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 4 | Tuesday, November 15, 2022 | Virtual Meeting

This Working Group, which consisted of a series of four sessions held under the Chatham House Rule, discussed 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 (see the full summary). The second session on September 13th addressed how companies are responding to these trends in board composition, leadership and committee structures, and capabilities (summary). The third session on October 13th focused on the two connected topics of (1) informing your board on ESG issues and stakeholder expectations and (2) the board's role in the company's communications and their own direct engagement with stakeholders (summary). The fourth and final session on November 15th addressed how boards can effectively evaluate the company's and senior management's ESG performance and relationships with stakeholders, as well as how boards can evaluate their own performance in this era of ESG and stakeholder capitalism. Below are the key takeaways from that discussion.

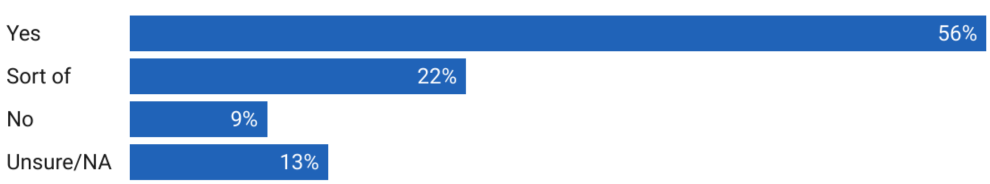
This Working Group is generously sponsored by Morrow Sodali and Weil, Gotshal & Manges.

Evaluating the *Company's* ESG Performance and Stakeholder Relationships

Evaluating the company's ESG performance

1. **Boards are evaluating their company's performance in ESG, but their assessment is somewhat rudimentary, according to a poll of working group participants.** Although a majority of respondents indicated that their board evaluates – at least to some extent – their company's ESG performance, almost half (48%) believe their board is only doing an *OK* job. Another 21% say their board is doing a *good* job and only 7% thinks it's doing an *excellent* job.

Poll question 1: Does your board evaluate your company's ESG performance on at least an annual basis?



32 respondents

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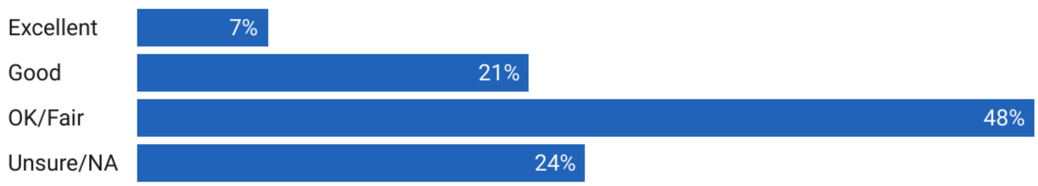
Poll question 2: How good of a job does your board do in evaluating your company's ESG performance on at least an annual basis?



29 respondents

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2. **The assessment of the company's ESG performance will depend on the maturity of the overall ESG program and the company's position on each issue.** Indeed, there will be a different degree of evaluation, depending on how deeply ESG is embedded in the company: from compliance with the law, to risk and cost reduction, to reputation protection, to leadership. Moreover, especially in those areas where the company is taking a leadership role, the board, when evaluating company performance, should consider the firm's impact on its own long-term welfare, as well as on its stakeholders, society at large, and the natural environment.

3. **The company's ESG performance evaluation needs to be built into the overall business evaluation.** An assessment of the firm's ESG performance will likely be ineffective if it gets done in a silo with the board focusing on just a few narrowly defined ESG measures. Just as ESG needs to be integrated into business strategy and operations to augment impact, so should ESG performance be measured as part of a more holistic review of the company's overall performance.

4. **While boards should look at ESG as part of the company's business, evaluating ESG performance is not as straightforward as evaluating financial performance.** Assessing ESG performance isn't as simple as looking at a few well-established financial metrics such as total shareholder return or earnings per share. In addition to the absence of universal (or even generally accepted) ESG metrics to assess *substantive* performance, there is also a need for boards to address process matters. These may require a somewhat different mindset, with the board asking questions such as: What does ESG/sustainability mean for the company? How are we integrating sustainability into the business in order to reduce risks and take advantage of opportunities? How are we organizing to successfully execute our sustainability strategy? How are we setting goals? How are we communicating our sustainability story? And how are we dealing with reporting frameworks, rating agencies, and regulators?

5. **While evaluating the company's performance in ESG does require a somewhat different approach from evaluating financial performance, companies already have a meaningful level of information about ESG performance – but that simply hasn't been shared with the board yet as part of an annual review process.** Companies may have already been tracking performance on certain ESG topics that are an integral part of their business strategy or company culture (e.g., employee health & safety; pollution; diversity, equity & inclusion). While it may take time to develop other relevant ESG measures of performance (e.g., percentage of revenue derived from, or spend on, sustainability-linked products and services), companies can start now by incorporating existing measures in their year-end (or even quarterly) assessments of corporate performance.

