HLS Program on Corporate Governance & Program on Institutional Investors

Corporate Governance Virtual Roundtable Series

March 23, 2022 Session

ESG Issues

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Best Practices for Establishing ESG Disclosure Controls and Oversight

Posted by David A. Bell and Ron C. Llewellyn, Fenwick & West LLP, on Thursday, February 3, 2022

Editor's note: David A. Bell is partner and Ron C. Llewellyn is counsel at Fenwick & West LLP. This post is based on their Fenwick memorandum. Related research from the Program on Corporate Governance includes The Illusory Promise of Stakeholder Governance (discussed on the Forum here) and Will Corporations Deliver to All Stakeholders?, both by Lucian A. Bebchuk and Roberto Tallarita; For Whom Corporate Leaders Bargain by Lucian A. Bebchuk, Kobi Kastiel, and Roberto Tallarita (discussed on the Forum here); and Restoration: The Role Stakeholder Governance Must Play in Recreating a Fair and Sustainable American Economy—A Reply to Professor Rock by Leo E. Strine, Jr. (discussed on the Forum here).

In recent years the demand for information regarding companies' environmental, social and governance (ESG) activities, risks and opportunities has risen sharply. Shareholders and other stakeholders seek ESG information that is useful, comparable and accurate, which necessitates that companies establish appropriate controls to gather, verify and disseminate such information. The variety of potential sources for ESG data may pose a challenge to companies trying to put a disclosure controls and procedures framework in place. This guide includes some suggestions and considerations for public companies in developing disclosure controls and related policies and procedures for ESG information.

Increased SEC Scrutiny

In September 2021, the United States Securities and Exchange Commission sent comment letters to a number companies in different industries seeking more information about their climate-related disclosures (or lack of such disclosures in their SEC filings) referencing the SEC's 2010 Guidance Regarding Disclosure Related to Climate Change, Release No. 33-9106 (Feb. 2, 2010). The SEC posted a Sample Letter To Companies Regarding Climate Change Disclosures in which it asked, among other matters, for companies to explain why certain climate-related disclosures were included in corporate social responsibility reports (generally found on company websites) but not SEC filings. The SEC has also expressed an interest in ESG disclosure more broadly, and has indicated the potential for rulemaking in the near future. Whether because of SEC regulations or to meet the expectations of investors and other key stakeholders, the amount of ESG information that companies will disclose in their SEC filings will likely increase. With the potential for increased visibility of ESG disclosure and the associated liability for false or misleading statements or omissions under securities law, as well as the risk of investor-, employee- or public-relations harm even where inaccuracies may not be material, companies should pay special attention to the disclosure controls that they have in place. Doing so will also better position companies if more ESG disclosure is mandated.

Disclosure Controls and Procedures

Under Rules 13a-15(a), (b) and (e) of the Exchange Act of 1934, as amended, public companies must maintain and periodically evaluate the effectiveness of their disclosure controls and procedures. This requirement extends to any ESG information that a company would be required to disclose under SEC regulations. For prudential reasons (including limitation of potential liability), these controls and procedures should also extend to significant voluntary disclosures, including voluntarily disclosed ESG information. As disclosure controls should already be in place for periodic and special reporting, a company's disclosure committee, and legal and financial reporting teams, may be well-positioned to implement a control structure for the reporting of ESG data that is integrated with a company's regular public reporting, including data that is voluntarily disclosed.

Determine What ESG Data to Collect

Given the broad nature of ESG, companies should focus on those risks and opportunities that are most material to their business. In many cases, a company may have already identified its key ESG issues but may also want to consult an established framework or standard such as the Sustainability Accounting Standards Board (SASB) or the Global Reporting Initiative (GRI)—or the framework under development by the International Sustainability Standards Board (ISSB)—for guidance on ESG risks and opportunities that are typical for an industry. ESG frameworks and standards may indicate specific metrics on which a company should report and for which it will need to gather data.

Companies should also consider the preferences of their largest shareholders and other important stakeholders regarding the information they would like the company to disclose. For example, BlackRock, one of the largest investors in many companies, has requested that companies disclose ESG data that is aligned with the recommendations of SASB and the Taskforce for Climate-Related Financial Disclosure in its Engagement Priorities for 2021.

In addition to shareholders, companies should also consider the expectations of their other stakeholders in determining the information on which they will report. Even if certain ESG information is not viewed as material by a company or its investors, it may garner significant interest from employees, consumers or customers. For example, a company may suffer a commercial disadvantage if it fails to disclose an ESG metric that its competitors disclose, or which consumers expect it to provide. Employee recruiting and retention may be similarly impacted. Business customers may also seek reporting of ESG metrics from companies in connection with supply chain due diligence initiatives and may require certain ESG reporting obligations in contracts.

Finally, many ESG ratings firms, on which some investors and creditors rely, will base a company's rating on its public disclosure. Companies should understand the most important ESG metrics for their industry and benchmark their ratings with peers to determine areas for new or increased ESG disclosure.

Data Gathering

Developing and documenting rigorous reporting procedures may pose a challenge for many companies. For example, companies may gather ESG data outside of enterprise resource planning (ERP) and financial reporting systems. Such data collection is often manually collected on spreadsheets and the process for gathering the data may differ depending on business unit, department or region. Still, companies should ensure that the data collection process is of sufficient quality for review if the company decides to get third-party assurance (discussed below).

Companies should also look to standardize their processes and create central repositories or reference sets for ESG data. Data management systems for ESG-related data should be formalized and automated if possible. More robust systems may have automated checks, secure access and data analytics, which surpass more manual processes that may rely on basic control activities like authorizations and manual data entry and recordkeeping. Where possible, companies should try to integrate ESG data with ERM systems.

The appropriate personnel to gather the information may already be apparent, particularly if it involves data that a company is already tracking. However, in some instances, employees may need to be trained or hired if the requisite expertise for collecting and/or analyzing the data does not currently exist at the company. As a precursor, it may be important for the company to train employees on the importance of the data as there may be a perception that it is not as valuable as the financial information on which the company is likely to have reported for a longer period than ESG data.

Data Review and Verification

Companies should establish processes for ESG data to be reviewed and verified by appropriate functional areas, including the process by which the data is collected and analyzed. As many companies do with financial reporting, companies may look to put a certification and sub-certification process in place. Controls should also be put in place to detect and prevent fraud related to ESG data, including segregation of duties and ensuring that whistleblowers are protected. Finally, companies should make sure that their ESG disclosure is consistent across platforms.

To the extent the same metric is disclosed in multiple places (e.g., the proxy statement and the corporate website), the information should be identical. While companies are not required to provide the same level of information sought by a voluntary ESG disclosure framework or standard in their SEC filings, as noted above, failure to do so might invite questions from the SEC, investors and other stakeholders regarding the sufficiency or materiality of the information being disclosed.

Developing Policies

Disclosure controls and procedures should be documented in policies once they are established. Such policies should specify what ESG data should be gathered, how it should be gathered, analyzed and reviewed, and the responsible parties. These policies should be monitored and reviewed periodically for effectiveness. Senior management and the relevant committee of the

board providing oversight of ESG matters should also have an opportunity to review and approve such policies. Once these policies are adopted, or if they are revised, they should be communicated to the relevant employees who will need to follow or implement them.

Third-Party Assurance

While not required for U.S. public companies, some institutional investors have begun discussing the potential desirability of third-party assurance of some ESG data. As a result—and to increase confidence in the data that they are reporting—some companies may seek assurance for their ESG data, particularly if it is included in a securities filing. Though this practice is still in its early days, some accounting firms and other third-parties are preparing themselves to offer attestation procedures for ESG-related reporting.

However, according to a recent survey by the Center for Audit Quality, only 6% of S&P 500 companies received assurance from a public company auditing firm, while 47% had assurance from a non-CPA firm. Companies looking to engage a firm for assurance services should ascertain whether the firm has appropriate expertise. In many cases, when it comes to ESG metrics, operational or industry experience may be more valuable than traditional financial auditing experience.

Accounting firms can offer review or examination services based on the criteria that a company uses for ESG-reporting (i.e., whether the information provided is in accordance with a third-party framework or standard such as SASB or company-developed metrics). As discussed in the Association of international Certified Professional Accountants and Center for Audit Quality's ESG reporting and attestation: A roadmap for audit practitioners, an examination engagement will provide reasonable assurance and will provide an opinion on "whether the ESG information is in accordance with the criteria, in all material respects." A review engagement will provide limited assurance and "express a conclusion about whether the [accounting firm] is aware of any material modifications that should be made to the ESG information in order for it to be in accordance with the criteria." A company should decide the appropriate level of assurance that it will seek, which may be influenced by the cost and the expectations of its shareholders and other stakeholders and potential for liability.

Management Oversight

A company's management should appoint a team tasked with monitoring its ESG disclosures and commitments, recognizing that these disclosures can appear in a variety of official, formal and even informal communications, such as SEC filings, website materials or sustainability or corporate social responsibility reports. This may consist of a formal management steering committee or a simpler structure. The broad scope of ESG will necessitate the involvement of various departments and functions within the company, including sustainability/corporate social responsibility, legal, human resources, investor relations, corporate secretary, communications, compliance, finance, risk management and relevant business units.

Many companies have formal charters for their management ESG committees, and such charters may include requirements regarding committee membership, frequency of meetings and reporting, committee leadership and duties and responsibilities. The duties specified in the charter could include:

- Determining the company's ESG priorities and strategy;
- Periodically reporting on progress of ESG objectives to the board and/or relevant board committee;
- Reviewing the company's ESG disclosures, procedures and policies for consistency;
- Identifying and assessing new ESG risks and opportunities and presenting the committee's findings to senior management and the board; and
- Managing internal and external communications of ESG matters.

Regardless of the level of formality, the management committee should ensure that ESG information is disclosed in a consistent fashion across the variety of platforms in which it may be disclosed. In addition, it should develop the policies and procedures discussed above and ensure that appropriate controls are in place for gathering the data. Finally, the management committee should create a process for regular reports to the company's board or the relevant committee overseeing ESG.

Coordination with Disclosure Committees

Following the enactment of the Sarbanes-Oxley Act in 2002, many companies adopted management disclosure committees to oversee their disclosure obligations under SEC rules and to evaluate their disclosure controls and procedures in support of the CEO and CFO certifications required by the act. In addition to the principal accounting officer and general counsel, these committees typically include senior officers in investor relations, tax, internal audit and relevant business units. Accordingly, for many companies, there will be significant overlap between members of their disclosure committees and their management ESG committee, which should facilitate the sharing of information.

Regardless of the respective composition of each committee within a company, there should be mechanisms in place to ensure the frequent and timely communication between the ESG committee and the disclosure committee. Drafts of ESG disclosure, whether for standalone reports or to be included on webpages, should be provided to the disclosure committee for its review. Similarly, the disclosure committee should share relevant SEC reporting disclosure that may impact the company's ESG disclosure with the company's ESG management committee.

For efficiency, companies should consider whether it would be appropriate to have an existing disclosure committee or sub-committee of the disclosure committee oversee ESG instead of having a separate management ESG committee. In that case, the disclosure committee's charter could be expanded to incorporate responsibility for ESG disclosure matters, including the addition of new members and responsibilities, and processes should be established for their involvement in and oversight of collection and dissemination of ESG data.

Leveraging Existing Processes and Procedures

It may be possible for a company to utilize existing disclosure controls and procedures for gathering, verifying and reporting its ESG data. Companies may leverage existing activities, controls and established internal expertise as well as existing and proven methodologies, approaches and concepts from internal control over financial reporting, such as IT controls or

monitoring techniques.[1] Companies can also use the disclosure controls and procedures for SEC reporting for ESG reporting, particularly if it involves the same or similar data.

For example, timelines and task lists developed for the SEC reporting calendar may also be utilized for ESG reporting, even though companies typically have flexibility in determining when they release their voluntary ESG disclosure. Thus, human capital management data that may be included in both a company's Form 10-K and its sustainability report would be subject to the same disclosure controls and procedures.

Board Oversight

A company's board of directors should play a key role in oversight of the company's ESG efforts, including ensuring that the company has appropriate ESG disclosure controls and procedures in place, and that ESG is integrated with the company's strategy. First, the board should understand and agree with management on the most important ESG risks and opportunities. Second, the board should consider assigning responsibility for some or all of its ESG matters to a board committee. It may choose to form a standalone committee for this purpose, or it may use one or more of the pre-existing committees. The importance of the board's oversight of ESG controls and procedures may favor assigning responsibility for oversight of them, and perhaps all ESG matters, to the audit committee which already provides oversight for financial reporting and related controls.

However, the audit committee already carries a heavy workload (often including cybersecurity) and ESG may get insufficient attention there. The nomination and corporate governance committee may also be a potential candidate for this task given its responsibility for overseeing corporate governance issues such as board diversity and political lobbying, which are important ESG focus areas. For some companies, it may be appropriate to divide oversight among multiple board committees depending on the topic (e.g., the nomination and governance committee would oversee governance-related issues; the compensation committee would oversee the use of ESG metrics in setting executive compensation, human capital management, and diversity, equity and inclusion; and the audit committee would review the effectiveness of ESG-related disclosure controls and procedures and oversee the attestation process if an auditor or other service provider is engaged for such services).

Regardless of the oversight structure, the board should seek regular reporting of ESG information from management, including progress against stated goals, as well as understanding the company's public disclosure posture. Board committees that are tasked with ESG oversight should include such responsibilities in their committee charters as many shareholders and other stakeholders want to understand the board's involvement in managing ESG. Discussion of these topics should also be considered (e.g., in the section discussing board oversight of risk and/or in the descriptions of the committees).

Finally, as part of its ongoing evaluation and refreshment activities, the board should consider whether it has the requisite expertise to understand and advise the company on its most pressing ESG issues. This includes understanding disclosure trends, peer company practices and

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[1] Leveraging the COSO Internal Control – Integrated Framework to Improve Confidence in Sustainability Performance Data, by Robert H. Herz, Brad J. Monterio and Jeffrey C. Thomson (September 2017).

challenges that may be particular to the company's industry. Accordingly, the nomination committee should identify and nominate, and the board should elect, individuals with backgrounds in relevant ESG issues of importance to the company to ensure that the board is able to provide appropriate oversight of ESG.

Conclusion

The intense interest in ESG underscores the importance of having a robust system of disclosure controls and procedures, as well as an appropriate oversight regime in place to ensure focus on important ESG priorities and the accuracy of ESG information. Once a company determines the ESG information that is most relevant to its business and stakeholders, it must face the challenge of establishing appropriate controls.

Enlisting the support of key functions within its organization and having the support of the board will be critical. Given the complexity and the importance of this undertaking, companies should begin the process of marshalling the necessary resources to meet the demands for ESG disclosure as soon as possible.

Workforce Diversity Data Disclosure

Posted by Kavya Vaghul, Aleksandra Radeva, and Kim Ira, JUST Capital, on Wednesday, March 9, 2022

Editor's note: Kavya Vaghul is Senior Director of Research and Aleksandra Radeva and Kim Ira are Research Analysts at JUST Capital. This post is based on their JUST Capital memorandum. Related research from the Program on Corporate Governance includes Politics and Gender in the Executive Suite by Alma Cohen, Moshe Hazan, and David Weiss (discussed on the Forum here), and Duty and Diversity by Chris Brummer and Leo E. Strine, Jr. (discussed on the Forum here).

Key Findings

- As of September 2021, the majority of companies in the Russell 1000 (55%) disclose some type of racial and ethnic workforce data, a notable increase since January 2021, when only 32% of companies disclosed racial and ethnic data.
- Between September 2020 and September 2021, the share of companies disclosing an EEO-1 Report or Intersectional Data, the gold standard for demographic data reporting, has more than doubled, from 4% to 11%.
- While EEO-1 Report or Intersectional Data disclosure has historically been concentrated in the Technology industry (24 companies at the time of this analysis), the number of companies disclosing this data in the Financials industry has nearly caught up, more than doubling between January 2021 and September 2021, from nine companies to 22 companies.

After a year and half of pledges and promises to help advance racial equity, totaling at least $50 billion in both internal and external initiatives, investors, regulators, employees, and other key stakeholders are still looking for signals of action from corporate America. For many, a first step is transparency around corporate diversity, equity, and inclusion (DEI) efforts and, in particular, around racial and ethnic workforce and board demographics as an indicator of the state of representation.

While stakeholders recognize that this is a work in progress for companies, and that they can't expect perfection, they're making it clear that they're no longer willing to accept inaction or silence on what steps companies have taken. Of Americans JUST Capital and The Harris Poll surveyed, 84% agreed that companies "often hide behind public declarations of support for stakeholders but don't walk the walk." Shareholder proposals on DEI soared last proxy season. Following New York City Comptroller Scott Stringer's call to 67 S&P 100 companies to share the racial, ethnic, and gender breakdown of their workforces, half of this group has either disclosed or committed to disclose this data. The SEC has noted that disclosure of human capital metrics—workforce-related data, policies, and practices—is a key area of focus and that it could be issuing standards for disclosure on these measures this year.

