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Governance Challenges 2017

Board Oversight of ESG

A Publication of the
National Association of Corporate Directors
and Its Strategic Content Partners

Heidrick & Struggles

KPMG Board Leadership Center

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Letter From the CEO

Dear Reader,

It is my pleasure to introduce the National Association of Corporate Directors' (NACD's) sixth edition of *Governance Challenges*.

Each year, NACD collaborates with our five strategic content partners—Heidrick & Struggles, the KPMG Board Leadership Center, Marsh & McLennan Companies, Pearl Meyer, and Sidley Austin LLP—to provide guidance for boards of directors on a hot-button governance issue for the coming year.

This year we have chosen to dive into the topic of corporate sustainability. Shareholders and stakeholders alike have heightened expectations for the role corporations play in today's society: a company's long-term strategy should create financial value in a socially and environmentally responsible way.

Studies have shown a link between the incorporation of environmental, social, and governance (ESG) concerns into strategy and improved long-term corporate performance.[1] Environmental risks such as climate change are not only affected by current company operations but also are poised to have a profound effect on future operations, making it all the more important for corporations to take the time now to make sustainable choices for the long term.

Directors are bound by fiduciary duties that now extend to considering ESG factors when providing oversight for strategy and risk, and this publication will assist directors as they attempt to meet these increased responsibilities.

Peter Gleason
President and CEO

March 2017

1 As an example, see *ESG & Corporate Financial Performance: Mapping the global landscape*, Deutsche Asset & Wealth Management, December 2015. https://institutional.deutscheam.com/content/_media/K15090_Academic_Insights_UK_EMEA_RZ_Online_151201_Final_(2).pdf

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Three Ways to Improve Oversight of ESG

Heidrick & Struggles

As global warming turns up the heat on the planet, investors are turning up the heat on boards. And investors are not only concerned about climate but also about other environmental, social, and governance (ESG) concerns: sustainability, diversity and inclusion, human rights, labor practices, executive compensation, employee relations, and board independence. No longer a question of corporate citizenship, these issues have become a matter of the board's fiduciary responsibility.

That's a far cry from the go-go, *laissez-faire* days of the 1970s and 1980s when responding to such concerns was seen as unprofitable—or even from the transitional period that followed, when responding was viewed as the right thing to do even if it wasn't great for business. What changed? Beginning in the early part of this century and continuing down to today, a mounting body of research has shown that investment strategies which consider ESG factors lead to better performance over the long-term.[1] And investors are putting their money—and their mouths—behind that proposition.

In early 2016, for example, Larry Fink, chairman of BlackRock, which currently manages more than $200 billion across sustainable investment strategies, wrote to CEOs of companies in which his firm invests on behalf of its clients. He asked each of them to lay out for shareholders a strategic framework for long-term value creation—"one that provides a perspective on the future, articulates the impact of the ecosystem on their strategy, explains how changes in that ecosystem might force the company to change course, and identifies metrics that support a framework for long-term sustainability."[2] And he asked them to affirm that such a framework for long-term value creation had been reviewed by their boards.

Large pension funds are also applying pressure by increasingly incorporating ESG analysis into their investment decisions. They see ESG lapses as red flags signaling trouble ahead—trouble that undermines the long-term value creation the funds seek in order to secure the retirement plans of their members. Some $8.1 trillion in assets are now managed using ESG factors, a threefold increase since 2010. In the past five years, TIAA-CREF Social Choice Equity Fund has doubled in size to a current $2.3 billion; a $2.4 billion Vanguard social index fund has quadrupled in size since 2011; and ESG index and research providers FTSE Russell, S&P Dow Jones Indices, and Sustainalytics have multiplied.[3] This is to say nothing of the trillions of dollars in funds that aren't held in specifically social funds but whose managers include ESG factors in their investment decisions.

For directors, issues other than ESG may have loomed larger in recent years—how to deal with activists, staying ahead of technology both commercially and as a matter of risk, and the continuing churn of M&A, spin-offs, and spinouts. Nevertheless, the risk of inaction on ESG is rising. And so are the opportunities for companies to set themselves apart from the pack through reduced operational risk, lower cost of capital, reduced operating costs through improved natural-resource management, increased market appeal to consumers and customers, and the ability to attract and retain top talent. Says Paul Polman, whose eight-year tenure as CEO of Unilever has been marked by an unwavering commitment to sustainability: "We are showing increasingly that . . . other stakeholders and shareholders benefit over the long term, with for example the market cap having more than doubled over this period. We also see brands with a strong purpose and social mission now growing twice as fast

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1 See, for example, *ESG & Corporate Financial Performance: Mapping the global landscape*, Deutsche Asset & Wealth Management, December 2015. https://institutional.deutscheam.com/content/_media/K15090_Academic_Insights_UK_EMEA_RZ_Online_151201_Final_(2).pdf

2 Chairman's Letter, April 10, 2016. https://www.blackrock.com/corporate/en-gb/investor-relations/larry-fink-chairmans-letter

3 Randall Smith, "Investors Sharpen Focus on Social and Environmental Risks to Stocks," *New York Times*, December 14, 2016. https://www.nytimes.com/2016/12/14/business/dealbook/investors-social-environmental-corporate-governance.html?_r=0

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as our other brands, and more profitably. Increasingly we are showing that a more purpose-driven model makes a lot of business sense."[4]

Faced with these pressures, risks, and opportunities, many boards increasingly review sustainability strategy, operational and reputational risk, regulatory compliance, and the like. And many continue to adopt best practices in corporate governance, even as the bar gets higher from year to year. But they may overlook or undervalue one of the most critical factors in ESG performance: the leadership and talent factor. Specifically, there are three leadership and talent levers a board can pull to help ensure that the company it oversees is best equipped to address ESG factors: create an ESG early-warning system on the board, gauge the readiness of the top team to manage ESG issues across disciplines, and assess the ability of the organization to accelerate ESG performance.

Establish an ESG early-warning system. A study of 1,200 leaders conducted by Wharton Executive Education found that 60 percent of senior executives admitted that their organizations had been blindsided by three or more high-impact events within a five-year period. Of those executives, 97 percent said that their organizations lacked an adequate early-warning system, leading to unforeseen impacts on the core business or product lines.[5] Unexpected, high-impact events that are ESG-related can be particularly damaging—ranging from a company-caused environmental disaster to dangerous product failures to corporate malfeasance and many more. Less spectacularly, insufficient attention to ESG can mean missed market opportunities, sluggish operations, diminished profits, loss of investor confidence, and a depressed stock price.

Boards should of course make sure that management is systematically tracking ESG performance, looking for ways to turn ESG into a competitive advantage, and regularly reporting to the board on the state of ESG in the company. But they can also consider the composition of the board and its ability to foresee threats and opportunities. If the board's capability is weak, then they might want to consider ESG expertise as one of the attributes required of new appointees. If the need for such expertise is particularly pressing, they can also temporarily expand the board to meet the need for someone who can fully appreciate the material implications of ESG issues.

