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Sustainability and ESG: The Governance Factor and What It Means for Businesses

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Editor's note: Elizabeth Robertson, Scott Hopkins and Simon Toms are partners at Skadden, Arps, Slate, Meagher & Flom LLP. This post is based on a Skadden memorandum by Ms. Robertson, Mr. Hopkins, Mr. Toms, Adam M. Howard, Greg P. Norman, and Abigail B. Reeves. Related research from the Program on Corporate Governance includes The Illusory Promise of Stakeholder Governance by Lucian A. Bebchuk and Roberto Tallarita (discussed on the Forum here); For Whom Corporate Leaders Bargain by Lucian A. Bebchuk, Kobi Kastiel, and Roberto Tallarita (discussed on the Forum here); Socially Responsible Firms by Alan Ferrell, Hao Liang, and Luc Renneboog (discussed on the Forum here); and Toward Fair and Sustainable Capitalism by Leo E. Strine, Jr (discussed on the Forum here).

Governance Factor: Beyond the Board

Corporate governance has long been a focal point for large corporates, listed companies and regulated entities, with numerous studies connecting good corporate governance with higher profitability. However, as the March 2021 effective date of the EU's Sustainability-Related Disclosure Regulation approaches, corporate governance is becoming increasingly important to companies of all sizes. This is, in part, due to investee companies needing to follow good governance practices, as a baseline, in order to be classified as a "sustainable investment."[1]

Corporate governance is not only facing increased scrutiny by investors and stakeholders but also regularly attracts adverse media attention. Directors wishing to safeguard themselves and the businesses they serve when discharging their duties should, therefore, be mindful of good corporate governance strategies and consider implementing strategies beyond the yardstick of the law.

This post explores several recommendations for companies seeking to improve their corporate governance framework, including:

- increasing board diversity and representation;
- ensuring that there is a strong compliance function;
- bolstering reporting lines and risk management procedures; and
- guaranteeing opportunities for stakeholder engagement.

[1] Sustainability-Related Disclosure Regulation, Article 2(17).

Diversity, Representation and Accountability

Increasing diversity and representation at board level has been demonstrated by a number of studies to provide consequential benefits to businesses, improving both their governance and profitability. One such study, carried out by the Harvard School of Public Health, concluded in a 2016 report that there are a range of advantages stemming from enhancing gender diversity on boards,[2] including (i) better buying and usage decisions, due to the board better representing the companies' customer bases; (ii) growth in the companies' talent pools; and (iii) diversity producing a difference in perspectives. One cited study found that the presence of women on boards led to companies having improved risk management as well as a better focus on long-term priorities. While the Harvard study was limited to assessing gender diversity, there have been numerous studies identifying benefits linked to better representation from enhancing ethnic diversity at board level.

In addition to empirical data that suggests better corporate governance outcomes stemming from enhanced diversity, corporates are facing greater external pressure from their stakeholders to increase gender and ethnic diversity at board level. An example highlighted in our article exploring the "social factors in ESG"[3] is the warning issued by L&G that, beginning in 2022, it will vote against companies that have retained all-white boards. L&G is not alone in adopting this approach. In 2017, State Street issued a pledge that it would vote against a reelection of chairpersons and senior members of boards that it deemed to be lacking in diversity, unless the board members demonstrated that they were committed to improving the diversity of their boards. State Street has followed up this pledge by issuing an open letter in August 2020 requiring companies in their portfolio to articulate goals related to racial and ethnic representation at board level.[4]

Furthermore, the Diversity Disclosure Initiative, a new initiative organised by the Illinois State Treasurer, is pressing companies in the US Russell 3000 Index to publish the racial and ethnic composition of their boards, in the hope that this will encourage the introduction of policies to vote against members of companies' Nomination Committees who do not report information on the racial or ethnic composition of their boards in their annual reports or proxy statements. Most recently, Nasdaq has filed a proposal with the U.S. Securities and Exchange Commission that, if approved, would require most Nasdaq-listed companies to have, or explain the absence of, at least two diverse directors.[5]

The U.K. Corporate Governance Code was strengthened in 2018 to promote gender, social and ethnic diversity in U.K. boardrooms, requiring companies to include a separate section in their annual reports describing the board's policy on diversity, including any measurable objectives the board has set and its progress towards meeting those goals.[6] Whilst the requirements of the U.K. Corporate Governance Code are not compulsory, as the regime operates on a "comply or explain" basis, it is generally considered to be best practice for companies to comply rather than

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[2] Harvard School of Public Health, "Why Diversity Matters: Women on Boards of Directors", 21 July 2016. Available here: https://www.hsph.harvard.edu/ecpe/why-diversity-matters-women-on-boards-of-directors

[3] Skadden client alert, "Skadden Discusses the Social Factors in ESG", 9 November 2020.

