# Excellence in ESG

*Even as environmental, social and governance issues become a focal point for stakeholders, boards are grappling with a lack of industry standards and uncertainty around shareholder expectations. Some lessons and strategies gleaned from Corporate Board Member's 2021 ESG Board Forum.*

With ESG promising to be an increasingly greater focal point for investors, directors are left grappling with a smorgasbord of confusing industry standards and uncertainty around shareholder expectations as they try to define, measure and communicate their company's environment, social and governance oversight efforts.

While some boards are still treating ESG as a package of check-the-box initiatives, many, if not most, are getting serious about it by digging deeper into the specific risks and opportunities that apply to their companies and incorporating it into both short- and long-term strategy.

It's clear ESG is not going anywhere as far as investors are concerned, Pay Governance Partner Tara Tay told attendees at Corporate Board Member's ESG Board Forum. "It's definitely not a fad. It's an emerging trend that we'll continue to see in going forward."

The following is a roundup of key lessons shared throughout the day.

## Navigating Biden's Agenda

Hours after he was sworn in, President Joe Biden made his climate agenda clear by announcing that the country would rejoin the Paris Climate Accord and cancel the Keystone XL pipeline, dismantling two of the more than 100 environmental actions taken by the Trump administration, with the remainder destined to end up in the same dustbin. That's left many companies and boards unsure of how new disclosure requirements might impact them.

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SEC Commissioner Elad Roisman, who was appointed by President Trump, spoke about the various costs and difficulties that will result from new line item disclosure requirements in the areas of ESG, and recommended five ways the SEC might tailor rules to mitigate costs:

1. **Scale disclosure for public issuers.** The cost of obtaining and presenting new disclosures will be proportionately greatest for smaller companies that have scarce resources and are trying to grow. It will similarly be high for less mature companies that are trying to develop and refine their business models. Scaling the new disclosure requirements could lighten the burden on smaller companies. “We have taken that approach with many of our existing required disclosures,” said Roisman, adding that new disclosure requirements should be limited to public companies only.

2. **Allow for some flexibility in presenting information.** “We'll need to be reasonable in our expectations of what companies can disclose and how they can disclose it,” says Roisman. For example, a good amount of environmental information is difficult to calculate and sources for it are typically outside the company and not always reliable. “I worry that for most ‘E’ information, companies will have to go to outside vendors to evaluate and obtain it and that our regulations will inflate the demand and cost for such data.”.

3. **Consider a safe harbor.** Roisman would advocate something similar to what is available for companies’ forward-looking statements “We'd be asking companies to tell us what they know as best as they can discern it. I worry we will chill that effort if we do not provide them some space to provide that disclosure.

4. **Disclosures could be furnished rather than filed.** Filing with the SEC, rather than just disclosing, could put companies in legal and regulatory crosshairs. “To the extent that the argument for additional SEC required E and S disclosures is that investors want the information and that they benefit from the uniformity and comparability that SEC required disclosures would provide, those benefits can be realized without imposing the level of liability that filing with the SEC presents,” said Roisman.

5. **Disclosures should have an extended implementation time.** Companies will be looking both to the SEC and to peer companies for guidance about what level of detail and scope of information meets requirements—and that may take a while, he said. “I hope that we can be patient in how we choose to implement this new regime in order to allow this natural process to occur.”

## Getting to Convergence on ESG

Boards are faced with an alphabet soup of ESG metrics, complicating their ability to benchmark and report on decisions that are unique to their companies. But standards convergence will have to happen if companies are going to satisfy growing stakeholder demand. "Investors are asking for these metrics so they can compare companies and [see] how they're running the company on a balanced basis. Employees want to know about their company and what they're doing, and customers you sell products to, they want to know your ESG standards," said Bank of America CEO Brian Moynihan. "It's mature to the point where, frankly, it's not a discussion of 'should we do it?' but more 'how should we do it?' And then, 'how do we avoid doing it too many times or [focusing on] immaterial things?'"

In an effort to get the business community closer to convergence, the World Economic Forum's International Business Council released the Stakeholder Capitalism Metrics (SCM) with a core set of 21 universal, comparable disclosures focused on people, planet, prosperity and principles of governance. "If you just close your eyes, you say, 'Oh God, it's another set of metrics,'" said Moynihan, who chairs the WEF's International Business Council. "But if people look at them, they're going to see that they incorporate the best of the other ones out there."

The Stakeholder Capitalism Metrics also have the unique advantage of having automatic buy-in from the 90 companies that have already signed on. "It's not the law of the land—this is a volunteer army at this point—but it provides influence to the law of the land and influence to the issuer side being represented because every one of those other groups is not driven by the issuer," said Moynihan, adding that having input from companies makes a better case for materiality for each of the disclosures.

