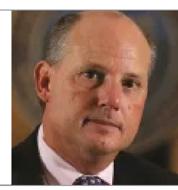

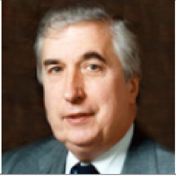

Editor-At-Large
Reynolds Holding

THE CLS BLUE SKY BLOG

COLUMBIA LAW SCHOOL'S BLOG ON CORPORATIONS AND THE CAPITAL MARKETS

Editorial Board
John C. Coffee, Jr.
Edward F. Greene
Kathryn Judge

Skadden Discusses the Social Factors in ESG

By Helena J. Derbyshire, Louise Batty, Damian R. Babic and Eleanor F. Williams November 9, 2020

Comment

Investors have historically overlooked social factors amid a focus on the environmental and governance counterparts as they assess the merit of an investment. This may have been due in part to the difficulty in quantifying social concerns as drivers of shareholder return as well as a lack of available data. However, recent trends demonstrate that the "S" in environmental, social and governance factors (ESG) is now an equally important consideration for companies and their shareholders.

In this article, we look at ESG matters in the employment context. An increased focus on social factors — such as diversity, working conditions and worker voice — has meant that quantifiability is no longer seen as a barrier for action and that those areas are, as a result, the focus of renewed review for many companies. We also look at the impact of ESG concerns on the relationship between companies and executives, which has gained attention in recent months. For example, in September 2020, the chief executive of Rio Tinto stepped down in response to investor backlash over the destruction of a 46,000-year-old Aboriginal site in Western Australia, and in the same month, BHP announced that it would link at least 10% of its executive compensation to environmental targets. These decisions demonstrate that social and employment considerations have a role to play in determining executive pay, managing public outrage and reducing a company's vulnerability to shareholder activism.

Working Conditions

Recent events have led to an increased focus on workplace conditions from the public and investors alike. The COVID-19 pandemic has highlighted the importance of safety in the workplace while the recent Sunday Times investigation into Boohoo also provided an important reminder to companies of their obligations under the Modern Slavery Act 2015 (MSA). In light of this increased focus, employers would be wise to reconsider their duties and obligations with regard to the workplace and workers in their supply chains.

The MSA places an express obligation (the reporting requirement) on companies with an annual turnover of more than £36 million and that do business in the U.K. to:

(i) report annually on the steps taken to ensure that modern slavery[1] is not taking place in their organization or supply chains; or

(ii) confirm that no such steps have been taken.

The Boohoo investigation involved two main allegations: first, that factory workers in the U.K. supply chain were paid as little as £3.50 an hour, far below the U.K. minimum wage; and second, that workers were required to work throughout the COVID-19 lockdown with little or no social distancing measures or protective equipment in place. The scandal not only highlighted duties under the MSA but also how consideration for workplace conditions has increased in importance in light of the pandemic.

Upon the news of the allegations, Standard Life Aberdeen (SLA), one of Boohoo's biggest shareholders, did not hesitate to sell almost its entire shareholding. SLA has several funds that aim to invest responsibly and they deemed the response of Boohoo's management team to the allegations to be inadequate, even though the company distanced itself from the supplier almost immediately.

Boohoo had not necessarily breached the MSA since there is no legal obligation under the MSA to ensure that modern slavery is not taking place (although practices that potentially qualify as modern slavery may entail other breaches of law). However, the MSA's reporting requirement aims to make companies consider working conditions in their supply chain and risk reputational damage if they do not, and Boohoo's case is a clear example.

Businesses should conduct thorough risk assessments to avoid becoming another public example. The pandemic has altered the way many businesses operate, with new health and safety requirements and risk assessments for the workplace in light of COVID-19 (see Skadden's May 13, 2020, client alert "Lifting the Lockdown: Returning to the Workplace Under the UK Government's Recovery Plan and Safe Working Guidance"). However, company assessments must stretch further than this. COVID-19 has also increased the chance of finding poor workplace conditions related to a business but existing outside of its own place of work, including in its supply chains. Conducting a thorough risk assessment to understand supply chains and reassessing monitoring procedures to better protect both staff and those in supply chains against exploitation is crucial. Offering training to staff, so employees know how to spot red flags and understand the procedures for raising issues, may also be appropriate.

These actions are examples of the kind of steps that should then be publicized as part of a company's MSA reporting requirement. Companies that can demonstrate engagement with the issues of modern slavery are likely to win favor with both the public and investors. The Boohoo case prompted many questions from the public and investors as to why funds branded as responsible in ESG matters owned shares in Boohoo, both due to specific modern slavery concerns and broader reservations about the "fast fashion" industry in general. Though the social practices of companies have previously been overlooked in considering how responsible or ethical a company is, this is unlikely to be the case going forward.

