



On the board's agenda | US

The front line of ESG disclosure: The board's role

Introduction

Rapidly changing global market trends in technology, the role of business in society, the effects of climate change, and other areas, have a significant impact on value creation. In response to these changes, companies and investors are taking a wider view of the opportunities and risks associated with businesses, particularly those related to the interdependent nature of businesses and the reliance of companies on people and natural resources to sustain and grow their businesses. To make informed decisions and evaluate how companies manage these risks and opportunities, stakeholder demands for more transparent, comparable, and reliable information on companies' environmental, social, and governance (ESG) risks and performance have never been greater—and the corporate community is taking notice.

The Business Roundtable recently released a statement on corporate purpose,¹ signed by over 180 CEOs who committed to leading their companies for the benefit of all stakeholders—

customers, employees, suppliers, communities, and shareholders. For board members, the statement underscored that directors need to understand the environmental and social impacts on the business strategy and risk profile of the companies they serve. Corporate response to the increasing risks and opportunities that ESG presents, along with the growing market expectation for better understanding of how ESG protects and drives value for an organization, has already resulted in a dramatic increase in disclosure. As companies continue to navigate this landscape, they will be called upon to provide even greater transparency in response to demands from stakeholder groups such as investors, customers, policy makers and regulators, and employees.

This issue of *On the board's agenda* explores developments influencing companies to improve transparency on ESG topics, and to consider the avenue for disclosure to most effectively meet the information needs of investors and other stakeholders. ➔

1. Business Roundtable, *Statement on the Purpose of a Corporation*

The reporting landscape: sustainability goes mainstream

There is mounting evidence that sustainability is going mainstream. The number of S&P 500 companies publishing some form of sustainability disclosure increased from 20 percent in 2011 to 86 percent in 2018.² Moreover, companies are currently placing more emphasis on the extent, form, location, and content of their environmental, social, and governance (ESG or sustainability) disclosures. Research by the Investor Responsibility Research Institute found that 40 percent of the S&P 500 now voluntarily address some aspect of sustainability in financial filings, and 23 percent address sustainability in their 10-Ks. Companies are also recognizing that simply providing the data may not go far enough for investors; accordingly, 36 percent of S&P 500 companies now obtain assurance on select ESG information in their sustainability reports and 3 percent obtain assurance on sustainability reports as a whole. The growing trend in which companies present or refer to broader nonfinancial measures in financial filings³ and obtain assurance on this information is based on the realization that such disclosures are an important consideration in the evaluation of company performance and future growth. Companies that are not harnessing the power of ESG transparency risk losing favor with investors or losing competitive advantage, and they may also be at a disadvantage when attracting and retaining customers and employees.

However, despite the demand for more transparency, there are still many unknowns in terms of how and what to disclose. A multitude of standard setting organizations supply reporting frameworks to the marketplace, and while some of these standard setters have similar metrics, there is currently no one ESG standard in the market to create transparent and comparable information. In addition, a host of raters and rankers supply data on sustainability performance to the market using their own proprietary methodologies, further complicating the landscape.

A glance at some of the commonly cited standard setters and raters and rankers demonstrates the fragmented state of sustainability disclosure that both companies and investors grapple with in the current marketplace. ➔



Standard setters

Sustainability Accounting Standards Board (SASB)

First US-based American National Standards Institute certified standard setter that provides industry-specific, financially material sustainability reporting standards.⁴

Global Reporting Initiative (GRI)

"An international, independent organization that helps businesses, governments and other organizations understand and communicate the impact of business on critical sustainability issues such as climate change, human rights, corruption and many others."⁵

Task Force on Climate-related Financial Disclosures (TCFD)

Established by the Financial Stability Board as "a market-driven initiative, set up to develop a set of recommendations for voluntary and consistent climate-related financial risk disclosures in mainstream filings."⁶

International Integrated Reporting Council (IIRC)

"The International Integrated Reporting Council (IIRC) is a global coalition of regulators, investors, companies, standard setters, the accounting profession, academia and NGOs. The coalition promotes communication about value creation as the next step in the evolution of corporate reporting."⁷



Raters and rankers

Over 650 raters and rankers provide ESG data to the market.⁸

	Examples:
ESG raters	CDP MSCI Sustainalytics
Credit raters	S&P Moody's Fitch
Proxy advisors	ISS Glass Lewis
Data providers	Bloomberg Thomson Reuters

2. Morgan Stanley, *Sustainable Signals: Asset Owners Embrace Sustainability*

3. Investor Responsibility, Research Institute, *State of Sustainability and Integrated Reporting 2018*

4. <https://www.sasb.org/>

5. <https://www.globalreporting.org/Pages/default.aspx>

6. <https://www.fsb-tcfid.org/>

7. <https://integratedreporting.org/the-iirc-2/>

8. www.ratesustainability.org



With no one ESG standard, companies may not clearly understand what information is valued by the marketplace, making them hesitant to collect and disclose additional data. Investors and other stakeholders also remain frustrated because information has varying degrees of quality and may not be consistent, comparable, and reliable.