[4] State Street, "Diversity Strategy, Goals & Disclosure: Our Expectations for Public Companies Letter to Board" Chairs, 27 August 2020.

[5] Press Release, Nasdaq to Advance Diversity Through New Proposed Listing Requirements, 1 December 2020.

[6] U.K. Corporate Governance Code 2018, Principles J – L and Provision 23.

publicly explain any noncompliance. In order to reap the benefits associated with enhancements to board-level diversity, companies should ensure that their diversity initiatives and appointments are not perceived as a box-ticking exercise by taking steps to achieve and demonstrate an inclusive decision-making process.

Entrenchment of Compliance in Governance Strategy

A good corporate governance strategy should go beyond board representation. Businesses seeking to improve their corporate governance also should ensure that they maintain a strong compliance function. Often referred to as the "second line of defence", an effective compliance function should be capable of:

- managing the demands of both external and internal stakeholders;
- engaging and having oversight of the business lines;
- ensuring compliance with any legal and regulatory obligations; and
- reporting to the board.

Certain U.K. and EU regulated entities, including entities which will be classified as financial market participants under the Sustainability-Related Disclosure Regulation (such as MiFID investment firms), are currently obliged to maintain distinct compliance functions proportional to the size of the business they operate. While smaller corporates and unregulated entities will not necessarily have a separate compliance function, financial market participants that are seeking to invest in these businesses will need to ensure that the business has good governance practices before these investments can be labelled "sustainable" under the Sustainability-Related Disclosure Regulation. Although it is not a requirement that all financial product suppliers make sustainable investments at present, the direction of travel in the market is such that these classifications will become increasingly important for companies to retain access to capital markets and other financing. A demonstration of strong internal compliance policies and procedures, as well as sound internal financial systems and controls, may assist in demonstrating that the investee company has good governance procedures.

In establishing and maintaining an adequate compliance function, boards and compliance officers should ensure that any legal requirements are met as a priority. However, in strengthening the compliance function, senior management also should consider the risks incurred by the business carried out and whether these risks warrant increased investment in the compliance function, including to enhance or introduce additional systems and controls.

Risk and Reputation Management

The entrenchment of good corporate governance strategies and procedures can reduce legal, regulatory and reputational risks to businesses. Conversely, a report conducted by the Institute of Chartered Secretaries and Administrators (ICSA) has concluded that a breakdown in corporate governance may lead to excessive risk-taking, placing businesses in potential jeopardy. ICSA cited the collapse of BHS in 2016 as an example.

In November 2020, the U.K. Financial Conduct Authority (the FCA) published the results of a review of listed issuers and how such entities approach disclosures relating to corporate governance, concluding that there is “room for improvement” by these entities. One area identified as deficient was that statements made by companies did not make it clear how nonexecutive directors provide constructive challenge.[7] Furthermore, the FCA found that there was overreliance on boilerplate disclosures, and it was unclear from company reports how the principles of the U.K. Corporate Governance Code have been applied in practice, including articulating what action has been taken and the resulting outcomes. The U.K. Financial Reporting Council (FRC) conducted a review of corporate governance reporting in November 2020. Amongst its findings, the FRC concluded that boilerplate reporting on principal decisions was common, but it has advised companies to navigate away from this approach. Instead, the FRC suggests that companies provide examples and explain the contribution of each principal decision to its long-term success. The FRC’s review also found that board statements regarding the challenges offered by independent nonexecutive directors were often vague and unsubstantiated. In order to improve reporting, the FRC has recommended that companies explain whether challenges were observed and whether these challenges led to the introduction of new ideas or approaches.

There are a number of duties incumbent on directors of U.K. companies under the U.K. Companies Act 2006. This includes an obligation for directors to act in the way they consider, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, having regard for a range of factors, including any relevant ESG factors. To the extent that the purpose of the company is silent on ESG factors, such issues should be considered to the extent that they are relevant to long-term shareholder value. However, under the U.K. Companies Act 2006, companies are permitted to modify their purpose to include other purposes beyond attaining shareholder return, such as the consideration of ESG factors. This approach may be explored by companies where stakeholders have encouraged the adoption of ESG-specific objectives and goals. In addition, the FRC has issued guidance regarding risk management procedures, guiding boards to design, implement and maintain “appropriate risk management and internal control systems that identify the risks facing the company and enable the board to make a robust assessment of the principal risks.”[8] While this guidance is not obligatory, directors and senior officers seeking to enhance their corporate governance procedures should not be passive in the decision-making process. Rather, they must be willing to scrutinise the information provided to them and challenge recommendations if there is not sufficient information provided to undertake the relevant decision.