While many of the companies that have signed on thus far are large organizations, being able to demonstrate progress on ESG metrics is becoming critical for smaller companies that are being asked by customers to get to net zero, for example, in order to be part of the supply chain. "When I talk to midsize companies, I say, 'This is hard, and it will take some time and effort and money, but you're going to have the expertise of people like ourselves to give you the why-fors and why-nots to what an offset is and all this stuff," he said, adding, "you can do it because you're going to have to do it, frankly. Because if you're a cleaning company, a food service company, a call center, a supplier we can't buy from you unless you agree to do these things across these metrics, because we have an agreement among ourselves that we're going to deliver on these metrics and you're helping us do that."

## DIVIDE AND CONQUER: HOW TO ALLOCATE ESG OVERSIGHT IN THE BOARDROOM

Given how many oversight issues fall under the ESG umbrella, it's no easy task for boards to figure out which ones are material, how best to monitor them, and how to keep the board's ESG IQ high enough to ensure no risks fall through the cracks. Paul DeNicola, principal of PwC's Governance Insights Center, posed those questions to two veteran directors, Ana Dutra, who sits on the boards of CME Group, Eletrobras, Harvest, Health & Recreation, and First Internet Bank; and Alejandro Wolff, a director with Albemarle Corporation, JetSMART Holdings and Frontier Group Holdings. The following is an excerpt of the discussion.

### How do you allocate responsibility for ESG oversight? Is it at the committee level or board level?

**Ana Dutra:** There is no one size fits all, but if we look historically, the components of ESG—sustainability, environmental issues, D&I, CEO compensation—have all lived in different committees on the board. So what I'm seeing is, let those topics live where they live and then create an ESG report at the end of the day [for the full board]. Establishing a separate ESG committee would likely create more confusion than help, because you would have overlap of issues.

Also, I've always been a fan of separating risk and audit, and now it's even more important. Audit is the rear view mirror, but if you look at cybersecurity issues, geopolitical issues, social justice issues, you are making a plan to mitigate the risk [in the future].

**Alejandro Wolff:** We have a very similar approach. The board as a whole has oversight responsibility and principal responsibility for aligning sustainability and ESG issues to corporate strategy. So having these committees feed into that board structure and oversight is important, and it happens naturally through the reports that the committees present each meeting. We also have a formal session that the board will look at ESG and sustainability as a whole to ensure that it's tied to corporate strategy long term.

I would add that, if you haven't done much in the past [on ESG], there might be an argument to establish a sustainability committee or an ESG committee to get things started and highlight just how important this is and the attention that the board and management ought to be paying to this range of issues.

### What ESG expertise do you have or need to have on the board?

**Dutra:** ESG can really encompass everything. So [you need to] distill that and understand where you have expertise and where you don't, because on one hand, I agree that the entire board needs to understand ESG and where the company stands. On the other hand, you can only have so many experts on different issues. So for example, in the CME Group, which is the largest futures exchange in the world, we're highly dependent on making sure that we are top notch, world-class in cybersecurity. So that's an expertise we need on the board. And quite frankly, it's proxy season, so understand where the proxy advisory firms are narrowing down, and that you have the type of expertise to respond.

**Wolff:** I would highlight one point which is that you really do need this expertise within management. No matter how much expertise you bring onto the board, you don't want the board to have more of the expertise to management does.

**What is the context in which you are discussing ESG? Who is doing the presentations?**

**Wolff:** We have ESG issues built into our charter checklists so each committee is dealing with an aspect of it that is appropriate to its role on a quarterly basis and reporting to the full board each meeting. The full board gets a presentation from management once a year formally. And then issues that come up over the course of the year—for example, human capital and social issues during Covid—that are dealt with on an ad hoc basis.

**Dutra:** With regard to who's doing the presentations, I've seen more and more exposure for the chief compliance officer on the board and particularly the risk committee. And again, that's a strategic decision the board and the company have to make if they are going to be more on the side of checking the boxes on compliance or if they are going to be on the cutting edge of all ESG issues and be more proactive. Also, the chief information security officer—a role that we didn't even have 15 years ago—is getting higher exposure as well.

## Linking ESG Performance and Pay

Many boards find themselves debating how they can better bind their executive incentives to their strategy and mission, and more broadly, to their impacts on the environment and society. But even with clear objectives, it's difficult to measure ESG outcomes in a way that meaningfully aligns pay with performance. But increasingly, companies are finding ways to identify non-financial elements that are drivers of future success and establishing corresponding incentive plans that balance those goals with performance in a way that provides both rigor and clarity, said Kaley Childs Karaffa, Nasdaq's Director of Board Engagement.

She pointed to McDonald's decision to base 15% of top executives' annual bonuses to human capital measures; Nike's goal of 45% of global leadership positions to be held by women in the next four years; and American Express building in executive bonus programs that tie goals to D&I metrics. "There's no shortage of complexities in not only determining what metrics to use, but then what approach to take and developing the right incentive program for ESG measures," said Karaffa.

Essential Utilities' compensation committee recently did a deep dive into the possible metrics to tie to comp and found safety—particularly for natural gas delivery, vehicular safety and water quality—was paramount. They also added DE&I goals this year, including taking the company from a 15% diverse environment to a 17% diverse environment. "We are looking to mirror the communities we serve," said CEO Chris Franklin. "So we literally went county by county across our 10-state footprint, and we said in each county, what does the diversity look like here?"