JUST 100 leaders have reiterated the importance of this transparency, especially when achieving diversity targets or full representation is still out of reach. Accenture CEO Julie Sweet said in an interview with CNBC that when Accenture first disclosed the demographic breakdown of its U.S. workforce in 2015 its "numbers weren't great," but that recruitment "improved in all of our diverse categories because transparency builds trust." Her sentiment was echoed by Nasdaq CEO Adena Friedman who said in a CNBC interview that Nasdaq's decision to disclose the racial and ethnic demographics of its workforce has bolstered shareholder relations.

"In some respects, you sit there and say, 'Well gosh I wish it was better, maybe I want to try and make it a better picture before I disclose it,'" she said. "But we made the decision, even though we know that we have work to do, to disclose that to investors and allow them to track our progress. Investors really appreciate the ability to track progress."

Friedman's point is one that many companies could soon no longer afford to ignore. At JUST Capital, we've been tracking if, and how, Russell 1000 companies have been sharing data around the demographics of their workforce and board. As investors, workers, the SEC, and others intensify their focus on these disclosures, we took a look at where companies currently stand and what's changed in how they're sharing this demographic information.

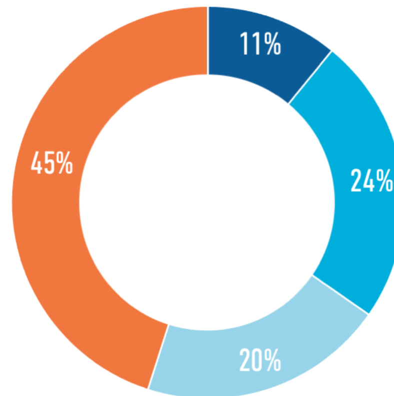
The Current State of Racial and Ethnic Workforce Data Disclosure

Despite how critical it is in assessing representation, the disclosure of racial and ethnic workforce data is highly unstandardized among companies in the Russell 1000. For instance, some companies follow the U.S. Census Bureau's groupings, which include five baseline racial identities set out in government reporting standards (White; Black or African American; American Indian or Alaska Native; Asian; or Native Hawaiian or Other Pacific Islander) and two ethnic identities (Hispanic or Latino; or Not Hispanic or Latino), while others either further disaggregate or aggregate these groupings. What's more, companies use different units of measurement: Some companies prefer to report the number (or count) of workers in each group while others display the data as percentages or shares of their U.S. workforce.

To best accommodate the wide variety of demographic data disclosed by companies, JUST Capital has been collecting 23 raw data points, comprising a range of highly generalized to highly granular racial or ethnic identities, since 2019. As of September 2021, when we last updated this data, **a slim majority of companies in our currently ranked Russell 1000 universe (55%) disclose some type of racial and ethnic data about their U.S. workforce**.

WORKFORCE RACE AND ETHNICITY DATA DISCLOSURE AMONG RUSSELL 1000 COMPANIES

■ EEO-1 Report or Intersectional Data ■ Detailed Race/Ethnicity Data ■ Overall People of Color Data ■ No Disclosure



Note: This chart is based on JUST Capital's evaluation of 954 companies from the Russell 1000 Index featured in our 2022 Ranking of America's Most JUST Companies. "EEO-1 Report or Intersectional Data" denotes that a company has disclosed highly detailed race/ethnicity data disaggregated by gender. "Detailed Data" denotes that a company has disclosed race/ethnicity data for at least three standard groups: Asian, Black or African American, and Hispanic or Latino.

Source: JUST Capital's corporate demographic datasets, with data as of September 2021.

The 23 raw data points also help us parse companies into three key disclosure types, from least to most granular: **(1)** Overall People of Color Data, **(2)** Detailed Race/Ethnicity Data, and **(3)** EEO-1 Report or Intersectional Data.

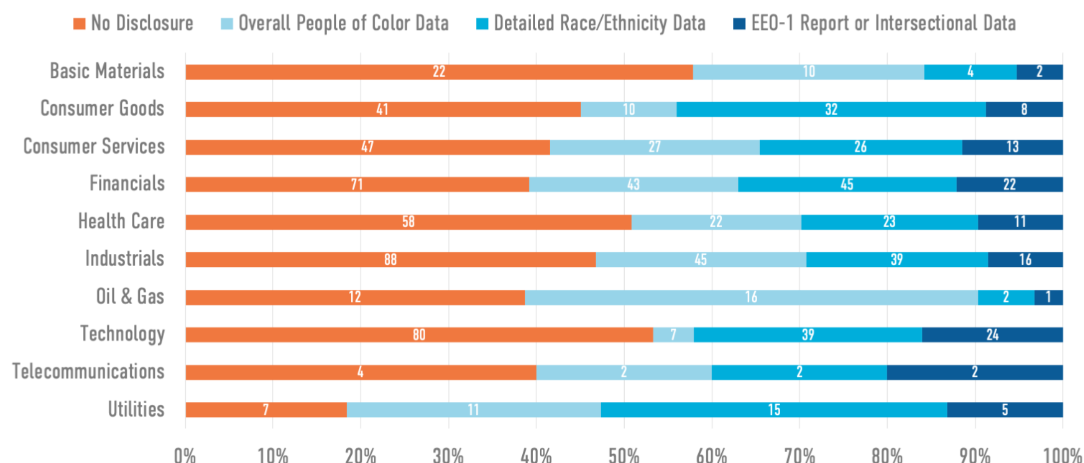
Currently, 20% of our ranked universe (193 companies) publicly report Overall People of Color Data. This highly generalized data is characterized by the disclosure of the number or share of workers identifying as People of Color (which companies more commonly refer to as "non-white" or "minority"), lumping together racial and ethnic groups that have different economic, social, and cultural experiences in the U.S.

Nearly 24% of our ranked universe (227 companies) share Detailed Racial/Ethnic Data. This disclosure type includes, at the bare minimum, a breakdown of the number or share of workers identifying as Asian, Black or African American, and Hispanic or Latino. Some companies categorized within this disclosure type also provide highly disaggregated data for different racial and ethnic groups—like American Indian or Alaska Native, Native Hawaiian or Pacific Islander, or Two or More Races—to more accurately capture representation.

Finally, **almost 11% of our ranked universe (104 companies) disclose an EEO-1 Report or Intersectional Data,** the most granular workforce demographic disclosure we track. Employers that have at least 100 employees are required to file, though not publicly release, an EEO-1 Report with the Equal Employment Opportunity Commission (EEOC) annually. Component 1 of this report asks companies to provide the number of employees by gender, racial, and ethnicity identity (a total of 14 intersectional groups) by 10 standardized job categories for a common payroll period. While these reports have their limitations, they also offer a highly standardized and comparable framework for racial and ethnic workforce data disclosure. Not every company, however, releases a full EEO-1 Report: **22 of the 104 companies released a modified or condensed version of an EEO-1 Report that either uses different units or omits select job categories**.

When further examining the workforce race and ethnicity data disclosure type distribution by industry*, we find that **a majority of companies in all but two broad industries—Basic Materials and Technology—report some type of workforce race and ethnicity data**.

RACE AND ETHNICITY DATA DISCLOSURE AMONG RUSSELL 1000 COMPANIES BY INDUSTRY



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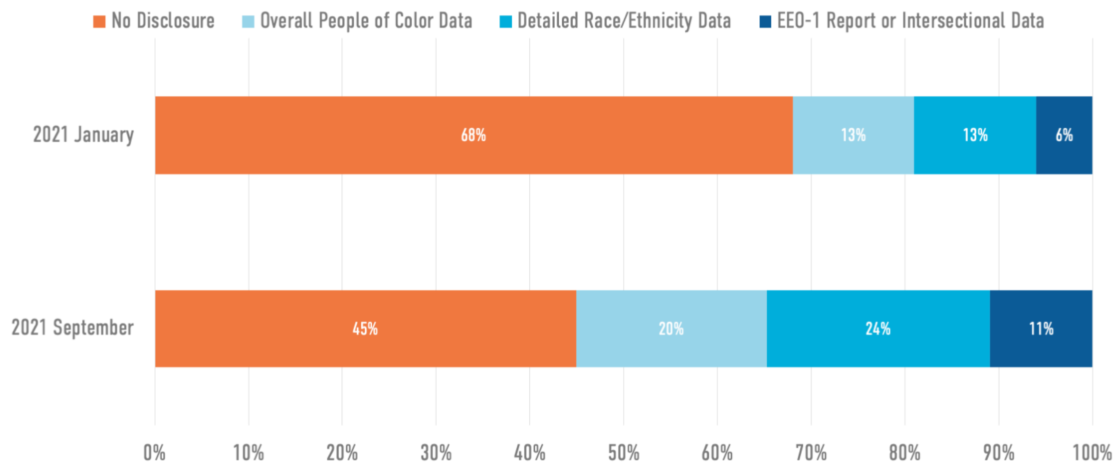
Source: JUST Capital's corporate demographic datasets, with data as of September 2021.

Companies in the **Utilities industry are the most likely to disclose some racial and ethnic workforce data**, with 82% (31 companies) in that industry sharing one of the three disclosure types. While there is no clear trend across industries for how each of the three disclosure types break down, it is interesting to note that companies in the Oil & Gas and Basic Materials industries appear to heavily favor disclosing Overall People of Color Data above more granular workforce race and ethnic data.

Changes in Racial and Ethnic Workforce Data Disclosure over Time

At face value, the current state of racial and ethnic workforce data indicates there is much room for improvement in both standardization and disclosure. But looking at this data over time tells an encouraging story.



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Source: JUST Capital's corporate demographic datasets, with data as of September 2021.

Since JUST Capital last ran this analysis, we have seen a flip in the data: In January 2021, only 32% of our ranked companies disclosed some type of racial and ethnic data and the majority of companies had *no* disclosure. Just nine months later, as of September 2021, 55% of companies (and therefore a majority) have some type of disclosure, amounting to a **23 percentage point increase in racial and ethnic workforce data disclosure rate**.

Changes in EEO-1 Report or Intersectional Data Disclosure over Time

While corporate racial and ethnic data disclosure across all three disclosure categories has grown substantially, the increase in EEO-1 Report or Intersectional Data disclosure is of greatest interest. In two years, it went from an obscure term on the fringes of the Environment, Social, and Governance (ESG) space to the focus of racial equity advocacy efforts among the institutional investor community.

When we first began tracking EEO-1 Reports (or other intersectional data) in November 2019, just 32 companies in our ranked universe at the time disclosed this rich demographic data. Since then, we have seen a rapid rise in disclosure: In September 2021, 104 companies disclosed an EEO-1 Report or Intersectional Data, a 225% growth from our 2019 numbers.

ESG Leader or Laggard?

Posted by Hannah Orowitz, Georgeson LLC, on Wednesday, March 16, 2022

Editor's note: Hannah Orowitz is Senior Managing Director of ESG at Georgeson LLC. This post is based on her Georgeson memorandum.

Companies are opening their eyes to their obligations for action and disclosure on environmental, social and governance (ESG) issues, either as a response to investor demand, recognition of the risk mitigation benefits and opportunities, or because of financial impact. Understanding your ESG rating is key to staying one step ahead of your competitors. It shows how you compare in your industry and helps identify where you need to improve on ESG.

How does a strong ESG position create value?

Regardless of how ESG considerations currently factor into your strategy and operations, it doesn't have to be difficult to make progress. It's no secret that companies with strong ESG practices reap the rewards. **It is becoming increasingly clear that strong company performance on ESG matters is closely aligned with increased investor interest and reduced risk.** It can also help reduce costs, improve top-line growth, increase productivity and minimize legal intervention. Developing a strong ESG position is vital to the long-term success of your business.

Compare and keep pace

With ESG issues top of mind for investors, it's important to know how your company's position is perceived in comparison to investor favored standards and frameworks, as well as your sector peers. Many investors often make their investment decisions based on peer group comparison, so it's important to ensure that your disclosures are up to standard. **Benchmarking is not only useful in helping you keep pace, but it's integral in helping you identify key areas for improvement.** Studying industry leader best practices can assist you in managing and reducing ESG risks, while also highlighting new opportunities for success.

Awareness and expectations concerning ESG reporting, while not new, have been amplified over the last 12 months, with a particular focus on increased disclosure of data and metrics. Over 90% of S&P 500 companies published sustainability reports in 2019 and on the heels of those disclosures, **many institutional investors reported increasing dissatisfaction with companies' disclosure of ESG risks**, as well as a lack of consistent and comparable disclosure of key ESG metrics and data.

Top five reporting frameworks and standards

CDP — formerly the Carbon Disclosure Project

CDP runs a global disclosure system that enables companies, cities, states and regions to measure and manage their environmental impacts, specifically climate change, deforestation and water security. CDP aims to motivate investors, companies and cities to work towards a sustainable economy using its database of self-reported environmental data.

GRI — Global Reporting Initiative

GRI provides disclosure standards for companies to communicate their impact on key sustainability issues such as climate change, human rights, governance and social well-being. GRI uses a modular approach of three universal standards applicable to all companies and three topic-specific standards — economic, environmental and social — that companies can choose from to report on.

IIRC — International Integrated Reporting Council

IIRC is a global coalition of regulators, investors, companies, standard setters, the accounting profession and non-governmental organizations. It's Integrated Reporting Framework is structured around six capitals (financial, manufactured, intellectual, human, social and relationship, and natural) intended to capture a full range of factors that can materially affect a company's ability to create value.

SASB — Sustainability Accounting Standards Board

SASB has developed a set of 77 industryspecific standards, which are captured graphically through its Materiality Map. They are available for individual sector download through SASB's website. The SASB standards were developed specifically for use by the financial markets to elicit decision-useful financially material information. Accordingly, its standards focus on sustainability risks and opportunities viewed as reasonably likely to impact financial performance and enterprise value.

TCFD — Task Force on Climate-related Financial Disclosures

The FSB (Financial Stability Board) Task Force on Climate-related Financial Disclosures Framework was developed to facilitate consistent climate-related financial risk disclosures to provide information to investors, lenders, insurers and other financial market participants. TCFD's recommendations are structured to elicit information regarding a company's approach to climate-related risks and opportunities across four core pillars: governance, strategy, risk management and metrics and targets.

Accordingly, there is mounting pressure for companies to produce integrated ESG reports that align with the industry-specific standards set by the SASB and the recommendations of the TCFD. In fact, the 'big three' asset managers — BlackRock, State Street and Vanguard — have expressed specific expectations that companies produce TCFD-aligned reporting. **These metrics facilitate public accountability and enable transparent evaluation of a company's success in achieving its purpose.**

Guidance on Climate-Related Disclosure

Posted by Benjamin Colton, Devika Kaul, and Michael Younis, State Street Global Advisors, on Friday, January 28, 2022

Editor's note: Benjamin Colton is Global Head of Asset Stewardship, and Devika Kaul and Michael Younis are Vice Presidents in Asset Stewardship at State Street Global Advisors. This post is based on their SSgA memorandum.

At State Street Global Advisors, we believe climate change poses a systemic risk to all companies in our portfolios. Managing climate-related risks and opportunities is a key element in maximizing long-term risk-adjusted returns for our clients. As a result, we have a longstanding commitment to enhance investor-useful disclosure around this topic. We have encouraged our portfolio companies to report in accordance with recommendations of the Task Force for Climate-related Financial Disclosures (TCFD)[1] since we first endorsed the framework in 2017. Since then, companies have improved the quality and quantity of climate-related disclosure and investors have matured their expectations. Yet, there is more progress to be made.

This post outlines our expectations with respect to climate-related disclosure and our approach to voting and engagement on this important topic. It draws upon insights from our engagement with portfolio companies, including over 250 climate-focused engagements conducted in 2021. We will continue to use our voice and our vote to ensure investors receive the information we need to assess how companies are approaching climate-related risks and opportunities and hold them accountable on their progress.

Our Expectations for Climate-related Disclosures

With disclosure aligned with relevant Sustainability Accounting Standards Board (SASB) standards as a floor, State Street Global Advisors aims to enhance TCFD adoption across the market. Momentum around TCFD-aligned reporting is growing, evident in the increase of regulatory mandates for TCFD disclosure and the use of this framework as the basis for efforts of international standard-setting bodies.[2]

We expect all companies in our portfolios to offer public disclosures in accordance with the four pillars of the TCFD framework: Governance, Strategy, Risk Management, and Metrics and Targets.

1. **Governance** The TCFD recommends companies describe the board's oversight of, and management's role in, assessing and managing climate-related risks and opportunities.

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[1] https://www.fsb-tcfd.org/publications/
[2] https://www.ifrs.org/news-and-events/news/2021/11/ifrsfoundation-announces-issb-consolidation-with-cdsbvrf-publication-of-prototypes/

2. **Strategy** The TCFD recommends companies describe identified climate-related risks and opportunities and the impact of these risks and opportunities on their businesses, strategy, and financial planning.
3. **Risk Management** The TCFD recommends companies describe processes for identifying, assessing, and managing climate-related risks and describe how these processes are integrated into overall risk management.
4. **Metrics and Targets** The TCFD recommends companies disclose metrics and targets used to assess and manage climate-related risks and opportunities.

