THE CONFERENCE BOARD

The Roles of the Board in the Era of ESG and Stakeholder Capitalism: Supplement 2

Optimizing Board Composition, Structure, and Capabilities in the Era of ESG and Stakeholder Capitalism

In partnership with:

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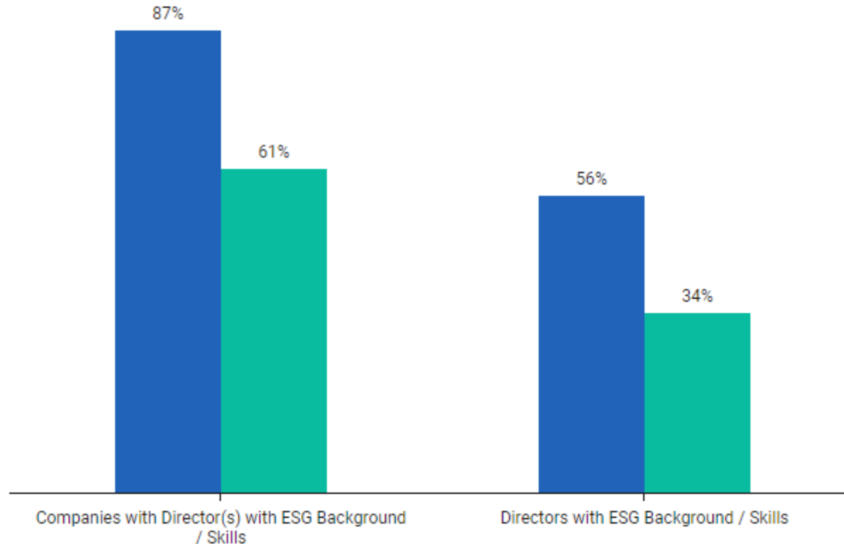
Optimizing Board Composition, Structure, and Capabilities in the Era of ESG and Stakeholder Capitalism

The Impact of ESG and Stakeholder Capitalism on Board Composition

The shifts toward ESG and stakeholder capitalism have significant implications for the composition of the board. Indeed, companies need boards with directors who have a diversity of backgrounds, as well as the skills and experience to effectively oversee the expanding list of responsibilities and demonstrate fluency in these areas. This is why companies are increasingly disclosing director experience in ESG.

- **Eighty-seven percent of S&P 500 (and 61 percent of Russell 3000) companies disclose that their directors have ESG experience** in one or more of the following key ESG areas: corporate governance, human capital, cybersecurity, ESG in general, climate, and the environment.

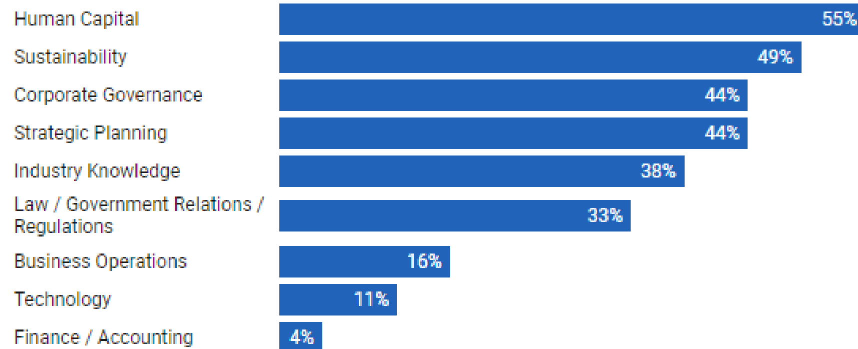


- **Based on these disclosures, 56 percent of S&P 500 (and 34 percent of Russell 3000) *directors* have some kind of ESG experience.** More specifically, 31 percent of S&P 500 (and 21 percent of Russell 3000) directors have corporate governance experience, with human capital not far behind at 28 percent (and 16 percent). By contrast, only 7 percent of S&P 500 (and 3 percent of Russell 3000) directors have either climate or environmental experience, but given the SEC's proposed climate

disclosure rules and investors' continued pressure on companies to have clear governance over climate, we can expect that number to rise.

