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US Corporate Governance: The Ascension of ESG

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The change in administration is expected to bring a governmental and regulatory climate that is vastly more hospitable to calls to facilitate the incorporation of environmental, social and governance (ESG) factors into investors' decision-making. This may take the form of a Securities and Exchange Commission (SEC) that is much more receptive to investor exhortations to mandate what they believe to be more meaningful and comparable company disclosures across a spectrum of ESG topics. Although the potential impact of this expected change in the regulatory climate should not be discounted, the reality is that the events of 2020 — chiefly, the COVID-19 pandemic and the increased focus on systemic racism following the murder of George Floyd — have accelerated and cemented the rise of ESG.

In this context, investors are placing more scrutiny than ever on how companies articulate their purpose and whether company interactions with their stakeholders — customers, employees, suppliers, investors and communities — drive long-term profitability, reduce risk and enhance business resiliency. In turn, boards of directors and board committees have been devoting ever-increasing levels of attention to oversight of ESG matters and likely will need to continue to do so.

Board, Management and Workforce Diversity

One example of the ascension of ESG relates to diversity, particularly racial and ethnic diversity, a topic implicating both the "S" and the "G." From a governance perspective, investors and others have embraced the view that diverse perspectives lead to better decision-making and, in turn, can reduce risk and improve company resiliency. From a social perspective, increasing board, management and workforce diversity presents an avenue to address systemic racism as well as racial wealth and income gaps exacerbated by the lack of diversity at certain levels within organizations.

Although board, management and workforce diversity are by no means new topics of interest for investors, the speed and intensity of enhanced investor focus in these areas over the second half of 2020 may be unparalleled. BlackRock, State Street and Vanguard — for many public companies, three of their largest shareholders — have each called for boards of directors to articulate their approach to board diversity as well as to oversight of diversity matters more generally. In addition, all three have indicated that they may vote against directors on boards they view as not having made sufficient progress in addressing diversity. Additionally, Legal & General Investment Management has said it will begin voting against nominating committee chairs at S&P 500 companies in 2022 if the board lacks any racially or ethnically diverse directors. Also, a number of state and local pension funds and other socially responsible investors have been engaged in letter-writing campaigns calling on companies to increase disclosure of director diversity and alluding to the possibility of negative votes at companies lacking board diversity.

The focus on board diversity is gaining momentum in other concrete ways. Proxy advisory firms Institutional Shareholder

This article is from Skadden's ***2021 Insights***.

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Services (ISS) and Glass Lewis have updated their policies and, for 2021, will flag boards lacking racial or ethnic diversity. In the case of Glass Lewis, the firm also will note a concern regarding boards with only one woman director. Negative voting recommendations from ISS and Glass Lewis relating to these items will start in 2022. In September 2020, California adopted a requirement that boards of public companies headquartered in California have at least one director from an underrepresented community by the end of 2021 and, depending on board size, at least two or three such directors by the end of 2022. Nasdaq has proposed listing standards that would require increased disclosure on director diversity and, subject to a phase-in period and a "comply or explain" approach, that Nasdaq-listed companies have at least one woman director and one director who is either racially or ethnically diverse or is a member of the LGBTQ+ community. The cumulative effect of investor and other efforts to increase board diversity resulted in a number of companies adding diverse directors in the last few months of 2020 and is likely to drive significant board refreshment efforts during 2021 and beyond.

This investor focus on diversity does not stop at the boardroom door. The New York City comptroller, among others, has led a campaign to increase company disclosure of EEO-1 report data. Provided by companies to the Equal Employment Opportunity Commission on an annual basis, this data reports the gender and racial/ethnic breakdown of a company's U.S. workforce in 10 specified job categories. According to a press release issued by Comptroller Scott M. Stringer, the initial letters to 67 S&P 100 companies resulted in 40 companies agreeing to provide this disclosure, and the comptroller has submitted shareholder proposals on this topic to 24 companies that did not respond to the letter. A number of other investors, including BlackRock, State Street and Vanguard, also have called for enhanced workforce diversity disclosure, including disclosure of EEO-1 report data. Recently, State Street announced that, in 2022, it will vote against compensation committee chairs at S&P 500 companies that do not disclose their EEO-1 report data. In addition, Comptroller Stringer has submitted shareholder proposals to four S&P 500 companies that appear to lack racial or ethnic diversity in their executive ranks, calling on those companies to adopt a policy that when senior executives are recruited from outside the company the initial list of candidates will include qualified female and racially/ethnically diverse candidates.

Investor concern regarding company approaches to diversity is not limited to board and workforce matters. Recently, some companies have received shareholder proposals seeking board reviews or "audits" to assess the racial impact of the company's products, services or policies, or to assess the company's impact on communities of color. Although it remains to be seen whether companies will be successful in their efforts to exclude these proposals from their proxy materials and what level of shareholder support these proposals will garner if voted on, their submission represents an investor focus — through a lens of racial equity — on the companies' relationships with customers, suppliers, communities and other stakeholders.

