ESG and stakeholder communication: The responsibility and role of the Board of Directors

You cannot direct the wind. But you can adjust your sails.*

VR-Tage Bad Ragaz, 25. November 2022

* Allison Herren Lee, Former Commissioner SEC, Washington D.C., June 2021

Plan for our discussion

1. **ESG – What has changed?**
2. What is our response?
3. Take aways

1. ESG – What has changed?

What is it?

ESG – Sustainability – Corporate Social Responsibility*

→ How companies ensure long-term, sustainable value-creation and their contribution to social welfare

* To avoid confusion on definitions, In the context of this discussion, these terms of expression shall be used synonymously | Definition: SWIPRA Services

1. ESG – What has changed?

ESG – a *new* paradigm? Really?

"It is not very unreasonable that the rich should contribute to the public expense, not only in proportion of their revenue, ***but something more than in that proportion****."*

"No ***society*** *can surely be flourishing and happy, of which the far greater part of the members* ***are poor and miserable****."*

Adam Smith, An Inquiry into the Nature and Causes of the Wealth of Nations, **1776**

1. ESG – What has changed?

ESG – a *new* paradigm? Really? * – 200 years later

1960's

Growing fund management industry and activists started to realize the huge opportunity shareholders had to **influence corporate behaviour**. In the US, the International Brotherhood of Electrical Workers invested their capital in developing affordable housing projects, while the United Mine Workers invested in health facilities.

1970's

The worldwide abhorrence of the **apartheid regime in South Africa** led to the greatest example of selective disinvestment. Both individual and institutional investors pulled their money away from companies with operations in South Africa. The combined efforts of protests and responsible investing paid off, with a massive $625 billion worth of investments redirected from South Africa by 1993. This led to economic instability, which contributed to the eventual collapse of apartheid

1980's / 1990's

- Environmental concerns gained more attention in the wake of disasters like Bhopal and Exxon Valdez. People became more aware about the threat of climate change.
- John Elkington, co-founder of the business consultancy SustainAbility published 'Cannibals with Forks: the Triple Bottom Line of 21st Century Business' in 1997, pointing to the emergence of non-financial considerations to be included in determining a company value.
- In 1998 the two journalists Robert Levering and Milton Moskowitz brought out the «Fortune 100 Best Companies to Work For», discussing the best-practicing companies in the US in terms of CSR, and looked at how their financial performance fared as a result.

2000's

- In 2004, former **UN Secretary General, Kofi Annan**, wrote to over 50 CEOs of major financial institutions, inviting them to take part in a joint initiative to find new ways to integrate ESG into capital markets. A year later, the initiative produced a report called **«Who Cares Wins»** arguing that embedding ESG factors in capital markets made good business sense and would lead to more sustainable markets and better outcomes for societies.
- **Rio 2012: UN Sustainable Development Goals 2030**

* Based on Metrikus, «The Prop Tech Guide to ESG»

1. ESG – What has changed?

ESG – a *new* paradigm? Really?

We firmly believe that sustainable growth and investment for any business also depends on what it does above and beyond what laws and regulations require. It is why we are committed to creating **a working environment based on the values of equal opportunity, diversity and meritocracy**. We have also adopted measures to **protect the environment, we adhere to high social standards and contribute to the communities** we are a part of.

UBS AR 2006

The Group understands corporate responsibility in terms of the "triple bottom line" – **value creation, sustainable environmental performance and social responsibility**. This concept is part of both **Group strategy and management systems** for many years.

Holcim AR 2007

- **ESG is not a new concept, it is «entrepreneurship»**
- ***But: Did we walk the talk?***

[Our] assessment process is based on the premise that **consideration of extra-financial factors adds to the overall financial evaluation of a company**. Extra Financial Factors have the **potential to have at least a long-term effect on financial performance** but lie outside the usual span of variables that get integrated into investment decisions, irrespective of whether they are part of the research process.

SAM Sustainability Asset Management 2008

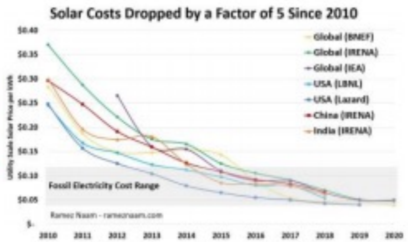
1. ESG – What has changed?

