The Roles of the Board in the Era of ESG and Stakeholder Capitalism

ESG Center Working Group Discussion Held Under the Chatham House Rule

Session 3 | Thursday, October 13, 2022 | Virtual Meeting

This Working Group, which consists of a series of four sessions held under the Chatham House Rule, discusses the evolving roles of the board of directors as companies navigate two fundamental and related shifts in capitalism: the broader focus on environmental, social, and governance (ESG) issues and the simultaneous shift to a multi-stakeholder form of capitalism.

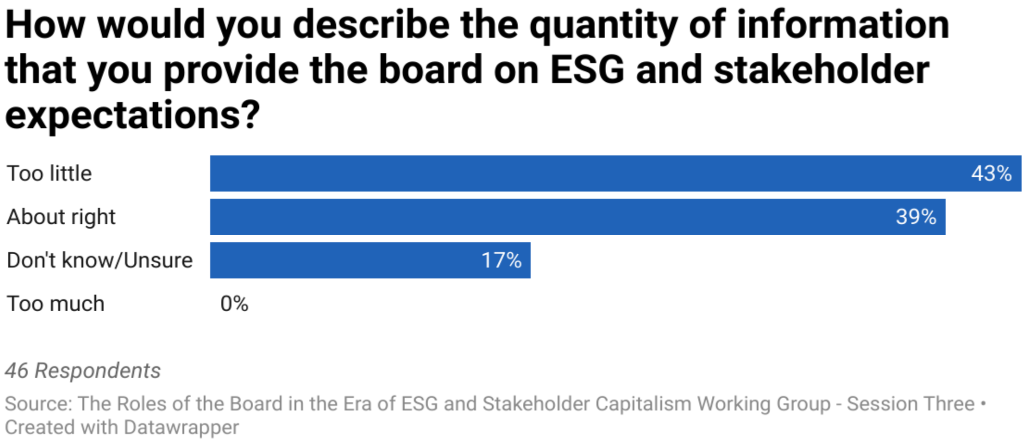
The first session on May 19th focused on the impact these trends are having on board discussions and key business decisions (the full summary can be found here). The second session on September 13th addressed how companies are responding to these trends in board composition, leadership and committee structures, and capabilities (the full summary can be found here). The third session on October 13th focused on the two connected topics of (1) internally briefing your board on ESG issues and stakeholder expectations and (2) the board's role in approving communications and engaging with stakeholders. Below are the key takeaways from that discussion.

This Working Group is generously sponsored by Morrow Sonali and Weil, Gotshal & Manges.

Communicating ESG Issues and Stakeholder Expectations to the Board

Status quo

1. **According to a poll of Working Group participants, boards tend to get *too little* (or just *about the right amount* of) information on ESG and stakeholder expectations.** None of the respondents believe their board is receiving *too much* information.



2. **Overall, the Working Group participants believe that the information on ESG and stakeholder expectations is of acceptable quality.** Even though most respondents (48%) say the quality of information is just *OK*, another 43% deem it to be *good*. None of the respondents believe that it is either *excellent* or *poor*.

How would you describe the quality of information that you provide the board on ESG and stakeholder expectations?

44 Respondents

Source: The Roles of the Board in the Era of ESG and Stakeholder Capitalism Working Group - Session Three • Created with Datawrapper

3. **According to a survey discussed at our first working group session, companies believe their boards have incorporated *ESG* better into their decisions than they have the *interests of multiple stakeholders* –** particularly when it comes to strategic and business planning, and external and internal communications. Conversely, with respect to decisions on product/service offerings and internal controls, boards are considering stakeholder perspectives/impact more so than ESG issues. There are only few places where boards are factoring ESG issues *and* multiple stakeholders into their key decisions *very well*.