Disclosure Expectations for Carbon-Intensive Sectors

State Street Global Advisors first articulated climate-related disclosure expectations for carbon-intensive sectors[3] in 2017. Building upon our earlier guidance, as of 2022, we expect companies in these sectors to disclose:

1. **Interim GHG emissions reduction targets to accompany long-term climate ambitions** We expect companies in carbon-intensive sectors to adopt short- and/or medium-term green house gas (GHG) emissions reductions targets. Companies that commit to long-term ambitions, such as net-zero by 2050, are expected to accompany these commitments with interim GHG targets to provide accountability.
2. **Discussion of impacts of scenario-planning on strategy and financial planning** We expect companies, especially in carbon-intensive sectors, to conduct climate scenario-planning exercises to better understand and position themselves to respond to climate-related risks and capitalize on opportunities. We encourage companies to demonstrate the link between scenario-planning and strategic outcomes as opposed to an isolated exercise. As recommended by the TCFD, we encourage companies to take multiple scenarios into account. While State Street Global Advisors is not prescriptive on scenario selection, we believe it is best practice to consider a scenario that limits global temperature increase to well-below 2°C consistent with the Paris Agreement[4] or a scenario aligned with a net-zero by 2050 pathway.
3. **Use of carbon pricing in capital allocation decisions** We expect companies in carbon-intensive sectors to incorporate climate considerations into capital allocation decisions, such as for existing or planned projects, portfolio decisions, and financial planning. Companies are establishing a price for carbon (also known as a "carbon price") to capture and monetize the costs/impacts of their activities as they relate to climate change. It allows for companies to express and incorporate the cost of operations, compliance, and future regulations into strategic decision-making. We evaluate if companies take forecasted carbon pricing into account for project assessment and encourage disclosure of the average and/or range of carbon price assumptions used.
4. **Scope 1, 2, and material categories of Scope 3 GHG emissions** We expect companies in carbon-intensive sectors to disclose Scope 1, Scope 2, and material categories of Scope 3 emissions. We consider it best practice for companies to obtain independent assurance of GHG emissions reporting. We recognize the inherent challenges associated with Scope 3 GHG emissions reporting, including data availability

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[3] Oil and gas, utilities and mining sectors

[4] Article Two of the 2015 Paris Agreement commits parties to "holding the increasing in the global average temperature to well below 2°C above pre-industrial levels and pursuing efforts to limit the temperature increase to 1.5°C above pre-industrial levels."

and uncertainty, double counting, and methodological challenges. However, Scope 3 emissions can account for the largest portion of a company's footprint—especially in certain carbon-intensive sectors—and is an area of increased focus for investors. Therefore, we expect companies to report Scope 3 emissions estimates, focusing on material categories[5] of Scope 3 emissions that contribute most significantly to the overall footprint. We also encourage companies to assess and begin implementing actions to achieve incremental Scope 3 emissions reductions where feasible.

Disclosure Expectations for Effective Climate Transition Plans

State Street Global Advisors is a signatory to the Net Zero Asset Managers initiative, reflecting our commitment as long-term stewards of capital to help companies effectively plan for the low-carbon transition and to hold companies accountable on progress. To that end, we believe it is our responsibility to provide portfolio companies with clarity on our expectations for effective climate transition plan disclosure.

We recognize that there is no one-size-fits-all approach to reaching net-zero and that climate-related risks and opportunities can be highly nuanced across and within industries. As a first step, our expectations serve to provide transparency on the core criteria we expect companies to address when developing climate transition plans. Further information on our approach to developing these expectations can be found here.

[5] As defined by the GHG Protocol's Corporate Value Chain (Scope 3) Accounting and Reporting Standard

The Corporate Director's Guide to ESG

Posted by Maria Castañón Moats and Paul DeNicola, PricewaterhouseCoopers LLP, on Wednesday, December 15, 2021

Editor's note: Maria Castañón Moats is Leader and Paul DeNicola is Principal at the Governance Insights Center, PricewaterhouseCoopers LLP. This post is based on their PwC memorandum. Related research from the Program on Corporate Governance includes The Illusory Promise of Stakeholder Governance (discussed on the Forum here) and Will Corporations Deliver to All Stakeholders?, both by Lucian A. Bebchuk and Roberto Tallarita; For Whom Corporate Leaders Bargain by Lucian A. Bebchuk, Kobi Kastiel, and Roberto Tallarita (discussed on the Forum here); and Restoration: The Role Stakeholder Governance Must Play in Recreating a Fair and Sustainable American Economy—A Reply to Professor Rock by Leo E. Strine, Jr. (discussed on the Forum here).

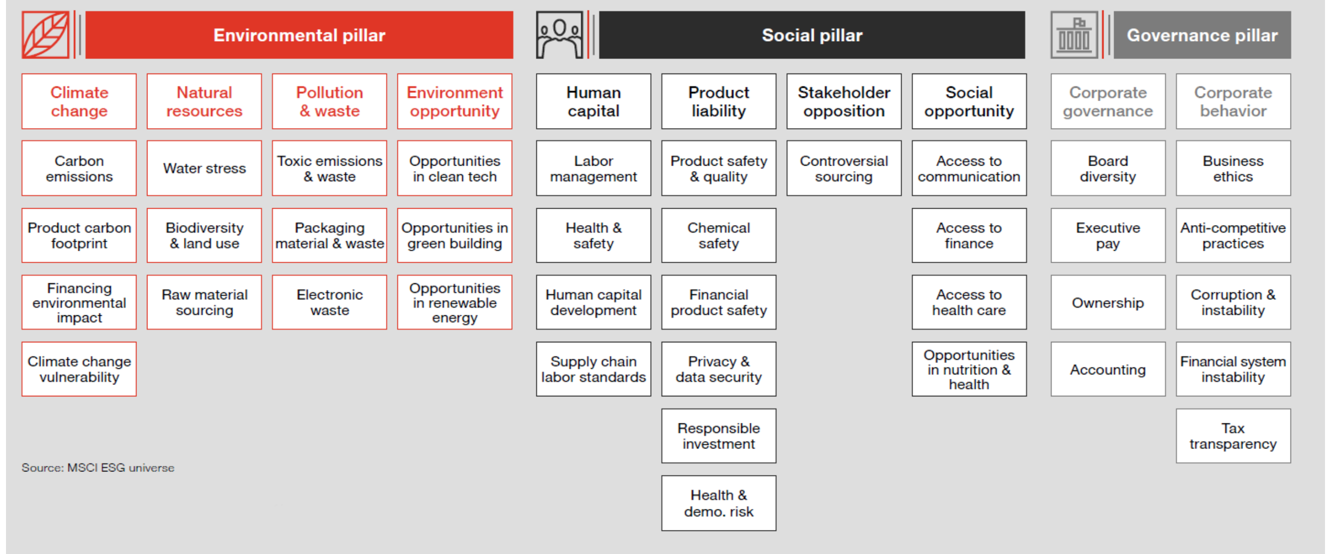
For many, the term ESG (environmental, social, governance), conjures notions of investors chasing feel-good stories of sustainability, diversity, and ethics. But given the heightened interests from various stakeholders, corporate directors know ESG is much more.

Far from being just window dressing, making organizations appear socially responsible to the outside world, there are real risks at play when it comes to ESG issues. And there are even more opportunities to be seized.

What is ESG?

ESG is on the minds of many investors today. It can represent risks and opportunities that will impact a company's ability to create long-term value. This includes environmental issues like climate change and natural resource scarcity. It covers social issues like labor practices, product safety, and data security. And it involves governance matters that include board diversity, executive pay, and tax transparency.

Figure 1 paints a picture of the breadth of topics that can fall under the ESG umbrella. Not all of them will be relevant or material for every company. For example, a financial services firm might focus more on human capital and data security, while a food and beverage manufacturer may be more interested in how they source raw materials.



What is ESG reporting?

ESG reporting is known by many names, including purpose-led reporting, sustainability reporting, corporate social responsibility reporting, and ESG risks and opportunities reporting. The market wants to know how companies are weighing risks and shaping business strategy in the context of ESG issues. Providing this information can help burnish a company's reputation, while withholding ESG information could potentially harm a company's valuation, access to capital, or its brand reputation in the market. In short, ESG reporting is disclosure of material ESG risks and opportunities, from both a qualitative and quantitative perspective. It also includes explaining how and where those ESG risks and opportunities inform the company's business strategy.

Why does the board oversee ESG?

As management teams look to improve the long-term value of the company, they need a strategic plan that takes advantage of market opportunities and addresses material risks. In its oversight role, the board is responsible for ensuring that the company's strategy is appropriate and will deliver results, and for overseeing associated material risks.

Some directors may not make the immediate connection to ESG issues when considering strategy and think of the ESG component as a "nice-to-have," rather than a necessity. But this ignores the point of ESG. It's about the ways in which value could be created or destroyed. For example, a consumer company might look to sustainable packaging as an opportunity to be responsive to consumer concerns. Or a manufacturing company might emphasize product safety or quality as part of their social obligations, even if it sacrifices short-term profits. Companies that don't think this way are risking their long-term value.

Investors want to know about the company's ESG efforts

Institutional investors tend to view ESG through the lens of long-term value creation. In addition, a growing population of ESG investors (also called socially responsible investors or impact

investors) focus specifically on sustainable companies. Combined, the investor voice in this area is getting louder.

Long-term shareholders: Institutional investors are urging companies to build ESG considerations into their long-term strategy, bringing it up during engagements and sometimes using shareholder proposals to force companies to take action. Some of the world's largest asset managers have voted against directors at companies that, in their view, lag on ESG. They say that identification and management of the ESG issues material to a company are essential to resiliency and risk mitigation, as well as strategy execution. They also say it leads to long-term increases in shareholder value. These investors are looking for more disclosures from companies, both qualitative and quantitative, so that they can better assess how the company is addressing ESG risks and opportunities. They want transparent reporting that demonstrates where companies are today and the goals they are striving to achieve in the future.

ESG investors: These investors focus on non-financial factors related to environmental, social, and governance topics as part of their analyses to identify risks and growth opportunities. They might focus on ESG risks along with financial performance, or specifically eliminate or select investments based on ethical guidelines. They may also track for positive impact that will benefit society or the environment. They rely on ESG disclosures to inform these investment decisions.

In general, companies with articulated ESG strategies are well positioned to access capital, as more and more investors look to invest in these types of companies.

Companies must also consider how investors obtain ESG information. Some investors obtain the information directly from the company, while others use ESG data compiled or determined by rating agencies (such as proxy advisory firms, ESG raters, and credit rating agencies). Other investors may use the data from rating agencies as a base to support their own independent analysis.

Ratings and rating agencies

What do they do?

Rating agencies gather data about a company's ESG efforts through direct surveys (which can be time consuming) or through the company's publicly available disclosures. They then provide ESG scores based on their view of a company's risk exposure versus their industry peers. Qualitative and quantitative data inform these ratings. Rating agencies also guide investors through the publication of benchmarking data. And some use their ratings to create ESG indices that might be licensed to asset managers and others to create ESG funds and other financial products.

Who are they?

MSCI, Institutional Shareholder Services (ISS), Sustainalytics, and S&P Global are among the most prominent. The methodologies used by these agencies vary and the resulting ratings are not consistently aligned with a particular ESG disclosure framework or set of standards and may not meet the needs of all institutional investors.

As investors and rating agencies use what ESG information is available, a company's ratings, access to capital, and brand perception can hinge on the messaging and disclosures a company chooses to make.

Other stakeholders want to know about the company's ESG efforts

A company's customers, employees, communities, and suppliers are typically looking for management to drive value creation, while balancing broader obligations that impact the bottom line. But they also have a significant voice. For example, ESG's impact is being felt in purchasing decisions. Half of consumer packaged goods growth between 2015-19 came from sustainability-marketed products and products marketed as sustainable grew 7.1 times faster than those that were not.[1] And if the company wants to attract and retain top talent from the next generations, know that Gen Z and Millennials (who will make up 72% of the global workforce by 2029)[2] are bringing their values to work and exhibiting greater concern about where their employers stand on environmental and social issues.

Regulators are focused on ESG information

Some overseas regulators have already incorporated elements of ESG into mandatory reporting regimes. So those companies operating internationally may already be familiar with the disclosure requirements of foreign regulators. For public companies in the United States, the SEC does not mandate specific ESG disclosures. Instead, they focus on the broader requirement to disclose material risks. Many companies already provide voluntary disclosures to address investor and other stakeholder interests.

In the US, the SEC recently introduced new disclosure requirements designed to provide stakeholders insight into human capital management—from the operating model, to talent planning, learning and innovation, employee experience, and work environment. The disclosures may help stakeholders evaluate whether a business has the right workforce to meet immediate and emerging business challenges and the nature and magnitude of the related investments.

> "If certain information that happens to fall in any of the ESG categories is material to that company, the company needs to disclose it. We expect management and the board to do

[1] NYU Stern Center for Sustainable Business, Sustainable Market Share Index™, March 2021.
[2] GreenBiz, "Workforce strategy in the time of coronavirus: The role of ESG," June 22, 2020.

that, and we will come after them when they don't."
— SEC Commissioner Elad L. Roisman, July 2020[3]

What exactly is the board overseeing?

Understanding why the board of directors should oversee ESG issues is the first step. But as with many things, the real work is in the details.

Management is responsible for developing and executing the company's strategy under the board's oversight. ESG risk and opportunity considerations should be embedded in the strategy.

If the company is already providing ESG metrics in a variety of places (such as on its corporate website, or through social responsibility reports), you may be well served to step back and consider whether the messaging is clear and consistent across channels. Is it tied to the company's purpose, and aligned with the business strategy? Does it focus on stakeholder needs and address material risks? In this section, we take you through the important considerations.

The maturity scale for ESG disclosure

Judged by how well they tell their ESG story through disclosures, companies generally fall into one of the three stages of maturity:

1. **Laggards.** Companies that don't have anything documented on corporate social responsibility, either in a report, on the website, or anywhere else. They haven't identified material ESG topics. In addition, they have not taken into consideration insights from investors or other stakeholders and their views on ESG topics. Essentially, ESG efforts of companies in this stage of maturity may still be anchored in philanthropy efforts rather than incorporating a strategic business focus.
2. **Middle of the pack.**
   Companies that may be publishing a sustainability or corporate responsibility report or disclosing information on a webpage, but do not have a cohesive ESG strategy that is linked to their business purpose and embedded in their core operations. They likely do not have standardized metrics to measure progress or the data gathering processes and controls required to do ESG reporting consistently and on a timely basis. Board oversight is scant at best.
3. **Front runners.** ESG strategy is regularly reviewed by board/committees and embedded in core operations. The company has adopted commonly accepted ESG/sustainability standards and reporting frameworks to guide their ESG disclosures. Robust processes, controls, and governance are in place to ensure disclosures are "investor grade."

Purpose, messaging, and activities: A company's purpose is often expressed as the reason it's in business. But it's more than that. A company's purpose, as well as messaging and activities, need to be aligned to the overall business strategy—how the company will achieve long-term sustainable returns. As companies create value among a diverse group of stakeholders, including investors, employees, customers, suppliers, and communities, it shouldn't come as a surprise

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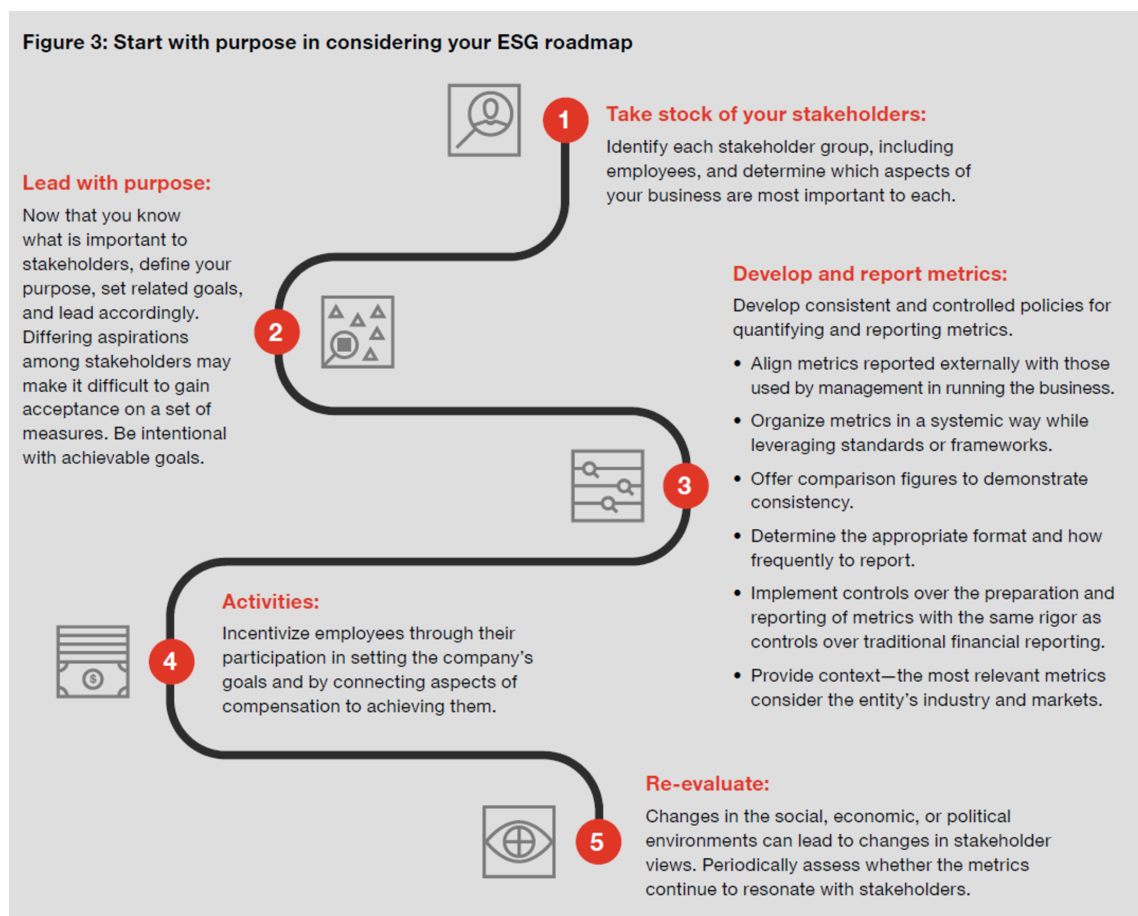
[3] Securities and Exchange Commission, "Keynote Speech at the Society for Corporate Governance National Conference," July 7, 2020.

that companies may struggle balancing all those interests. To help find a balance, the board and management need to work together to define what's important and find the best way for the company and its stakeholders to measure progress. Figure 3 lays out a roadmap to consider as boards focus on ESG strategies grounded in the company's purpose.