A number of high-profile boards have in recent years appointed directors who fill that bill. In January of this year Exxon Mobil elected climate scientist Susan Avery to its board. A physicist and former president and director of the Woods Hole Oceanographic Institution in Massachusetts, she has authored or co-authored more than 80 peer-reviewed articles on atmospheric dynamics and variability. In 2012 ConocoPhillips named Jody Freeman to its board. She is the Archibald Cox Professor of Law at Harvard Law School and founding director of the Harvard Law School Environmental Law and Policy Program. She formerly served as counselor for Energy and Climate Change in the White House from 2009 to 2010 and as an independent consultant to the National Commission on the Deepwater Horizon Oil Spill and Offshore Drilling in 2010. The board of General Motors, in 2014, elected John J. Ashton, who served for four years as a vice president of the International Union, United Automobile, Aerospace and Agricultural Workers of America (UAW). In January of this year, Jørgen Vig Knudstorp, executive chairman of the LEGO Brand Group, was nominated by Starbucks to stand for election to the company's board at the annual stockholders meeting in March. Though he was recruited for, among many other things, his global leadership and consumer experience, LEGO is well known for being environmentally conscious and he said that he found Starbucks fascinating and inspiring not least because of its "ambitious responsibility agenda."[6]

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[4] Alexandre Mars, "Doing Well By Doing Good: An Interview with Paul Polman, CEO of Unilever," *The Huffington Post* (blog), May 9, 2016. http://www.huffingtonpost.com/alexandre-mars/doing-well-by-doing-good-_1_b_9860128.html

[5] Colin Price and Sharon Toye, *Accelerating Performance: How to Mobilize, Execute, and Transform with Agility,* (New Jersey: John Wiley & Sons, 2017), pp. 46–47.

[6] Starbucks Nominates Three New Board Members (press release, Starbucks Corp., January 24, 2017). https://news.starbucks.com/news/starbucks-nominates-new-board-members

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Make sure the top team has the right capabilities for driving exemplary ESG performance. Companies that want to maintain public confidence and protect shareholder value—especially those in industries with high ESG risks—will need leaders who think strategically about the issues, communicate clearly and persuasively, and possess sound business knowledge and judgment. In addition to strategic and communication skills, the heightened importance of ESG calls for a number of interdisciplinary and cross-functional competencies, which include the following:

- Ability to develop trusting relationships with a variety of company constituents before an issue becomes a problem.
- A solid grounding in a wide range of environmental processes, procedures, technologies, social issues, and governance requirements at the local, state, federal, regional, and international levels.
- A knowledge of financial operations that extends beyond budgeting to an understanding of how finance intersects with ESG and the ability to make a business case for a new direction.
- Familiarity with technological and process advances and an understanding of the trends in ESG and their influences on the company and the industry segment.

All leaders in the C-suite—not just the chief sustainability officer, chief risk officer, or chief diversity officer—should be aware of today's higher ESG stakes. Does the CFO incorporate ESG factors into financial analyses? Does the chief marketing officer understand the difference between greenwashing and demonstrable corporate commitment to environmental goals—and that greenwashing not only alienates consumers but signals to investors that integrity may be a problem in other areas of company operation? Is the CHRO able to sincerely incorporate the company's ESG performance into the company's employer brand, or would employees and potential employees respond skeptically? Does the executive team as a whole see ESG as an issue of long-term competitiveness?

Make sure the organization has the ability to accelerate ESG performance. In today's new normal of constant disruption and fleeting competitive advantage, performance depends on the ability to accelerate—to mobilize around a set of strategic priorities, efficiently harness resources, experiment and innovate ahead of the market, spot opportunities and threats, and pivot at a faster pace than competitors. The ability to accelerate performance in ESG is particularly important because when approached with a competitive mind-set the issues are future oriented and fast moving, requiring rapid innovation in technology, operations, and business models. Instead of acting as wise overseers of ESG only, boards will also act as catalysts of speed, making sure that management has in place the ability to accelerate ESG performance as needed.

In our firm's research we have found that an organization's capacity to accelerate performance depends on 13 drive factors and their corresponding drag factors (*Fig. 1 on page 7*). These drive and drag factors can operate at all levels of the enterprise: in individuals, teams, and the organization as a whole. When systematically cultivated, the drive factors prepare the organization to accelerate performance. The corresponding drag factors, when ignored, materially slow and at times completely inhibit performance. Boards that insist that the company systematically assess and address these critical drive/drag factors will not only help ensure better ESG performance but see better performance overall.

Superior performance on ESG issues at all levels of senior leadership—the board, C-level, and the top tiers of management—generates substantial benefits that can increase investor confidence. Those benefits include difficult-to-quantify but highly valuable factors like enhanced brand and increased attractiveness as an employer (especially among millennials, many of whom insist on working for purpose-driven companies). They also include immediate financial benefits: lower insurance payments, lower operational costs, and avoidance of fines. And most important for investors and directors alike, exemplary ESG performance confers competitive advantage over the long term, helping ensure that the company not only survives but thrives.

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Figure 1

Drive factors to accelerate organizational performance

Mobilize

Customer first	Energizing leadership	Clarity
Always responsive to changing customer demands	High-energy buzz	Everyone aligned and committed to purpose, ambition, and clear priorities
Low customer attrition	Empowerment at every level	
Consistent service excellence	Strong role models who inspire others to bring their best performance	

Execute

Simplicity	Ownership	Winning capabilities
No bureaucracy	Meritocracy	Talent magnet
Lean processes	Delivery culture	Great talent-development processes
Streamlined structure	Integrity-driven processes	Best talent in key roles

Transform

Innovation	Challenge	Collaboration
Culture of disruptive thinking, idea generation, and experimentation	Supportive, frank feedback and debate	Work as one organization
Fast adoption	Highest performance expectations	High level of trust
		Coordinated processes and communication

Agility

Foresight	Learning	Adaptability	Resilience
Think ahead to anticipate and plan for changing circumstances	Learn quickly to avoid repeating past mistakes	Quick to adapt to changing circumstances	Recover quickly and emerge stronger from setbacks
	Improve continuously		

Source: Colin Price and Sharon Toye, *Accelerating Performance: How Organizations Can Mobilize, Execute, and Transform with Agility* (Hoboken, NJ: Wiley & Sons, 2017).

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Connecting Social Responsibility and Strategy in the Boardroom

KPMG Board Leadership Center

The context for corporate performance is changing rapidly: Consideration of the corporation's role in society is moving from the periphery to the center of corporate thinking as investors, customers, employees, and other stakeholders are challenging companies to understand the total impact of the company's strategy and actions. A tighter connection between "social capital" and bottom-line performance is being forged.

By any name—corporate social responsibility, sustainability, corporate citizenship, or environmental, social, and governance (ESG)—how a company manages environmental and social issues and connects these activities to financial and operational performance increasingly signals to investors how well the company is run and its long-term financial sustainability.

In this environment, it is critical that boards understand how the company is managing the risks and opportunities related to environmental and social issues, and embedding its initiatives into the corporation's strategy and culture.

As Stanley S. Litow, vice president of corporate citizenship and corporate affairs for International Business Machines Corp. and president of the IBM International Foundation, observed: "People are getting more sophisticated about the connection between corporate responsibility and business strategy, and rightly so. If you are strategic and analytic, being a good corporate citizen can also produce real sustainable value for your company."[1]

In an interview with the KPMG Board Leadership Center to discuss his research on investor engagement on ESG issues, Harvard Business School Professor George Serafeim emphasized the importance of ensuring that the board is part of the discussion. Serafeim told us, "We now have strong evidence that ESG issues are significant value drivers and that the strategic importance of different ESG issues varies across industries. At the same time, the role of the private sector in solving big problems, such as climate change and social inequality, is clear. The adoption by world leaders in September 2015 of the Sustainable Development Goals was a formal recognition that, without the private sector, we are not going to make much progress toward a more inclusive and sustainable form of economic development."[2]

The notion that doing good and creating value are not mutually exclusive is not new, but how these issues are framed and discussed has a major impact on understanding why they matter to the business and how to address them. It requires a deep understanding of the business and the issues affecting the company's long-term success.

Companies—and boardroom discussions—are moving at different speeds on addressing environmental and social issues. But no matter where along its journey the company is, the board can help leadership move forward by helping the company focus on the big picture.

Help set (or reset) the context for the company's discussion of environmental and social issues. What do these issues mean to the company and its customers, employees, and investors? Why do they matter? How do the company's corporate responsibility initiatives relate to long-term value? Leadership from the board is critical, and language matters. (A boardroom discussion about the "connection between environmental stability and the company's financial stability" will be more nuanced and meaningful than a discussion about "global warming.")