How Well Boards Consider ESG Issues *and* Stakeholders in Key Decisions

Very well	Moderately well	Not well
• Regulatory Disclosure	• Strategic Plan	• M&A
• Corporate Culture	• Business Plan and Operating Budget	• Organizational Structure and Staffing
	• Product and Services	• Compensation and Benefits
	• Internal Controls	• Capital Budget
	• External Communication	
	• Internal Communications	

Source: The Roles of the Board in the Era of ESG and Stakeholder Capitalism Working Group – Session 1 (80 respondents)

Effective practices in communicating with and engaging the board on ESG topics

4. **Unlike financial literacy or being an audit committee financial expert, there is no regulatory or commonly accepted definition of the level of ESG knowledge a board should have.** A survey of over 500 C-suite executives found that only 30% of executives rated their board's "expertise" in ESG as good or excellent. There may be several reasons for this low score. First, the survey asked about expertise, rather than familiarity, fluency, or knowledge. Second, some still associate ESG primarily with climate, an area where directors are unlikely to have significant expertise or even experience. Third, as one Working Group participant pointed out, the results may be shaped by management anxiety about its own level of ESG knowledge, as well as that of the board.

5. **Companies should aim to ensure that their board has a collective fluency on ESG topics, including risks and opportunities, that are relevant to the company's business.** With over 200 issues across the 'E', 'S', and 'G', management can't – or shouldn't – expect boards to address them all. But there are three filters it can apply when setting goals (or expectations) for the board's ESG capabilities:

    I. Focus on those areas that are strategically important to the company and where it can have the greatest impact on its own long-term welfare, as well as on its stakeholders, society at large, and the natural environment.

Environmental (~80)

Biodiversity and conservation	Plastic, packaging, and materials
Climate	Waste
Energy	Water and effluents
Greenhouse gas (GHG) emissions	Air pollution

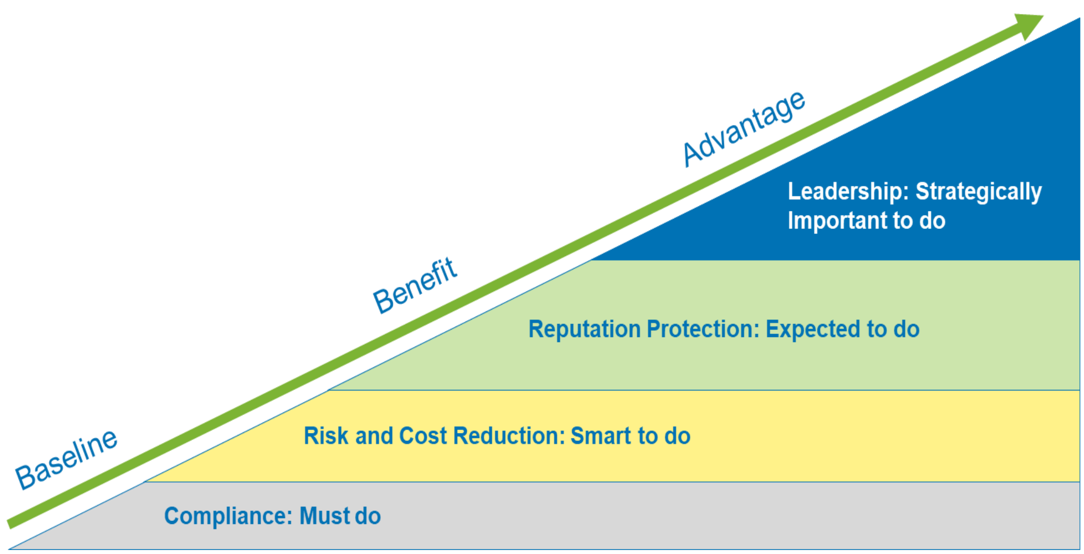
Social (~100)

Animal rights and welfare	Supply chain and procurement practices
Corporate citizenship and philanthropy	Corporate culture
Economic impact	Diversity, equity, and inclusion (DEI)
Human rights	Talent recruitment and development
Corporate political activity	Employment and labor relations
Public health	Employee health and safety
Product safety	Sexual harassment

Governance (~50)

Anti-competitive behavior	Data security & privacy
Ethics and compliance	Crisis management
Corporate purpose	Litigation
CEO succession	Intangible assets and innovation
CEO performance evaluation	Corporate reputation
Shareholder engagement	Tax strategy
Stakeholder engagement	Risk management

    II. Understand that the level of required knowledge will depend on the company's position on each issue and how far it wants to go: to comply with the law, to reduce costs, to manage reputation, or to become an industry leader.



