

# STRATEGIC OVERSIGHT OF ESG

## A BOARD PRIMER

EXCERPT

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# UNDERSTANDING THE BOARD'S ROLE IN ESG OVERSIGHT

ESG (environmental, social, and governance) performance as a criteria for investment has a growing impact on value preservation, value creation, and, ultimately, the future of the corporation itself. Although ESG is as broad as it is amorphous in scope, it is not an insurmountable topic for the board agenda. Here, we provide background information on why ESG has become a board-level issue and how boards can break this large topic into smaller components that will enable them to provide effective oversight of ESG.

To ensure a practical focus on how corporate boards can provide effective oversight of ESG, NACD interviewed company directors and sustainability executives representing a wide spectrum of companies varying in size, maturity, and industry. Their insights have been collected and distilled for this primer, which has been designed not only for directors who are just beginning to have ESG discussions in the boardroom but also for those who seek to refresh and refine their knowledge. Quotes from director interviewees have been anonymized and appear in italics throughout.

## The Evolution of ESG

Although the capital markets have a long, if varied, history of making socially conscious investments, it was arguably the launch of the Who Cares Wins initiative in 2004 that sought to make ESG concerns a core component of mainstream investment decisions.<sup>1</sup> This joint effort between the UN Global Compact, the International Finance Corp., and the Swiss government resulted in the creation of the Principles of Responsible Investing (PRI), which officially launched in 2006.<sup>2</sup> Since then, the number of signatories has grown from 100 to more than 2,800 globally, demonstrating the mainstream and widespread adoption of ESG criteria in investing.

The investor community has intensified its focus on the intersection of business with larger concerns for people and the planet, and as a result, companies and their boards have gradually started to prioritize doing business responsibly. In the *2019–2020 NACD Public Company Governance Survey*, nearly 80 percent of directors reported that their board is focused on some aspect of ESG,<sup>3</sup> with 52 percent seeking



**For us, sustainability is not an end in and of itself; it is a means by which we turn over more rocks, look at more information, and add a complementary lens in order to gain conviction on a company's strategy, operations, and prospects for growth.<sup>4</sup>**

– Karina Funk, a portfolio manager at Brown Advisory Inc.

<sup>1</sup> Global Compact, *Who Cares Wins: Connecting Financial Markets to a Changing World*, 2004.

<sup>2</sup> PRI Association, "About the PRI."

<sup>3</sup> NACD, *2019–2020 NACD Public Company Governance Survey* (Arlington, VA: NACD, 2019), p. 5.

<sup>4</sup> Esther Whieldon, Michael Copley, Robert Clark "Major ESG investment funds outperforming S&P 500 during COVID-19."

ways to improve their own understanding of ESG performance.<sup>5</sup> This data suggests that today’s directors are becoming increasingly aware of the importance of ESG to investors, consumers, and the company’s bottom line.

Directors are bound by fiduciary duties, which many argue now extend to considering ESG factors when providing oversight of strategy and risk. The broad scope and dual nature of ESG—which facilitates the creation of opportunities for business or reputational value, while also managing risks associated with ESG impacts—present a significant governance challenge for boards.

Directors who are approaching ESG oversight for the first time are likely most familiar with the G (governance) element, which encompasses the traditional corporate governance domain, including the effectiveness of the board and its committees in areas such as setting executive compensation, nominating board candidates, and overseeing financial reporting and disclosures.

The E (environmental) and the S (social) elements—and the specific ways in which boards need

to be attuned to them—may be less familiar territory for many directors. (Nevertheless, just as some of the more nuanced details of governance are universal, there are some E and S factors, such as employee health and safety, that apply to all companies, regardless of their industry sector.) Figure 1, below, breaks down facets of each ESG component.

Unlike governance (the G), for the E and the S, the majority of factors are industry specific. For example, a technology company that uses server farms is more likely to consider monitoring energy management and less likely to care about greenhouse gas emissions, while an airline may have greenhouse gas emissions as a focal point but not water use.