Figure 3: Start with purpose in considering your ESG roadmap



Risks: As the board considers the company's purpose, think about it from a risk perspective, incorporating a broad stakeholder group. Environmental and social factors heavily influence some of the thorniest business challenges companies must overcome, including workforce challenges, innovating and incorporating new technologies, and supply chain disruptions. Companies should regularly review competitor disclosures as a means to surfacing additional ESG-related risks and should consider sharing the results with the board. As risk profiles are expanding, and as companies improve how they assess ESG risks, they need to step back and examine their enterprise risk management (ERM) process. The probability and impact of ESG risks should be captured in the ERM effort. As a result, management will have a structured framework to use to manage and mitigate those risks.

Qualitative and quantitative messaging: Stakeholders want a comprehensive, cohesive story when it comes to ESG. Qualitative ESG messaging should reinforce the company's purpose statement, while metrics provide the quantitative facts that bring that purpose to life and help companies measure their progress toward goals. ESG metrics are already making their way into disclosures, as a way of helping investors compare companies across industries. The metrics

should focus on current state and milestones along the way to achieving long-term goals, all of which should be monitored by the board.

Materiality is an important criteria in deciding which metrics to disclose. The challenge is thinking about materiality from both a financial and social perspective, as discussed below.

Weighing double materiality

Most times, when you think about materiality, it is from the perspective of the company's financial statements. But companies should consider materiality as it relates to all stakeholders, balancing financial materiality against the interest of those same collective stakeholders. "Double materiality" encompasses both of these factors.

- **Financial materiality** takes into account how ESG issues will impact a company's financial performance, and its impact on the company's ability to create long-term value.
- **Social materiality** focuses on how a company's actions impact people and the earth.

Depending on the company's customers or employees, this could have a significant impact on its brand and long-term value. When thinking about materiality, companies should consider the materiality concept most important to their stakeholders. Usually, financial investors are interested in financially material information, while a broader range of stakeholders (including many ESG investors), desire socially material information about environmental and social impacts.

Companies are turning to a materiality analysis—formally engaging with internal and external stakeholders to identify the issues uniquely material to the company—as a strategic business tool. Companies need to examine how they look for opportunities in the market as well as their overall risks and risk management practices. It is essential to connect the analysis back to the broader business strategy.

Companies also need to ensure the accuracy of the information they disclose. Are adequate internal controls in place for quantitative, data-based metrics? And when choosing to adopt a framework or standard that incorporates specific metrics, has the company considered whether it is feasible to meet the commitments of the chosen framework/standard?

In addition, when thinking about qualitative disclosure and quantitative metrics, companies should assess its competitors' disclosures to gauge how they compare. And finally, the company should assess its third-party ratings. Are they weaker than their peers in certain areas? Understanding the company's scores and how they compare to peer companies could also help highlight areas for improvement.

ESG standards and frameworks: Using standards and frameworks allows for consistent and comparable disclosures, aiding investors in their decisions. It also helps companies to have guidance to follow and obtain assurance over disclosed information.

In order to make sense of the options, it is important to understand the difference between standards and frameworks. Generally speaking, standards, which follow a typical process

(including receiving public comments), offer specific guidance for measurement and disclosure. Frameworks, on the other hand, provide general guidelines on disclosure.

Disclosure standards, frameworks, and others with a point of view

The major standards and frameworks

A number of business associations have also developed recommendations to help members standardize ESG disclosures within their industries. The National Association of Real Estate Investment Trusts (NAREIT), for instance, produced a guide designed to help members better understand and navigate the ESG reporting frameworks, and the Edison Electric Institute (EEI) launched an ESG template to help member electric companies provide uniform ESG/sustainability information. Separately, the World Economic Forum's International Business Council issued a white paper that outlines a common set of metrics to enable consistent reporting.

Standards:	**According to their website:**
Global Reporting Initiative (GRI):	
The GRI provides ESG standards that address disclosures of socially material topics affecting a company's stakeholders. It also requires that companies determine the issues that are material in consultation with stakeholders.	GRI helps business and governments worldwide understand and communicate their impact on critical sustainability issues such as climate change, human rights, governance, and social well-being. This enables real action to create social, environmental, and economic benefits for everyone. The GRI Sustainability Standards are developed with true multi-stakeholder contributions and rooted in the public interest.
Sustainability Accounting Standards Board (SASB):	
The SASB recommends topics and metrics for 77 different industries across all three pillars of ESG. These standards provide guidance on how organizations can align their reporting with investor needs and how companies gather standardized data.	The SASB's mission is to establish and improve industry specific disclosure standards across financially material environmental, social, and governance topics that facilitate communication between companies and investors about decision-useful information.
Frameworks:	**According to their website:**
The Carbon Disclosure Project (CDP):	

The CDP supports various users to measure their risks and opportunities on climate change, deforestation, and water security.	CDP is a framework which focuses investors, companies, and cities on taking urgent action to build a truly sustainable economy by measuring and understanding their environmental impact. The CDP has created a system that has resulted in unparalleled engagement on environmental issues worldwide.
The Task Force on Climate-related Financial Disclosures (TCFD):	
The TCFD provides 11 recommendations across four pillars: governance, strategy, risk management, and metrics & targets.	The TCFD's mission is to develop recommendations for more effective climate-related disclosures that could promote more informed investment, credit, and insurance underwriting decisions and, in turn, enable stakeholders to understand better the concentrations of carbon-related assets in the financial sector and the financial system's exposures to climate-related risks.
Others:	
A number of business associations have also developed recommendations to help members standardize ESG disclosures within their industries. The National Association of Real Estate Investment Trusts (NAREIT), for instance, produced a guide designed to help members better understand and navigate the ESG reporting frameworks, and the Edison Electric Institute (EEI) launched an ESG template to help member electric companies provide uniform ESG/sustainability information. Separately, the World Economic Forum's International Business Council issued a white paper that outlines a common set of metrics to enable consistent reporting.	

Where to disclose: Once a company has decided on its purpose, messaging, metrics, and which standards and frameworks to use, it will have to consider where to disclose the information. Among the most common platforms are proxy statements, CSR/sustainability reports, company websites, and annual reports. It is important to understand the common location for the company's industry as well as evolving stakeholder preferences.

Disclosure platforms

Proxy statements: More companies are including ESG information in their proxy statements as a way to communicate directly with investors. This disclosure often includes discussion of:

- the ESG risks and opportunities identified by the company, and their areas of focus,
- the governance and operations structures from a management perspective (for example, whether a committee or a specific person is responsible for developing and executing the company's ESG strategy and frequency of reporting to the board),

- how and how often the topic is discussed with various stakeholders, such as whether the topic was specifically targeted for shareholder engagement,
- progress against implementation goals, including the company's current state, periodic milestone goals, and other long-term goals, and links to the company's other sustainability information, including reports or materials on the company's website.

CSR/sustainability reports: A sustainability report has been the historic channel for many companies to communicate sustainability performance and impact—whether positive or negative. Often these reports describe employee volunteer opportunities, in-office recycling programs, or recruitment efforts at local colleges, rather than the material risks and opportunities impacting long-term value creation that are of interest to investors. If a company is planning to use its CSR report as a platform for delivering ESG disclosures, be sure to consider whether it reports material risks and opportunities that would be considered relevant to investors, as well as other stakeholders. Also, think about whether the sustainability activities described link to the company's purpose and overall business strategy. The biggest concern with most current CSR reporting today is that it does not focus on long-term value creation or address material risks to the business—both of which are on the minds of investors.

Websites: Companies also often house ESG information on their websites, with pages dedicated to their sustainability goals and efforts. The websites often include links to additional sustainability information, such as ESG score cards.

SEC annual and quarterly reportings: To the extent issues are material, companies disclose them in the risk section or management's discussion and analysis section of their SEC reporting. Earnings calls: Some companies are also using their earnings calls to showcase their ESG efforts. This approach allows them to improve corporate communication with investors on material ESG issues and demonstrate how their ESG efforts are embedded in their overall value creation plan.

The number of companies that have chosen to publish annual sustainability or ESG reports has grown significantly in recent years, with 90% of companies in the S&P 500 publishing such reports.[4] But often, these reports do not address what investors are looking for.

Measuring and monitoring progress: The company should set specific goals and milestones when developing its strategy. And, as the company moves through the process, it should track its progress against these goals and milestones. We recommend that the company consider disclosing how it is tracking against those milestones and goals to keep all stakeholders informed.

How does the board oversee ESG?

Now that you know what the board is overseeing when it comes to management's development and execution of an ESG strategy, how exactly does the board go about overseeing these efforts? The board will have to consider a number of different topics/issues.

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[4] Governance & Accountability Institute, 2020 Flash Report S&P 500, July 2020.

Where responsibility lies: Because ESG strategy should align with business strategy and focus on material risks and business drivers, the full board will want to understand the ESG messaging and how those risks are being mitigated. If this is a new area of focus for the board and the company, directors may need to assign detailed oversight to specific committees to help the ESG strategy launch smoothly. Ultimately, ESG issues will be relevant to all committees. For example, the nominating and governance committee will be interested in the shareholder engagement element, while the compensation committee will be interested in accountability through compensation. The audit committee will be interested in the disclosure, messaging, and metrics.

As the board determines where ESG oversight will be assigned, it may want to consider the following questions:

- Do we have a specific committee with the capacity, interest, and skills to take the lead on overseeing the company's overall ESG efforts? If not, will the full board take on this responsibility or should we create a new committee?
- Have we considered how the committees will stay aligned on ESG considerations? Have committee charters and proxy disclosures been updated to transparently disclose to shareholders and other stakeholders the board's allocation of ESG oversight responsibility?

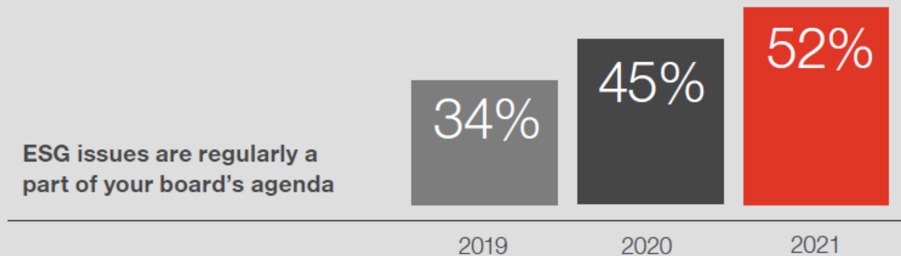
Board oversight and investors' expectations:

Investors are continuing to expect more and more transparency from boards in how they oversee particular topics. ESG oversight is no exception. Boards can find a number of ways to provide shareholders with the information they seek.

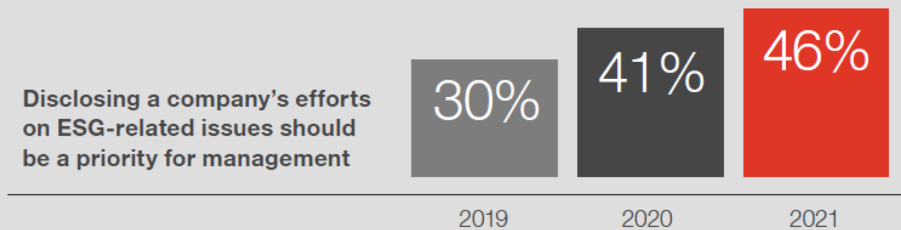
- Robust disclosure in the proxy statement describing the board's oversight efforts
- Updates to board committee charters to address committee oversight responsibilities related to ESG
- Additional information about directors' skills that enhance their contribution to ESG oversight efforts

Directors start to come around on ESG

In 2021, more than half of directors (52%) say that ESG issues are regularly a part of the board's agenda, up from prior years (34% in 2019 and 45% in 2020).



Directors are also much more likely to say that disclosing a company's efforts on ESG-related issues should be a priority for management.



Q: Which of the following statements do you agree with about ESG (environmental/social/governance) issues? (select all that apply); Which of the following do you agree with as it relates to ESG reporting/disclosure? (select all that apply)
Base: 660 (2019); 624 (2020); 788, 812 (2021)
Sources: PwC, *2019 Annual Corporate Directors Survey*, October 2019; PwC, *2020 Annual Corporate Directors Survey*, September 2020; PwC, *2021 Annual Corporate Directors Survey*, October 2021.

Integrating ESG into board oversight responsibilities

Full board

Oversee:

- **Strategy**: Are ESG risks and opportunities integrated into the company's long-term strategy? How is the company measuring and monitoring its progress against milestones and goals set as part of the strategy?
- **Messaging:** Do ESG messaging and activities align with the company's purpose and stakeholder interests?
- **Risk assessment**: Have material ESG risks been identified and incorporated into the ERM? Has the board allocated the oversight of these risks to the full board or individual committees?
- **Reporting**: What is the best communication platform to use for the company's ESG disclosures?

Audit committee

Oversee:

- **Disclosures**: Are the ESG disclosures (both qualitative and quantitative) investor grade? Which ESG frameworks and/or standards is the company using?
- **Processes and controls:** Are there processes and controls in place to ensure ESG disclosures are accurate, comparable, and consistent?
- **Assurance:** Should independent assurance be obtained to ensure ESG disclosures are reliable?

Compensation committee

Oversee:

- **Accountability**: Are the ESG goals and milestones effectively integrated into executive compensation plans?
- **Talent and culture**: How is management organized to execute the ESG strategy? Are the right people and processes in place? Does the company have a culture which embraces ESG efforts?

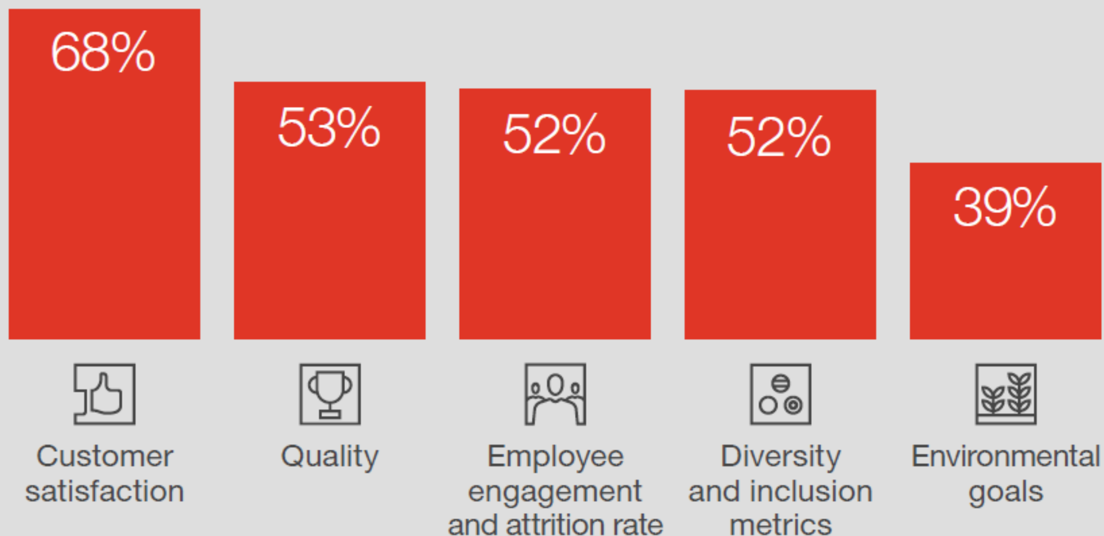
Nominating and governance committee

Oversee:

- **Engagement**: Is the company's ESG story being effectively communicated to investors and other stakeholders?
- **Board composition**: Does the board have the necessary expertise and skills to oversee ESG risks and opportunities?
- **Education:** Does the board understand why ESG is important to investors and other stakeholders? Is the board appropriately educated on ESG?

