MORROW SODALI

SHOULD COMPANIES TAKE A STAND?

by John C. Wilcox, Chairman Emeritus, Morrow Sodali

One of the most controversial questions confronting business leaders today is whether they should speak out publicly on environmental, social and governance issues.

In the past the answer to this question was largely discretionary, the issue being whether it was appropriate for corporate CEOs to act as "business statesmen" and take a stand on contentious issues in the public domain. The prevailing assumption was that the CEO's job is to make a profit, not to opine on issues beyond the scope of the business.

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Today, however, corporate involvement in public affairs gives rise to questions that go beyond business statesmanship: ***To what degree do environmental, social, governance (ESG) and political issues impact a company's business risks and value drivers?*** And the obverse: ***Do the activities of a company have an impact on the environment, the economy and society?***

These are questions that business leaders ignore at their peril. The public role of companies is in the headlines every day, reflecting a business environment transformed by climate change, stakeholder capitalism, corporate purpose and, most immediately, the global pandemic.

The emergence of ESG issues has generated a wholesale reevaluation of corporations' so-called "social compact." It has upended the concept of "shareholder primacy" and raised questions about traditional methods of auditing and evaluating companies. Corporate "externalities," "intangibles," "purpose," "culture," "values" and other qualitative factors – formerly characterized as "non-financial" – are now recognized as integral to a company's risk profile, financial health and long-term value. Accordingly, corporate executives and boards of directors are expected to attend to an expanding list of ESG topics. These include climate change, human capital management, pay equity, gender and ethnic diversity, Black Lives Matter, #MeToo, the wealth gap, human rights, immigration, gun control, domestic terrorism, voting rights, political contributions, and more.

Simultaneously with their impact on corporations, ESG issues are having a transformative effect on institutional investors and shareholders. Giant financial institutions such as BlackRock, State Street, Vanguard and Fidelity, joined by many other asset owners and managers around the globe, are including ESG factors in their investment decision-making

So what lies ahead for companies? How should they prepare for a future in which ESG plays a central role in their strategic planning, corporate reporting and engagement? How will ESG affect their communication with institutional investors, beneficial owners, employees and other stakeholders? What internal processes will companies need to develop to determine whether an ESG issue is material and how to respond when it surfaces in a public forum?

*Here is an approach taken by **Kate Rebernak**, founder and CEO of **FrameworkESG**:*

To know where you're going, understand where you are

In the past several years, companies have come under increasing pressure from key stakeholders to integrate ESG considerations into their operations and disclose ESG-related performance with greater rigor and particularity. Where to begin?

1. **Know where you are.**

Take an inventory of all your activities that related to ESG issues to see what you can already get credit as well as gaps in performance and disclosure.

Conduct a materiality analysis to better understand the concerns of key stakeholders about your sector and your business. Consider whether your enterprise risk management (ERM) framework and process account for external perspectives. If you don't have an ERM framework, a materiality assessment is one place to start.

Conduct a benchmark analysis. Look at direct competitors, indirect competitors, customers, and peers, and throw in a couple of leaders for good measure.

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and stewardship of portfolio companies. A new generation of millennial and Gen X shareholders is bringing their personal concerns about the environment, society and politics into their selection of asset managers, their choice of asset classes and directly into their engagement with the companies they own. ESG issues have become a dominant focus for shareholder activists and have contributed to their growing record of success. Social media are further accelerating the process by which corporations are linked to ESG issues in the news.

ESG issues are predicted to play a prominent role in the 2022 annual meeting season. The Conference Board recently published its ***C-Suite Outlook-2022***, which contains the following observation:

> ***CEOs worldwide are far more concerned about stakeholder pressure than shareholder activism.*** *Evolving stakeholder expectations of the role of business in society ranks far above shareholder activism as a factor that CEOs expect to have an impact on their company this year. This is most pronounced in the US, where CEOs rank the impact of stakeholder expectations as 11th, far ahead of shareholder activism at #26.*[1]

The takeaway: in 2022 CEOs need to be prepared to take a stand on ESG issues of concern to their stakeholders. Public attention to ESG issues means that a company's "ESG/stakeholder profile" is as important today as its ownership profile was during the era of shareholder primacy. In response, corporate communications, investor relations and board engagement programs must address ESG topics and stakeholder concerns in the context of business strategy and financial results.