Political focus: society expecting more from businesses

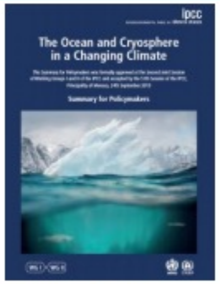
Extreme weather events

Impacts on security

Cheaper renewable energy



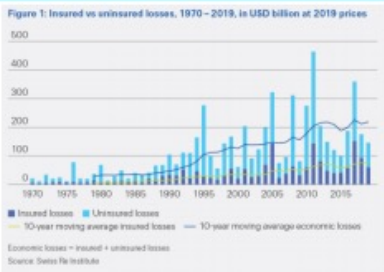
New climate research



Civil society action

Financial regulator warnings on stability

Uninsurable world



Influence shifting

Climate Action 100+

Global Investors Driving Business Transition

New geopolitics of energy

1) Urgency

*Source: The inevitable policy response 2021 policy forecast

1. ESG – What has changed?

What has changed: More «Blaming & Shaming» – challenges for reputation

Whistleblowers accuse EY of whitewashing suspicious trades at longstanding client

FTSE 100 companies hit boardroom diversity targets

Most groups fail to hire from ethnic minorities at executive level despite gains, Parker review finds

96% of Caterpillar Shareholders Vote in Support of Climate Action -- A Critical Development in Decarbonizing Industrials Sector

Biggest banks sustain coal financing despite defunding drive

Companies used carbon credits created in oil extraction projects

Process to tap inaccessible deposits employs captured carbon and w... therefore eligible to generate offsets

Exxon loses board seats to activist hedge fund in landmark climate vote

Fashion brands/Xinjiang: cottoning on to an ethical dilemma

There is a price to pay for staying friends with China by using cotton or garments forced labour may have produced

Revolut under pressure from its auditors to improve internal controls after UK regulators highlighted significant flaws in the auditing of its accounts, including an "unacceptably high" risk of "material misstatement".

Asset managers fail to act on pledges to divest from Brazil over deforestation

Lack of action by institutional investors comes as rate of rainforest clearing hits 15-year high

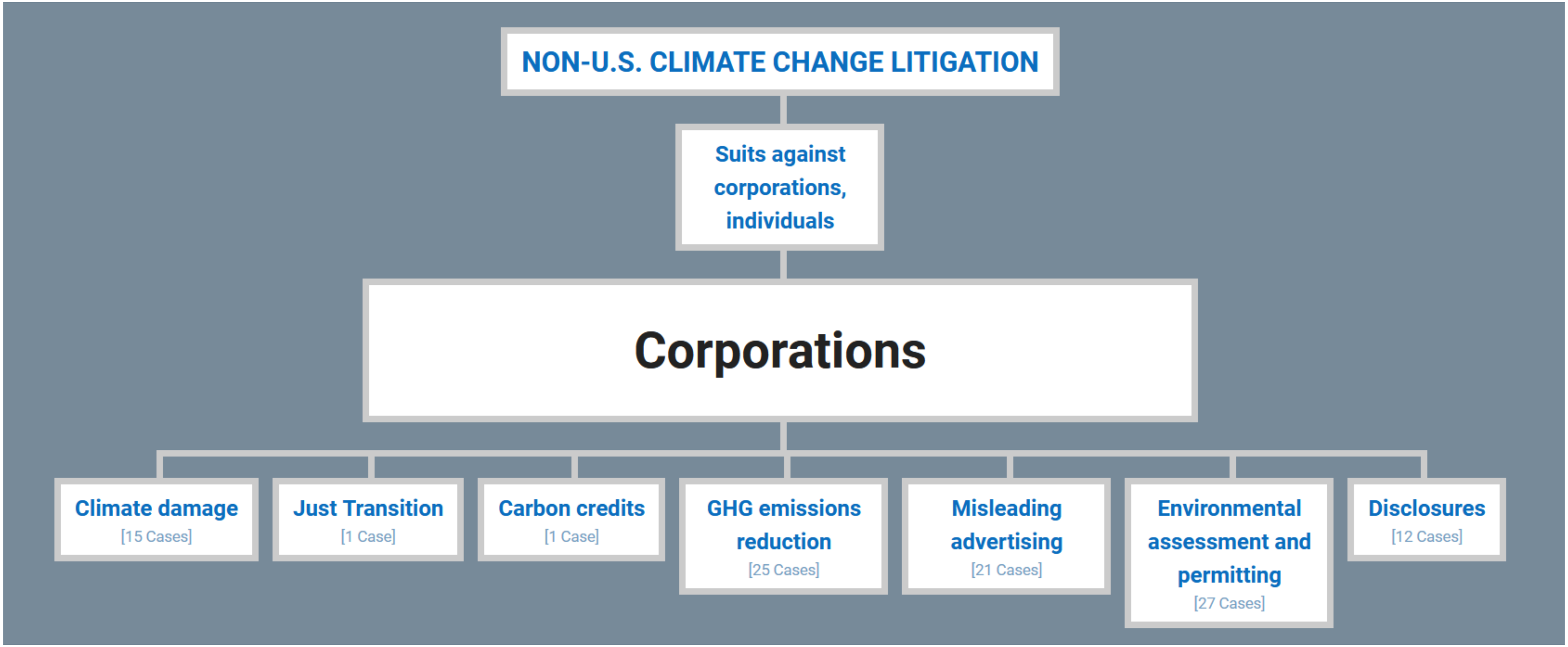
Norwegian oil fund denounces 'corporate greed' over executive pay