- **When companies disclose ESG experience on their board, they typically have several directors with such experience**: seven directors, on average, in the S&P 500 and five directors in the Russell 3000. (For comparison, the average board size is 11 directors in the S&P 500 and nine in the Russell 3000.)

According to the working group participants, human capital, sustainability, governance, and strategic planning are the areas of *professional experience* that have become *more important* in directors. This doesn't mean that these areas are the *most important*, but they have moved up as companies navigate the intensified focus on ESG and the needs of stakeholders.



As companies enhance their board's composition, they should keep a few things in mind:

- **Having specialist directors can be counterproductive if the rest of the board defers to them too much.** While companies may want to add directors with specialized experience in key areas such as human capital management and cyber, generalist skills and attributes are still more important. Specialist experience on the board can be helpful, but it should be a "plus" factor. Directors with general strategic business experience—and who understand the various roles of the board—will be better suited to ensure the board has appropriate (board- and board committee-level) oversight of the company's key ESG risks and opportunities.
- **Deep industry knowledge can help in ESG oversight.** Well-rounded directors are those who really understand their firm's industry, including its incumbents and insurgents. Indeed, deep industry knowledge provides directors with heightened sensitivity to the array of ESG risks and opportunities and stakeholder views most relevant to the company. Yet, when seeking industry experience, companies should refrain from bringing on directors whose views of sustainability were cemented at a time when it was a siloed discipline or a purely philanthropic effort.

- **Although corporate proxy statements tend to emphasize the *diversity* of skills and experience of the board, the board and company are well served by having directors with certain skills and attributes *in common***, such as openness to change, intellectual curiosity, and proactiveness. Effective directors should also not just view ESG as a source of risk but understand that emerging environmental and social issues present their firm with new business opportunities.
- **A company's purpose isn't only useful in its employee recruitment efforts; it can also help attract and retain high-quality directors.** When talking about the role of "purpose" in attracting and retaining talent, we typically think of employees. But directors shouldn't be left out of this discussion: attracting and retaining high-quality directors is vitally important for the long-term success of the company. And just as companies are attracting employees based not only on what they do or sell, but also on what the company stands for,[1] they can leverage the firm's purpose to encourage candidates to join the board, and the result will be a director with the drive to devote sufficient time and energy to the company.

How to Avoid Allegations of Greenwashing Your Board

Companies are facing a growing risk of allegations of "greenwashing" their board. Mainstream investors intensifying their review of director qualifications, activist investors looking for weak spots, and the SEC's forthcoming disclosure rules on cybersecurity, climate, and potentially human capital management are compelling companies to disclose director experience in these areas.

To decrease the risk of being accused of inflating directors' ESG qualifications or providing insufficient support for the company's disclosures, boards need to carefully assess the *depth*, *breadth*, and *recency* of their directors' ESG experience before citing such experience in their proxy statement or other corporate communications.

This assessment will likely require more than just including ESG-specific questions in the annual Director & Officer questionnaire; it should also involve a candid discussion with both the governance committee and the full board of the criteria for qualifying as having ESG experience. For example, does a former CEO of a multinational firm—whose CHRO reported to her—qualify as having human capital management experience? What if a board member's relevant cyber background is largely from 15 years ago?

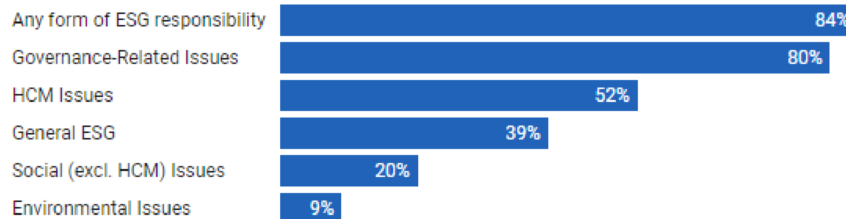
It also requires individual directors to be candid about their experience and to keep abreast of developments in their area of expertise.

The Impact of ESG and Stakeholder Capitalism on Board Committee Structure and Leadership

Most Russell 3000 companies (84 percent) disclose that they assign some form of ESG responsibilities to the full board and/or one or more committees.[2] Typically, nominating/ governance (nom/gov) is the assigned committee, especially at smaller companies.

