ESG: ADDRESSING AN EVOLVING ISSUE

By Kelly Malafis

In August 2019, the Business Roundtable came out with a new statement on the purpose of a corporation. For the first time, the focus expanded from serving shareholders and creating long-term value to serving all stakeholders by delivering value to customers, investing in employees, dealing fairly and ethically with suppliers and supporting the environment and people in the community.

While this statement is bold, it is a response to the increased focus by shareholders on Environmental, Social and Governance (ESG) matters. Investors are evaluating how companies are addressing ESG issues and their impact on the long-term sustainability and value creation for each organization. Some of the largest institutional investors, including BlackRock and State Street, have put boards on notice that they will be holding directors and company management accountable for how ESG issues are managed. The major proxy advisory firms (Institutional Shareholder Services and Glass Lewis) now provide their clients with ESG ratings for each company they evaluate, highlighting related risks to investors in these areas.

What should board members generally and compensation committee members specifically be doing to address ESG? Each board should define what ESG means for their organization as each company has a unique operating model or business strategy that may include ESG initiatives to varying degrees. Many boards are doing this. We have seen the creation of ESG committees of the board or modifications to committee charters to incorporate ESG oversight (for example, many compensation committees now have oversight of diversity and inclusion). Once companies and boards define what ESG means for them, it will be important to articulate the following:

- Objectives for each of these initiatives
- Criteria for assessing performance against these objectives
- Approaches for holding management accountable

The governance area of ESG has improved in the past decade, with many organizations focused on strengthening shareholder rights and demonstrating the alignment of pay and performance in response to input from shareholders and shareholder advisory groups. A strong and independent board is a key factor in governance and across industries, and many boards have embraced independent director sessions, board refreshment and balanced tenure, skills and diversity. Showcasing of governance enhancements has become common in proxy statements, and we expect companies to continue to maintain strong governance practices.

The environmental aspects of ESG have been more common in certain industries, such as energy, utilities and manufacturing, though the focus on the environment is gaining momentum across industries. Companies are focusing on how they manage climate change, emissions, spills, water conservation and other sustainability efforts. Organizations such as the Sustainability Accounting Standards Board have developed standards so companies and investors can assess the risks and opportunities across industries.

The social aspects of ESG have focused on human capital and the impact of a company's products or policies on society. The topics of human-capital management, employee engagement and gender pay equity have increasingly worked their way into board meeting conversations, with gender pay equity raising the fundamental issue of representation and inclusion. These statistics are measurable, and detailed analysis over time can help hold management accountable and demonstrate progress. It is now very common for compensation committees and, in some instances, the full board to receive updates on representation across an organization.

A natural question is to what extent should ESG factors be incorporated into incentive compensation plans? CAP reviewed the proxy statements of 2020 early filers (companies that filed their most recent proxy statement between December 2019 and January 2020) and found that approximately one-third incorporate some type of ESG metric in their executive compensation plan decision-making. The types of metrics varied significantly by industry as not all aspects of ESG will be critical to every organization's business strategy. For example, carbon emissions may be more material for an energy company than a professional services company. When incorporating ESG factors, most companies in our review applied the metric to their annual incentive plans using a qualitative assessment of the factor. The metric generally reflected a small percentage of the overall weighting (5 percent–15 percent of the total incentive). Companies and boards should discuss the best ways to hold management accountable for ESG progress, including incorporating such progress into incentive plan performance.

Every board and management team should identify which ESG matters are material to their organization and understand how they should be approached and monitored and how to communicate their approach to investors. While the Covid-19 pandemic in 2020 has turned the focus of management on business continuity and crisis management, we expect ESG matters will continue to be prominent factors considered by institutional investors, proxy advisory firms and other stakeholders. It will be important for companies to define the ESG factors that have the greatest impact on their business as transparency and disclosure on how ESG matters are addressed have become increasingly essential parts of shareholder engagement.

Every board and management team should identify which ESG matters are material to their organization and understand how they should be approached and monitored and how to communicate their approach to investors.

Kelly Malafis (kelly.malafis@capartners.com) is a founding partner of Compensation Advisory Partners, who advises committees and management on executive and director compensation matters.

cap Compensation Advisory Partners