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[1] *Corporations and Society: Doing Social Good While Doing What's Good for Business*, Harvard Business Review Analytics Services, 2017. https://boardleadership.kpmg.us/content/dam/blc/pdfs/2017/20166-hbr-report-kpmg-web.pdf

[2] "Sustainability issues move from the periphery," KPMG Board Leadership Center, October 2016. https://boardleadership.kpmg.us/relevant-topics/articles/2016/10/sustainability-issues-move-from-the-periphery.html

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Just as communicating with external stakeholders on these issues is important, the dialogue within the company—including those who are leading corporate responsibility programs and the C-suite and boardroom leaders who review and fund them—is essential.[3]

Thomson Reuters Corp. President and CEO Jim Smith emphasized the critical importance that corporate responsibility initiatives be tied to the business mission. "When you do that, there's an authenticity that resonates with the external world, and a galvanizing effect inside the firm because you're going after issues your people care about," Smith said in a recent interview.[4] That approach may also help increase the chances that corporate commitment to, and funding for, those initiatives will continue in the event of budget constraints.

Energize management's assessment of the risks and opportunities. For starters, determine whether management has identified and understands the significant social and environmental *risks* related to the company's operations—e.g., environmental degradation, product and worker safety, and waste generation—including associated legal, regulatory, brand, and reputational risks. Are there *opportunities* to improve operational efficiencies through investments in social and environmental initiatives, such as reducing water usage, energy consumption, carbon emissions, or waste? Help determine how the company should target its environmental and social investments. Take a close look at the company's supply chain—where some of the company's greatest environmental and social risks and opportunities may reside. Beyond firm-specific initiatives, companies may address social and environmental concerns through other types of activities, including industry self-regulation, working with governments and non-governmental organization (NGOs), and emerging markets engagement.[5]

Embed environmental and social initiatives into the company's strategy and look at these issues in terms of long-term value creation. What are the opportunities to improve the company's strategy and operations by making environmental or social-related investments that align with the company's business interests and long-term viability? This will involve trade-offs, potential disruptions, and an innovative mind-set. New skills and expertise (in the C-suite and on the board) may be required, as well as different key performance indicators and scorecards. As most boards and business leaders who are well down this path will tell you, *this isn't easy*.

Tell investors and stakeholders about the company's environmental and social efforts. Insist that the company's environmental and social activities—progress, results, and linkage to strategy—be effectively communicated to investors, employees, and customers. Ensure that communication covers what the company is doing, why, and how it benefits the long-term interests of the company and its stakeholders. Do investors have the information they require to evaluate the company's environmental and social investments and their implications for long-term value? What are the views of investors and other stakeholders regarding the company's management of environmental and social issues?

Leaders from companies who have experience in this area emphasize the importance of ensuring that corporate responsibility programs make sense for shareholders and stakeholders, as well as the communities in which the company operates. That sentiment was echoed in comments during a discussion of corporations' role in society by board members and business leaders who attended KPMG's Annual Audit Committee Issues Conference on January 9–10, 2017, in Boca Raton. As one director put it, "The company needs to bring its investors along this

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[3] *Corporations and Society: Doing Social Good While Doing What's Good for Business*, Harvard Business Review Analytics Services, 2017. https://boardleadership.kpmg.us/content/dam/blc/pdfs/2017/20166-hbr-report-kpmg-web.pdf

[4] *Corporations and Society: Doing Social Good While Doing What's Good for Business*, Harvard Business Review Analytics Services, 2017. https://boardleadership.kpmg.us/content/dam/blc/pdfs/2017/20166-hbr-report-kpmg-web.pdf

[5] George Serafeim et al., "The Role of the Corporation in Society: Implications for Investors," p. 4, The Calvert-Serafeim Series, Calvert Investments, September 2015. https://www.calvert.com/calvert-documents.php

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The importance of communicating purpose, long-term value, and vision

Q: How important is it to communicate purpose and long-term value and vision to your market?

More important than quarterly earnings	**37%**
Equally as important as quarterly earnings	**34%**
Less important than quarterly earnings	**29%**

Source: Wall Street Journal*/KPMG poll, December 2016*

journey—and you do that, first and foremost, by focusing on the corporate responsibility efforts that connect to the company's strategy and long-term success, and by clearly communicating the company's vision and commitment to that vision."

Help set the tone at the top and culture around environmental and social initiatives. How is the company rewarding social responsibility and encouraging innovation and prudent risk-taking? Help to alleviate short-term pressures and give management "permission" to think and act long-term. As a director at KPMG's Issues Conference noted, "Cascading corporate culture down into the organization starts with the CEO's and C-suite's compass and character—and then it's about the ability to communicate the corporate purpose consistently and relentlessly over time."

Environmental and social issues continue to rise on investor agendas and can no longer be seen as "soft" reputational issues to simply be handled by the public relations or marketing department. Today, a company needs to see corporate responsibility as both a matter of principle and an economic imperative to be embedded into strategy and culture—and the board has a key role to play in setting the context, tone, and expectations to make this happen.

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A Framework to Assess and Disclose the Impact of Climate Change on Financial Performance

Marsh & McLennan Companies

The risks related to climate change and the opportunities for transitioning to a low-carbon economy are having a greater impact on core corporate strategies and operations. In this evolving business landscape, companies face pressure to understand and disclose the effects of climate-related risk on financial performance. Boards of directors, in their role of risk oversight, must ensure that climate-related threats are being considered in management's enterprise risk management programs and in strategic and operational planning.

A growing need to understand the financial impact of climate risks

Many companies are responding to pressure from shareholders and other stakeholders to disclose more information about the impact of their operations on the environment. Approximately 75 percent of the companies that make up the Standard & Poor's 500 Index produced sustainability reports in 2015, and roughly 6,000 companies worldwide provide climate data on the CDP's (formerly the Climate Disclosure Project) global disclosure platform regarding their greenhouse gas emissions.[1]

However, as the direct and indirect impact of climate-related risks grow in number and severity companies face additional pressures to disclose not only how the company is impacting the environment but also to provide clear information on how climate change may affect corporate performance. This demand is not necessarily new. Since 2010, the U.S. Securities and Exchange Commission (SEC) has called on publicly traded companies to disclose in their annual filings how climate change can impact the organization or present material risks.[2] However, the quantity and quality of disclosure vary greatly.[3] At the same time, investors are demanding that companies disclose the links between corporate performance and climate risks. In 2016, in the aftermath of the COP 21 meeting, 89 climate-change shareholder resolutions were filed, as shareholders voiced their concern over climate-change risk.[4]

In many instances, investors are dissatisfied with companies' current sustainability reports. While the reports provide much information on the sustainability efforts of the company (such as cutting water usage or reducing greenhouse gas emissions), they are often lacking in terms of the impact of climate threats on financial performance and how the company plans to respond strategically and operationally. As a result, the information is inadequate for making investment and capital allocation decisions.[5] The current status is a sore point with investors and other stakeholders, who are seeking to assess their own exposure to climate risk and expect the companies they invest in to do the same.[6]

Internally, companies struggle with reconciling sustainability reporting and financial reporting. Slow-moving climate-related risks and their potential effects are often difficult to identify and quantify, and in many cases they do

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1 See CDP data at https://www.cdp.net.