6. **Companies should determine their own approach to evaluating their ESG performance to avoid being pulled in various directions**. Companies are facing numerous ESG (disclosure) regulations – both in the US and beyond – as well as a myriad of expectations from investors, rating agencies, and other stakeholders. If they simply measure their performance in response to either investor concerns (who may be focused too much on risk and not enough on strategic opportunities) or regulations (which are different depending on the region),

the assessment might become fragmented and misshapen. By taking a business-oriented, tailored approach – similar to what they already do when it comes to risk management – companies are more likely to look at ESG performance in an integrated way.

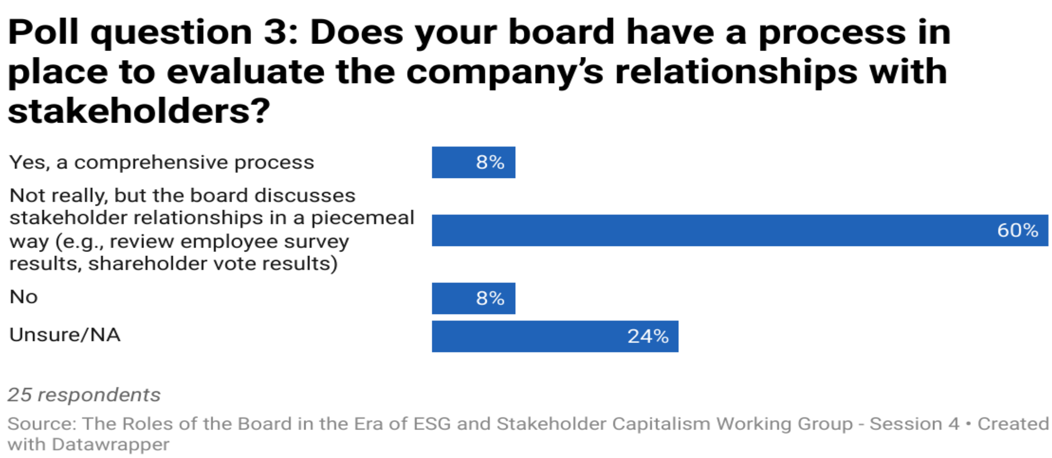
7. **The company's ESG performance evaluation should be driven by senior management, not the board**. Indeed, management owns this process and needs to ensure it has the systems and tools in place to measure and report on company performance. Only when management is comfortable that the company's performance in ESG can be – and has been – adequately assessed, the board can get involved.

8. **There should be alignment among the board's assessment of the company's, senior management's, and its own board performance in ESG.** These evaluation processes tend to be discrete and somewhat disconnected. It's especially important that the board's assessment of senior management's performance and its own performance tie back to the evaluation of the company's performance.

9. **There should also be some level of alignment between the board's assessment and investors' assessment of the company's ESG performance – but this can be hard to achieve.** Both boards and investors evaluate the company's performance in ESG, which is why boards will want to ensure there's alignment between how they themselves assess the company and how investors go about this. But there seems to be a disconnect in several respects. First, rather than taking a holistic view, investors tend to look at companies' ESG performance generically and – both driven by their own agenda and due to a lack of resources – often focus on a narrow set of metrics, without considering the company's unique circumstances or ESG priorities. Second, the way investors are structured (with a portfolio side that is focused on financial results and a stewardship side that is focused on ESG) is leading to bifurcation within companies as they are getting mixed signals regarding what they are being assessed on.

Evaluating the company's stakeholder relationships

10. **Boards are evaluating the company's relationship with its stakeholders in a somewhat ad hoc manner, according to a poll of working group participants.** Indeed, a majority of respondents (60%) indicated that their board doesn't have a comprehensive process in place to evaluate the company's relationships with stakeholders but rather discusses stakeholder relationships in a piecemeal way. For example, the compensation committee might be looking at employee satisfaction and the nominating/governance committee might be looking at shareholder voting results.



11. **Companies can evaluate their relationships with stakeholders in various ways.** For example, they can look at the *quality of the relationship* with each stakeholder group (that is, investors, employees, consumers,

business partners, regulators, etc.); whether they are serving their stakeholders' *interests*; and/or if they're meeting their stakeholders' *expectations*.

12. **With different stakeholders having divergent interests and expectations, it's nearly impossible to employ a unified stakeholder strategy, which is why each stakeholder group will require its own approach.** Generally speaking, companies will want to:

    – Consider the state of their relationship with *every stakeholder group* and ensure there's a constructive, two-way dialogue with each of them. This allows companies to understand what's important to their different stakeholders as well as where they can have the biggest impact.

    – Serve the interests of *most stakeholder groups,* as this is at the heart of the shift toward multistakeholder capitalism, in which companies are placing a higher priority on serving the long-term welfare of constituents beyond their shareholders. However, this is not that relevant when it comes to regulators, as companies typically are less concerned with serving their regulators' interests.