Most boards have assigned responsibility for governance and human capital management

Board (Committee) ESG Responsibilities



Company Disclosure in the Russell 3000

Source: ESGAUGE, 2022 • Created with Datawrapper

The decision to task the nom/gov committee with ESG responsibilities is likely to evolve over time as companies experiment with different approaches to address the expanding array of environmental and social risks, associated stakeholder expectations, and regulatory developments. But even if boards are temporarily “parking” ESG responsibilities in the nom/gov committee, they should consider whether the committee has the right composition and staff support to do its job effectively.

Our latest data furthermore indicate that ESG oversight is the prevalent category under general ESG responsibilities and most frequently assigned to the nom/gov committee. The nom/gov committee is also most likely to be responsible for climate-related topics (the most prevalent environmental issue for which board committees have responsibility) and corporate political activity (the most common social issue).

On the other hand, the audit committee leads the way in having responsibility for governance-related issues, with ethics and compliance being the most prevalent category. Finally, talent recruitment & development and diversity, equity & inclusion—the most prevalent human capital management issues—are most frequently assigned to the compensation committee.

Companies should allocate ESG responsibilities based on which areas truly matter for them. The list of ESG issues has grown to encompass more than 200 topics, and some industries will lead on certain topics, but no company can be a leader in all ESG areas. To understand which issues matter, companies will want to look beyond the traditional materiality assessment and conduct a more strategic analysis based on their firm’s current position and capabilities, opportunities and risks, and the competitive landscape related to ESG.[3]

Allocating ESG responsibilities

- **Companies should address the full board's role with respect to ESG.** For example, the full board, often upon the recommendation of the nom/gov committee, can function as an "air traffic controller" and decide where ESG responsibilities go. Moreover, the board (not the nom/gov committee) may be best positioned to have overall responsibility for ESG strategy, particularly as it relates to the marketplace through the company's products and services, and workplace through its workforce and operations.
- **One committee generally doesn't have the bandwidth (or expertise) to oversee all aspects of ESG.** A benefit of allocating ESG responsibilities to several board committees is that each can dig deep—perhaps deeper than the full board—into its assigned area(s). This allocation will vary by company. For example, primary responsibility for overall ESG reporting and/or staying abreast of the latest ESG trends could be assigned to the nom/gov committee; the audit committee could be responsible for ESG-related disclosure controls and procedures, while the actual mitigation of ESG risks could be allocated to either the risk or the safety & operations committee; and the compensation committee is typically responsible for some aspects of human capital management.
- **The full board or nom/gov committee might be best positioned for the responsibility of coordinating efforts.** There are risks to be controlled and managed, including potential overlap in responsibilities ("mission creep") as well as the siloing of issues with individual committees. The full board, or nom/gov committee, is likely best able to assess where issues overlap (or where they are buried).
- **Collaboration among committees can be enhanced by holding joint meetings.** For example, a joint meeting of the audit and nom/gov committee could focus on the overlap between strategy/substance and disclosure. This is an effective way to break down siloes.
- **How ESG responsibilities are allocated and who is responsible for coordination should be detailed (and kept up to date) in the company's corporate governance documents.** Many companies are now reviewing their committee charters relating to ESG responsibilities, and this should be an annual process. The governance of ESG may evolve as a company moves from establishing its ESG program, to executing it, to refining it over time. Further, it's important for companies not to limit the review to committee charters, but to include the corporate governance policy, transaction approval guidelines, ethics and compliance policy, and other documents relating to the responsibilities of the full board.
- **The allocation of ESG responsibilities should include a discussion of committee rotation and committee chair succession.** Just as boards consider the composition of the full board on a continuous basis, so should they be thinking about the composition of their committees to ensure each committee is made up of directors with the right mix of skills and experience to effectively oversee the expanding list of committee responsibilities.

Board leadership

The shifts toward ESG and stakeholder capitalism also have implications for board leadership. Indeed, in choosing a board chair or lead independent director (LID), boards may wish to consider a broader set of skills, experiences, and attributes than before. An effective chair/LID works well with the CEO, is respected by other directors, and often engages with shareholders. In the current era, it is also helpful for the LID or independent board chair to embody and model some of the key attributes sought in directors today, including openness to change and intellectual curiosity. And it is important to ensure that the LID or board chair is conversant in ESG topics and sees ESG as an area of opportunity, not just risk or regulatory burden for the board.