As boards begin to learn about ESG, it can be easy to drown in the “alphabet soup.” The board should be mindful of not getting lost in the terminology. As one former sustainability officer noted, “Directors should use the signals these terms provide to drive oversight of risk, bottom-line results, value-chain resiliency, productivity, innovation, long-term shareholder value, and value creation for the business and society.” (See below.)

FIGURE 1  
Selected ESG Topics

ENVIRONMENTAL	SOCIAL	GOVERNANCE
Climate Change Energy Management Environmental Impact of Product Portfolio Environmental Management Water Use and Sourcing Natural Resources Biodiversity, Emissions	Health and Safety Human Rights Human Capital Management Data Privacy Employee Rights	Business Ethics Compliance Board Structure Board Composition Compensation Shareholder Rights Executive Compensation Anti-Corruption, Bribery

<sup>5</sup> NACD, 2019–2020 NACD Public Company Governance Survey (Arlington, VA: NACD, 2019), p. 26.

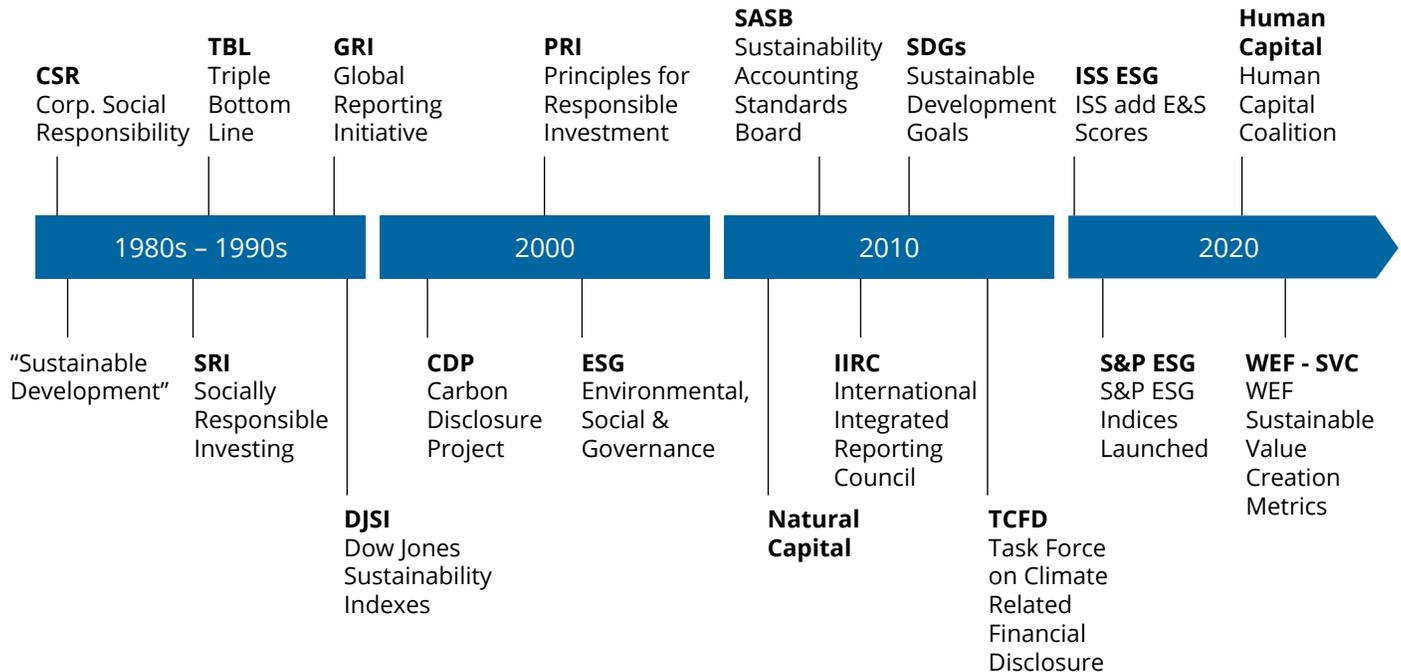
## Key ESG Terms and Time Lines

The idea that all companies have a role to play in the betterment of society is not a new concept, but the role of the corporation since the United States was founded has evolved. In their earliest forms, corporations were granted government approval and were required to serve a public interest.<sup>6</sup>