2 SEC Interpretive Guidance on climate change disclosure became effective in February 2010.

3 *Environmental Disclosure Committee Newsletter*, American Bar Association, Vol. 13, No. 1, May 2016, p. 11. http://www.americanbar.org/content/dam/aba/publications/nr_newsletters/ed/201604_ed.authcheckdam.pdf

4 "Proxy Season Preview: U.S. Environmental & Social Issues," Institutional Shareholder Services Inc. (ISS). https://www.issgovernance.com

5 Emily Chasen, "Investors Want More From Sustainability Reporting, Says Former SEC Head," *CFO Journal* (blog), Nov. 12, 2015. http://blogs.wsj.com/cfo/2015/11/12/investors-want-more-from-sustainability-reporting-says-former-sec-head/

6 For example, Mercer has partnered with many large pension funds to examine the impact of different climate scenarios on their long-term investment performance. See: https://www.mercer.com/our-thinking/investing-in-a-time-of-climate-change.html

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not align easily with corporate planning timelines. Companies may lack a clear-cut structure for integrating these risks effectively into their strategic and operational risk decision-making process.[7]

The recently released draft recommendations report from the Financial Stability Board's (FSB) Task Force on Climate-related Financial Disclosures (TCFD) is an important step toward addressing these challenges and concerns.[8] Initiated at the request of the G20 Finance Ministers and Central Bank Governors, the TCFD, chaired by Michael Bloomberg, was an industry-led effort, with 32 global members representing experts from the private sector and covering a broad range of industries and financial markets.[9] The goal of the proposed disclosures—designed to be applicable to all organizations in all industries—is to support the reporting of climate-related risks and opportunities in financial filings. This will provide relevant, forward-looking information to investors, lenders, and insurance underwriters on the potential financial impact of climate-related risks and opportunities, and what is being done to manage them.

The TCFD recommendations focus on disclosures related to the financial impact of climate change on the company's bottom line—not on a company's impact on the environment and climate. The recommendations reinforce existing reporting requirements in most G20 jurisdictions to disclose material risks for companies with public debt or equity. The task force worked closely with developers of other climate disclosure frameworks (including the CDP) to make use of preexisting and commonly used recommended disclosures. In this way, the task force recommendations do not introduce *yet another framework* for voluntary reporting, but they will rather act as a catalyst for consistent climate-related financial disclosures. This should increase the quality and quantity of information, while reducing the burden on those preparing the reports.

Climate risks place growing pressure on strategies and operations

In adopting the TCFD recommendations, companies will need to link those issues associated with climate change with their strategy, risk, and opportunity analysis. The information not only offers greater transparency for investors and other stakeholders but also can provide companies with insights into building greater resilience in the face of rising climate-related risks. As highlighted in the *Global Risks Report 2017*, climate change is a major trend underlying the top 10 global risks; extreme weather was among the top five global risks in terms of both likelihood and impact over the next 10 years, as was the failure of climate-change mitigation and adaptation.[10]

The TCFD report suggests climate-related risks and opportunities be grouped into the following categories (see exhibit on page 13):

- **Physical risks** relating to acute risks such as extreme weather events, and chronic risks associated with long-term shifts in climate patterns with impact on resource availability.
- **Transition risks** relating to the move to a lower-carbon economy, including policy, legal, technology, market, and reputational risks.
- **Climate-related opportunities**, including opportunities to improve resource efficiency, manage energy costs, develop new products and services, capture new markets, and improve organizational resiliency.

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[7] See also, *Unlocking Growth by Integrating Sustainability: How to Overcome the Barriers* by Lucy Nottingham, director, Global Risk Center, Marsh & McLennan Companies, 2016. http://www.mmc.com/content/dam/mmc-web/Global-Risk-Center/Files/Unlock-growth-by-integrating-sustainability.pdf

[8] To learn more about the task force, draft reports and timeline of activities, please visit www.fsb-tcfd.org.

[9] The task force included Marsh & McLennan Companies' Jane Ambachtsheer, partner, Mercer Investments. A list of all members can be found at www.fsb-tcfd.org.

[10] *The Global Risks Report 2017*, World Economic Forum, prepared with the support of Marsh & McLennan Companies. http://www.mmc.com/global-risk-center/overview/grc-global-and-emerging-risks.html

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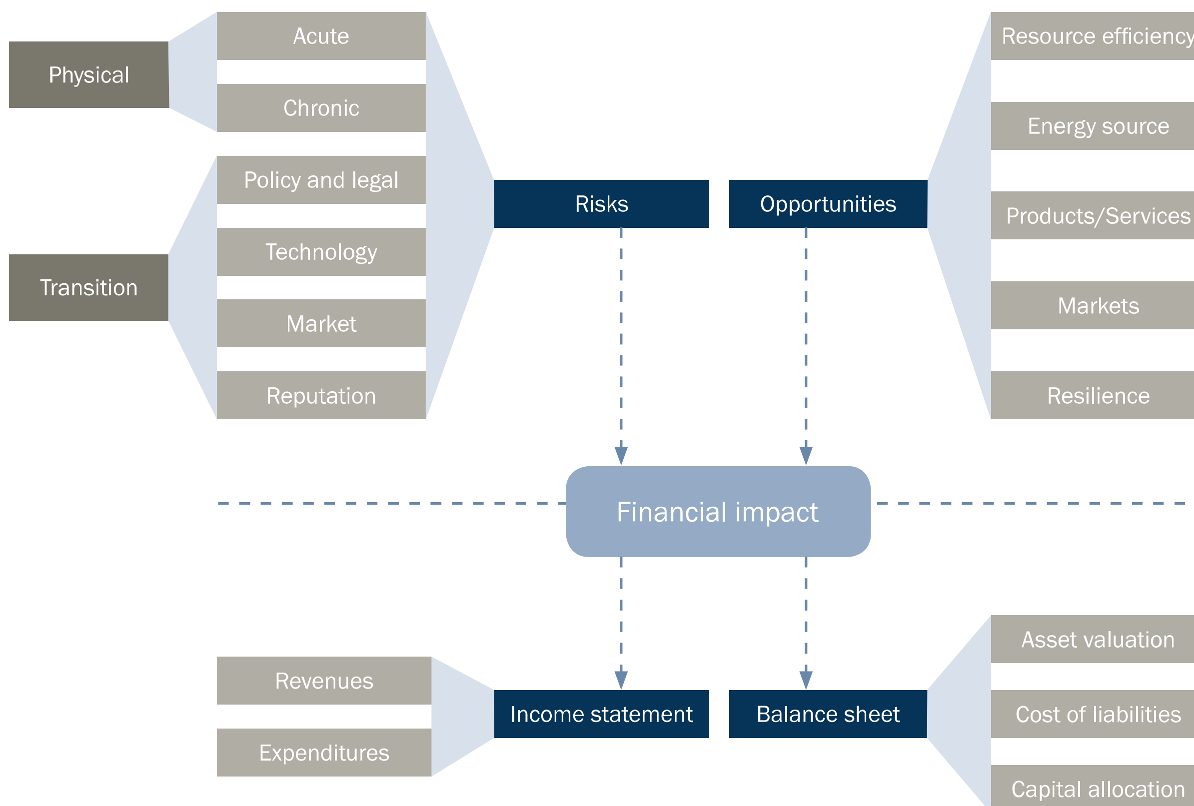
Climate-related risks and opportunities can impact organizations' financial performance.



Source: Recommendations of the Task Force on Climate-related Financial Disclosures

Examined through this lens, it is clear that companies across all industries—including those in the financial, energy, transportation, materials and building, and agriculture and food sectors—are, or will be, affected by the physical and transitional impact of climate change. For example, beverage companies are increasingly sponsoring public-water restoration projects to hedge against drought-related risks, which could hamper production and drive up their costs. Denim and textile companies are investing in new technologies to produce fabrics without using any water, allowing them to realize cost savings and simplify their operations in an era of increasing water scarcity. Car manufactures are leveraging the "Grid of Things" to support their long-term strategies with electric cars. Household appliance manufacturers are responding to demands for greater energy efficiency in their products. Banks are reviewing credit-risk assessment and lending procedures and are incorporating climate risk into their loan-making process. Asset managers are exploring top-down and bottom-up tools and analysis to support more effective modelling and pricing of climate-related information.