ESG metrics tied to executive compensation

In our *2021 Annual Corporate Directors Survey,* we asked directors which non-financial metrics they think should be linked to executive compensation



Q: Which of the following non-financial metrics do you think should be included in executive compensation plans? (select all that apply)
Base: 815
Source: PwC, *2021 Annual Corporate Directors Survey,* October 2021.

Considering ESG goals and milestones as elements of executive compensation

Many investors are focused on the connection between ESG goals and executive compensation. By tying incentive plan metrics explicitly to the company's ESG strategy, a company is not only encouraging the achievement of those ESG goals, it is also signalling the importance of those issues. A growing number of shareholder proposals are asking companies to link the two. And a number of large companies have already taken steps to do so.

Linking purpose, risks, and messaging: The company should ensure that its purpose is reflected through its messaging and activities, while looking at it with a risk lens. And as part of its oversight role, the board should engage with management to understand how the company's purpose, messaging, and risks all tie together. For example, in considering the company's purpose and the metrics management uses to measure performance, the board should keep sight of the risk landscape. You may want to ask the following questions of management:

Purpose and stakeholders

- Has the company clearly articulated a purpose that considers key stakeholder needs and aligns with business strategy?

- Has the company considered how its purpose compares to that articulated by its competitors?

Risks and ERM

- Do the company's existing risk processes include identification of any ESG risks? Should any of the risk identification processes be expanded to allow for a broader scope of risks to be captured?
- Does the ERM process include assessment and mitigation plans for all ESG-related risks that
have been identified?
- How does management prioritize ESG risks and opportunities? Are these ESG risks and opportunities included in capital allocation decisions?

Messaging

- How is the company communicating its purpose and its goals in furtherance of long-term sustainable success? Is the company using both quantitative information, such as metrics, and
qualitative information to measure its progress?
- How does the company monitor what competitors are doing, what the rating agencies are reporting, and other benchmarking data?
- Is the company transparently tracking their performance against milestone goals, as well as long-term goals, so stakeholders and others can monitor progress?
- Has the company evaluated various ESG standards and frameworks to determine whether it is addressing the most significant risks and issues facing its industry?

Reliability of ESG information: Once the company has settled on the qualitative and quantitative messaging it will disclose, the board will want to verify the information is consistently prepared and reliable. After all, investors will be using it to analyze the company and make investment decisions.

The board needs to understand management's policies and procedures supporting the assessment of internal controls over these disclosures. Determining that the right controls are in place to ensure consistency and accuracy of reporting will be key as well as whether the company should consider obtaining some type of assurance over the ESG information disclosed. You may want to ask:

- Does the company have robust policies and procedures to support the development of their disclosures? Do their disclosures adhere to the requirements of particular frameworks or standards? Are the disclosures investor-grade?
- Has management found any gaps in the internal controls that support the completeness and accuracy of the disclosures? If so, how does management plan on mitigating those gaps? Is the disclosure committee one of the controls used by the company to ensure its disclosures are appropriate?
- Would stakeholders be confident with the accuracy of the disclosure without independent assurance? Could independent assurance serve as a differentiating factor among peers?

Disclosures: With the messaging determined and an assessment of the reliability of the information complete, the board should understand where the company will be disclosing its messaging. Boards may want to consider the following questions:

- Are disclosures made in the right place and does that address various stakeholder preferences? For example, a customer or an employee will most likely refer to the company's website for ESG information, while an investor would more likely refer to either corporate responsibility reporting, annual reports, or proxy statements.
- Are disclosures consistent across various platforms and appropriate for the different audiences of each? For example, are material risks disclosed in a corporate responsibility report aligned with those identified in the company's Form 10-K filing?
- Is the messaging being incorporated in operational discussions, such as quarterly analyst calls?
- Has the company considered its exposure when including ESG information in SEC filings?

Conclusion

Rapid strides have been made in unlocking the business value of ESG in recent years. The ESG issues a company faces vary widely by industry and company maturity, and there's no one-size-fits-all solution. But the one thing that's a sure bet is that directors have a big role to play in guiding management to allocate the appropriate resources and attention. Forward-looking companies value being a frontrunner on ESG issues because they see the connection to the company's long-term success.

Coming to Terms with a Maturing ESG Landscape

Posted by Peter Reali, Jennifer Grzech, and Anthony Garcia, Nuveen, on Thursday, March 17, 2022

Editor's note: Peter Reali is Managing Director and Global Head of Stewardship, Jennifer Grzech is Director of Responsible Investing, and Anthony Garcia is Senior Director of Responsible Investing at Nuveen. This post is based on their Nuveen memorandum. Related research from the Program on Corporate Governance includes The Illusory Promise of Stakeholder Governance (discussed on the Forum here) and Will Corporations Deliver Value to All Stakeholders? both by Lucian A. Bebchuk and Roberto Tallarita; and For Whom Corporate Leaders Bargain (discussed on the Forum here) and Stakeholder Capitalism in the Time of COVID, both by Lucian Bebchuk, Kobi Kastiel, and Roberto Tallarita (discussed on the Forum here).

The momentum and support for environmental, social and governance (ESG) integration into the investment process has reached critical mass. Most companies now recognize the strategic need to have an ESG story, and some are even leveraging ESG leadership as a key differentiator from competitors.

Stakeholders may be looking for 2022 to represent the year that real-world impact is universally accepted as being in the long-term best interests of businesses. However, investors may disagree on how far the market is from that reality. Yet, it is becoming increasingly apparent to investors and stakeholders alike that there is market conflation of the inputs that go into corporate management of ESG risks and opportunities — such as reporting, policies and oversight — and the outputs of improvement on important environmental and social indicators — such as lower carbon emissions or greater pay equity among workers. For example, one interpretation of progress among the Climate Action 100+ universe of companies (i.e., the world's largest corporate greenhouse gas emitters) is that nearly 85% have established oversight for climate risk. Another interpretation is that less than 3% of those companies have disclosed a quantifiable and trackable strategy in line with net zero emissions.

As stakeholders push for stronger stances and tangible outcomes, investors must navigate the shifting sands of financial materiality and the appropriateness of setting expectations for companies that may not yield results for years, if not decades. But with a recognition that the entire financial system will be significantly affected by long-term environmental and social (E&S) impacts comes a responsibility for investors to credibly address risks and opportunities today, rather than years in the future.

Figure 1: Reorienting E, S, and G along the lines of transparency, accountability and impact

One way to enhance credibility may be through a clearer categorization of ESG information and even proxy ballot items not just in terms of E, S or G, but in terms of the direct objectives or intentions they address.

Category	Summary	Outcome Example
Transparency	Consistent, material disclosure that can inform investment analysis Foundation for establishing ESG oversight, developing ESG commitments and assessing the results of company actions	New or improved reporting on climate risk
Accountability	Policies, business strategies, oversight structures and incentives aimed at appropriately managing financially material ESG issues ESG-related commitments with clear, relevant key performance indicators (KPIs)	Set a science-based, net zero carbon commitment
Impact	**Operational:** The measurable results of company policies and practices **Products and services:** The measurable results of company products and services for the environment and/or affected individuals and communities	Emissions reduction achieved through intentional changes to business strategy

Source: Nuveen

While there is no regulatory definition or market standard on what constitutes transparency, accountability and impact when it comes to ESG, such a framework forces investors to assess the meaning of existing ESG information and recalibrate expectations for what additional progress really looks like.

With the significant increase in ESG transparency over the last few years, investor engagements and shareholder proposals are increasingly focused on accountability and impact. In this maturing landscape, a recognition that reporting does not automatically generate impact has resulted in a greater focus on accountability as the bridge, with more calls for public commitments, strategies and even pay incentives related to E&S issues in particular.

While it may be too early for investors to coalesce around accountability expectations to drive significant vote dissent, the 2022 proxy season will likely see a continued evolution of more clearly articulated standards. If the precedent on board diversity is anything to go by, it is likely

that boards will adapt and the market as a whole can move past transparency, toward accountability. We anticipate this to be an important turning point given where the tangible E&S outcomes of proxy voting currently stand.

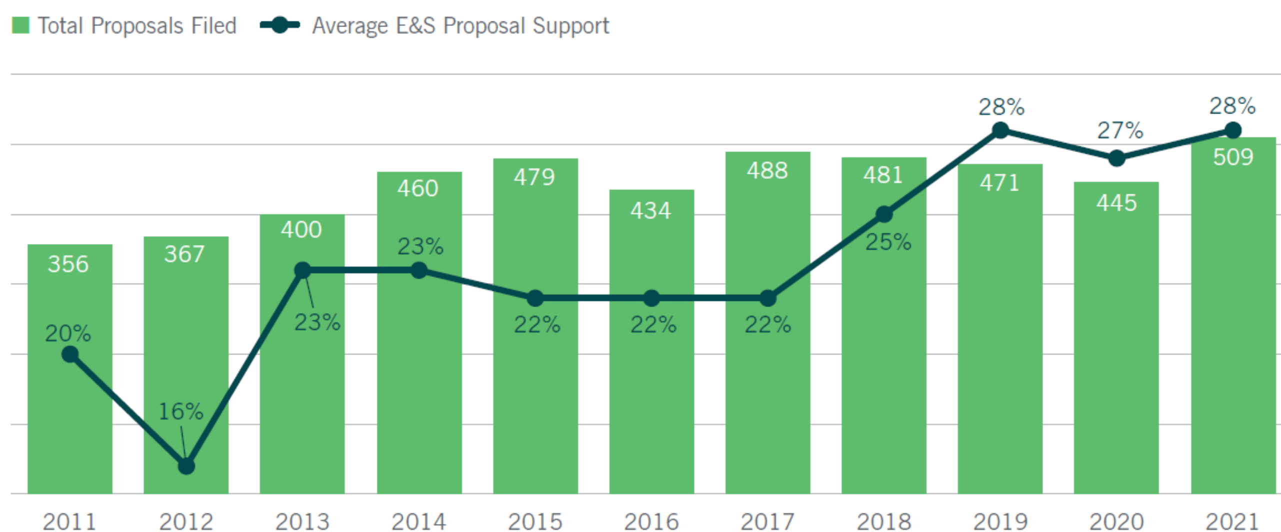
The Divergence Between Shareholder Proposal Support and Election of Directors

Since the first E&S-related shareholder proposal received majority support in 2016, each subsequent year has reset the high water mark for shareholder proposal support (4 in 2017, 8 in 2018, 12 in 2019, 21 in 2020, and 32 in 2021) and the trend is likely to continue accelerating in 2022 (Figure 2). Changes in the SEC's position on the social policy significance of E&S issues will increase not only the quantity of shareholder proposals that appear on ballots, but also the specificity of what the proposal requests of the company. This has implications for the number of proposals making it through that focus on accountability and impact.

Investors seem to be applying greater scrutiny to boards of directors — indicated by a creeping number that received lower support (6.1% received less than 80% support in 2021 vs 5.3% in 2020). However, there also seems to be low correlation between investors' stated ESG priorities and director election votes. Even for investors that appear favorably in both number of ESG shareholder proposals supported and number of directors voted against, the reasons for each set of votes are often unconnected.

Figure 2: Environmental and social shareholder proposals

Filed and average proposal support from 2011 – 2021



Source: ISS, *2021 Proxy Season Review on Shareholder Proposals*

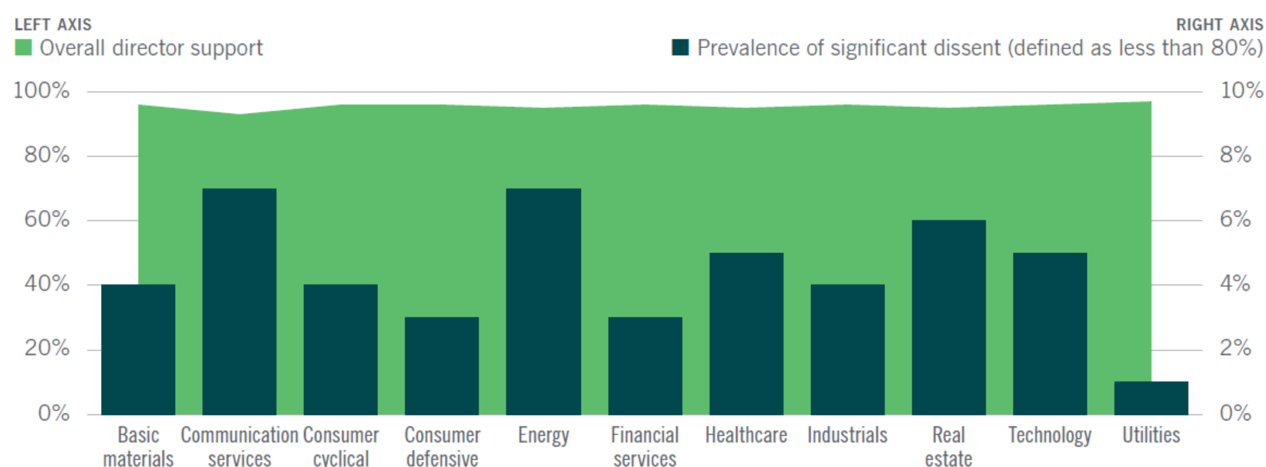
Many investors share anecdotal examples of E&S issues influencing a decision to vote against directors, but traditional governance issues like shareholder rights and director overboarding remain the predominant factors for directors receiving less than majority support from investors.

While investors are not required to disclose any or all reasons behind a vote against a director, there is little evidence that a company's failure to address E&S risks or be responsive to a shareholder proposal resulted in a director receiving less than majority support.

For director votes in the most carbon intensive sectors, there has been a generally high level of director support — around 95% support in 2021 — and little differentiation relative to other industries despite a heavy focus on climate change among the proponents of shareholder proposals. There is some incidence of industry carbon footprint correlating to lower director support. Coal companies had 86% overall support and 40% prevalence of significant dissent, but there are many governance issues at those companies which more likely drove dissent rather than environmental performance or escalation of environmentally-focused stewardship (Figure 3).

Figure 3: Director support levels by sector at 2021 annual meetings

Overall support levels and prevalence of significant dissent



Sources:
ISS, *2021 Proxy Season Review on Director Elections & Governance and Proxy Insight Director Voting Data*

One possible reason for continued board support, despite a lack of progress on low-carbon transition strategies and actual decarbonization, is that companies in carbon intensive industries are more likely to disclose climate-related information in line with investor expectations. The amount of information disclosed, in particular relative to industries where climate risk is less direct or well understood, could be holding back investor votes against directors at energy companies that are perceived to have met a higher standard of transparency on an absolute basis.

Yet, as investors raise the bar on climate expectations, the fact that over half of the Climate Action 100+ focus companies had stated a net zero by 2050 goal, but less than half have a clearly defined decarbonization strategy, could forecast a turning tide. In cumulative terms, only 2% of companies have at least partial alignment across all of the Climate Action 100+ key performance indicators (KPIs) (Figure 4).

The rise of net zero commitments from asset owners and asset managers suggests investors may be prepared to translate newly enhanced ESG transparency into investment decision-making, including voting against directors where companies' carbon footprints are clearly misaligned with the investors' strategies for achieving net zero. On the other hand, investors may be focused on engagement and understanding company strategy related to carbon reduction with 2025 or 2030 as the more appropriate dates to assess company performance against a low carbon strategy.

Assessing Shareholder Proposal Support Against Real-World Outcomes

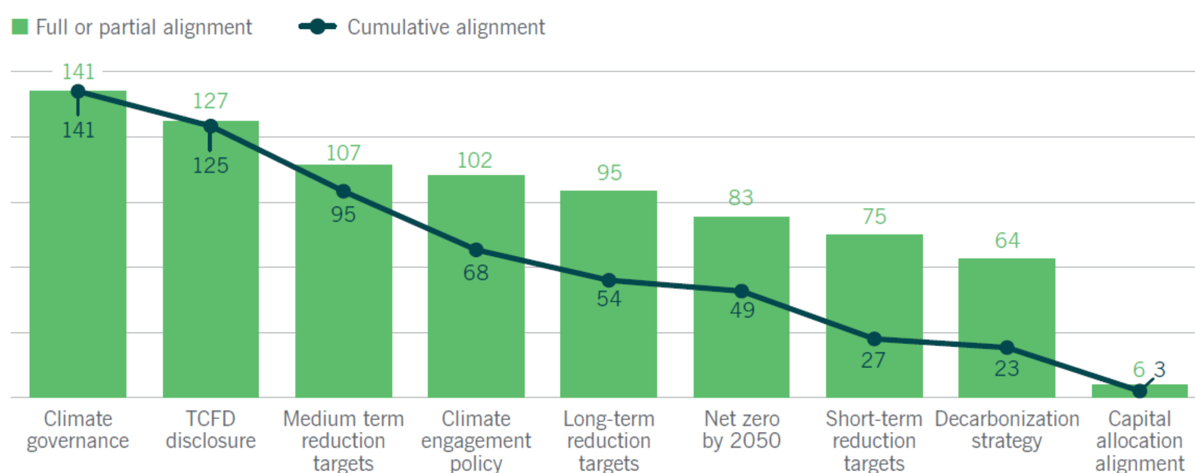
The history of E&S proposals receiving majority support is limited, but the early evidence suggests that support does lead to company responsiveness and positive improvements — at least when measured by ESG ratings. Based on E&S shareholder proposals that received majority support from 2018 – 2020, the most common outcome is for the companies' ESG ratings to improve on both an absolute and industry-relative basis. More than two thirds of companies (69%) have seen an improvement in MSCI ratings and almost 60% now have environmental or social ratings that are above the industry average.[1]

However, ESG ratings do not exclusively or even primarily measure the impact a company has on its stakeholders. Usually, the ESG ratings focus on transparency and whether the company faces any ESG-related controversies. The ESG ratings do not measure whether, or to what extent, policies adopted or KPIs reported lead to improvements for the stakeholders they are intended to address. In other words, despite the correlation between shareholder proposal support and ESG ratings improvements, the real-world outcome is less clear, or perhaps yet unrealized.

