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# Board Oversight of ESG: Beyond Disclosure

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While pressure from institutional investors, such as BlackRock, Vanguard, and State Street, has contributed to increased focus and urgency on environmental, social, and governance (ESG) matters, so has pressure from environmental groups, employees, customers, and other corporate "stakeholders." State Street has announced that it will start voting against the boards of companies that underperform their peers when it comes to ESG standards. *See,* CEO's Letter on Our 2021 Proxy Voting Agenda (January 11, 2021).

Simultaneously, as we highlight below, the Securities and Exchange Commission (SEC) announced, in the first quarter of 2021, multiple efforts to highlight climate change in corporate disclosures and to increase scrutiny and, potentially, enforcement focus on company disclosure efforts on climate and other environmental, social and governance matters.

While the topic of ESG disclosures is not new, the increased attention to the topic, and climate change in particular, is noteworthy and expected to remain an area of focus of regulators under the Biden Administration. On April 22, 2021, the White House published the U.S. International Climate Finance Plan, as called for in President Biden's January 2021 "Tackling the Climate Crisis at Home and Abroad" Executive Order. The Plan is intended to present the United States' strategic approach to international climate finance over the next four years by outlining steps that the United States will take to mobilize climate finance.

As noted above, large institutional investors and asset managers have identified ESG and sustainability initiatives as a significant engagement priority making it critical for companies not just to disclose but to address active board-level oversight of ESG issues in 2021.

## SEC Announcements Evidence SEC's Intent to Increase Role in ESG Topics

On February 24, SEC Acting Chair Lee issued a statement directing the Division of Corporation Finance "to enhance its focus on climate-related disclosure in public company filings." In that Statement, the Acting Chair called for SEC staff to study existing disclosures on the topics addressed in the 2010 Guidance. This study, Lee suggested, could feed into updates to the Guidance to meet the needs of the current market and environment.

On March 4, the SEC announced the formation of a Task Force in the Division of Enforcement focused on climate and other ESG issues. – Acting SEC Chair, Lee, made a March 15th speech at the Center for American Progress, entitled "A Climate for Change: Meeting Investor Demand for Climate and ESG Information at the SEC" where she was more explicit about the direction the SEC wants to take. [See the text of the speech.]

The SEC's April 9 Risk Alert details its observations of deficiencies and internal control weaknesses from examinations of investment advisers and funds regarding investing that incorporates environmental, social, and governance factors. The Risk Alert gives examples of what it considers to be deficient ESG-related compliance programs and disclosures by advisors and funds. It also provides examples of what it considers to be effective ESG compliance and disclosure practices.

The SEC also introduced a page on its website dedicated to ESG matters.

## Commodity Futures Trading Commission (CFTC) Establishes Climate Risk Unit

On March 17, 2021, the CFTC's Acting Chairman Rostin Behnam announced the establishment of the Climate Risk Unit (CRU) to support the agency's mission by focusing on the role of derivatives in understanding, pricing, and addressing climate-related risk and transitioning to a low-carbon economy.

The CFTC's CRU represents the agency's next step in response to what has become a global call to action on tackling climate change. The CRU is intended to accelerate early CFTC engagement in support of industry-led and market-driven processes in the climate—and the larger ESG—space critical to ensuring that new products and markets fairly facilitate hedging, price discovery, market transparency, and capital allocation.

## Guidance for Corporate Boards

As institutional shareholders invest record amounts in ESG-conscious funds and companies, boards of directors are looking for ways their companies can design and implement a business strategy that produces a sustainable future and remain relevant in a world where climate change, social injustice, pandemics, disease prevention and wellness are the new normal. (See ISS Corporate Solutions; Glass Lewis ESG Initiatives 2021)

On January 26, 2021, 61 top business leaders across different industries announced their support for stakeholder ESG metrics and disclosures released by the World Economic Forum and its International Business Council. Understanding whether and how corporate boards are prepared to address ESG goals is critical for companies to fulfill this commitment.