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Climate change and the personal liabilities of company directors

The increasing focus on climate-change exposures presents new and different challenges for directors and their companies, with the threats of class action lawsuits, significant remediation costs, and irreversible damage to the corporate and personal brand growing ever more likely. Some of the allegations that may trigger directors and officers (D&O) policies include:

- **a.** Breaching fiduciary duties in not considering the financial risks associated with climate change
- **b.** Failing to comply with legislative reporting requirements
- **c.** Failing to disclose climate-related liabilities
- **d.** Disseminating false or misleading or incomplete information on climate risks
- **e.** Mismanagement of climate-related risks
- **f.** Negligence in allowing the company to emit greenhouse gases into the atmosphere
- **g.** Failing to protect the company's assets

To hedge against this landscape, companies must carefully consider what protection for climate-change exposure can be provided through current D&O policies. In addition, they should examine what potential gaps exist and how a policy is going to respond in the event of an environmental issue, shareholder litigation, or regulatory scrutiny.[11]

Recommended framework for disclosure of climate-related risks and opportunities

Understanding and disclosing the financial impact of climate-change risk will require the same level of oversight and management as other aspects of risk and financial reporting to ensure information that is relevant, clear, comparable over time, verifiable, and timely. This has implications for boards of directors, senior executives, chief investment officers, chief risk officers, and risk leaders. The task force structured its recommendations around the following four thematic areas that represent core elements of how organizations operate:

- **Governance:** The organization's governance around climate-related risks and opportunities, including the role of the board. Consideration of climate impact will need to be integrated into organizations' overall processes, including strategy setting and risk management.
- **Strategy setting:** The actual and potential impact of climate-related risks and opportunities on the organization's strategic and financial planning. This may include an assessment of how various climate-change scenarios could affect operations and performance. This will require that CFOs and Chief Investment Officers familiarize themselves with the impact of climate-related risks and the use of scenario-planning tools in setting strategy.[12]
- **Risk management:** The process used by the organization to identify, assess, and manage climate-related risks. Organizations should identify these climate risks and opportunities in the short, medium, and long term.

[11] *Climate Change on the Corporate Governance Landscape*, Marsh, 2016. https://www.marsh.com/content/dam/marsh/Documents/PDF/en_au/Climate%20Change%20on%20the%20Corporate%20Governance%20Landscape.pdf

[12] For more, see "Technical Supplement: The Use of Scenario Analysis in Disclosure of Climate-Related Risks and Opportunities," available at www.fsb-tcfd.org.

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- **Metrics and targets:** The metrics and targets used to assess and manage relevant climate-related risks and opportunities. For example, utilizing carbon footprint and other climate-risk metrics or targets can be used to make and monitor investment decisions.

Given their potential impact on the organization, climate-related risks must be integrated into the company's ongoing risk assessment and quantification processes and the board's oversight of risk management. In describing the board's oversight of climate-related issues, the TCFD recommends that directors consider the following to support disclosure:

- Processes and frequency by which the board and/or board committees (such as audit, risk, or other committees) are informed about climate-related issues
- Whether the board and/or board committees consider climate-related issues when reviewing and guiding strategy, major plans of action, risk-management policies, annual budgets, and business plans, as well as when they are setting the organization's performance objectives, monitoring implementation and performance, and overseeing major capital expenditures, acquisitions, and divestitures
- How the board monitors and oversees progress against goals and targets for addressing climate-related issues

Five questions directors should be asking management

Given the rising challenges of climate-related risks and the growing demands for improved disclosure, boards can use the following questions to guide board-management dialogue and to understand the organization's climate resilience:

1. Are our strategies and operations at risk, given expected climate changes and the drive to a low-carbon economy?
2. Is the organization's governance of climate-related risks and opportunities robust and effective?
3. Does the organization's strategy and financial planning accurately assess and reflect the actual and potential impacts of climate-related risks and opportunities?
4. Does the organization have a process in place to identify, assess, quantify, and manage climate-related risks?
5. Is the organization using metrics and targets to assess and manage relevant climate-related risks and opportunities?

Conclusion

Understanding a company's impact on the climate will continue to be a key element of sustainability programs and corporate reporting. But it is critical that boards and senior management have clear insights into the financial impact of climate change on their company's strategy and operations. The draft recommendations of the Financial Stability Board's Task Force on Climate-related Financial Disclosures are a good starting point for climate-related disclosures by companies and will likely be accepted by the market and investors. Companies that can respond to the risks of climate change by improving their resilience are likely to emerge as industry leaders in this changing business environment.

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How Compensation Can Support Improved Environmental and Social Governance

Pearl Meyer

In the United States, environmental, social, and governance (ESG) issues have become a priority, especially for the largest public companies. In a 2017 survey, "Pearl Meyer Quick Poll: ESG and its Potential Link to Incentives,"[1] 60 percent of companies surveyed report that ESG issues are a top concern and of those, 34 percent indicated that ESG issues are firmly entrenched in their companies. From an external reporting perspective, the Governance and Accountability Institute, a consulting and research firm focused on sustainability issues, says that in 2015, 81 percent of the S&P 500 published corporate reports on their ESG positions, up from just 20 percent four years prior.[2] While not driven by disclosure regulation, the topic is receiving attention largely due to a combination of investor, employee, and customer interest.

Outside the United States, the interest in ESG is also being driven by regional regulation. For example, the Taiwan Stock Exchange requires that its listed companies publish a corporate social responsibility report and the Tokyo Stock Exchange's governance code includes a strong suggestion that companies do so. Beginning in 2017, public companies in Europe with more than 500 employees will be required to report on several nonfinancial metrics related to the environment and their social and employment policies.

Recently, the Conference Board, Bloomberg, and the Global Reporting Initiative launched the Sustainability Practices Dashboard—a web-based tool with data on 75 social and environmental practices among the S&P Global 1200, including executive compensation policies tied to ESG metrics. It was developed in response to *"growing demand from company directors, investors, financial analysts, and other stakeholders for comparative data in the sustainability field."*

Corporate boards appear to have taken note. The 2017 Pearl Meyer Quick Poll (also referred to as the "Pearl Meyer survey") of more than 100 directors and corporate executives shows that 85 percent of respondents personally feel ESG issues should be formally addressed within a company. Almost 60 percent believe that ESG issues are important to customers and more than 75 percent say they are currently important to investors or may be in the future.

How are boards managing ESG?

At this point, most boards seem to be addressing ESG issues either through current standing committees or at the full board level. Research analysis done by Pearl Meyer in support of the NACD *2017 Director Compensation Report* shows that among 1,400 public companies reviewed, only slightly more than five percent of boards have a designated committee to address ESG issues.[3] Not surprisingly, most of the formal committees focus on environmental and safety issues, and the companies are in either the utilities, energy, or materials industries. The analysis shows that ESG issues are usually the responsibility of the governance committee and sometimes the audit committee.

1 Pearl Meyer Quick Poll: Environmental and Social Governance and its Potential Link to Incentives, March 2017. https://pearlmeyer.com/research-reports/quick-poll-esg-and-its-potential-link-to-incentives

2 "FLASH REPORT: 81% of the S&P 500 Index Companies Published Corporate Sustainability Reports in 2015," press release from The Governance and Accountability Institute, March 15, 2016. https://globenewswire.com/news-release/2016/03/15/819994/0/en/FLASH-REPORT-81-of-the-S-P-500-Index-Companies-Published-Corporate-Sustainability-Reports-in-2015.html

3 Based on data collected and analyzed as part of Pearl Meyer's authorship of the NACD *2017 Director Compensation Report*.

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What is the link between ESG and shareholder value?