    – Meet the expectations of *some stakeholder groups* and educate others. While it's vital for companies to meet the expectations of their regulators and investors, it's going to be impossible to meet (or be guided by) the expectations of *all* their stakeholders, including employees and customers with views on all sides of the spectrum. To increase their stakeholders' (employees', especially) understanding and acceptance of the firm's positions, including on ESG, companies will want to educate their stakeholders about the company's business model and the intersection between the firm's business success and sustainability.

13. **Maintaining fruitful stakeholder relationships is a two-way street and takes some effort on the part of the company's stakeholders as well**. For example, as companies mature in their approach to and assessment of ESG, so should investors evolve in order for the dialogue on these complex and nuanced issues to remain constructive. This might require additional resources and a change in mindset (e.g., investors should not regard ESG solely as an area of risk but also opportunity or focus on generic metrics but take a tailored approach when assessing each company on ESG).

Evaluating *Senior Management's* ESG Performance and Stakeholder Relationships

14. **Boards have an opportunity to approach their annual evaluation of management's performance more holistically (including but not limited to ESG factors) by using their approach to succession planning as a model.** Boards and compensation committees typically assess management's performance in the context of executive compensation where they look at a predefined set of (predominantly financial and operational) goals. Yet, when it comes to promotion/development practices and succession planning, they tend to evaluate executives more comprehensively and look at how each individual executive is carrying out their full breadth of responsibilities as well as how they are doing in their relationships with stakeholders, which brings into play the executive's "soft skills" such as agility, authenticity, empathy, and ability to listen. There's an opportunity to bring some of that holistic approach to management's annual performance discussions. For example, to the extent that these soft skills have been implicit, boards can bring them up as an explicit discussion.

15. **Even while taking a more holistic look at executive performance, boards should not try to "re-do" the work that the CEO is already conducting in evaluating other executives' performance.** It's unrealistic to think that the board or compensation committee conducts a comprehensive review of each executive every year. However, it should have visibility into how the CEO evaluates each executive (including their ESG performance and relationships with stakeholders), and the CEO should bring to the board's attention anything notable, especially as it concerns risks and opportunities for the company.

16. **CEOs and boards will want to consider whether, how, and on what cadence to solicit input from across the C-suite on an individual executive's performance.** Compensation committees don't typically include, either in person or by proxy, the non-financial side of the house (e.g., human resources, government relations, corporate citizenship/community relations, marketing, and investor relations) when discussing executive performance. However, these functions represent the views of the company's stakeholders (e.g., employees, regulators, communities, consumers, and shareholders). CEOs and boards may want to consider how those departments' perspectives can be brought to bear in periodic, if not annual, evaluations of management's performance.

Evaluating *the Board's* ESG Performance and Stakeholder Relationships

17. **Boards don't need a separate questionnaire on how they are fulfilling their roles with respect to ESG and stakeholder views, but they should consider building these topics into the traditional board and committee self-evaluations.** In order for this to be successful, it needs to be practical. For example, boards can incorporate the notion of ESG and stakeholder interests into existing questions on board composition, leadership, and capabilities, and include oversight of ESG into questions on board committee structure and board meetings.

18. **There are, however, a few broader questions on ESG and stakeholder views that boards might want to add to existing evaluations.** These include whether the board has a good understanding of – and consensus on – the ESG issues that matter most and how to balance various stakeholder views; whether the corporate governance policy appropriately reflects the board's responsibilities with respect to ESG issues and stakeholder interests; and whether the board is effectively taking relevant ESG issues and stakeholder interests into account in its discussions and decisions.

19. **The evaluation of the board's ESG performance and stakeholder relationships will likely evolve over time.** Indeed, as a company's ESG program matures, so will the board's role with respect to ESG. Initially, the board may want to assess whether ESG responsibilities are allocated adequately among the full board and its committees. Later, this may shift to building – and evaluating – the board's understanding of key ESG issues and stakeholder views.

20. **A deeper and more advanced evaluation of the board's ESG performance and stakeholder relationships may result in an increased gap between what the board knows and what is disclosed.** Given its sensitive nature, boards need to be mindful about how transparent they want to be in their public disclosures regarding their performance in this area – whether it's in written materials or in engagement calls with investors.

21. **ESG can be a potential source of dysfunction on the board in several ways.** First, while boards may not make decisions on specific ESG issues, they are typically engaged before or informed at the time of a decision. This can get them sidetracked if they get too deeply involved on the company's stance – especially on divisive social or political issues. Second, directors may view the importance of ESG and stakeholder views very differently, which can lead to division and disagreement on the board. Ignoring this division can lead to simmering tensions, which in turn hinder board effectiveness.

22. **Having directors with divergent views on ESG and stakeholder capitalism, however, doesn't necessarily lead to dysfunction on the board, as long as the differences are addressed sufficiently.** One way to align director perspectives is by ensuring that ESG is integrated into the company's business strategy and engaging (and educating) the board on the business case for ESG so that individual directors get a better understanding of the company's most important ESG risks and opportunities. Different views can also be addressed and resolved through company purpose statement. If the board finds common ground on the company's purpose, it can have a cascading effect in maintaining a touchstone of consensus for future discussions.