    III. Recognize that education takes time, so fluency will increase along with the maturity of the firm's ESG program.

6. **Companies can enhance communications to the board, and the board's engagement, on ESG topics in various ways**.
    I. Through the board's discussion of the company's **purpose**. As noted in prior publications, the classic formulation is that a mission is what a company does, a vision is what a company hopes to accomplish, values reflect how a company acts, and purpose is why a company does what it does. Successful purpose statements – which are often linked to a broader societal goal – are outward-facing, forward-looking, and inherently optimistic. As such, they are natural springboards for product innovation and can help guide board decisions.
    II. By integrating ESG into **strategic planning and operating/capital budget processes**, as it then will automatically feed into the CEO dashboard and board agenda – and thus drive accountability.
    III. Through **human capital management,** which is a natural starting point to integrate ESG and stakeholder views into board decisions. According to a poll at another working group session, just 21% of participants said they have an HCM strategy that is reviewed at the board level. But having a strategy that addresses the company's current workforce, the workforce that's needed to execute the firm's strategy over the next 3-5 years, and how the company plans to get there, is a way of addressing several key ESG issues as well as the expectations and welfare of a key stakeholder group: employees.
    IV. Through incorporating ESG into **compliance and risk management** discussions at the board level. According to a report issued by ESG Center earlier this year, boards generally engage well with risk and compliance, but less so with sustainability. However, as companies' focus on ESG grows, so does the natural intersection of these three areas. Discussions with the board on compliance and risk can integrate ESG issues.

Effective practices in communicating with and engaging the board on stakeholder views and expectations

7. **Boards tend to understand their investors' views better than they do those of other stakeholders.** A vast majority (89%) of participants in an earlier working group session said that their board has a good understanding of their investors' views and expectations. By contrast, only 56% of boards are believed to understand the views of employees, followed by customers (44%), and communities (15%).

8. **Investors *themselves*, however, increasingly expect boards to understand the views of other stakeholders.** Investors know that companies are operating in a multistakeholder environment, and that the company's long-term success depends on the company's understanding of stakeholder expectations and the company serving the stakeholders' long-term welfare.

9. **Board knowledge of stakeholders has several dimensions.** These include: (i) how the company is *viewed* by different stakeholder groups, (ii) how the company is *affecting* stakeholders, and (iii) how the company is *balancing the needs* of different stakeholders, including those instances in which the company seems to be favoring or responding to some stakeholders and not others. Understanding how the company is balancing the interests of different stakeholders should include a discussion of the short- and long-term benefits, risks, and tradeoffs in the company's approach.

10. **It's important to put stakeholder views in context**. As former Citigroup Board Chair Dick Parsons said on a Conference Board webcast, companies are naturally responsive creatures. But companies shouldn't just react to the latest pressure from a single stakeholder group – or the board (as well as investors and others) will wonder who is running the show. It is critical for management, when it discusses stakeholder views, to put those views in the context of the company's business goals and explain how the response aligns with the firm's long-term strategy.

11. **Keeping the board informed on stakeholder views requires data on those stakeholders**. Management should focus on what kinds of data the company is collecting on the views of employees, customers, business partners, and others both on the company itself as well as on relevant environmental and social topics – and how it is building that data into regular reports provided to the board. After all, boards don't have unlimited time to engage directly with the company's stakeholders. Moreover, to be able to make effective decisions, especially those that directly impact the company's stakeholders, reliable data are needed – as well a willingness to accept and act on those data.