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E and S versus G

The transition to "ESG engagement" presents company managers with substantial new challenges. In particular, the monitoring of environmental and social policies cannot rely on the compliance methodology used for corporate governance. While governance can be evaluated across different companies using a standardized checklist of best practices (albeit often with a comply-or-explain option), a prescriptive, one-size-fits-all approach does not work for environmental and social issues. E and S factors vary widely at individual companies, depending on their industry, size, location, competitive standing and a variety of other considerations. This problem of variability is apparent in the proliferation of competing global standards that have been developed to measure climate risk and assess responses to climate change across different industries and in different markets. SASB's 77 industry standards are a case in point.

However, global E and S standardization remains an important goal. Companies, investors, NGOs and regulators deem standardization essential to achieve comparability and ensure fair valuation of both listed and private companies. An important move toward standardization is the recent creation of the International Sustainability Standards Board

1. The Conference Board, ESG Alert: What CEOs Think of ESG & Other Big Issues in 2022 and Ways to Reduce Growing ESG Disclosure Risk, January 14, 2022.

What issues do they say are important? Do they have stated goals? What metrics do they use? How do they communicate? How do you stack up?

2. **Chart where you want to be.**
Do you want to be a leader? A fast follower? Run with the pack? No one wants to be a laggard. Decide where you want to be. Prioritize the issues you want to address. Set internal goals, even if they are, at first, to understand what your baseline performance is so that you can set realistic, measurable, and achievable targets.

3. **Look for early and easy — or easier — wins.**
Consider using renewables to reduce cost and environmental impact. Look for ways to increase employee engagement: such efforts are often low budget and high impact. One is to connect your company's purpose to the United Nations Sustainable Development Goals, or SDGs. Which of the SDGs are most closely aligned with your business and its contribution to society?

4. **Use ESG as a lens through which to assess and drive performance.**
Align ESG issues with your core strategy, products and services, and operations. Here again, you might be surprised that some things you're already doing fall into one of the three buckets: E, S. or G. Manage and measure your ESG performance using accepted frameworks and standards such as the Global Reporting Initiative, SASB, or the TCFD.

5. **Don't go it alone.**
Look for partners—nonprofit organizations, universities, other complementary companies, or even clients—to support and advance the efforts you've undertaken to address the highest-priority issues for your company. Investing in partnerships with reputable organizations can amplify both your impact and your message and help you build trust with key stakeholder groups.

6. **Embrace transparency.**
Communication is a two-way street. Use every engagement as an opportunity to understand and respond to stakeholders' expectations. Though you won't always satisfy them, there's enormous trust-building potential in listening, even if you ultimately decide to go in another direction.

(ISSB), a consolidation of the International Financial Reporting Standards Foundation, the Climate Disclosure Standards Board and the Value Reporting Foundation (which in turn combines the Sustainability Accounting Standards Board and the International Integrated Reporting Council).

Despite the push for standardization and even if ISSB does achieve its objective of providing "a comprehensive global baseline of sustainability disclosures," bespoke analysis of individual companies on E and S issues will continue to be necessary.

Thinking differently about materiality, or not?

Experts and regulators pondering the growing need for customized treatment of E and S factors have suggested that the traditional concept of "financial materiality" should be supplemented with alternative definitions. Among the new definitions are "double materiality," "dynamic materiality" and "pre-financial materiality."

It is important to consider carefully whether the financial materiality standard is sufficiently comprehensive to embrace ESG issues. If so, alternative definitions may confuse materiality analysis rather than clarifying it.

In an April 27, 2021, comment letter to the Securities and Exchange Commission on the subject of "Climate Change Disclosures," Uber Technologies, Inc. recommended an expanded approach to materiality that would not require a redefinition. While endorsing an ISSB-type "harmonized climate change disclosure framework" that "… would not only provide the standardization, comparability and reliability sought by investors and other stakeholders, but would allow … companies to streamline reporting and communications on climate change," Uber made the following statement:

> *"… we encourage the Commission to consider requiring that companies perform* ***a company-specific materiality assessment*** *to identify the ESG issues most relevant to their businesses. We believe that the most useful ESG disclosures will be* ***grounded in the specific issues that are relevant to the particular company****, as opposed to generic ESG disclosures that may or may not apply in a company's individual circumstances."* [Boldface added]

Uber's "company-specific materiality assessment" contemplates a two-step analytical process that, in addition to determining what an average investor would want to know, asks additional questions: ***What issues do we, the people running the business, think are strategically important? What do our stakeholders want? To what degree are third-party standards applicable to our business? What are peer companies doing? What do our statement of corporate purpose, our company values, our culture, our reputation, our branding and our public image require?***

These are important business questions whose answers are contextual and specific to individual companies. They in no way depart from the traditional standard of financial materiality. In fact, they rely on it. **A company's determination as to whether an ESG issue is material ultimately turns on whether the issue has an actual or potential financial impact on the business.** Once the financial materiality determination has been made, the ESG issue is no longer theoretical. It is redefined as a business issue grounded in the company's specific activities and circumstances.