Shareholder primacy became the prevailing theme in the 1970s,<sup>7</sup> with the purpose pendulum beginning to swing back to stakeholders in the

1980s. As they tend to do, the pendulum has continued to swing back and forth between these two purposes for the past 40 years. The key terms and time line illustrated in Figure 2 conveys how the ideas underpinning the modern ESG movement have emerged, evolved, and become more refined over the past 40 years. Figure 3 shows a few of the most common investing styles on a values spectrum.

FIGURE 2  
ESG Timeline and Key ESG Terms



Source: 21C Impact. Used with permission.

<sup>6</sup> Leonardo Davoudi, Christopher McKenna, and Rowena Olegario, "The historical role of the corporation in society," *Journal of the British Academy*, Volume 6, Supplementary Issue 1 (*Reforming Business for the 21st Century*).

<sup>7</sup> Milton Friedman, "The Social Responsibility of Business Is to Increase Its Profits," *The New York Times*, September 13, 1970.

### Socially Responsible Investment

“This is considered the oldest and most established term relating to sustainable investing, and is grounded in more ethically and values-focused approaches to investment.”<sup>8</sup>

### Corporate Social Responsibility

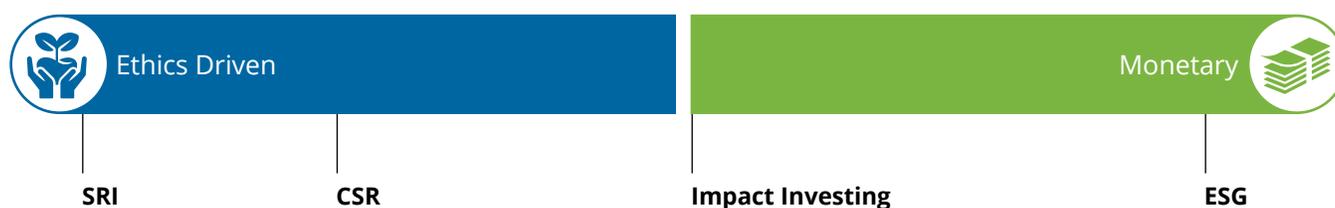
Corporate social responsibility is a type of international private business self-regulation that aims to contribute to societal goals of a philanthropic, activist, or charitable nature by engaging in or supporting volunteering or ethically-oriented practices.<sup>9</sup>

### Impact Investing

“Impact investments are investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return.”<sup>10</sup>

FIGURE 3

## Sustainability Investing Spectrum



### COVID-19 Puts ESG in High Relief

The coronavirus pandemic that began in the early part of 2020 globally has heightened the perception that ESG factors can affect a company's risk management and improve their resiliency. UBS, in a statement on sustainable investing after COVID-19, said that, “We expect increased investor focus on ESG considerations after COVID-19, with particular demand for greater corporate transparency and stakeholder accountability.”<sup>11</sup> The year 2019 saw a record year of net flows into sustainable trade funds in the United States at \$20.6 billion for the year, which is four times the previous record set in 2018.<sup>12</sup> In the first quarter of 2020, ESG funds saw half of last year's total inflows at \$10.5 billion.<sup>13</sup> ESG-focused funds weathered the first quarter of 2020 better than their conventional counterparts did, with 24 of 26 ESG index funds outperforming their closest counterparts.<sup>14</sup>

While some of this outperformance can be attributed to less exposure in the oil and gas sector, ESG indices focus on companies that have disclosed a focus on comprehensive risk assessment—information not only on potential ESG risks but also on the impact of their mitigation strategies, such as decreased total Occupational Safety and Health Administration recordable incidents and reduced costs from natural resources.