12. **To capture information on employee sentiment, companies will need to go beyond the employee engagement survey and focus on an in-depth assessment of corporate culture.** Management can collect data on employee views in various ways. The employee engagement survey and/or retention/turnover rates can render useful information, but these datapoints alone often don't paint a complete picture. This is why company culture should be an area for board attention. But since it's hard to measure, management and boards will need to go the extra mile in understanding their firm's (evolving) culture, for example through in-depth culture assessments and recurring pulse surveys on specific topics. Additionally, some companies are experimenting with moderated employee roundtable discussions to collect information on company culture as well as employee expectations more broadly.

13. **To gather additional data on stakeholder views and perspectives, companies can also leverage the channels that are already in place for collecting core business information**. For example, a company's salesforce may very well collect information on customer views and expectations that goes beyond "ordinary" product/services needs or complaints. Additionally, business partners are increasingly **considering sustainability when choosing suppliers,** so it can be helpful to report to the board on those discussions, as they can have significant financial consequences and lead to ideas for business innovation.

The Board's Role in ESG Communications and Engaging with Stakeholders

The board's role in reviewing and approving ESG communications to stakeholders

14. **In addition to approving SEC filings that include ESG information, it is helpful for the board, at a minimum, to understand the breadth and depth of external and internal ESG-related communications and the processes by which management seeks to ensure the accuracy and consistency of those communications.** Boards need to review and approve the disclosures made in SEC filings such as the 10-K and proxy statement. And audit committees will likely be responsible for ensuring that the company has appropriate processes in place to support those disclosures. Beyond that, however, it can help for boards to have a broader picture of ESG communications and their supporting processes. First, those communications often contain important commitments (e.g., climate or DEI goals). Second, the SEC is increasingly focused on

inconsistencies in disclosures made across a company's various communication channels. Third, these communications can present the risk of (being accused of) greenwashing.

15. **There are benefits and risks to having the board (or board committees) approve ESG communications beyond those included in SEC filings.** Asking the board or committee to vote on a report can focus attention in a way that goes beyond simply having them "review" a document. Having the board, or board committees, approve ESG reports can help (i) educate the board about the company's ESG program and stakeholder interests, (ii) ensure the board is aligned with the company's statements, and (iii) assure the quality of the information being provided. At the same time, there are other ways to achieve these educational, alignment, and quality goals. It is up to each company to determine the best way to achieve those goals and whether having the board vote on the reports will have more benefits than costs.

16. **Companies are adopting different approaches to help ensure consistency in ESG disclosures.** Some companies have their internal audit department conduct periodic analyses of ESG disclosures across their various communication channels. Other firms have developed a framework to facilitate a multidisciplinary review of ESG disclosures. And others ensure all communications with respect to a particular ESG topic (e.g., HCM) come from a "single source of truth" (e.g., the HR department).