What are stakeholders looking for?

Different stakeholders have different objectives and information needs, complicating companies' approaches to ESG disclosures.

Investors and shareholders

Investors express concern that they are not able to access consistent, comparable and reliable ESG information. Many believe the lack of disclosure requirements contributes to this challenge. Investor and shareholder interest have led to an increase in the attention companies are giving to ESG disclosure and transparency. In fact, a recent survey by McKinsey highlighted investors' belief that sustainability reports should undergo an audit to increase confidence in the data.⁹

Increasingly, investors expect a level of disclosure of ESG performance comparable to what they expect with respect to financial performance, reinforcing the importance of ESG as a factor in developing an overall company evaluation. Evaluating ESG information at the onset of a potential investment can help investors better understand and determine the investees' governance and short- and long-term strategies related to addressing material risks and opportunities. Once an investment takes place, investors use ESG information to monitor performance, much in the way they use financial information.

In addition to investment due diligence and performance monitoring, investors exercise their influence and execute their ESG strategies through proxy voting and shareholder proposals. The 2019 proxy season was the third consecutive year in which environmental and social-related proposals accounted for the majority of shareholder

proposals,¹⁰ and many proponents pushed for company action on ESG transparency, strategies, and goals. The importance to investors of engaging companies and holding directors accountable on ESG topics is reflected in the proxy voting guidelines and annual stewardship reports for some of the largest asset managers, including BlackRock and State Street Global Advisors.

- BlackRock's 2019 proxy voting guidelines for US securities state "We may vote against the election of directors where we have concerns that a company might not be dealing with E&S factors appropriately. Sometimes we may reflect such concerns by supporting a shareholder proposal on the issue, where there seems to be either a significant potential threat or realized harm to shareholders' interests caused by poor management of material E&S factors."¹¹ In the 2018–19 reporting year, BlackRock engaged 256 companies globally on environmental risks and opportunities.¹²
- State Street's 2019 proxy voting and engagement guidelines stated "When voting, we fundamentally consider whether the adoption of a shareholder proposal addressing a material sustainability issue would promote long-term shareholder value in the context of the company's existing practices and disclosures as well as existing market practice."¹³ During the 2018–19 proxy season, State Street Global Advisors engaged 153 companies on sustainability and long-term strategy topics.¹⁴

Stock exchanges

As a result of the increased investor demand for ESG information, stock exchanges are acknowledging the importance of such disclosures. According to a sustainability survey¹⁵ conducted by the World Federation of Exchanges, "[n]early all responding exchanges (90%) reported having some form of ESG initiative." In addition, Nasdaq recently published an ESG reporting guide¹⁶ to encourage disclosure and offer support to companies navigating the evolving disclosure standards. The guide is intended to help companies across geographies and market capitalizations with their ESG reporting efforts. ➤

9. McKinsey & Co., *More than values: The value-based sustainability reporting that investors want*, August 2019

10. See Westcott, Shirley, "2019 Proxy Season Preview," Harvard Law School Forum on Corporate Governance and Financial Regulation, April 15, 2019

11. BlackRock Proxy Voting Guidelines for US Securities, January 2019

12. BlackRock 2019 Investment Annual Stewardship Report

13. State Street Global Advisors, 2019 Proxy Voting and Engagement Guidelines: North America (United States & Canada)

14. State Street Global Advisors Stewardship Report, 2018–19

15. WFE Sustainability Survey April 2019, *Exchanges Advancing Sustainable Finance*

16. Nasdaq, *ESG Reporting Guide 2.0—A Support Resource for Companies*, May 2019

Policy makers

The European Union (EU) significantly advanced ESG disclosure by issuing a directive¹⁷ on nonfinancial reporting which requires certain companies to disclose nonfinancial information. Depending on the specific requirements determined by each EU member state, information must be disclosed about environmental performance, social and employee matters, human rights performance, and anticorruption and antibribery matters. Given the global reach of investors and other stakeholders coupled with the fact that EU companies now disclose ESG performance, global entities that do not provide such information may be at a disadvantage. Other recent actions include the European Commission's examination of how to integrate sustainability considerations into its financial policy framework and recent adoption of a sustainable action finance plan.