Finally, after the recent purchase of a natural gas utility, the company announced they would shrink the carbon footprint by 60% over 15 years. "It's a little more difficult to say how you're going to mark progress, especially if you think about it in a short-term incentive plan versus a long-term incentive plan. Frankly, it could end up there, but we haven't made that determination."

<u>**Tara Tay, Partner with Pay Governance, listed the five questions boards are asking:**</u>

1. What are the company's relevant ESG topics or issues that we're trying to address?
2. Which ESG issues have the greatest impact on our enterprise value creation?
3. How can ESG performance be measured and is the internal information that we have reliable?
4. What is the appropriate time horizon for measuring ESG?
5. How much incentive should be tied to an ESG metric?

## INVESTORS WEIGH IN ON THE EXXON VOTE

When ExxonMobil lost three board seats to little-known activist hedge fund Engine No. 1 this past spring, it demonstrated what even a tiny investor could do to pressure boards and management to get climate religion. In a session moderated by Katie Martin, partner and board chair for Wilson Sonsini Goodrich & Rosati, institutional investors shared whether they supported Engine No. 1's director nominees and what the take-home lesson is for public company boards in general.

**Peter Reali, Management Director, Head of Engagement, Responsible Investing, Nuveen, a TIAA Company:** We have been engaging with Exxon for years and expressing concerns around not just climate risks, but overall company performance. In this case, we supported all four of Engine No. 1's nominees and that was done entirely for investment reasons, full stop. And what does this mean [in the big picture]? This means that for companies that aren't taking the ESG factors that are important to them into account, we are willing to use the power of the proxy, the accountability mechanism we have, to effect change at the company.

**John Hoeppner, Head of US Stewardship and Sustainable Investments, Legal & General Investment Management:** We supported the four nominees from Engine No. 1 and we were quite early in our public expression that this was the right decision for the company, again, for financial reasons, with a big climate tilt. This is a very big deal in terms of broader investment stewardship relations with companies. This is not just a director vote—this was an activist who took an aggressive position to change the structure of the board. So what does that really mean looking forward? That means if you're a sustained laggard by the investment community's consensus, things may change fast. You become a risk, a target. So that's brand new. We have never seen an ESG activist win majority slate in the U.S. that I'm aware of. That's a big sea change.

**Kristin Drake, Head of Investment Stewardship, Dimensional Fund Advisors:** We've always said, if you want to really push change, it needs to be votes on directors, or through a proxy contest. It was really interesting to see Exxon—it was very clear that shareholders wanted to see a change. Just generally, in terms of addressing E&S concerns, votes on directors are much more effective. And in terms of identifying companies that we want to target, we did a climate letter campaign towards the end of last year that was focused on companies in industries where climate change is likely to be material and where board oversight of climate risk is not disclosed. And we'll also look at what the company has said is material. If the company is in an industry where SASB says, 'Hey, this risk is likely material' and the company doesn't identify it as material, then we dive into why. Is there something different about this company, about their strategy, about their operations that makes it reasonable that this issue isn't considered material? So it's very case by case, and we do come at it from, um, a board perspective, um, both in our voting and in, in our engagement and in what we look for disclosure wise.

## Tackling the Social Dynamics of ESG

Coming out of 2020, there is heightened attention on how companies are responding to their employees, suppliers, customers and communities—and they are being asked to disclose proof of their progress. New York City Comptroller Scott Stringer called on companies to enhance D&I disclosures, and new SEC disclosure standards require companies to provide stakeholders insight into human capital. Consider discussion the following with legal, compliance and HR departments to make sure you're properly overseeing this issue.

1. **Get ready to disclose.** If you're not already doing so, prepare to share your EEO-1 report, as that is fast becoming the norm. "The EEO-1 is not the perfect solution, but we think it's a start," said Yumi Narita, Executive Director of Corporate Governance, NYC Comptroller's Office, who points out that 62 of the Fortune 100 have committed to or are already disclosing their EEO-1 data. Having those reports, rather than each company's individual corporate sustainability report, allows investors to compare and contrast company progress.

2. **No wishy-washy language.** When having conversations with investors, or any stakeholders, “it’s is very, very important that boards begin to have real concrete specificity and real clarity,” said Virginia Gambale, board member for JetBlue, FirstDerivatives, Virtu Financial, and Nutanix. Investors will no longer tolerate vague statements about culture. “Those who use the word ‘culture’ very loosely are now, from all constituents, being forced to really fine tune and define what is our culture? What defines us?”

3. **Don’t reinvent the wheel.** Given the new guidance regarding disclosure on human capital management and executive pay, “go look at competitors’ 10-Ks to see if they did a better job or a worse job than you,” said Donna Anderson, Head of Corporate Governance, T. Rowe Price. “Find the most robust disclosures and adopt those.” Also, go back through your own proxy and search for phrases like “diversity of thought,” which implies that diversity around gender, race and other minorities, is not really important, she said. “Those stand out to us.”

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