This increased attention on workplace conditions is here to stay. The COVID-19 pandemic has given a new meaning to workplace safety, with a newfound understanding emerging globally of the importance of ensuring employees feel safe in their place of work. The pandemic, alongside public scandals, has made the social aspect of ESG responsibilities more visible and potentially expected to be taken as seriously as its environmental and governance counterparts.

Diversity

It is not only the pandemic that has focused attention on corporate social responsibility. Amid the Black Lives Matter protest movement — rekindled in the days after George Floyd's tragic death — many companies have introduced new measures intended to boost diversity.

In the U.S., Institutional Shareholder Services (ISS) called on companies to disclose the ethnicities of their directors and senior executives. While the advisor has compiled its own information on the diversity of companies in the past, this new request illustrates its aim in seeking more comprehensive and standardized disclosure. Most recently, Legal & General (L&G) warned that it would vote against any company that still had an all-white board by 2022, thereby blocking the reelection of a firm's nomination committee chairman if the company failed to take action.

In the U.K., the recent Colour of Power report, resulting from research led by Trevor Phillips, the former chief of the Commission for Racial Equality in the U.K., demonstrated little or no minority representation in key areas of U.K. business and society. The report identified 1,097 "powerful" roles, only 51 of which were filled by nonwhite people. This number has only increased by 15 since 2017, with a third of that increase resulting from the doubling of the number of ethnic minority ministers in Boris Johnson's administration. Government-backed targets and company promises have not yet gone far enough in addressing this lack of diversity.

In both countries, Black Lives Matter protests have created an opportunity for companies to focus on this issue. There is, perhaps, no other option, given the public outcry and the attention on companies to do more. Even beyond the present moment, however, research demonstrates that diversity in an organization can lead to increased profitability, greater creativity, stronger governance and better problem-solving abilities. A Boston Consulting Group study found that companies with more diverse management teams reported a greater payoff from innovation and higher EBIT margins. Reminders and data abound showing that diversity is not only a value to be strived for in and of itself but also an integral part of a successful business. Training to address the structural issues and challenges that employees of ethnic minority backgrounds face is a good place for companies to start.

Initiatives that have helped increase gender diversity could also improve minority representation. For example, the 30% Club is a global campaign to increase gender diversity at board and senior management levels, with a group established in 2010 to increase women's representation on the boards of the U.K.'s largest companies. When the movement proved successful, a new target was set of creating boards comprised of 33% women by 2020. This is a voluntary target, rather than a mandatory quota, that many companies have adopted. Similar targets with regard to racial diversity would likely prove useful (both in addressing the issue itself and in reassuring investors).

Changes to the Equality Act 2010 in 2017 also made it compulsory for companies in the U.K. with more than 250 employees to report gender pay gap figures at the end of the financial year. The gender pay gap is the difference between the average hourly earnings of a company's male and female employees. While there was no expectation for employers to report gender pay gaps for the 2019/20 reporting year due to the COVID-19 pandemic, the previous figures have effectively highlighted gender pay discrepancies. In the amendment's first year, the reports revealed that men were paid more than women in over three-quarters of companies, though the efficacy of this reporting in combatting pay discrepancy has been questioned because while companies can face fines and convictions for not submitting reports, little evidence exists of enforcement actions in practice. Gender pay reporting has succeeded, however, in raising awareness of the issue, so while further efforts are likely necessary, we expect imposing on companies similar obligations regarding minority representation would only support goals to increase diversity.

The government is not likely to bring about any initiative like this soon, given its focus on the pandemic and Brexit. However, an unofficial version of the reporting could still be used, and investors will call for this data as they examine the diversity of companies more closely after the events of 2020 have heightened awareness and shifted society's focus. Even if diversity goals are not yet brought into official government initiatives, they exist in the eye of the

public. Proactively providing this information can help companies maintain a publicly aligned focus on issues of racial inequality and boost their standing with investors.

Remuneration and Share Plans

Investor reaction to remuneration proposals and the widening gap between executive and workforce pay continue to attract headlines and interest from investors and regulators. Since 2013, shareholders of U.K. quoted companies have had a binding vote on the company's remuneration policy, and in the financial services sector, variable pay has been regulated under the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) Remuneration Codes since 2010 (following the 2008 financial crisis). Most recently, the European Union Shareholder Rights Directive II (implemented in the U.K. in 2019) has replicated the U.K. requirements in giving shareholders a right to vote on a company's remuneration report and policy on a Europe-wide basis. While the EU regulations have not required a substantial change in approach for U.K. companies, regulation of executive pay remains a priority both in the U.K. and more widely.