The key is to communicate your understanding of your stakeholders' expectations and how the direction you take will help the company create value for them in the long term.

Stakeholders don't expect perfection. They do expect transparency. So articulate your goals and measure, track, and communicate progress, even if it's not great. Companies that communicate transparently about their ESG efforts—both successes and challenges—have invested in something of an insurance policy. If an issue bubbles up, the fact that you've been seeking to understand it, manage it, and communicate about it will help you avoid a schism in trust with key stakeholders.

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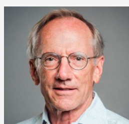
While Uber's company-specific materiality assessment rests on traditional financial criteria, the approach will over the long term require companies to undertake substantial organizational and behavioral adjustments. ISSB standards will provide helpful guidance for companies willing to adopt reforms such as integrated reporting, holistic management, stakeholder engagement and greater board transparency as a means to achieve ESG integration.

The concept of company-specific materiality assessments also impacts institutional investors. It will require them to dig more deeply into the inner workings of individual portfolio companies and to engage with their managements systematically. It will further reduce their reliance on standardized metrics, regulatory guidelines and the wholesale recommendations from outside advisors and service providers.

Conclusion

The answer to whether a company should take a stand on specific ESG issues should be resolved internally well before the question arises in the public domain. Because materiality carries with it an obligation to disclose, a company's corporate reporting and communications should provide a narrative that enables stakeholders and the public to understand how the company has dealt with its material ESG issues. That narrative in turn provides a script if the company chooses to speak out publicly. Non-material ESG issues that fall outside a company's business should require no public stance and should be left for debate among advocacy groups, academics, politicians and the media.



JOHN WILCOX

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John Wilcox is Chairman Emeritus at Morrow Sodali and served as the company's Executive Chairman from 2006 through 2020. From 2003 to 2008 he was Senior Vice President and Head of Corporate Governance at TIAA-CREF. Prior to joining TIAA-CREF he was chairman of Georgeson & Company.

During his career, John has specialized in corporate governance, capital markets regulation, director education, cross-border standard-setting and investor communication. He has served on many boards and committees, including the Committee for Economic Development, NYSE Euronext, Nasdaq, The Conference Board Global Corporate Governance Center, the National Association of Corporate Directors, the Weinberg Corporate Governance Center; the American Bar Association Committee on Corporate Laws and wallstreetlawyer.com. John is a widely published author on the topics of corporate governance, proxy voting, shareholder communications and board responsibility. He has testified before Congress and regulatory agencies in markets around the world on matters relating to securities regulation and is on the faculty of a variety of director education programs.

John received a B.A. from Harvard College, where he was a member of Phi Beta Kappa, an M.A. from the University of California, Berkeley, where he studied as a Woodrow Wilson Fellow, a J.D. from Harvard Law School and an LL.M degree from New York University Graduate School of Law.

KATE REBERNAK

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Kate Rebernak is the Founder and CEO of FrameworkESG. With more than 30 years of experience as a strategic thinker, advisor, and communicator, Kate has been advising companies her entire professional life.

Formerly a commercial-litigation attorney whose clients included federal financial institutions and banks, insurance, and other public companies, Kate brings a variety of perspectives to inform her work with clients.

She is the founder of FrameworkESG where she leads the firm's growth strategy and advises company leaders on the integration of ESG issues into corporate strategy and operations. Kate speaks and writes on the value of ESG as an operating lens and the effective prioritization and management of ESG issues. Her work has been widely published.

Kate served on the board of directors of Cornerstone Capital Inc. from 2013-2021 and chaired the board's nominating and governance committee.

She served as a guest lecturer at the Yale's Graduate Business and the Environment Consulting Clinic from 2009–2020. Kate holds a B.A. in English from the University of Missouri at Columbia, from which she graduated Phi Beta Kappa, and a J.D. from Saint Louis University School of Law. She is a member of the State Bar of Texas and a lifetime member of Net Impact.