[1] Source: Nuveen analysis of MSCI ratings as of 12/31/2021. The comparison was based on the MSCI ratings pillar most relevant to the shareholder proposal theme.

Figure 4: Climate action 100+ focus companies

Cumulative alignment with net-zero key performance indicators



Source: Climate Action 100+, *Net Zero Company Benchmarks*

Looking at climate change, for example, companies may develop new reporting or make low-carbon- aligned commitments in the short-term to improve ESG ratings. But meaningful reduction in a company's carbon footprint requires capital expenditures and changes to business operations that often require more time. Reviewing shareholder proposals for the past decade relative to an impact indicator such as carbon intensity shows a mixed picture. Analysis of shareholder proposals that have received significant support (30% or more) going back to 2011, shows that fewer than half (48%) of the vote outcomes translated to sustained reduction in carbon intensity from the year of the annual meeting to present. In terms of assessing real-world impact, only 22% of companies had an average annual reduction in carbon intensity of greater than 3%, which, if sustained over 10 years, would translate to a 25% reduction in emissions intensity. Given global decarbonization in 2021 was about 2.5%, these results generally align with business as usual (Figure 5).

Figure 5: Changes to carbon intensity at companies

Where climate-related shareholder proposal received >30% support

Source: Nuveen analysis of MSCI and Proxy Insight Data as of 31 December 2021. Carbon intensity is defined as total Scope 1 + 2 + 3 emissions/total company revenue. Annual change in carbon intensity uses the year a shareholder proposal received majority support as the company's baseline year for emissions intensity. The cumulative year over year change from the baseline was averaged over the number of years since the vote to account for the different time periods.

Granted, in some cases shareholder proposals were filed at the same company in multiple years. ExxonMobil and Chevron Corporation alone account for 8% of the data sample. This may skew the results since companies that make improvements are less likely to require continued advocacy via additional shareholder resolutions. Nonetheless, this data points to a need for investors to be mindful that the support for shareholder proposals does not always create the outcome being sought in the proposal. It also raises the question of what should define the success of a shareholder proposal given the limits to their scope.

Focusing on Shareholder Proposals as Tool for Transparency and Accountability

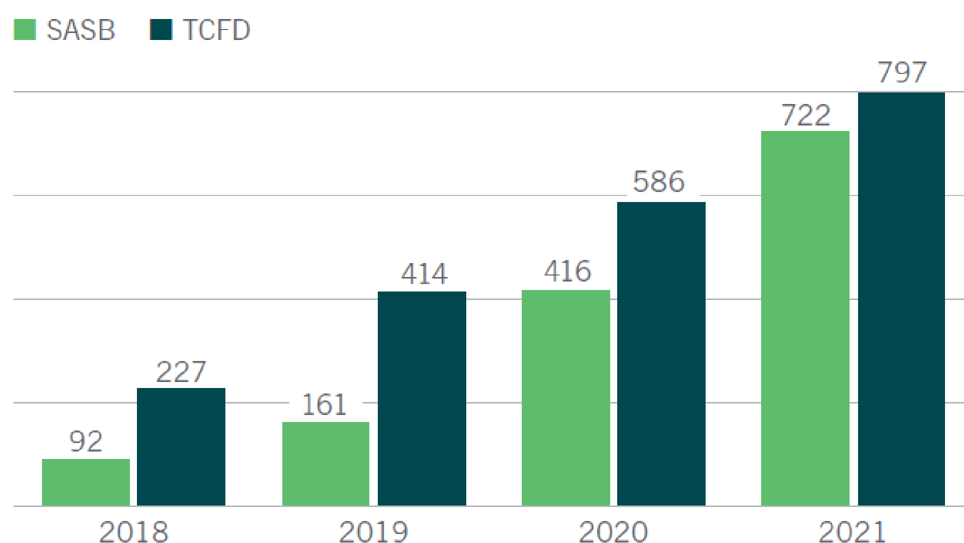
Despite something of a lack of evidence for shareholder proposals catalyzing environmental or social impact, they have generated meaningful change. Earlier versions of climate-related shareholder proposals were often broad-based and transparency focused; e.g., seeking a sustainability report. This is in contrast to the current proposals requesting specific greenhouse gas (GHG) reduction targets or strategies to keep business operations aligned with net zero ambitions.

What the period of 2011 – 2018 does represent is the foundational work that stewardship advocacy has had on ESG transparency and creating a focus on material ESG disclosures that can drive assessments of company accountability. Since the publication of the Sustainability

Accounting Standards Board's (SASB) materiality map standards in 2018, there has been a significant uptick in the number of companies providing material ESG disclosure in line with the SASB and Task Force on Climate-Related Financial Disclosures (TCFD) frameworks (Figure 6).

Figure 6: Number of companies reporting in line with material ESG standards

S&P 1200 companies



Source: The Value Reporting Foundation, *More Than Half of S&P Global 1200 Now Disclose Using SASB Standards,* September 22, 2021

Looking at climate risk specifically, the quality of TCFD reporting is improving in terms of companies not only establishing aspirational targets or acknowledging climate as a material risk to the business, but also creating the infrastructure to manage climate risk. More than 52% of companies (a 14% improvement from 2018) now address climate risks and opportunities of the business and 13% (an 8% improvement from 2018) even address the resilience of the current climate strategy if market or social momentum spur a faster low carbon transition.[2]

The SEC's new standards will allow for more shareholder proposals with specific expectations with regard to company strategy making it to ballots. For companies to continue to be responsive, they will have to more closely align with the accountability or impact expectations of the stakeholders and investors that supported the proposal. So long as investors hold companies to account for responsiveness to achieving impact in the same way they have for responsiveness to ESG reporting expectations, then real-world E&S outcomes may begin to manifest from shareholder proposals.

[2] The Task Force on Climate-related Financial Disclosures 2021 Status Report.

Escalating Unaddressed ESG Issues to Votes Against Directors

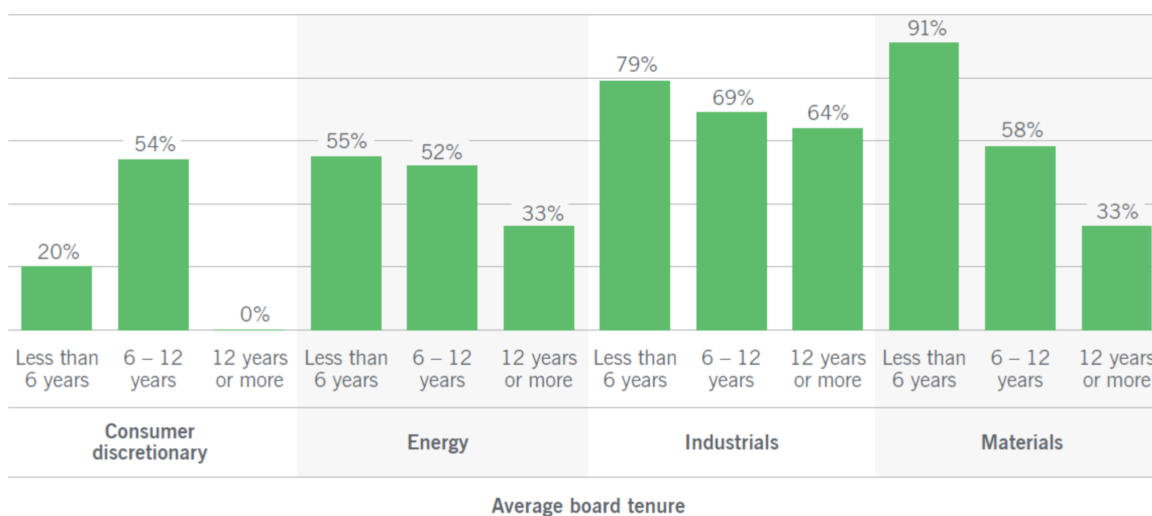
The proxy contest at ExxonMobil was seen as a watershed moment for investors' conviction on developing a business strategy aligned with the low carbon transition. While carbon reduction cannot be expected over a six-month period, Exxon's recently announced corporate strategy suggests business as usual, as the company will continue to invest 90% of capital expenditures into its legacy businesses.

Investors continue to advocate for more accountability via independent board leadership and more climate expertise in addition to target setting, and there have been some positive results in terms of influencing Exxon to make a net zero by 2050 commitment. However, the Exxon commitment excludes scope 3 emissions and raises questions about how far investors will be able to push the company.

Analyzing the market more broadly though, board refreshment does exhibit greater correlation to positive outcomes on climate performance than shareholder proposal support. Over the past decade, companies with the lowest average board tenure were more likely to have reduced carbon intensity at a greater rate than industry peers. In addition, boards with the highest average tenure are more likely to lag industry peers in carbon intensity reduction (Figure 7).

Figure 7: Relative carbon intensity reduction among S&P 1500 companies (2011 – 2021)

% of companies with carbon intensity reduction > industry average



Source: Nuveen analysis of MSCI and ISS data 01 January 2011 – 31 December 2021.

Conclusion

Market participants often focus exclusively on transparency or impact in their company assessments. However, distinguishing and assessing company accountability, in terms of the ESG targets the company sets and the detailed plans it has to achieve those targets, is more

likely to indicate which companies are making meaningful progress toward impact and which companies are using transparency to deflect stakeholder pressure.

Investors themselves must increasingly contend with their own transparency, accountability and impact when it comes to stakeholder expectations. This requires that ESG conviction extend beyond the shareholder proposal vote, if the investment thesis is truly that companies' management of ESG issues affects sustainable, long-term value creation. In this context, votes against boards based on unmet E&S expectations may be the new frontier of active ownership.

The Russian Invasion of Ukraine: A Lesson in Stakeholder Capitalism?

Posted by Peter Essele, Commonwealth, on Wednesday, March 16, 2022

Editor's note: Peter Essele is Vice President of Investment Management and Research at Commonwealth. This post is based on his Commonwealth memorandum. Related research from the Program on Corporate Governance includes The Illusory Promise of Stakeholder Governance (discussed on the Forum here) and Will Corporations Deliver Value to All Stakeholders? both by Lucian A. Bebchuk and Roberto Tallarita; and For Whom Corporate Leaders Bargain (discussed on the Forum here) and Stakeholder Capitalism in the Time of COVID, both by Lucian Bebchuk, Kobi Kastiel, and Roberto Tallarita (discussed on the Forum here).

It's possible that the autocratic regime in Russia didn't fully appreciate the power of stakeholder capitalism. In the wake of the invasion, stakeholders have clearly chosen sides—and they do not include the Kremlin. Corporations have responded, and many have decided to sever Russian ties through divestment. Shell and BP recently announced their intention to abandon their involvement in Russia. Further, Sberbank (Russia's largest lender) says it is leaving the European banking market in the face of Western sanctions against Moscow.

The actions are a clear signal that the world is pivoting toward a stakeholder capitalism model, one that is designed to benefit *all* parties. Those parties include customers, suppliers, employees, shareholders, and, most importantly, communities. Stakeholder capitalism proponents argue that serving the interests of all stakeholders, as opposed to only shareholders, offers superior long-term success to businesses. Many believers assert that it is a sensible business decision, in addition to being an ethical choice.

Shareholder Primacy Vs. Stakeholder Capitalism

For decades, shareholder primacy has reigned, which is the notion that corporations are only responsible for increasing shareholder value. In that model, profits are maximized at all costs through open and free competition without deception or fraud. Put simply, corporations are solely motivated by profit potential. End of story.

The recent events in Ukraine highlight a clear evolution beyond the shareholder primacy model, as evidenced by first-movers like BP and Shell, which have placed social good over profits. The decision to divest of Russian assets and partnerships places social responsibility over short-term profits (especially as oil prices skyrocket globally). It's also a move that's aligned with long-term, sustainable value creation in an investment environment that places significant weight on intangibles like brand reputation.

If the shareholder primacy model still dominated the corporate and investment world, it's likely that firms such as Shell and BP would have simply weathered the negative public relations backlash until the Russia-Ukraine episode was in the rearview mirror. In that case, the profit potential and subsequent increase in share price (due to the rise in oil) would've helped placate investors, and they would have brushed off the impartial stance taken by the two firms. Thankfully, for humanity's sake, that world is shifting quickly in favor of stakeholder capitalism, as Larry Fink points out in his prescient 2022 Letter to CEOs.

Recent events have highlighted that stakeholder capitalism and profit maximization are not mutually exclusive outcomes. In fact, they're very closely aligned, particularly as one's time horizon increases.

Russia Exposure and PPS Select

As stewards of more than $12 billion in client assets (as of March 3, 2022), Commonwealth has clearly taken note of recent events and how they could potentially affect clients' long-term goals. As fiduciaries, we are obligated to make decisions in the best interest of clients, which includes maximizing returns for stated levels of risk. It's why we've had many discussions in recent days to discuss the impact to clients as the situation unfolds, particularly as it relates to Russian exposure across portfolios.

Within our Preferred Portfolio Services® (PPS) Select asset management platform, Russian exposure is minimal, and we expect it to decrease further over the coming weeks. Many of the asset managers we've spoken to have plans to divest, and we're hopeful that direct Russian investment will be nonexistent when underlying holdings are released in the next reporting period. Any Russian exposure that remains will likely be the result of illiquidity, where names remain in the portfolio in small portions because of an inability to sell on listed exchanges.

MSCI and FTSE Russell recently announced their intention to cut Russian equities from widely-tracked indices, as they've been deemed uninvestable. As a result, we expect our passive models to be largely void of Russian exposures as well in the coming months.

While some investors may consider Russian equities an investment opportunity, we would caution against this approach at this time, as the previous comments suggest. The public continues to push global exchanges to delist Russian-domiciled firms, so it's very likely that buyers will be left empty-handed without a liquid market. The result would be ruin, as opposed to other geopolitical value opportunities in the past that have presented a more attractive risk/reward scenario. At this time, investors are faced with a boom or bust scenario, skewed mostly toward the latter.

Looking Beyond Investments

From an investment perspective, we remain vigilant as the situation continues to unfold, and we will continue to do what we feel is in the best interest of clients. As mentioned, we are in regular contact with asset managers to understand their position and will react accordingly if it differs from our own.

Finally, our hearts go out to all those affected, directly or tangentially. The discussion of exposures, markets, and profits feels petty when viewed in contrast to the struggle that many of our fellow global citizens face daily. It can be difficult to put on a straight face at times like this when humanity is clearly not okay. Let's all hope for a resolution where calmer heads prevail.

The False Promise of ESG

Posted by Jurian Hendrikse (Tilburg University), on Wednesday, March 16, 2022

Editor's note: Jurian Hendrikse is a PhD Candidate at the Tilburg School of Economics and Management. This post was co-authored by Mr. Hendrikse; Elizabeth Demers, Professor of Accounting at the University of Waterloo; Philip Joos, Professor of Accounting at the Tilburg School of Economics and Management; and Baruch I. Lev, Philip Bardes Professor Emeritus of Accounting and Finance at NYU Stern School of Management.

Millions of investors and countless fund managers direct their investments to companies that are highly-rated on the basis of their environmental, social, and governance ("ESG") activities in an attempt to do good. The claim by ESG advocates, pundits, and many academics that highly-rated ESG companies and funds also deliver superior returns bolsters this move: Doing better by doing good. The best of all worlds.