With such strong board-level and investor focus on the topic, many have asked about the link between ESG and shareholder value. For example, a recent report from Glass Lewis notes that several global companies had *"suffered massive blows to shareholder wealth as a result of significant environmental, social, and/or governance-related issues."*[4] That same publication cites various research indicating companies that have adopted strong environmental and social policies may show better performance in financial metrics such as earnings per share, return on equity, and cash flow. And a 2012 study from Harvard Business School says these "high sustainability" companies *"are more likely to make executive compensation a function of environmental, social, and external perception metrics."*[5]

Where do companies stand on the ESG continuum and what is the role of compensation?

We believe that most public companies are taking some sort of ESG action. Among those who are, they are likely somewhere on a continuum between simple reporting of basic ESG actions on one end, to an "ideal state" of seamless integration of numerous ESG issues into the corporate culture, business strategy, and executive-compensation plan. Where a company lands on this continuum may be driven in part by the size of the enterprise and/or its industry. For example, safety metrics have long been an element of many executive pay programs in the energy and manufacturing sectors. (For more on safety-related performance measures, see "*It's Time to Review Safety Incentive Programs*," by Pearl Meyer Managing Director Ed McGaughey.)

Many companies are taking the customer, employee, and/or shareholder interest in ESG seriously and identifying those long-standing activities already taking place in their organizations that fall into the ESG category. Existing HR goals like hiring diversity or environmental, health and safety measures can easily be reported as ESG-related actions. Energy usage and resource conservation efforts may also apply.

On some level, these types of identified actions may also be represented as a component of some executives' performance-based compensation (particularly health and safety, as noted), but it is unlikely these factors are explicitly stated as ESG performance metrics. If present at all, the metrics are most likely indirect and folded into larger measurement components. Pearl Meyer's survey showed 11 percent of respondents indicating direct links between executive compensation and ESG, with the most common factors being health and safety policies.

In an EY survey of executives at large-cap companies,[6] 21 percent of these executives indicated *"the leadership team's compensation is driven in part by sustainability performance"* and 30 percent said the company had received shareholder inquiries about the practice. Likewise, 24 percent of the large-cap firms studied by the nonprofit Ceres organization link executive pay to sustainability metrics.[7]

At a minimum, one benefit of tracking these activities is that they can be packaged as a corporate social

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4 In-Depth: Linking Compensation to Sustainability, Glass Lewis, March 2016. https://globenewswire.com/news-release/2016/03/15/819994/0/en/FLASH-REPORT-81-of-the-S-P-500-Index-Companies-Published-Corporate-Sustainability-Reports-in-2015.html

5 Robert G. Eccles, Ioannis Ioannou, and George Serafeim, "The Impact of Corporate Sustainability on Organizational Processes and Performance," revised March 2014. http://www.nber.org/papers/w17950.pdf

6 2013 Six Growing Trends in Corporate Sustainability, EYGM Limited, 2013. http://www.ey.com/Publication/vwLUAssets/Six_growing_trends_in_corporate_sustainability_2013/$FILE/Six_growing_trends_in_corporate_sustainability_2013.pdf

7 Gaining Ground: Corporate Progress on the Ceres Roadmap for Sustainability, Ceres, 2014. https://www.ceres.org/resources/reports/gaining-ground-corporate-progress-on-the-ceres-roadmap-for-sustainability/view

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responsibility report, which can serve to either meet various regional requirements (e.g., those mentioned earlier for the Taiwan Stock Exchange, the European Union, etc.) or as a positive corporate communication to interested investors, employees, and customers.

Moving further along the scale, for some firms these more basic measures and additional factors, such as supply-chain processes or waste reduction, may be less on the margins and well incorporated into the functioning of the organization. This may be due in part to the company's industry or business model and at some point the ESG elements become an ingrained part of how they do business or "operationalized." One director responding to the Pearl Meyer survey voiced the opinion that ESG is a part of the context in which the company operates, and to report on those factors solely as a result of investor or customer interest might not be a holistic view.

The same survey shows some level of ESG integration with business practice. Almost 30 percent of respondents have operationalized supply-chain practices (although only 11 percent of those have then made a direct link to compensation), and almost 40 percent have operationalized health and safety, 30 percent of which have then directly linked those measures to executive pay.

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In the most mature phase, ESG-related practices are inherent to the firm's business strategy and a core component of its culture. This maturity may have come about as a proactive hedge against disruption and may have required changes in product or service offerings, or possibly even business model or target markets. In these rare cases, the companies are very transparent about the role of ESG in their strategies and directly link ESG to the executive team's pay.

The Ceres report noted previously calls out Alcoa as a shining example—where "*20 percent of executive cash compensation is tied to safety, environmental stewardship (including GHG reductions and energy efficiency), and diversity goals*"—and Exelon, a Fortune 100 energy company where the executive team is rewarded for *"meeting non-financial performance goals, including safety targets, GHG emissions reduction targets, and goals engaging stakeholders to help shape the company's public policy positions."*

These firms are certainly outliers, yet the Pearl Meyer survey shows that a remarkable number of executives and directors do believe ESG issues have a large role in their companies. Fifty percent say ESG issues are linked to the firm's business strategy and 40 percent say they relate to business goals. Interestingly, one-third indicate ESG factors are *"aligned with their firm's value proposition and/or its competitive differentiation."*

A director responding to the Pearl Meyer survey did note that "some maturation needs to occur" in measuring ESG before there can be widespread adoption of ESG as an incentive metric.

Boards that are thinking about these issues now and taking steps to advance their progress are clearly ahead of the curve.

Linking ESG to financial results: compensation recommendations

In the long run, we believe executive compensation can be a powerful tool for advancing business and leadership strategies. For those boards that strongly believe in moving their companies along this continuum and pursuing a deeper operationalization of ESG factors—whether in response to regulation, stakeholder push, and/or the bottom line—incentives may be a catalyst.

- Each organization will approach ESG in the way that is best for its business model and culture. Companies can begin by evaluating a standard set of ESG components. Which of those are clearly linked to your business strategy?
- Conduct a value-driver analysis to understand which of those ESG factors have the most impact on the near-term business and which can drive long-term value creation. (See example on following page.)
- Balance the leading and lagging metrics that matter, using the same thoughtful methodology to determine the nonfinancial metrics linked to ESG as you do when choosing financial performance metrics.
- Design your pay programs to align with your value drivers and clearly outline to plan participants how they can get from point A to point B.

As is the case with financial results, setting ESG goals and measurements in this way will be an intensive exercise, requiring careful thought and analysis to be effective. One board member's comment on the Pearl Meyer survey recognized both the difficulty and the reward by noting that managing ESG is a complex endeavor, yet managing complexity is a key to success.

Finally, beyond driving actions, don't underestimate the role compensation can play in communicating priorities. Including incentives based on ESG in your plan signals to all stakeholders—including employees and management—its importance to the company and can spur the process of embedding it into the business and the culture.

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Corporate Social Responsibility: Board Oversight, Disclosure, and Engagement

Sidley Austin LLP

U.S. public companies are under pressure to satisfy expanding legal obligations as well as evolving societal expectations about what it means to be a responsible corporate citizen. In response to these pressures, many boards have increased their attention to corporate social responsibility (CSR) issues in analyzing the risks they face relating to operations and strategies and in determining what the company should disclose regarding CSR matters.

Oversight of CSR matters

CSR issues are coming into sharper focus in boardrooms as shareholders, customers, and employees emphasize the importance of high standards of ethics and respect for sustainability, human rights, environmental protection, and diversity in the global marketplace. For example, BlackRock Inc. released its annual letter to CEOs in January 2017 indicating that it expects the companies in which it invests to devote attention to CSR issues like sustainability of operations, environmental factors that affect the business, and the company's role as a member of the community. In accordance with their fiduciary duties, board members should be attentive to CSR matters as part of strategy development and oversight of risk and compliance at the company, and they should determine an approach to CSR that is tailored to the company's needs.