2) Focus / Spotlight / Litigation!

*Source: Financial Times

1. ESG – What has changed?

Fiduciary Duty, Greenwashing & Litigation: be reliable and measurable



*Source: http://climatecasechart.com/non-us-climate-change-litigation/

1. ESG – What has changed?

How did we get here?

Macro Factors

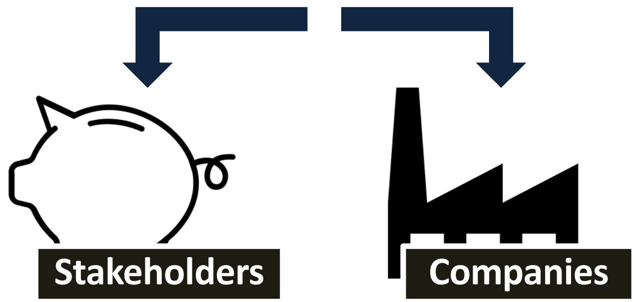
- Global warming
- Globalization
- Supply Chain disruptions
- Geopolitics and rising threats
- Social disparities
- Human rights
- Migration
- Pandemic
- Floods, Fires, etc.

Micro Factors

- **Short-termism**
- **ESG was not considered a strategic success factor**
- Financial crisis caused by financial institutions
- Compliance failures
- Lack of sensibility and ethical behavior
- Excessive compensation
- E&S hypocrisy

Politics & Regulation

- Political activism
- Accountability
- Transparency
- Disclosure



3) Actions required

Illustration: ©SWIPRA Services

1. ESG – What has changed?

4) Integrated view requires leadership from the top

Plan for this discussion

1. ESG – What has changed?
2. **What is our response?**
3. Take aways

2. What is our response?

The board on top of things: the guardian of long-term thinking?*

Supply Chain → [factory] → **Stakeholders**

- Clients
- Markets
- Employees
- Investors
- Social welfare

Source: TCFD

Leadership, Strategy, Purpose, Culture

Long-term value generation along the supply and value chain

Capital Allocation: Investing in ESG goals and ESG risk-opportunities profile

Stakeholder Dialogue / Communication / Disclosure / Reputation

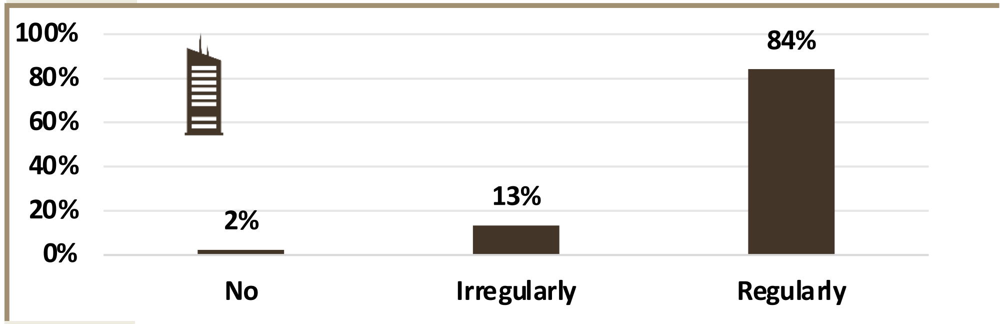
- **ESG reflects the way we lead and conduct our business, how we communicate and behave. It is far more than compliance exercise. And we have to make ourselves accountable.**
- **ESG is a strategic imperative, reflecting a company's DNA and corporate culture. It is the board's responsibility.**