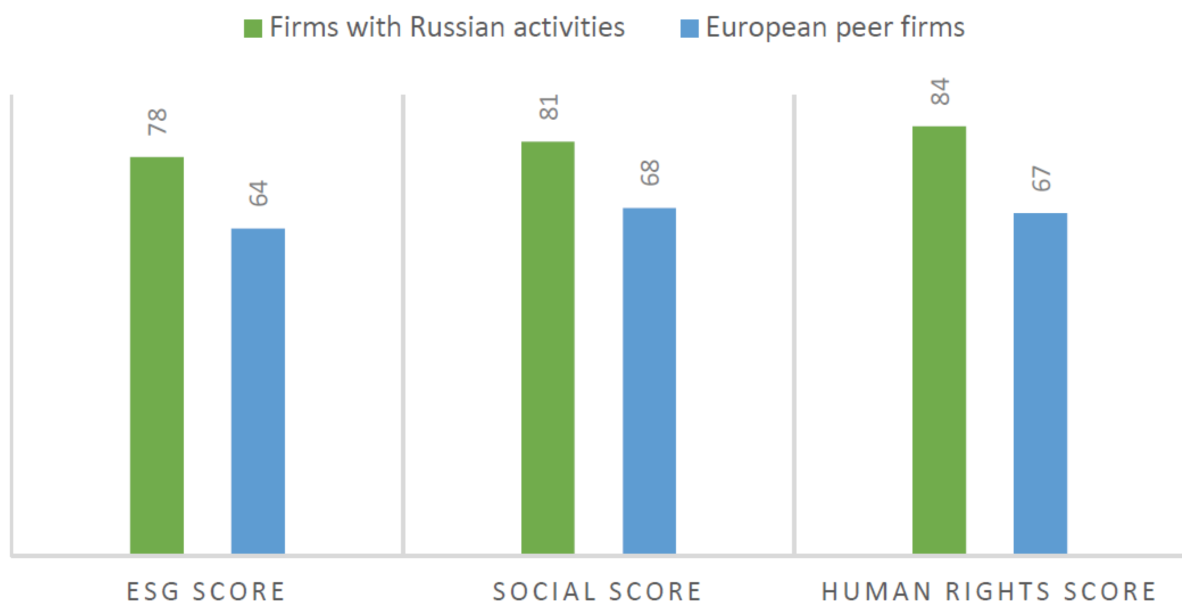
But do ESG ratings really deliver on the promise? Are highly-ranked ESG businesses really more caring of the environment, more selective of the societies in which they operate, and more focused on countries with good corporate governance? In short, is ESG really good? The answer is no.

We demonstrate this by focusing on a group of companies that are now at the center of the world's attention: businesses with substantial operations in Russia. Russia's disregard for the environment, appalling social norms and behaviors, and extremely poor corporate governance are well-known and widely-documented. So one might reasonably expect that business involvement in such a country would detract from the ESG rating of the involved company. To our great surprise, this is not the case.

We examine the ESG scores and response to the Russian invasion of Ukraine for all European firms with a substantial presence in Russia, which we define as companies with Russian subsidiaries that generate more than US$100 million in sales and that have more than US$100 million in total assets. We focus on Russian subsidiaries of large European firms because these represent significant investments of economically important firms that are unambiguously identifiable from standard sources. We search the Amadeus database of Bureau van Dijk for firms that meet these activity thresholds and intersect this with Refinitiv's EIKON database to generate a list of 75 non-financial European firms that have significant subsidiary activities in Russia with available Refinitiv ESG scores. On average these firms earned 6% of their sales in Russia.

Some startling observations emerge. First, as represented in the figure below, the average ESG scores of firms with substantial activities in Russia, a country that is well-known for its corruption and significant human rights abuses, is 78 out of 100. By comparison, the average ESG score of all other similar-sized non-financial European companies (i.e., those with sales in excess of US$2B) in the Refinitiv database is just 64. The average score of the Russia-invested group on

the "S" (i.e., social) pillar dimension is 81 versus a comparable European peer group average of just 68. In terms of their human rights performance (i.e., a subcomponent of the social pillar), the firms profiting from Russian activities earn a whopping average score of 84 versus a much more modest 67 for their European peer firms. Remember, higher ESG scores are supposed to be indicative of *more* socially responsible corporate behavior, so according to Refinitiv, European companies with substantial subsidiary operations in Russia are, on average, significantly *more "responsible,"* both overall (i.e., on the basis of ESG) and on the "social" and "human rights" sub-dimensions, than comparable European firms with zero or more limited Russian operations in the periods leading up to the recent invasion.



A full 12 days after the invasion, a surprisingly high 28% of European firms had not taken even the most modest form of public action, such as the condemnation of Russia's invasion or even the expression of a soft voice of support for the Ukrainian people. Even after intensified public pressure, as of today (March 15th) only 53% of the 75 firms have publicly announced significant action in the form of ceasing their subsidiary's operations in Russia.

High overall ESG scores combined with slow (or no) meaningful action by many firms begs the ultimate question—how useful is a firm's ESG score for predicting its response to the Russian invasion? The answer: not very.

We use duration analyses to investigate whether ESG predicts the timeliness with which companies announce their withdrawal from Russia. After simultaneously considering the firm's size, profitability, and the amount of sales being generated in Russia, our analyses yield surprising overall conclusions: there is no statistical association between companies' ESG scores and the timeliness of a meaningful response to the Russian invasion. If you're an investor who has been picking stocks based on ESG scores under the assumption that your money is likely to

be funding more socially responsible corporate behavior, particularly in periods of extreme crisis such as Russia's invasion of a sovereign country, you should be very disappointed.

Overall, our analyses reveal that the former Ukrainian finance minister, Natalie Jaresko, was fully justified in calling out so-called "virtuous" (high ESG) firms for not walking the talk of socially responsible corporate behavior. Our evidence suggests that Russian-invested European firms that have higher overall ESG scores, and even those with higher "social" and "human rights" scores, do not move more quickly to exit their Russian operations in response to Russia's invasion of Ukraine. If ESG scores are going to remain meaningful and fulfill their promise of enabling socially responsible investing, they need to do a much better job of reflecting the rated firm's activities in suspect countries that are known for widespread corruption and human rights abuses.

2022 Proxy Season Preview

Posted by Chuck Callan (Broadridge), Paul DeNicola (PwC) and Matt DiGuiseppe (PwC), on Monday, March 14, 2022

Editor's note: Chuck Callan is Senior Vice President of Regulatory Affairs at Broadridge Financial Solutions; Paul DeNicola is Principal of the Governance Insights Center, PricewaterhouseCoopers LLP; and Matt DiGuiseppe is Managing Director of the Governance Insights Center, PricewaterhouseCoopers LLP. This post is based on their Broadridge/PwC memorandum.

This post provides insights into key corporate governance and shareholder voting trends in the 2022 proxy season. We include data on the results of 4,125 public company annual meetings held between January 1 and June 30, 2021, along with five-year trends.

The 2022 proxy season is shaping up to be an especially active one, with environmental, social, and governance (ESG) matters. Given the SEC's recent revisions to guidance regarding shareholder resolutions, it's likely that many more proposals targeting climate change, diversity and inclusion, and other hot-button social issues will come to a vote. And, based on commentary from proxy advisory firms and large institutional investors, directors on boards of companies that are not taking proactive steps in these areas may face increased opposition.

From climate change to racial injustice, expectations that companies will take these matters seriously have never been higher. The 2022 proxy season will show just how focused investors are on making sure the companies they invest in are addressing them.

Against that backdrop, the key issues we're watching include:

- A "race to the top" on climate change
- Evolving expectations around human capital
- The shifting landscape of shareholder activism
- Trends in retail and institutional shareholder voting

Looking Back on the 2021 Proxy Season

Support for shareholder proposals grew steadily over the past five years. In the 2021 proxy season, support overall rose to 40%, on average, up from 37% in 2020. There is significant divergence in the voting support by retail and institutional investors. As a group, retail shareholders were half as likely to favor shareholder proposals as were institutional investors. This is true not only for all 404 shareholder proposals that Broadridge tracked for the 2021 season but also for proposals on climate and corporate political spending. See the Appendix below for additional trends and insights.

What to Expect in the 2022 Proxy Season

Climate Change

Climate change is the top issue to watch in the 2022 proxy season. Many investors are no longer satisfied simply with greater disclosure of companies' climate impacts and risks. They're looking for concrete emissions targets. They want to see robust board oversight of climate risks. As a case in point, State Street Global Advisors said it will start voting against directors at some companies that don't disclose (1) emission reduction targets or (2) how their boards are overseeing climate change-related risks, as required under the Task Force on Climate-related Financial Disclosures (TCFD) framework.[1]

Additionally, proxy advisory firms have toughened their policies on climate change. Institutional Shareholder Services (ISS) will recommend a vote against incumbent directors at the companies it finds to have inadequate climate change disclosures or that lack emissions reduction targets.[2]

New rules being developed by the SEC could radically change the future landscape for public companies when it comes to climate change-related disclosures.[3] Many shareholders are watching intently to see whether the companies they invest in are ready for a shift away from voluntary disclosures to mandatory ones. That will keep questions about climate risk oversight top of mind for many investors as they vote their proxies, even though any changes that could be coming from the SEC would not be expected to go into effect until a future season.

Investors are engaged in a "race to the top" to see who can hold their portfolio companies to the highest standards

Last proxy season, the largest institutional investors opposed more directors because of inadequate climate risk oversight and they supported more shareholder proposals seeking to strengthen climate disclosures and policies. It's likely that this trend will continue in 2022 as investors engage in a "race to the top" to see who can hold their portfolio companies to the highest standards.

Proponents of shareholder proposals may seek to take advantage of this trend. Last year, shareholders submitted 85 climate change-related proposals, up more than 40% from 2020. Support for the 24 climate proposals rose to 49% on average, versus about 41% a year earlier, and 11 of these proposals passed—a nearly threefold increase over 2020.[4] It's likely that shareholder support will rise even further in 2022. What's more, this proxy season's climate proposals will better target companies' climate risk oversight weaknesses based on institutional investors' voting policies. With large institutional investors providing greater visibility into the

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[1] State Street Global Advisors, "CEO's Letter on Our 2022 Proxy Voting Agenda," January 12, 2022.

[2] Fenwick & West LLP, "Proxy Advisors Update Voting Guidelines for 2022 Focusing on Board Diversity, Climate and ESG Oversight," December 9, 2021..

[3] Reuters, "U.S. SEC chair Gensler says new climate risk rules will require companies to detail, measure commitments to mitigating climate change," December 7, 2021..

[4] Skadden, Arps, Slate, Meagher & Flom LLP and Affiliates, Matters To Consider for the 2022 Annual Meeting and Reporting Season, December 2021.

rationale behind their proxy voting policies, proponents have a valuable playbook on how to win support for their causes.

With institutional investors holding about 70% of the shares, climate change will certainly be one of the key issues to monitor this year.[5]

Human Capital

The COVID-19 pandemic has put workforce issues front and center for many investors. They want a better understanding of how companies are handling worker safety, return to office and other workplace policies, and hiring to fill deep workforce shortages. Many investors also expect companies to support racial justice by disclosing workforce diversity data and making their boards more diverse.
Human capital encompasses all of these matters and more, and it's poised to be one of the most important topics to monitor for the upcoming proxy season.

For now, investors are largely focused on disclosure. Through engagement with company management teams, institutional investors such as New York City's public sector pension funds have been able to significantly increase the number of firms disclosing their EEO-1 forms, the report of workforce diversity data provided to the US Equal Employment Opportunity Commission.

As a result, a majority of S&P 100 companies now share this information.[6] With State Street Global Advisors pledging to vote against compensation committee chairs at companies that do not disclose these forms, it's likely more companies will decide to do so. That may keep the number of related shareholder proposals coming to a vote relatively low.

The SEC is considering whether to require public companies to increase their reporting on human capital issues. SEC Chair Gary Gensler has said the new disclosures could include metrics on turnover, training, compensation and benefits, and diversity, among others.[7]

And, just as investors' approach to climate change has evolved from a focus on disclosure to a broader push for stronger governance and oversight, it's likely that human capital management will follow a similar path. We expect demand for concrete plans and commitments to happen even faster than it did with climate change.

Harvard Law School Forum on Corporate Governance

Investors Press for Progress on ESG Matters

Posted by Marc S. Gerber and Raquel Fox, Skadden, Arps, Slate, Meagher & Flom LLP, on Wednesday, February 9, 2022

Editor's note: Marc S. Gerber and Raquel Fox are partners at Skadden, Arps, Slate, Meagher & Flom LLP. This post is based on their Skadden memorandum. Related research from the Program on Corporate Governance includes The Illusory Promise of Stakeholder Governance by Lucian A. Bebchuk and Roberto Tallarita (discussed on the Forum here); Companies Should Maximize Shareholder Welfare Not Market Value by Oliver Hart and Luigi Zingales (discussed on the Forum here); and Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee by Max M. Schanzenbach and Robert H. Sitkoff (discussed on the Forum here).

Takeaways

- The SEC plans to propose an array of new disclosure requirements relating to ESG matters.
- A record number of shareholder proposals involving environmental and social issues won majority support in 2021.
- Institutional investors will vote against directors where companies have not met certain minimum director diversity goals or made certain ESG disclosures.
- Investors are demanding that boards actively oversee climate risk mitigation efforts.

The second year of the Biden administration is likely to see significant and wide-ranging Securities and Exchange Commission (SEC) rulemaking covering various environmental, social and governance (ESG) topics, a process that is likely to be contentious and politicized. Meanwhile, investors are not waiting for SEC action. They continue taking matters into their own hands, demanding improved disclosure, greater management attention to these issues and increased board oversight, and they are voting against directors and management when they are unsatisfied. Boards of directors need to remain diligent in understanding this constantly evolving landscape, determining which ESG topics have the greatest relevance for their companies and engaging with shareholders and other stakeholders to assess their perspectives and convey the board's robust oversight of relevant matters.

SEC ESG Agenda

ESG disclosures were a recurring topic in speeches in 2021 by the SEC's chair and commissioners, the focus of a new SEC enforcement task force and the subject of comment letters. ESG disclosures also featured prominently in the agency's semiannual regulatory agendas published in June and December 2021. Although these regulatory agendas can be viewed as aspirational, the range of ESG matters included makes clear the emphasis this area will receive. Topics include:

- **Board diversity.** Proposed rules could require companies to provide enhanced disclosures about the diversity of board members and nominees;
- **Climate change.** New rules may seek disclosures on governance, strategy and risk management related to climate matters, as well as specific metrics for items such as greenhouse gas emissions;
- **Human capital management.** New mandates may require disclosure of metrics such as workforce turnover, skills and development training, compensation, benefits, demographics (including diversity) and health and safety; and
- **Cybersecurity governance.** Proposed rules could require disclosures about cybersecurity risk management and governance.

A Record Number of E&S Shareholder Proposals Won Majority Support

Most shareholder proposals are nonbinding requests that a company or its board of directors take some kind of action. Failure to act on a proposal that was supported by a majority of votes cast at a shareholder meeting can result in a board being labeled as "unresponsive," and, in turn, directors receiving significant negative votes in the next election.

Proposals on traditional governance matters—from board declassification to proxy access to eliminating supermajority voting—have a long track record of drawing majority support. On the other hand, historically, very few shareholder proposals relating to environmental and social (E&S) topics won that level of backing.

That is no longer the case. In 2021, a record 39 E&S shareholder proposals received majority support, almost double the record of 21 set in 2020 and more than triple the 12 in 2019. Topics achieving majority support included:

- Environmental and climate change matters, including setting reduction targets for greenhouse gas emissions and reporting on the alignment of companies' lobbying efforts with the 2-degree Celsius goals (15 proposals);
- Board diversity, workforce diversity and other human capital-related matters (13 proposals); and
- Political contributions and lobbying expenditures reporting, a topic of increased investor focus in the wake of the January 6, 2021, U.S. Capitol riot (10 proposals). (See "Companies Face New Pressure From Shareholders and Regulators To Disclose Political Policies and Contributions.")

As the 2022 annual meeting season approaches, these results may motivate companies to negotiate with proponents to withdraw proposals rather than have them go to a vote.

Board, Management and Workforce Diversity

Investors have put increasing emphasis on issues of systemic racism and boardroom, C-suite and workforce diversity since the murder of George Floyd in 2020 and the protests that ensued. That has had an impact in boardrooms. According to the 2021 U.S. Spencer Stuart Board Index, at S&P 500 companies last year, 47% of new directors were racially or ethnically diverse and 30% of all S&P 500 directors were women.

Investors and other stakeholders remain keenly interested in building on this progress. Moreover, as reflected in the voting policies of proxy advisory firms and investors, many believe that diversity matters are relevant for all companies, regardless of industry, although many provide some latitude based on company size:

- **Institutional Shareholder Services (ISS).** For companies in the Russell 3000 or S&P 1500, ISS will generally recommend against nominating committee chairs where the board has no apparent racially or ethnically diverse members or women. Starting in 2023, ISS' policy regarding companies with all-male boards will extend beyond those included in the two indices.
- **Glass Lewis.** The firm will generally recommend against Russell 3000 nominating committee chairs where the board has fewer than two women directors. Beginning in 2023, it will generally recommend against nominating committee chairs at Russell 3000 companies whose directors are not at least 30% gender diverse. Glass Lewis may recommend against nominating committee chairs at S&P 500 companies with "particularly poor" disclosure about director diversity and, in 2023, it will recommend against the nominating committee chair at S&P 500 companies lacking any individual or aggregated director diversity disclosure.
- **State Street Global Advisors.** In 2021, the firm started voting against nominating committee chairs at S&P 500 companies that did not provide board racial/ethnic diversity information. In 2022, it will vote against nominating committee chairs at S&P 500 companies that do not have at least one director from an underrepresented community.
- **BlackRock.** The firm states that boards should aspire to 30% diversity and have at least two directors who identify as women and at least one who identifies as a member of an underrepresented group. It reports that a lack of board diversity was the top reason for its votes against directors in the Americas region in its 2020-21 proxy voting year.