Board members should understand the business case for the company's CSR efforts. Even though many constituents now view CSR as vital to a company's long-term success, it remains difficult to verify whether the benefits of CSR efforts exceed their costs and if they increase shareholder value. Key benefits are improvements in operational efficiency, employee retention, ability to attract certain investors, product innovation and quality, and customer loyalty. Failure to identify and mitigate CSR-related risks could potentially result in significant damage to the business including reputational harm, unstable supply chains, work stoppages, consumer boycotts and product recalls.

Board members should ensure that the company's CSR efforts align with its strategy and core values. A CSR strategy should be grounded in ethical principles and designed to support economic growth and should address the environmental and social impacts of business decisions. The CSR program should also reinforce internal controls and reduce risk.

The board should clearly define its expectations regarding the company's approach to CSR. Some CSR initiatives are mandated by law or regulation (e.g., with respect to child labor and the environment) while others are voluntary. The board may be asked to help resolve tension as to whether CSR efforts should address broad environmental and social issues or focus only on areas where the company's operations have a direct impact. The board and management should determine the most significant CSR issues and risks associated with the company's strategy and operations and allocate resources appropriately.

The board should ensure that the CEO exhibits leadership commitment to CSR issues that are important to the company, which may be accomplished through regular internal communications regarding CSR or employee training about the potential CSR impact of their decisions. The board should also consider how the company incentivizes consideration of CSR issues in decision making (e.g., performance targets in executive-compensation plans).

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The board and management should establish a process for board oversight of CSR matters. First, they should determine whether a standing or newly created committee will be delegated the task of overseeing CSR efforts or whether the full board or specified directors will handle this duty. Some large U.S. public companies have established board committees devoted to CSR oversight. According to the *2016 Spencer Stuart Board Index*, 10 percent of S&P 500 boards disclosed that they have a separately designated public policy/social and corporate responsibility committee and 7 percent disclosed that they have a separate environmental, health and safety committee. If a company has not established a separate committee, the board may consider revising the charter of the committee to which it has delegated the task of overseeing CSR efforts to explicitly address such responsibilities.

When reviewing board composition, the board should determine whether its members have the right expertise and skill sets to execute their duties, including as they relate to CSR. It may be advisable to determine whether the board (or the relevant committee) would benefit from the addition of a director with experience overseeing CSR initiatives. In any event, board members tasked with overseeing CSR should generally familiarize themselves with CSR challenges and trends relevant to the company and its industry; shareholder priorities relating to CSR matters as communicated through proxy-voting policies, other public statements, and engagement; proxy advisory firm viewpoints; and CSR-related disclosure recommendations and industry standards, such as those issued by the Global Reporting Initiative (GRI) and the Sustainability Accounting Standards Board (SASB).

To facilitate the board's oversight duties, the board and management should determine what information will be provided to the board (or the relevant committee) and how frequently. They should also identify the member(s) of management responsible for providing reports to the board (or the relevant committee) on the company's CSR efforts. The board (or the relevant committee) should consider making CSR a regular agenda item, either on a stand-alone basis or as part of its discussions on strategy or risk management.

Finally, the board (or the relevant committee) should periodically review and assess the effectiveness of the company's CSR efforts against peer companies, leading industry standards, and the CSR-related priorities of key shareholders. The board and management should first determine the appropriate metrics to be used—whether financial or tied to environmental or social issues (e.g., water usage, reducing emissions, or employee turnover). It may also be important to assess the CSR approach and the commitment of the company's suppliers, customers, and other business partners.

Disclosure regarding CSR matters

Shareholders, customers, employees, and business partners increasingly expect more meaningful disclosure regarding CSR matters. Investors have started to look beyond financial information and sustainability reports (which are typically backward-looking) to determine how companies create long-term sustainable value. In January 2017, State Street Global Advisors sent a letter to directors of its portfolio companies urging them to "clearly [communicate] their approach to sustainability and its influence on strategy" as CSR issues "over the long-term . . . can have a material impact on a company's ability to generate returns." CSR shareholder proposals frequently call for greater transparency about corporate policies and actions regarding a particular issue, such as political and lobbying activity, sustainability, safety, or child-labor issues. Boards and management should balance transparency with concerns about protecting strategic information and the time and cost associated with enhanced disclosure.

It has become the norm for large U.S. public companies to disclose their CSR initiatives. According to a 2016 Governance & Accountability Institute report, 81 percent of S&P 500 companies published a corporate

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responsibility/sustainability report in 2015, up from just 20 percent in 2011. Nevertheless, a December 2016 study by the SASB found that CSR-related disclosure is lacking—81 percent of the more than 700 companies surveyed disclosed CSR-related risks, but 52 percent of them used ambiguous, boilerplate language and failed to disclose plans to address such risks.

Boards and management should determine the preferred content of disclosure about CSR and the corresponding advantages and disadvantages. They may choose to provide only required disclosures and/or discuss matters specifically raised by their investors, or they may choose to voluntarily disclose additional information such as how the company's long-term strategy incorporates sustainability considerations. The board should be involved in the decision as to whether to publicly disclose CSR goals and, if so, which metrics to use and how frequently to report on progress toward those goals.

The table below sets forth the U.S. Securities and Exchange Commission (SEC) disclosure requirements that most commonly trigger disclosure of CSR matters.

Most relevant SEC disclosure requirements	
Regulation S-K Item 101	Business description disclosure
Regulation S-K Item 103	Legal proceedings disclosure
Regulation S-K Item 303	MD&A disclosure of material known trends/uncertainties
Regulation S-K Item 503(c)	Risk-factor disclosure
2010 SEC Guidance	SEC staff guidance regarding climate change disclosure
Exchange Act Rule 13p-1	SEC 2013 conflict minerals disclosure rule

The SEC has recently faced pressure to mandate additional CSR disclosures. Of the more than 275 nonform comment letters submitted in response to the SEC's April 2016 concept release on Regulation S-K disclosures, two-thirds address CSR issues, 80 percent of which call for enhanced disclosure about CSR issues in SEC filings. However, enhancing CSR-related disclosure requirements is not expected to be a priority of the SEC under the Trump administration.

Disclosure about CSR matters may also be required by international or state laws. For example, certain companies doing business in California must disclose their efforts to eradicate human trafficking in their supply chains.

In addition to required disclosures, public companies should consider other benchmarks when determining whether and what to disclose regarding CSR. The most well-known benchmarks are the GRI Sustainability Reporting Standards (last updated in October 2016) and the SASB Implementation Guide released in January 2016. Further, boards should continually monitor how the company's CSR disclosure compares to that of its peers. Finally, companies may consider disclosing the specific goals or performance targets tied to CSR that may trigger compensation payouts.

Boards and management should also determine the preferred placement of their CSR-related disclosures, bearing in mind that there may be greater liability risk associated with disclosure made in SEC filings versus in a sustainability report or on the company's website. We have observed a recent increase in proxy statement disclosure regarding CSR, and companies are increasingly linking to sustainability reports in their SEC filings. As part of its risk-oversight and compliance duties, the board (or the relevant committee) should ensure that a comprehensive internal reporting process is in place relating to CSR disclosure.

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Engagement with shareholders on CSR matters

It is becoming a mainstream practice for investors to consider CSR issues in their voting and investment decisions, viewing it as interconnected with corporate values and financial performance. In a 2014 EY survey, 90 percent of investor respondents indicated that ESG issues "played a pivotal role" in their investment decisions.

Given this heightened focus, boards should determine which members of the board and management will engage with shareholders on CSR matters. Whom to designate may vary based on the identity of the shareholder and the materiality of the subject to be discussed. For example, it may be appropriate for the CEO and chairman of the board to participate in engagement involving one of the company's largest shareholders or an issue that could have a significant impact on the company's operations or reputation.