“The pandemic has demonstrated on a large scale the importance of other factors that are paramount to ESG investors. Among them: disaster preparedness, continuity planning and employee treatment through benefits such as paid sick leave as companies direct employees to work from home.”<sup>15</sup>

<sup>8</sup> Schroders, *Understanding sustainable investment and ESG terms*, p. 5.

<sup>9</sup> Sheehy, Benedict, “Defining CSR: Problems and Solutions,” *Journal of Business Ethics*, December 2015.

<sup>10</sup> See the Global Impact Investing Network's webpage, “About Impact Investing.”

<sup>11</sup> UBS, “Sustainable investing after COVID-19,” May 12, 2020.

<sup>12</sup> Jon Hale, “Sustainable Fund Flows in 2019 Smash Previous Records,” *Morningstar*, January 10, 2020.

<sup>13</sup> Pippa Stevens, “Sustainable investing is set to surge in the wake of the coronavirus pandemic,” *CNBC*, June 7, 2020.

<sup>14</sup> Jon Hale, “Sustainable Funds Weather the First Quarter Better Than Conventional Funds,” *Morningstar*, April 3, 2020.

<sup>15</sup> Kristin Broughton and Maitane Sardon, “Coronavirus Pandemic Could Elevate ESG Factors,” *the Wall Street Journal*, March 25, 2020.



## FOUR FUNDAMENTAL CHALLENGES

While ESG has become a common topic for discussion in the boardroom, many boards struggle with how to deliver effective ESG oversight. NACD has identified four fundamental challenges and provided corresponding solutions that draw from primary research.

### CHALLENGE 1

#### **Defining ESG for Your Organization**

- Use company products & services to anchor your company's definition of ESG.

### CHALLENGE 3

#### **Moving the Board to Active Oversight**

- Clarify the board's ESG oversight responsibility and roles.
- Ensure effective management reporting to the board.

### CHALLENGE 2

#### **Integrating ESG Into Company Strategy**

- Identify the most material risks and opportunities.
- Link ESG to the company financials.

### CHALLENGE 4

#### **Addressing Increasing External Expectations**

- Engage with investors to understand their unique perspectives.
- Understand critical stakeholder perspectives.
- Externally report the current state of the company's ESG oversight.



## CHALLENGE 2

# INTEGRATING ESG INTO COMPANY STRATEGY

Incorporating ESG into the overall company strategy helps focus company resources on the most important business areas. According to the [2019–2020 NACD Public Company Governance Survey](#), 49 percent of respondents said that they had discussed ESG’s link to long-term strategy during 2019.<sup>18</sup> Boards should be involved throughout the strategy-setting process, and they have a critical role to play during periods of adjustment, especially when a company is incorporating new external trends and performance expectations—such as ESG—into the strategy.

Linking ESG with strategy and core operations demonstrates a company’s approach to creating sustainable, long-term value for investors. “We’ve

*heard directly from shareholders, ESG is not something you do on the side, it should be part of the strategy,”* commented one director. Another director shared a similar sentiment: “*These things have to be embedded in the strategy, the overall strategy of the company; they can’t sit on top of it. [ESG] really had to become fundamental to how the company’s strategy is executed.*”

This incorporation into the company’s overall strategy remains a struggle for many. According to State Street Global Advisors’ CEO Cyrus Taraporevala, less than 25 percent of the companies evaluated and engaged by State Street had meaningfully identified, incorporated, and disclosed material ESG issues into their strategy.<sup>19</sup>

<sup>18</sup> NACD, [2019–2020 NACD Public Company Governance Survey](#) (Arlington, VA: NACD, 2019), p. 10.