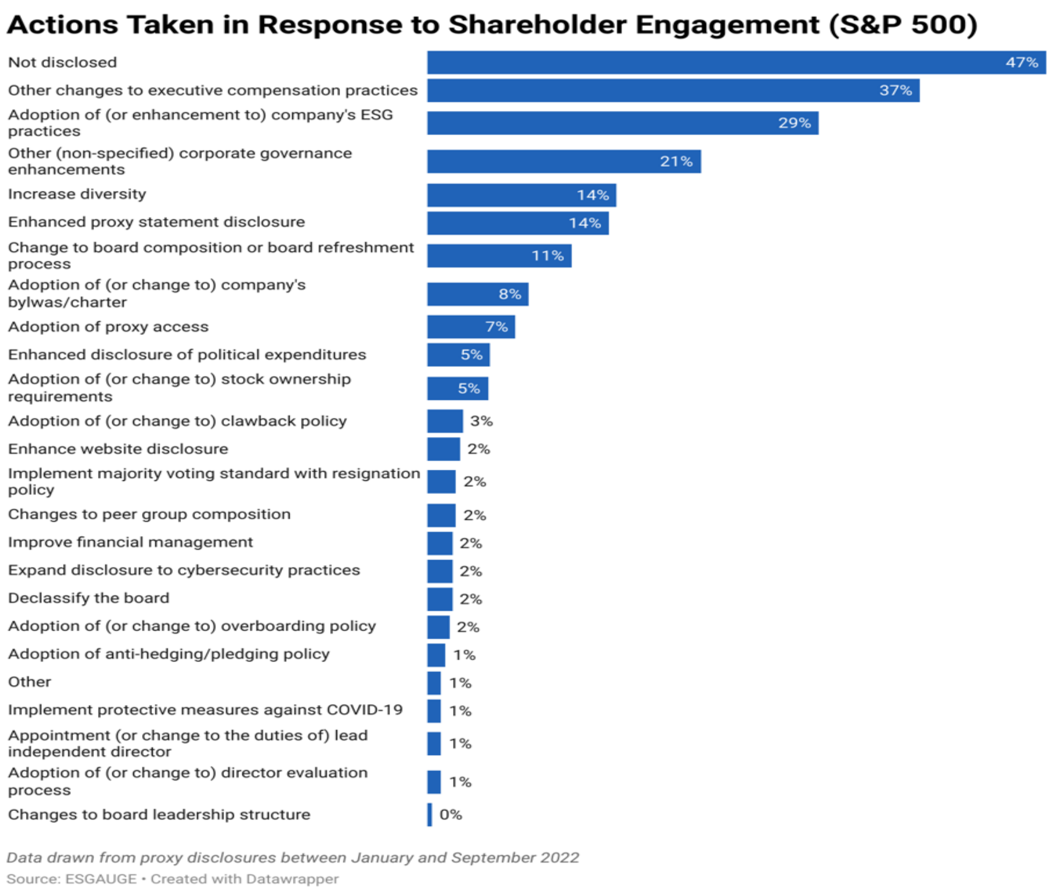
Effective board-stakeholder engagement practices

17. **Companies are finding that direct engagement by board members with investors and other stakeholders can be an effective way to supplement the data that the board receives.** According to exclusive Conference Board and ESGAUGE data, slightly over 50% of S&P 500 firms disclose that their directors are having direct conversations with *shareholders*. Directors are also meeting with *employees* in several different contexts: ranging from one-on-one interactions that help to inform succession planning, to site visits, to meetings with departments (e.g., audit committee chair with internal audit), to other types of employee gatherings. And at some firms, directors are meeting with communities, including through established *community advisory groups*.

18. **It is important to share the information gathered by directors in these engagements with the rest of the board.** Even at firms where the Lead Independent Director routinely meets with major investors, the rest of the board can feel in the dark about those discussions. Management can help ensure that the takeaways from those conversations are shared with the board, and that the board and relevant committees have time to discuss them.

19. **There is room for companies to expand the scope of their disclosures on shareholder engagement.** 79% of S&P 500 companies that disclosed information on their shareholder engagement practices in their 2022 proxy statement indicated that they were looking for feedback on governance and executive compensation. This suggests that the motivation to engage with shareholders is largely tied to shareholder voting (e.g., on director elections and say-on-pay). But we know that shareholder engagement often goes beyond – and indeed, focuses on – environmental and social topics. Companies should take a fresh look at how they describe the scope of and reasons for their shareholder engagement.

20. **Similarly, companies can be more transparent about the actions they are taking in response to such engagements.** Almost half of S&P 500 companies do not disclose this information. But of those that do, most companies indicated to have made some changes to their executive compensation practices (37%) and to have adopted (or enhanced) company's ESG practices (29%).



21. **Board engagement with stakeholders, especially employees, can be energizing for the company's stakeholders as well as directors themselves.** For example, engagement with employees (e.g., through employee engagement groups or town halls) can help the board get a feel for employee views, in building a more transparent corporate culture, and the board's and management's confidence in each other.