There are several methods companies can use to gauge how their shareholders feel about CSR issues. In addition to reviewing investors' specific requests for CSR-related information, the SASB Implementation Guide can help companies identify the industry-specific CSR topics most likely to be material to their shareholders. Boards and management can also review their top institutional investors' investment decisions and policies relating to CSR. For example, State Street Global Advisors distributed a letter to corporate boards in January 2017 setting forth its expectations as to how boards can work with management to incorporate sustainability into long-term strategy. Attached to the letter was a framework setting forth its approach to evaluating companies' CSR efforts, including guidance for boards as set forth in the table below.

State Street Global Advisors' Framework: Questions for boards to guide their approach to CSR
1. Has the company identified the sustainability issues material to the business?
2. Has the company analyzed and incorporated sustainability issues, where relevant, into its long-term strategy?
3. Does the company consider long-term sustainability trends in capital allocation decisions?
4. Is the board equipped to adequately evaluate and oversee the sustainability aspects of the company's long-term strategy?
5. Does the company's reporting clearly articulate the influence of sustainability issues on strategy?
6. Is the board incorporating key sustainability drivers into performance evaluation and compensation programs?

Finally, companies can track how their investors voted on CSR shareholder proposals. Recently there has been a marked increase in the number of CSR shareholder proposals and levels of shareholder support for such proposals continue to rise as reflected in the chart on page 25.

More than 400 CSR shareholder proposals were submitted in 2016. According to Institutional Shareholder Services (ISS), a record nine CSR proposals received majority support in 2016 compared to one in 2015 and seven in 2014, the previous record.[1] Average support for CSR proposals reached 20.5 percent in 2016, up from 20.1 percent in 2015 but down from a high of 21.9 percent in 2014. The table on page 25 shows the most prevalent CSR shareholder proposals voted on in 2016 along with the corresponding levels of average support. The trend toward increasing numbers and support of CSR shareholder proposals is expected to continue in 2017, particularly in relation to climate risk.

[1] The nine majority-supported CSR shareholder proposals in 2016 related to the following topics: calls for board diversity (2); political contributions disclosure (2); methane emissions management; sustainability reporting including greenhouse gas emissions reduction goals; animal welfare; prohibiting sexual orientation/gender identity discrimination; and gender pay reporting.

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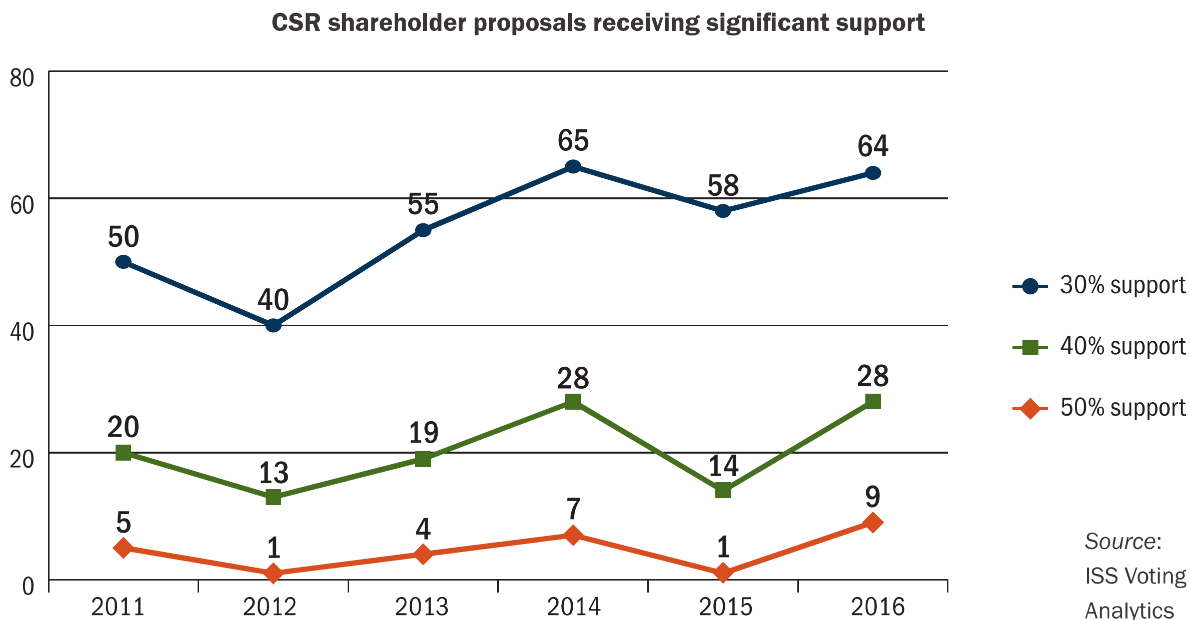

Most prevalent CSR shareholder proposals in 2016 (and 2015) (*Source*: ISS Voting Analytics)				
Topic	Prevalence in 2016 (2015)*	# Voted in 2016 (2015)	Average support (% of votes cast) in 2016 (2015)	# With majority support in 2016 (2015)
GHG/Climate risk	#2 (#4)	55 (34)	24.4% (22.4%)	1 (0)
Lobbying disclosure	#4 (#5)	41 (35)	24.4% (25.8%)	0 (0)
Political spending	#5 (#7)	25 (30)	33.1% (33.7%)	2 (0)
Sustainability report	#12 (#15)	14 (20)	32% (30.9%)	1 (1)
Human rights	#15 (#9)	10 (17)	11.6% (7.9%)	0 (0)

*Number rankings refer to prevalance based on shareholder proposals overall (i.e., not limited to CSR proposals).

Ceres publishes an annual summary of the proxy-voting records of major mutual funds and investment firms on CSR shareholder proposals. State Street Global Advisors supported 46 percent of shareholder proposals relating to climate change in 2016. On the other hand, BlackRock and Vanguard did not support any such proposals. Those asset managers have now found themselves on the receiving end of CSR shareholder proposals for their 2017 annual meetings, a sign of increasing pressure on institutional investors that vote against—or abstain—on CSR proposals.

It is common for shareholder proponents to seek enhanced disclosure of the company's policies and efforts relating to a particular CSR issue. Through engagement, companies are often successful in negotiating withdrawal of such proposals by committing to provide such disclosure (e.g., a sustainability report, report on political contributions/lobbying, or report on gender pay).

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For Further Reading

- NACD, *Oversight of Corporate Sustainability Activities Handbook*
- *NACD Directorship*, "Sustainability Matters, But What Does It Mean for Your Company?" July 30, 2015.
- Veena Ramani, "Five Key Steps for Building a Climate-Competent Board," *NACD Board Leaders' Blog*, March 7, 2017.
- William Young, "Sustainability: No Longer a 'Soft Issue' for Boards," *NACD Board Leaders' Blog*, Aug. 16, 2016.
- Global Reporting Initiative, GRI Standards
- Ceres Reports

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Appendix: NACD's Strategic Content Partners

HEIDRICK & STRUGGLES

HEIDRICK & STRUGGLES serves the executive talent and leadership needs of the world's top organizations as a premier provider of leadership consulting, culture shaping, and senior-level executive search services. Heidrick & Struggles pioneered the profession of executive search more than 60 years ago. Today, the firm serves as a trusted advisor, providing integrated leadership solutions and helping its clients to change the world, one leadership team at a time. For more information, visit www.heidrick.com.

The **KPMG BOARD LEADERSHIP CENTER** champions outstanding governance to help drive long-term corporate value and enhance investor confidence. Through an array of programs and perspectives—including KPMG's Audit Committee Institute and Private Markets Group, the WomenCorporateDirectors Foundation, and more—the Center engages with directors and business leaders to help articulate their challenges and promote continuous improvement. Drawing on insights from KPMG professionals and governance experts worldwide, the Center delivers practical thought leadership—on risk and strategy, talent and technology, globalization and compliance, financial reporting and audit quality, and more—all through a board lens. Learn more at kpmg.com/blc.

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