Regarding workforce diversity, in 2021 shareholder proposals calling for disclosure of a company's workforce diversity statistics or reporting on the company's diversity and inclusion efforts routinely were withdrawn following company agreements to make those disclosures. The proposals that proceeded to a vote largely achieved majority support. In addition, starting in 2022, State Street will vote against compensation committee chairs at S&P 500 companies not disclosing their federally mandated EEO-1 report data on workforce diversity, likely resulting in disclosure of that data becoming the norm for large cap companies in 2022.

Board Oversight of Climate Change Strategies and Risks

Investors and other stakeholders remain sharply focused on the risks and opportunities presented by climate change. In addition to being the topic of shareholder proposals, climate risk is more frequently a topic raised by shareholders when engaging with companies, factored into voting decisions and used by activist investors.

As a starting point, investors want assurance that there is board oversight of these matters. For example, Glass Lewis will generally recommend voting against the governance committee chair where a company fails to disclose the board's oversight role of environmental and social issues (although it is agnostic as to whether this oversight is done by the full board, a separate committee, an existing committee or individual directors).

In the case of carbon-intensive industries, investors and others are looking not just at board oversight but at the steps the company is taking to address climate risk. Investors view this issue as impacting the economics of their investment. For example, BlackRock states that companies that address these risks early "will also be best positioned to capture associated growth opportunities at a time of significant industry transition." BlackRock focuses on over 1,000 carbon-intensive public companies and reported that in the 2020-21 proxy year, it voted against 255 directors based on climate-related concerns it believed could affect long-term shareholder value.

Similarly, for 2022, ISS has adopted a new voting policy relating to the 167 companies currently identified as the Climate Action 100+ Focus Group. ISS will recommend against the incumbent chair of the responsible board committee if it determines the company is not taking the "minimum steps" needed to understand, assess and mitigate climate risks, both for the company and larger economy. Noting that "minimum steps" may increase over time, for 2022, the firm is looking for detailed disclosure about climate risks, including board governance, corporate strategy, risk management analyses and metrics/targets, and reduction targets for greenhouse gas emissions that cover at least a significant portion of the company's direct emissions.

Advice for Boards Going Forward

The key takeaway for boards of directors is this: Investors and other stakeholders expect them to fully understand and be engaged in overseeing their company's approach to relevant ESG matters, including the risks and opportunities, impact on strategy and investment decisions, and disclosure and reporting. They also expect boards to have the necessary competence or expertise to ask the right questions about these matters and to be able to articulate the company's approach when engaging with shareholders.

Finally, it is worth stressing that many of these items are not "one and done." This is a dynamic landscape in a world challenged by, among other things, new phases of a global pandemic, supply chain issues and extreme weather events. The relevance of various ESG topics may evolve with changes in a company's business and strategy, and oversight mechanisms that were appropriate at one point in time may not work at another.

Looking to 2022, ESG matters likely will demand increasing attention from management and boards of directors and will continue to grow as a measure by which investors assess their performance. Boards that fail to regularly refresh their understanding of ESG matters in light of their particular company's circumstances risk losing the confidence and support of investors.

Boards Face Backlash as ESG Tips the Scales During 2021 Proxy Season

Posted by Rodolfo Araujo and Garrett Muzikowski, FTI Consulting, Inc., on Friday, December 17, 2021

Editor's note: Rodolfo Araujo is a Senior Managing Director and Garrett Muzikowski is a Director in the Strategic Communications segment at FTI Consulting, Inc. This post is based on their FTI Consulting memorandum. Related research from the Program on Corporate Governance includes The Illusory Promise of Stakeholder Governance by Lucian A. Bebchuk and Roberto Tallarita (discussed on the Forum here); Companies Should Maximize Shareholder Welfare Not Market Value by Oliver Hart and Luigi Zingales (discussed on the Forum here); and Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee by Max M. Schanzenbach and Robert H. Sitkoff (discussed on the Forum here).

Against a backdrop of pandemic- and climate-related concerns, ESG emerged as a top concern for today's investors—and boards are being held accountable.

A tectonic shift in the focus toward environmental and social topics occurred during the 2021 proxy season, reflecting the importance for organizations to successfully manage environmental, social and governance (ESG) risks and opportunities. Large institutional investors not only backed environmental and social shareholder proposals like never before, but they also voted against the reelection of directors at portfolio companies where ESG management was perceived as ineffective. As a result, companies are beginning to feel a sense of urgency in developing sound ESG programs that meet shareholders' evolving expectations.

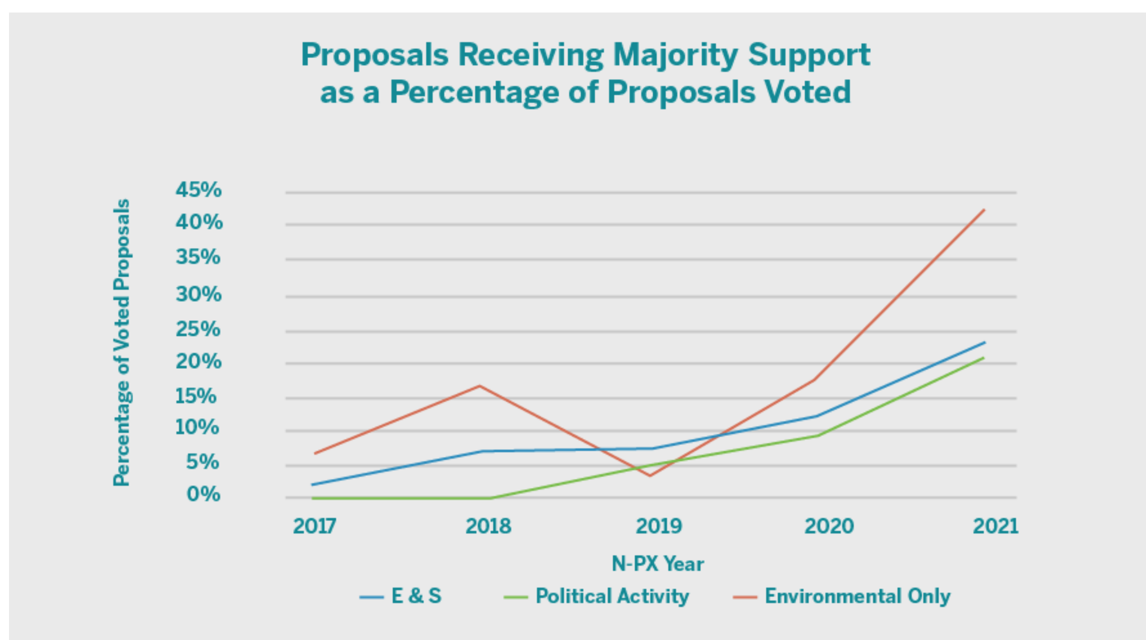
Investors Leading the Charge

ESG's prominence among stakeholders is nothing new. Companies and their investors, employees, suppliers, customers, communities—along with nongovernmental organizations (NGOs) and regulators—have been analyzing ESG topics in some capacity for years. However, for many stakeholders, the past year served as a catalyst to hyper-focus on ESG-related topics. Organizations navigated a lot of uncharted territory since the onset of COVID-19: pandemic-related health concerns, civil unrest from social injustice, economic inequalities and climate change all amplified the importance of a well-run ESG program.

Out of all stakeholder groups, investors were arguably the ones to shift their attention most drastically toward ESG—applying significantly more pressure for change at their portfolio companies than in years past. This change is noticeable when looking at trends of environmental and social (E&S) shareholder proposals and the largest asset managers' voting behavior. For example, 29 E&S shareholder proposals received majority support in this year's proxy season, up nearly double from the 16 that received majority support the year prior. The 2021 proxy season

saw nine political activity proposals pass; an additional five proposals related to climate lobbying passed. In 2020 only five political activity proposals passed, and a mere one related to climate lobbying.[1]

The increase in number of passed proposals was not the result of a sheer increase in proposals. In fact, there was a general decrease in the number of E&S proposals voted on over the past few years. More so, this is reflective of a change in investor behavior, especially when analyzing environmental issues. The graph below outlines the number of proposals that passed as a percentage of proposals that went to a vote:[2]



A factor contributing to the decrease in number of proposals voted on and increase in pass rates is the greater frequency with which filed shareholder proposals are being withdrawn from the ballot. Companies are increasingly engaging with shareholder proponents to reach a compromise of some form on the proponent's request in exchange for withdrawing the proposal.

As You Sow's Resolutions Tracker serves as a strong example of this. Excluding blocked proposals by the company at the SEC and proposals at AGMs yet to take place, As You Sow has filed 71 shareholder proposals in 2021—but only 22 have made it to vote. As You Sow has withdrawn 49 proposals in 2021 and indicated that an agreement was reached on 42 of these proposals, compared to 13 in 2018. This represents reaching an agreement on 59 percent of proposals that were not blocked in 2021, compared to 37 percent in 2018.

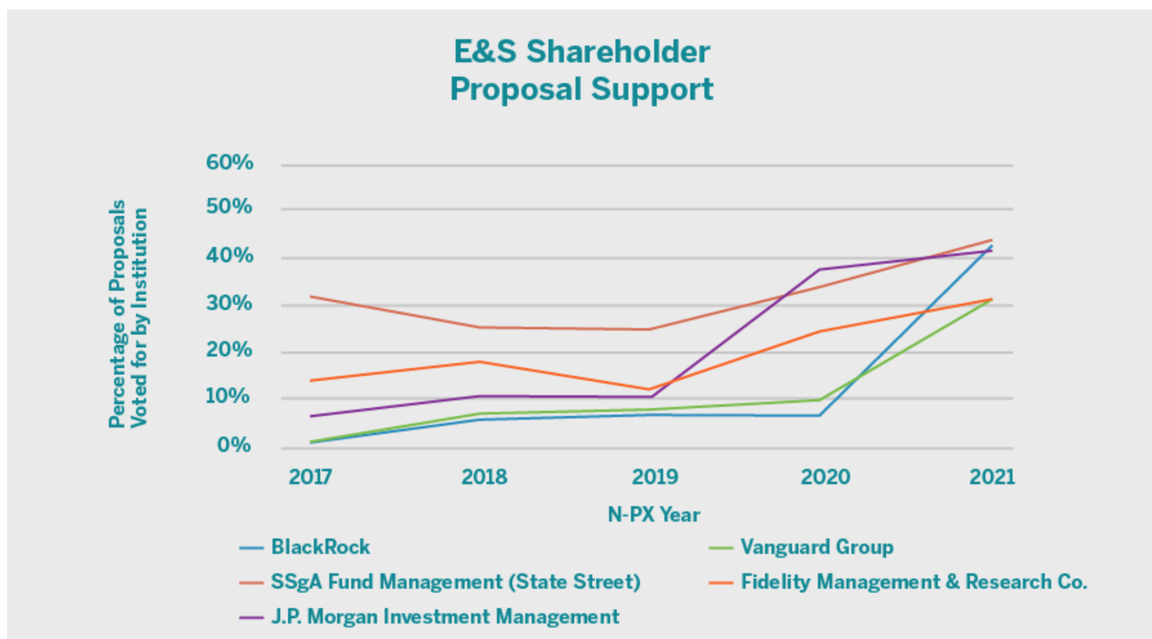
[1] Data available from Proxy Insights, 2021

[2] Data collected from Proxy Insight reports by FTI Consulting was used to produce the information contained in the three graphs in this article.

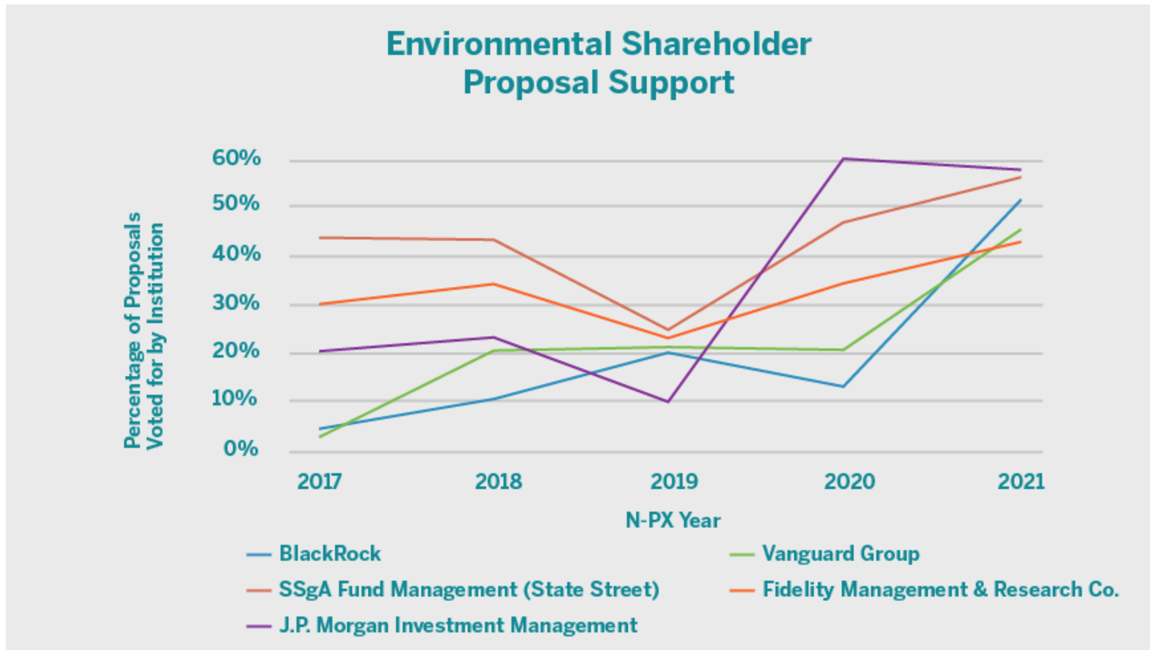
Most Influential Asset Managers Behind This Trend

Investors, especially large passive investors with long-term investment horizons, have recognized the importance of successful ESG management at their portfolio companies. Their stewardship teams' external communications and evolving engagement priorities have reflected such focus. Still, some of the world's largest asset managers have faced criticism for not consistently supporting E&S shareholder proposals or managing climate change–related risks.

This past proxy season served as a tipping point for investors when looking at newly available 2021 proxy season[3] voting behavior at the largest asset managers. Whether caused by the aforementioned global events, pressure from critics or other factors, large asset managers significantly increased their support levels for E&S shareholder proposals this past proxy season, which in turn increased the average support level of these proposals:



[3] Proxy season recognized here as the N-XP year which in 2021 accounts for the votes cast between July 1st 2020 and June 30th 2021.



Board Accountability on ESG Issues Is Here to Stay

Beyond specifically voting on shareholder proposals, investors are beginning to vote against directors for poor ESG oversight. For example, during the 2021 proxy season, BlackRock voted against 255 directors for climate-related concerns, according to their Voting Spotlight. Other investors also took this approach, in addition to voting against directors for issues at the board level, like voting against directors for a lack of racial/ethnic or gender diversity.

BlackRock's approach to board accountability in the 2021 proxy season was not an anomaly, but rather evidence of a tipping point in how asset managers are evolving their approach to board accountability on E&S topics. Further, a stronger stance on ESG issues has provided a competitive edge to asset managers. Investors are increasingly looking for asset managers whose investment and stewardship strategies align with their personal interests, beliefs and work to address broader societal challenges. The money invested in ESG funds more than doubled in 2020 and is expected to reach $1 trillion by 2030.

Asset managers who have led the push for portfolio companies to successfully manage E&S topics are now able to market themselves as aligned with shifting investor interests and responsible stewards of capital. *Given this scenario, competition for funds and the fear of being an outlier among peers will likely continue to drive investors to support stronger ESG management at their portfolio companies.*

Don't Forget About Activists

For activist investors, including ESG demands can increase the likelihood of a successful campaign through multiple channels. Large asset managers made the importance of ESG clear, so any well-structured activist campaign that highlights ESG failures as part of the rationale for board refreshment will immediately resonate with large investors to some degree.

Beyond this, society's focus on environmental and social topics is another medium for an activist's campaign to gain momentum. For example, this year's Engine No. 1 campaign against ExxonMobil was widely covered in the media, oftentimes with little effort by the activist fund itself. Political organizations, NGOs and other investors that agreed with Engine No. 1's views on climate change were often discussing the campaign, which put added pressure on investors to vote on the dissident slate.

Activists' inclusion of ESG into campaigns is likely to become more frequent—and why wouldn't it? At its worst, an activist is simply throwing one more argument for board refreshment against a target company and hoping it sticks. At its best, incorporating ESG into activist campaigns can provide free advertising and win over large, long-term-focused investors who are needed to successfully win a proxy contest.

Stay Ahead of the Curve

The 2021 proxy season was a tipping point for ESG, and asset managers' message was loud and clear: Any company that is not staying ahead of the ESG curve will face additional shareholder scrutiny. Further, shareholders consider poor ESG programs reflective of poor oversight at the board level and poor risk management techniques.