<sup>19</sup> State Street Global Advisors, “[CEO’s Letter on our 2020 Proxy Voting Agenda](#),” January 28, 2020.

SOLUTION 1

**IDENTIFY THE MOST MATERIAL ESG RISKS AND OPPORTUNITIES**

The first step to integrating ESG into the company’s strategy is to look at the risks and opportunities. The board needs to understand the current ESG risk profile or key exposure areas for the company that they serve. A risk profile identifies and assesses the risks that are inherent in the corporate strategy and business model<sup>20</sup> and should consider

the company’s most material ESG risks. ESG risks should be considered and evaluated in the same manner as other traditional enterprise risks. In its [2019 report](#), Ceres, an investor-driven organization, demonstrates how ESG risks can be treated like traditional risks as seen in Figure 5.

FIGURE 5  
**How do ESG factors fit within mainstream risks?**

TYPE OF RISK	EXAMPLE	ESG FACTORS
<b>Governance Risks</b>	Board decision-making including CEO selection, executive compensation and board composition	<ul style="list-style-type: none"> <li>• Growing shareholder focus on:                             <ul style="list-style-type: none"> <li>– Diversity of the board</li> <li>– Recruiting directors with ESG or climate expertise with the ultimate goal of building “climate competent boards”</li> <li>– Linking executive compensation to ESG factors</li> </ul> </li> <li>• ESG risk impact on directors’ and officers’ insurance</li> </ul>
<b>Board Approval Risks</b>	<ul style="list-style-type: none"> <li>• M&amp;A</li> <li>• divestiture</li> <li>• major capital expenditures</li> <li>• new product lines</li> </ul>	<ul style="list-style-type: none"> <li>• ESG performance as a factor in mergers and acquisitions-related valuations</li> <li>• Access to capital impacted by ESG performance</li> <li>• Growing consumer focus on ESG solutions</li> </ul>
<b>Enterprise Risks</b>	<ul style="list-style-type: none"> <li>• Reporting risks</li> <li>• operational risks</li> <li>• human resources/ labor risks</li> <li>• compliance risks</li> <li>• reputational risks</li> <li>• litigation risks</li> </ul>	<ul style="list-style-type: none"> <li>• Fines and penalties arising from ESG violations</li> <li>• ESG regulations</li> <li>• ESG-based litigation</li> <li>• Extreme weather events disrupting operations</li> <li>• Workplace injuries or deaths</li> <li>• Sexual harassment</li> <li>• Data privacy and data security breaches</li> <li>• Market devaluation from an ESG liability                             <ul style="list-style-type: none"> <li>– Loss of liability insurance coverage</li> <li>– Loss of assets, reduced profits and reputational damage</li> <li>– Diminished likelihood of business receiving services and capital from financial institutions</li> </ul> </li> </ul>
<b>Emerging Risks</b>	<ul style="list-style-type: none"> <li>• New technologies</li> <li>• economic/regulatory policy change</li> </ul>	<ul style="list-style-type: none"> <li>• Impacts from growth of artificial intelligence technology on job creation and local economies</li> <li>• Genetic engineering and nanotechnology impact on product development and human health</li> </ul>

Source: Ceres, *Running the Risk*. Used with permission.

<sup>20</sup> NACD, *Director Essentials: Strengthening Risk Oversight* (Washington, DC: NACD, 2016), p. 12.

<sup>21</sup> NACD, *2019–2020 NACD Public Company Governance Survey* (Arlington, VA: NACD, 2019), p. 10.

# Why NACD?

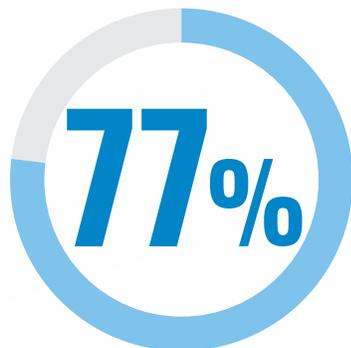
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