While the last 12 months have seen individuals and corporations grapple with one crisis after another, corporate boards of directors should remain vigilant in their oversight of the ever-developing ESG risks.

## Where Should Boards Start?

While most directors recognize the need to clearly define what a company stands for beyond maximizing shareholder value, identifying tangible steps toward their ESG goals are critical.

**Posting Policies and Reports.** Directors should emphasize that a well-articulated organizational purpose has the power to rally employees, and a company's social and environmental contributions can help create a compelling employee value proposition. Consumers' buying patterns are also shifting toward brands and companies that address important societal issues.

- Responsible Board Committees (Compensation Committee for Human Capital Management (HCM) or the Nominating and Governance Committee for ESG/Sustainability) should make sure

their company has adopted and posted on their website all appropriate reports, e.g. human rights, corporate social responsibility (CSR) or sustainability, environmental, supplier code of conduct, diversity and inclusion, etc. In the 10-K, include an HCM report and make sure it is accurate and comprehensive. Some companies have gone further and formed new standing ESG committees.

- The idea here is that an “ESG purpose” differentiates a corporation from its competitors and can confer competitive advantage, which in turn helps create tangible value.

**Assigning Responsibility.** Consider assigning responsibility for your ESG program to one person: general counsel, head of investor relations, CFO or Chief ESG Officer.

**Relevant Charters.** If necessary, amend or create board or committee charters to provide for this responsibility and appoint appropriate members to such committees.

**ESG Rankings.** Boards should know their ISS and other ESG rankings (e.g. State Street’s R-Factor or Blackrock) to determine if improvement is necessary and what remedial actions need to be taken. This effort might include, among other things, adding or supplementing training and safety programs, benefits and wellness programs, diversity hiring and promotion programs, community outreach, evaluate energy efficiency, water usage, waste minimization, greenhouse gas emissions and climate risk and impact on natural resources.

**Stronger commitment to diversity, equity and inclusion (DEI)**

With the spotlight on representation and equality, many directors expect their companies to strengthen their commitment to building a diverse and inclusive workforce.

- Boards should start by understanding that diversity is a business imperative.  They might create programs to ensure that you have a workforce that is representative, at every level, of the diversity of customers, investors, communities and partners.
- Consider adding new diverse board members to fill vacancies or where expertise is needed or desired. In turn, directors should anticipate becoming more involved in overseeing these efforts.
- Overall, directors believe that an organization’s CEO must set and sponsor DEI strategy. The Chief Human Resources Officer is a key stakeholder who provides input to the strategy and is primarily responsible for its implementation while the Board plays a critical oversight role, which may involve requiring management not only to explain which initiatives are in place but also to provide evidence of progress.

**Directors should evaluate success of these ESG activities across all business units and measure results.**

## Supporting long-term value creation

While Directors recognize that companies must be profitable to survive, they also understand that generating sustainable long-term value requires carefully balancing the interests of shareholders and other stakeholders. Achieving this balance will help companies meet evolving ESG priorities while maximizing their value.

- Companies with better ESG profiles stand to benefit from preferential and lower cost of debt

offered by financial services firms, as well as from an influx of capital in sustainable investing, which may result in valuation premiums.

- Boards are increasingly aware of the direct and indirect financial linkages of sustainable ESG practices and long-term value creation for all stakeholders.
- Good governance practices, including ESG, may make a company's stock eligible for inclusion in certain indices or investment portfolios.

## Conclusion

Boards should be prepared to engage on their ESG oversight role as priorities such as sustainability, climate change and social responsibility themes continue to gain momentum. In particular, investors want public companies to provide more meaningful and easily comparable ESG reporting metrics, especially on climate-change.

Listen to our recent Kelley Drye *Legal Download* podcast "Top Environmental Social & Governance Concerns for Corporate Boards."

For further guidance on how your board can comply with ESG standards, email me at ckleshinksi@kelleydrye.com