The Impact of ESG and Stakeholder Capitalism on Board Capabilities

The intensified focus on ESG and stakeholder interests has increased the need for boards to assess and improve their capabilities in these areas. But unlike financial literacy or being an audit committee financial expert, there is no regulatory or commonly accepted determination of the level of ESG knowledge a board should have.

Yet, a 2021 survey of over 500 C-suite executives found that only 30 percent rated their board's "expertise" in ESG as good or excellent.[4] There may be several reasons for this low score: 1) the survey asked about expertise, rather than familiarity or fluency; 2) some still associate ESG primarily with climate, an area where directors are unlikely to have significant expertise or even experience; 3) the results may be shaped by management anxiety about its own level of ESG knowledge—or it may not have a full understanding of the board's ESG capabilities.

Board fluency in ESG

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. There are three filters it can apply when setting goals (or expectations) for the board's ESG capabilities:

- **Focus on 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 Issues)

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

Social (~100 Issues)

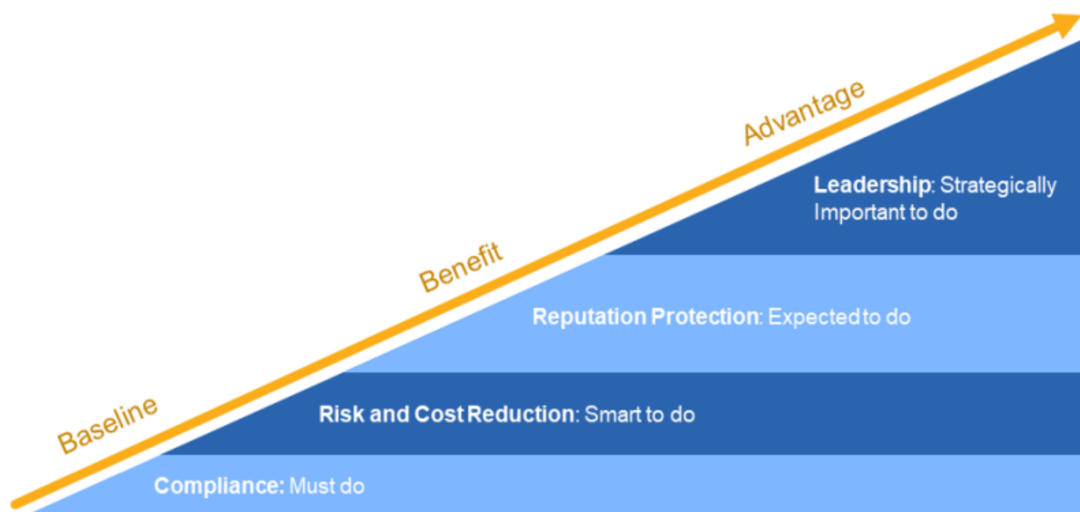
Animal rights and welfare	Supply chain and procurement practices
Corporate citizenship and philanthropy	Corporate culture
Economic impact	Diversity, equity, and inclusion (DEI)
Human rights	Talent recruitment and development
Corporate political activity	Employment and labor relations
Public health	Employee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

Governance (~50 Issues)

Anticompetitive 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
Board diversity	Executive compensation

Source: *The Role of the CEO in Driving ESG*, The Conference Board, November 2022

- **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. This is a fundamental part of making sure the board stays fluent—both on the issue and the company's position on the issue. It furthermore ensures that the board can lend its expertise where appropriate and make meaningful contributions.



Source: *The Role of the CEO in Driving ESG*, The Conference Board, November 2022

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

Ways boards can enhance or maintain their own fluency in ESG:

- **Be(come) more educated on ESG issues that tie to the firm's main risks and opportunities.** For example, set aside time at board meetings (or dinners or supplemental sessions) to learn about the company's major ESG priorities and plans. Meet regularly with the firm's senior sustainability executives or arrange other opportunities for a deeper dive into key ESG areas that matter most to the company.
- **Hold an (annual) enterprise risk meeting where senior risk executives update the board on the latest regulatory developments and expectations, mission-critical risks, industry trends, and broader ESG/governance lessons learned (e.g., from the *Boeing* case).** This allows for a discussion about where the firm's (and industry's) greatest risks and opportunities are, the firm's risk culture, and whether the board is comfortable with the processes and practices in place for identifying, managing, and mitigating those risks.
- **Seek outside education on ESG.** It is common for companies to inform directors about external governance programs and seminars. Attending these may be covered by the directors' travel & expenses policy.