While there has been some regulatory action in Europe, the momentum is just starting to build in the United States, with recent Congressional hearings on climate change and limited proposals on ESG disclosure. On September 20, 2019, H.R.4329, the ESG Disclosure Simplification Act passed out of the US House of Representatives Financial Services Committee. Should the proposal become law, it would require public companies to disclose certain ESG matters in annual filings with the Securities and Exchange Commission (SEC). Though regulatory action in the current US environment seems unlikely, a threshold for reporting this information already exists. Registrants are required to disclose material information to comply with the SEC's disclosure requirements, meaning, if companies determine that ESG topics are "material" under the SEC's requirements, companies should consider the appropriate disclosure.

Customers

Product expectations are changing as millennials and Generation Z enter into and mature within the workforce and develop more disposable income of their own. According to Deloitte's 2019 Millennial Survey,¹⁸ these end-consumers will patronize and support companies that align with their values, with 42 percent saying that they have begun or deepened a business relationship because they perceived a company's products or services to have a positive impact on society or the environment.

Employees

Similar to customers, employees seek to work at companies that reflect their expectations with regards to purpose, culture, and professional development. Companies that deliver alignment on those expectations may be better positioned to attract and retain the best talent. For example, Millennials, who became the largest generation in the workforce in 2016,¹⁹ have "concerns about safety, social equality, and environmental sustainability and believe that business should consider stakeholders' interests as well as profits", according to Deloitte's 2019 Millennial Survey. ESG disclosure can serve as a differentiator among companies and can enhance an employee's confidence, trust, and loyalty across generations.

17. Directive 2014/95/EU, *Non-Financial Reporting*.

18. The Deloitte Global Millennial Survey 2019—*Societal Discord and Technological Transformation Create a "Generation Disrupted."*

19. Pew Research Center, *Millennials are the largest generation in the labor force*, April 11, 2018

20. Directors & Boards, "SEC Chief Takes on Short-Termism and ESG."

How does this impact the board?

The surge in ESG reporting is only beginning. As the market continues to organize around disclosure standards and methods, the board's accountability in this area will likely increase. Directors will need to better understand how sustainability is linked to a company's strategy and the corresponding opportunities and risks. As SEC Chairman Jay Clayton recently said, "If a matter—whether it is considered an ESG matter or not—is going to affect the company's bottom line or presents a significant risk to the business, I would expect [boards of directors] to do something about it. If the matter is material, I also would expect the company to disclose the matter and what they are doing about it. This is consistent with general fiduciary obligations of directors and officers, as well as our disclosure rules."²⁰

Directors will likely also play a role in helping their companies to proactively communicate their corporate purpose and sustainability story to the stakeholder groups outlined here. Those who are not responsive to the market movement towards increased transparency and disclosure may find themselves on the defensive, losing the opportunity to craft the story and control delivery of the narrative. This could have a lasting effect on public perception of a company and damage a carefully built brand and reputation. ➤



Questions for the board to consider asking:

1. Does the board understand the risks and opportunities for the business with respect to sustainability? Is there an understanding of how those risks and opportunities impact the company's strategy? Is ESG integrated into the company's enterprise risk management activities?
2. Who within the company is responsible for ESG management and performance disclosure and what is the internal governance structure? How does the company identify ESG issues that are material and collect data that supports high-quality disclosure?
3. Does the company understand what types of disclosures its largest investors and other stakeholders seek and how does the company and the board respond? Is there an established and compelling sustainability narrative that the company uses to tell its story?
4. If the company currently reports on ESG matters, how often is the form and content of that reporting revisited to assess changes and modifications to reflect current trends?
5. Is sustainability the responsibility of the full board or is it delegated to one or more committees? What role could the audit committee play in reviewing and assessing the disclosure of material ESG matters? How often does the Board receive updates on sustainability performance and through what form?

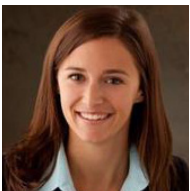
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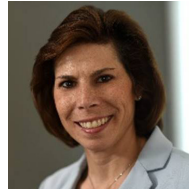


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