures the highest level of governance.[1]

Web3 and the metaverse can also impact sustainability by considerably reducing the need for human travel, resulting in less traffic, fewer accidents, and less pollution. The metaverse can also help reduce pollution caused by job-related activities. For example, governments might conduct military training activities, such as pilots flying warplanes, in the virtual world, lowering emissions.

The emergence of Web3 and the metaverse presents an opportunity for businesses to reinvigorate and harden ESG and sustainability efforts. From greater governance practices to energy savings, Web3 and sustainability can help organizations better align business goals with environmental, societal, and governance goals. This can lead to a more sustainable future for all.[2]

1 See: https://economymiddleeast.com/news/web3-and-blockchain-technology-help-solve-global-esg-issues/, last visited on April 20, 2023.

2 See: https://www.virtusa.com/trends-2022/converging-trends/web-3-0-and-the-metaverse---esg-and-sustainability, last visited on April 20, 2023.

Types of ESG-related Disputes

i. Parent-Company Liability Claims — In recent years, there has been a trend of litigating against parent companies of subsidiaries operating in jurisdictions with concerns over access to justice, such as in Africa and South America. The claimants bring their claims against the parent companies in countries such as USA and UK, alleging environmental damage, or violation of human rights by the subsidiary.

ii. Climate-Change Disputes — With the increasing awareness regarding climate change, disputes relating to climate change are one of the biggest chunk of ESG disputes. Climate change disputes relate to greenhouse emissions, or the ecological damage caused by corporations. Another type of climate change related disputes include the claim of "greenwashing", wherein the businesses are accused of making false statements and promises about their environmental efforts in the ESG practices to attract investors and consumers.

iii. Supply chain ESG Disputes — ESG disputes have also arisen in relation to the supply chains of corporations. These concerns range from forced labour and human rights violations to climate change related issues arising in the supply chain of a company. Several jurisdictions have enacted legislation requiring that companies conduct due diligence with respect to the human rights and environmental impacts of their business activities, and their partners in the supply chain. Such as the German Supply Chain Due Diligence Act (GSCA) which imposes an obligation on German companies to identify, document and report potential human rights and environmental violations committed by their direct and indirect suppliers.

iv. Energy Charter Treaty Arbitration — On the flip side of the coin, there are also proceedings initiated by the companies that have been adversely affected by the ESG based legislations passed by the governments. These are generally initiated by the energy companies affected by the legislations on reducing greenhouse gas emissions.

Role of Arbitration in ESG-related Disputes

The increasing growth of ESG obligations has translated, in practice, into more frequent ESG risk allocation clauses in the commercial contracts that companies enter into in their operations. A clear example of this trend can be seen in M&A transactions, which often address ESG issues, including in representations and warranties. ESG disputes relating to such contractual clauses are frequently resolved through arbitration, just like many other contractual disputes.

The advantages of arbitration in ESG-related disputes is threefold:

1. ESG disputes, such as climate change, are often legally and technically complex. Arbitration allows for the selection of specific adjudicators with relevant expertise and for the tailoring of the proceeding to the needs of each case.

2. ESG-related disputes involve cross-jurisdictional issues, such as a company having its supply chains operating across various jurisdictions. Arbitration is often regarded as the best method of resolving these sorts of cross-border cases.

3. ESG disputes often require an initial adjudication that cannot wait, such as an imminent risk of irreversible environmental damage resulting from an activity. Arbitration also allows for obtaining injunctive relief in an expeditious and efficient manner.

Conclusion — The Future of ESG Reporting & Investments

More and more companies are recognizing the significance of incorporating a robust environmental, social, and governance (ESG) agenda into their long-term plans and are therefore increasing their efforts to measure and report various metrics. Although there are still noticeable gaps in the information available, there are various initiatives underway aimed at enhancing the quality of data accessible to investors. The International Sustainability Standards Board's (ISSB) mission to unify different ESG frameworks offers a genuine prospect of establishing an international standard for disclosures. Additionally, International Organisation of Securities Commission's (IOSCO) proposals to enhance the ESG data industry will lead to greater transparency regarding the methodologies of data providers.

Governments' endorsement of mandatory ESG disclosures, as opposed to voluntary ones, will enhance investors' understanding of companies' ESG performance and bolster their trust in the reported metrics. However, it is worth noting that transparency and reporting alone will not have a tangible impact on the real world. For instance, compelling public companies to disclose their ESG practices will not stop unaccountable private entities from acquiring harmful assets, thus exacerbating sustainability challenges. Therefore, in addition to this top-down effort, a more grassroots approach is necessary to address the specific ESG concerns of individual companies.

Both companies and investors acknowledge that direct communication is crucial. By engaging more with companies, investors and their external managers are gaining valuable insights that enable them to effectively integrate ESG considerations into their investment strategies and help companies achieve concrete sustainability outcomes. Consequently, many regions require additional frameworks and enforceable mandates to encourage companies to establish clear targets and incentives, and to monitor progress toward these objectives as part of a robust investor-stewardship program.[1]

Start-ups have largely been left out of the conversation when it comes to ESG until now. Considering the immense societal role that startups play in society today, it is crucial for each and every company, no matter their size, to consider and define what ESG means for their organization and stakeholders they serve. ESG must come from all stakeholders including the boardroom, CEO, founders, investors, shareholders and employees in order to make it truly work and make the difference we all need it to.

India's focus on directors' duties to consider shareholders as well as other constituencies lay a strong statutory foundation for the legal recognition of ESG, both on a financial basis and an entity approach. Coupled with this are strong regulatory moves by the Indian financial regulators (including SEBI) to develop ESG reporting and to encapsulate ESG concerns as part of shareholder stewardship initiatives. Despite the substantial legislative and regulatory advancements made towards ESG in India, several obstacles persist, and the progress achieved thus far can only be regarded as work-in-progress.

1 See: https://assets.ctfassets.net/bxxzjfpinfqw/2hljRz6upSUo3bpeQ6fRSm/56747d739f374665196fc01109bda19b/ESG_conundrum_report.pdf, last visited on April 20, 2023.

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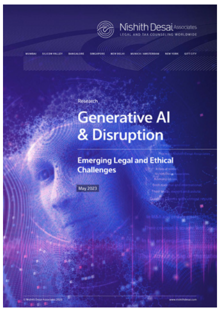

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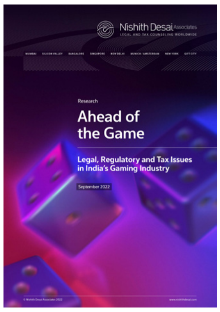

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