*Illustration: ©SWIPRA Services AG

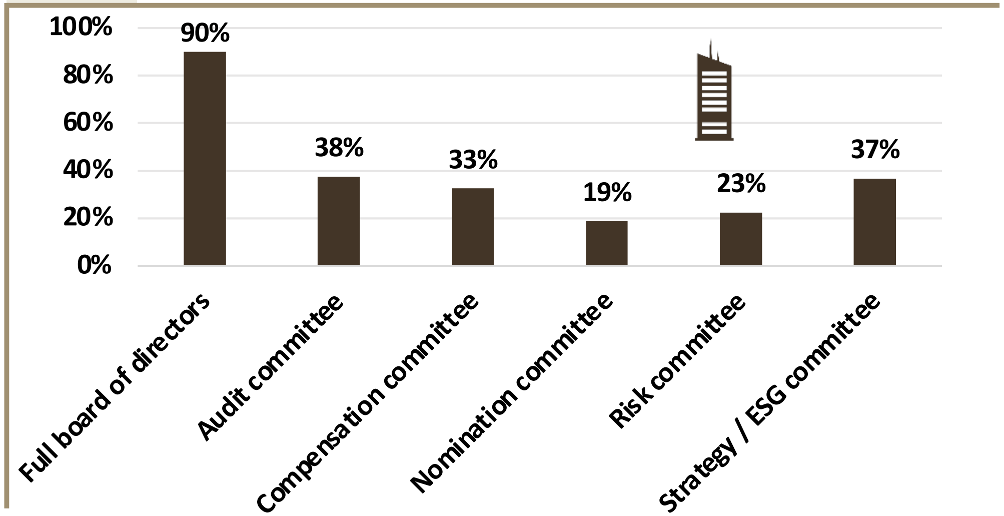
2. What is our response

ESG on the board's agenda *

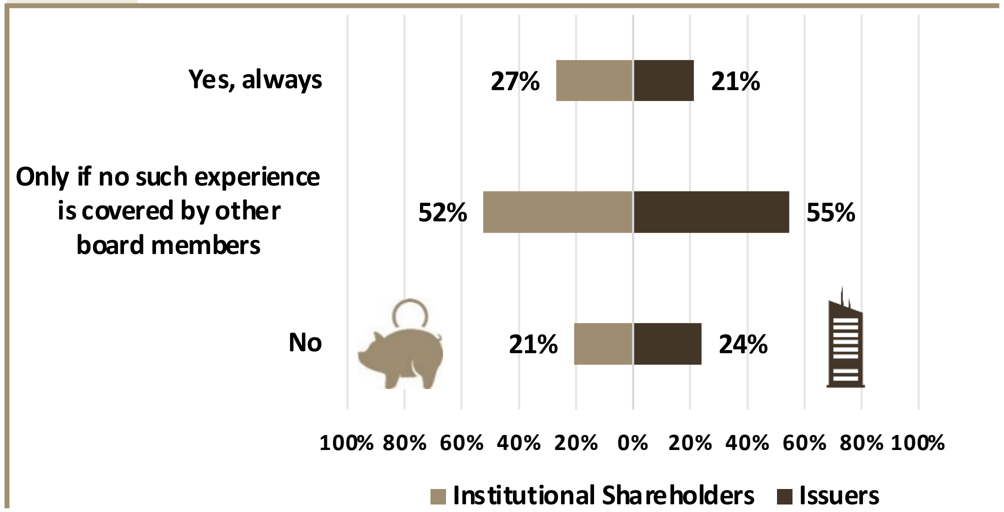
Are sustainability topics on your board's agenda?
Survey 2022



In which bodies of the board are ESG topics discussed?
Survey 2022



Relevance of ESG experience in board appointments
Survey 2022



- Sustainability has become a regular agenda item on the board of directors and has become a criterion in the board refreshment process
- It will be key for boards to stay on top of this development and to make their ESG ambitions visible and accountable.