Corporate governance strategies also may be improved by ensuring that there is effective oversight and meaningful challenges to business decisions, whether regarding legal and regulatory standards, assessments of environmental impact and reputational risk, or internal policies. This provides value to the business, given the potential damage adverse media attention on poor decisions may have, as has been shown by the recent media attention on Rio Tinto following its decision to proceed with the destruction of Aboriginal sites in Western Australia, despite the allegations that Rio Tinto was aware of the significance of the site.

Furthermore, in order to substantively bolster corporate governance practice and the risk frameworks, entities should ensure that they have clearly documented reporting lines, which are communicated to employees, managers and directors. Committee structures that are

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[7] FCA, Corporate Governance Disclosures by Listed Issuers, November 2020.

[8] Financial Reporting Council, “Guidance on Risk Management, Internal Control and Related Financial and Business Reporting”, 2014, paragraph 24.

commensurate with the size of the business conducted also can improve corporate governance. Companies should, however, be mindful of creating committees that do not have a clear delegation of responsibility and end-point accountability.

Strong whistleblowing procedures and channels are an important element of an appropriate risk and reputation management framework. The focus on strengthening whistleblowing systems and controls for regulated entities, and the allocation of individual responsibility for such systems, has increased in recent years, as is demonstrated by the FCA's expectation that firms will appoint a nonexecutive director as a "whistleblowers' champion." Failures by regulated entities to have appropriate whistleblowing systems and controls may result in enhanced monitoring and scrutiny by the FCA, financial penalties and public censure. These penalties also may extend to the senior managers of regulated entities, where there is individual misconduct or actions taken to undermine the whistleblowing procedures, as was shown by the Final Notice and fine issued against the chief executive officer of a multinational financial services company in 2018.[9] This not only resulted in enhanced monitoring by the FCA, but also attracted negative media attention for the group. Whistleblowing controls also are important for nonregulated entities in the U.K., not only because of the legal rights and protections attaching to whistleblowers under the U.K. Employment Rights Act 1996 (as amended by the U.K. Public Interest Disclosure Act 1998), and the legal and financial consequences of breaching these, but also as a way of identifying and solving genuine issues in the business and avoiding adverse risks to the reputation of the business and its senior management. In order to avert these risks, organisations should ensure that they implement and maintain both strong whistleblowing controls and employee and management training on the whistleblowing procedures..

Stakeholder Engagement Financial market participants may be tempted to see a tension between making "sustainable investments" and the promotion of the financial success of their organisations. One way for any planned financial market participants to determine the correct balance is to enhance stakeholder engagement as part of their stewardship strategy. Actions financial market participants may take to improve stakeholder engagement include providing greater disclosure of voting to their stakeholders, specifically as to the position adopted on the ESG strategies. A failure to do so may have adverse consequences, including shareholder activism, negative media coverage and the removal of board members who fail to sense wind changes or demonstrate commitments to issues raised by stakeholders. Furthermore, a short-term or one-track focus on the maximisation of financial return, without due regard to a company's long-term success and other factors, including wide-ranging ESG factors, may result in reputational as well as environmental damage. Such an outcome could have a significant impact on a company's share price. While the disclosures required under the Sustainability-Related Disclosure Regulation may lead to enhanced stakeholder awareness, financial market participants may wish to get ahead of the curve and initiate greater stakeholder engagement regarding the organisation's approach to sustainability.

Conclusion

As has been discussed in this post, in order to meet the requirement for a "sustainable investment", companies must be capable of demonstrating good governance practices as a baseline; on the other side of the table, investors should be mindful of the governance practices

[9] FCA Final Notice, Mr. James Edward Staley, 11 May 2018.

adopted by companies in their portfolios. While at present the guidance relating to corporate governance procedures is not compulsory for nonregulated companies, it is likely that there will be greater emphasis and increased due diligence into the procedures in place following the introduction of the Sustainability-Related Disclosure Regulation (or equivalent legislation adopted by the U.K. government) and, as a starting point, such companies should be considering enhancing their existing corporate governance procedures to ensure a greater focus on diversity, compliance, risk management and stakeholder engagement.