Climate Change and Sustainability

Another example of the ascension of ESG relates to investor policies on climate change and sustainability matters — the "E" in ESG. Early in 2020, BlackRock's annual letter to CEOs stated that "climate risk is investment risk." As evidenced by seven shareholder proposals that received majority support in 2020, compared to none in 2019, climate change and sustainability issues have been areas of ongoing and increasing investor focus. For some, the economic upheaval resulting from the coronavirus pandemic is a harbinger of the type of economic upheaval that may be caused by climate change. In recent months, the Board of Governors of the Federal Reserve System has recognized the risks climate change poses to the U.S. financial system, and an advisory committee subcommittee report to the Commodity Futures Trading Commission stated that "[c]limate change poses a major risk to the stability of the U.S. financial system and to its ability to sustain the American economy."

In announcing its expectations for 2021, BlackRock stated that it is expanding the group of companies for which it focuses on climate change from 440 to more than 1,000, calling on these companies to "disclose a business plan aligned with the goal of limiting global warming to well below 2 degrees Celsius, consistent with achieving net zero global GHG emissions by 2050." In addition, BlackRock will evaluate whether companies' public statements on policy issues that are material to their strategies align with their corporate political activities. Moreover, BlackRock is changing its approach to voting on shareholder proposals relating to sustainability matters. Under the new policy, for 2021, BlackRock may support shareholder proposals on relevant sustainability issues where it agrees with the intent of the proposal, without waiting to assess the effectiveness of BlackRock's engagement with management on moving the issue forward, or where it believes management is making progress but that voting for the proposal may accelerate progress.

In June 2020, Vanguard published a note describing its expectations for companies and boards with respect to climate risk governance. Vanguard indicated that it expects companies to be aware of climate risks and opportunities, and that boards should effectively oversee their companies' approach in this area and be transparent about their decision-making processes. Vanguard also cited favorably the framework created by the Financial Stability Board's Task Force on Climate-related Financial Disclosures for disclosing climate change-related strategy, risk management, governance, metrics and targets. In addition, Vanguard notes that where climate issues are material to a company, it expects an effective board to include directors with relevant climate change competency and experience, and related experiences such as change management and pivoting businesses to take advantage of new technologies.

COVID-19

State Street has expressed its belief that "the COVID-19 crisis accelerates the need for transformative change to address climate change" and that it will continue to "encourage companies to disclose how they are addressing both climate risks and opportunities through engagement and voting on shareholder proposals." In addition, State Street recently became a member of Climate Action 100+, an investor engagement initiative on climate change, and announced that its climate change focus will be on companies it believes are "especially vulnerable to the transition risks of climate change," as well as "companies in other sectors that, while not as carbon intensive, also face risks such as the physical impacts of climate change."

To date, there have been a few activist investor situations in which the investment hypothesis involved the potential upside of more climate-friendly changes in operations. Perhaps the largest test of this activist strategy will take place in 2021 as a major U.S. oil company faces the prospect of a proxy fight to refresh the board of directors with candidates the activist views as more capable of implementing the strategic changes necessary to create value in a world adapting to climate change.

In light of these updates, we expect a rising number of climate change- and sustainability-related shareholder proposals to receive majority support at 2021 annual meetings, as well as increasing levels of investor-company engagement on these topics. (See "Climate Change Should Drive Energy and Environmental Policy.")

Senate Working Group

In October 2020, Democratic Sens. Elizabeth Warren, Tom Carper, Tammy Baldwin and Mark Warner announced their formation of a working group to develop legislative proposals relating to corporate governance. In 2018, Sen. Warren introduced the Accountable Capitalism Act, which would require companies with more than $1 billion in revenue to obtain a federal charter stating the company's "purpose of creating a general public benefit," defined as "a material positive impact on society resulting from the business and operations" of the company. Whether that bill or similar legislation is introduced in the Democratic-controlled Senate remains to be seen. Although investor-led efforts, such as those described above, will continue to drive the ESG agenda, it is likely that this working group will attempt to move an ESG and corporate stakeholder-centric agenda forward via legislation.

Board Oversight

The key takeaway for boards of directors is that investors expect them to exercise oversight of their companies' approach to material ESG issues and consider their companies' impact on stakeholders beyond shareholders. As reflected in a recent Glass Lewis voting policy update, beginning in 2021, for companies in the S&P 500 index, Glass Lewis will note as a concern the absence of clear disclosure of board-level oversight for environmental and social issues. Then, beginning in 2022, for S&P 500 companies, Glass Lewis will escalate this concern by generally recommending against governance committee chairs for failure to provide disclosure of board-level oversight of these issues. BlackRock, State Street and Vanguard have each expressed that they expect to continue to engage with companies and directors on a variety of ESG topics, seeking to understand the board's approach to overseeing matters such as the company's approach to diversity, climate change and other ESG topics. For companies that have not yet done so, the first step is to ascertain which ESG topics are material to their company and then assess the best approach for board oversight.

The events of 2020 and their aftermath have made it clear that ESG is not a fad that will recede, even during a crisis. If anything, 2020 made ESG's importance clear to investors and firmly established ESG as being a more important engagement and voting topic going forward.