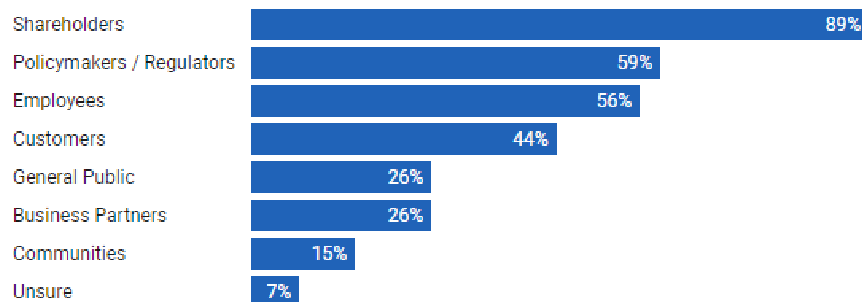
Board knowledge of stakeholders

Board knowledge of *stakeholders* has several dimensions. These include: 1) how different stakeholder groups view the company, 2) how the company is affecting stakeholders, and 3) how the company is balancing the needs of different stakeholders, including when 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 trade-offs in the company's approach.

Boards tend to understand their investors' views better than they do those of other stakeholders. Indeed, a vast majority (89 percent) of working group participants said that their board has a good understanding of their investors' expectations. Only 56 percent of boards are believed to understand the views of employees, followed by customers (44 percent), the public and business partners (26 percent), and communities (15 percent).

Boards best understand investor expectations

Q: My board has a good understanding of the views and expectations regarding the firm of the following key stakeholder groups (choose all that apply)



In-meeting poll question - 27 repondents

Source: The Roles of the Board in the Era of ESG and Stakeholder Capitalism Working Group - Session 2 •

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

Boards that don't understand their business partners' (and to some extent their customers') views/expectations of the company can benefit from learning about them. Pressure from business partners and consumers to address a plethora of ESG issues, such as climate and diversity, has increased significantly in recent years: nearly 70 percent of procurement officers are now considering sustainability when choosing suppliers[5] and for consumers, there is a disconnect between the top sustainability attributes that influence their purchases and what companies are disclosing.[6] This underscores that there are real business and financial consequences for (not) addressing these stakeholders' expectations, and companies will therefore want to make a concerted effort to get their perspectives into the boardroom.

Companies can enhance their board's understanding of stakeholder perspectives by:

- **Bringing in outside expertise to keep the board up to date on external views of the company.** Outside experts can conduct independent surveys of how investors, employees, and/or others view the firm and share the results with the board.
- **Ensuring the CEO is transparent with the board about how various stakeholders view the company.** To this end, the CEO can meet with investors and other stakeholders and bring the learnings from those conversations back to the board. It's pivotal that boards stay current on market views and hear about the good, the bad, and the ugly so they understand their strong points and their areas for improvement.
- **Having their directors—the independent board chair or LID specifically—engage directly with their firm's stakeholders to hear firsthand about their attitudes toward the company**. These conversations can be uncomfortable, especially when difficult issues are raised. However, it's critical for the board to listen and learn—and make sure management sufficiently addresses stakeholders' concerns.

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[1] Thomas Singer, *Purpose-Driven Companies: Lessons Learned*, The Conference Board, October 2020.

[2] Although this number is high, it's not that surprising given the scope of issues examined (39 issues, including common ones such as compliance & ethics and CEO succession).

[3] Merel Spierings and Paul Washington, *The Role of the CEO in Driving ESG*, The Conference Board, November 2022.

[4] *Board Effectiveness: A Survey of the C-suite*, PwC and The Conference Board, November 2021.

[5] *Sustainable Procurement Barometer 2021*, EcoVadis, July 2021.

[6] *Sustainability: Purchase Drivers vs Disclosure*, The Conference Board, May 2022.