Against this background, the COVID-19 pandemic has resulted in increased focus on executive pay and responsible remuneration. The fear of a recession and job losses combined with a significant portion of U.K. employees receiving 80% of their pay through a furlough scheme (reportedly nearly a quarter of all British employees were furloughed in April) has meant that actions taken by companies in relation to remuneration across the workforce are subject to public scrutiny. Many companies recognized the "mood music" in the spring of 2020, and cut executive salaries (typically by 20%) and decreased, canceled or deferred bonus payments in solidarity with furloughed employees, with some executives also donating a portion of their remuneration to charity. Where companies have taken government funding under the furlough scheme, obvious questions arose about the use of those funds, and investors and the public clearly expected executives to "share the pain"[2] and take a pay cut on a par with the wider workforce.

However, salary and bonus are only part of the story. A large proportion of executive pay consists of annual share awards under share incentive arrangements, commonly referred to in the listed company context as "Long Term Incentive Plans" (LTIPs). Executive participation in share plans is market practice and, indeed, often required from a governance and regulatory perspective, but payments under these share incentive plans or LTIPs are regularly criticized by investors and the public alike over quantum and the apparent ability for these schemes to pay out regardless of a firm's poor financial performance. In the context of the COVID-19 pandemic, investors were quick to issue statements and guidance on the expected response of remuneration committees in addressing the impact on remuneration outcomes and the annual grant of share awards.

The Investment Association's April statement[3] was clear that, where companies had reduced or canceled dividend payments, sought to raise additional capital from shareholders, or required government support such as furloughing employees, investors expect this relief to be reflected in remuneration outcomes. The statement also warned against the potential for "windfall gains" where share awards are granted at a time of share price volatility. In the financial services sector, regulators have similarly set expectations regarding the impact of COVID-19 on variable pay. The PRA was quick to state in March 2020 that it expected banks not to pay any cash bonuses to senior staff, including all material risk-takers.[4] Then in July, the FCA confirmed in its letter to remuneration committee chairs that the role of remuneration in driving culture and behaviors remained a key focus through the COVID-19 pandemic.[5] Additionally, the European Central Bank has informed firms it expects credit institutions to adopt "extreme moderation" in relation to variable remuneration payments until January 1, 2021.[6]

Share incentive plans, when used properly, can be a force for good and are relevant to the ESG debate on a number of fronts. Remuneration structures, including employee share plans, help drive a desirable culture and behaviors at the executive level and for employees throughout the business. At a senior level, the vesting of share awards and bonus payments is typically linked to meeting performance targets, and while historically those targets have comprised financial metrics, including ESG targets is becoming increasingly popular. Where ESG performance conditions are included, these have usually looked to environmental factors (with particular prevalence in certain industries such as the energy and mining sectors), with social metrics considered more difficult to quantify. However, going forward we likely will see an expansion in the types of performance metrics used and the inclusion of wider social and governance factors.

In the financial services sector, the ability to "ding" bonus and share award payments (known as "malus" and "clawback") for inappropriate behaviors and risk-taking is a powerful tool in the regulation of culture and practices within firms. The use of malus and clawback has also become expected by investors outside the financial services sector, and investors are clear in their expectation that remuneration committees exercise their discretion to reduce payouts where appropriate in light of poor financial performance and, increasingly, broader factors. More holistically, the broad use of employee share schemes throughout the business (not solely at a senior level) is indicative of a commitment to employee welfare and a fair renumeration structure and supports an inclusive culture, employee engagement, and alignment of employee and shareholder interest.

While the financial services industry received the greatest level of regulatory and investor attention following the 2008 financial crisis, the effects of COVID-19 are triggering changes in practices across all industries. All companies will be subject to similar scrutiny, with investors expecting the biggest action by those industries most adversely affected. The pandemic has accelerated the move towards requiring more responsible remuneration practices and appropriate use of remuneration structures. Investors and the public will be watching to see whether companies convert the spring 2020 gestures into more permanent remuneration reform and a commitment to use remuneration structures to drive desirable culture and behaviors across the workforce.

ENDNOTES

1 "Modern slavery" encapsulates human trafficking, forced labor and other forms of human exploitation.

2 Nils Pratley, "Schroders Is Right To Warn on Executive Pay. Now It Can Lead by Example," *The Guardian*; 2 April 2020.

3 "Executive Remuneration in UK Listed Companies: Shareholder Expectations During the COVID-19 Pandemic," 27 April 2020.

4 PRA Statement on Deposit Takers' Approach to Dividend Payments, Share Buybacks and Cash Bonuses in Response to COVID-19, 31 March 2020.

5 Letter to RemCo Chairs, 22 July 2020.

6 Remuneration Policies in the Context of the Coronavirus (COVID-19) Pandemic, 28 July 2020.

This post comes to us from Skadden, Arps, Slate, Meagher & Flom LLP. It is based on the firm's memorandum, "Finding the 'S' in ESG: Boardroom and Employee Considerations," dated October 29, 2020, and available here.

Leave a Reply

Your email address will not be published. Required fields are marked *

Comment

Name *

Email *

Post Comment

© Copyright 2020, The Trustees of Columbia University in the City of New York.