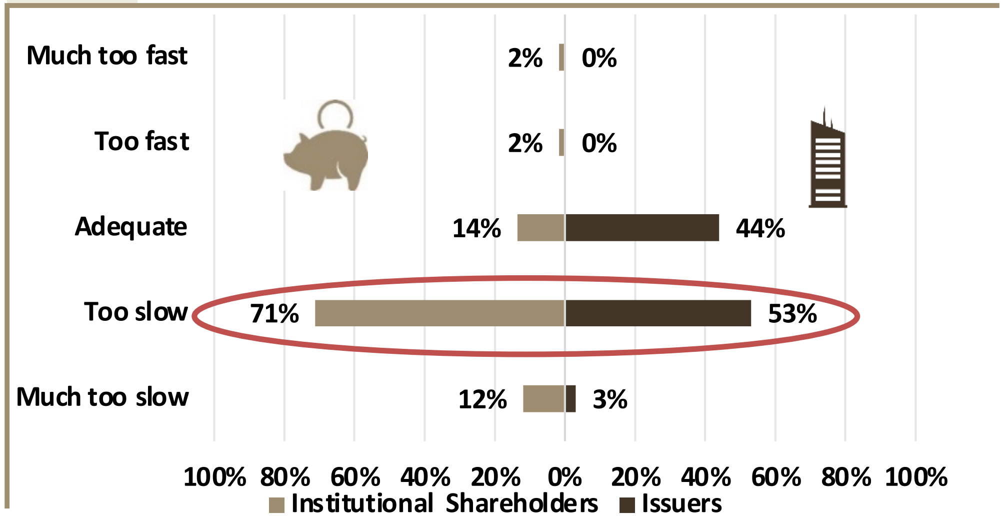
* Source: SWIPRA Corporate Governance Survey 2022 – UNPUBLISHED

2. What is our response?

ESG goals: Are we focused on the long term?*

Pace of moving toward E&S goals

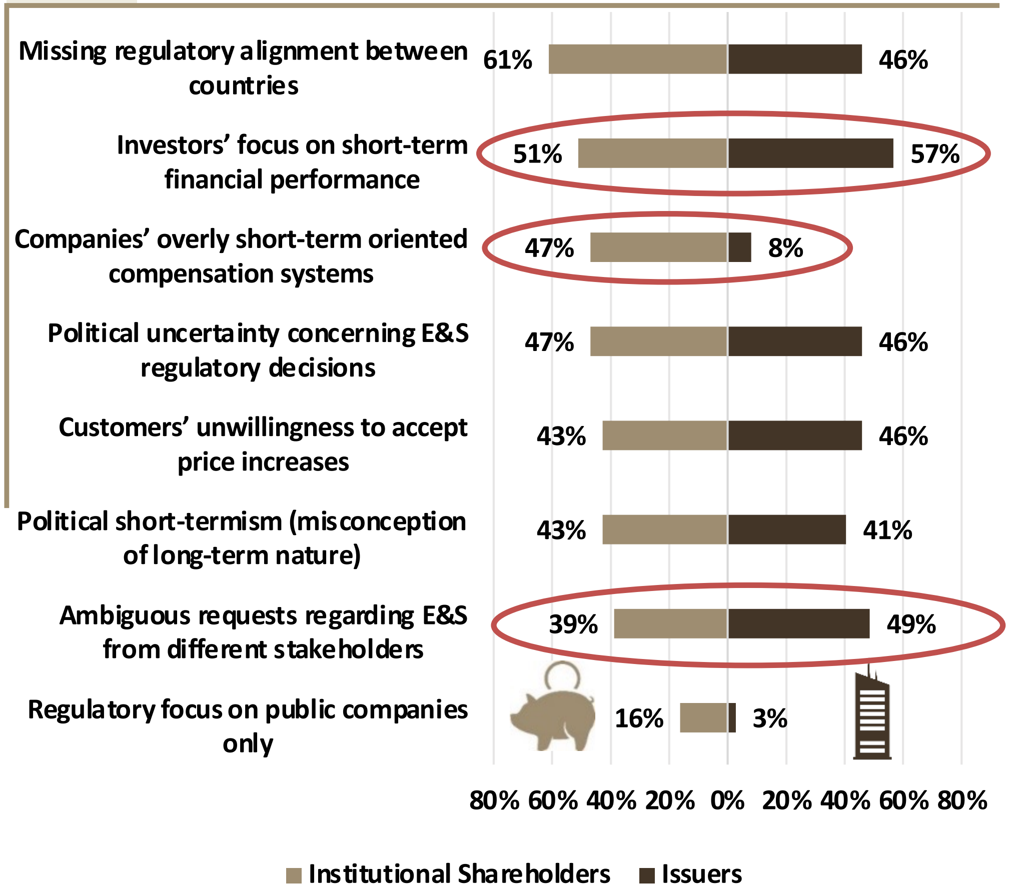
Survey 2022



- Market almost unanimously perceives the speed towards E&S goals too slow
- Reasons for why the pace is too slow clearly differs and often targets the other side
- Need for better mutual understanding of what is and what can be done

Factors slowing down progress

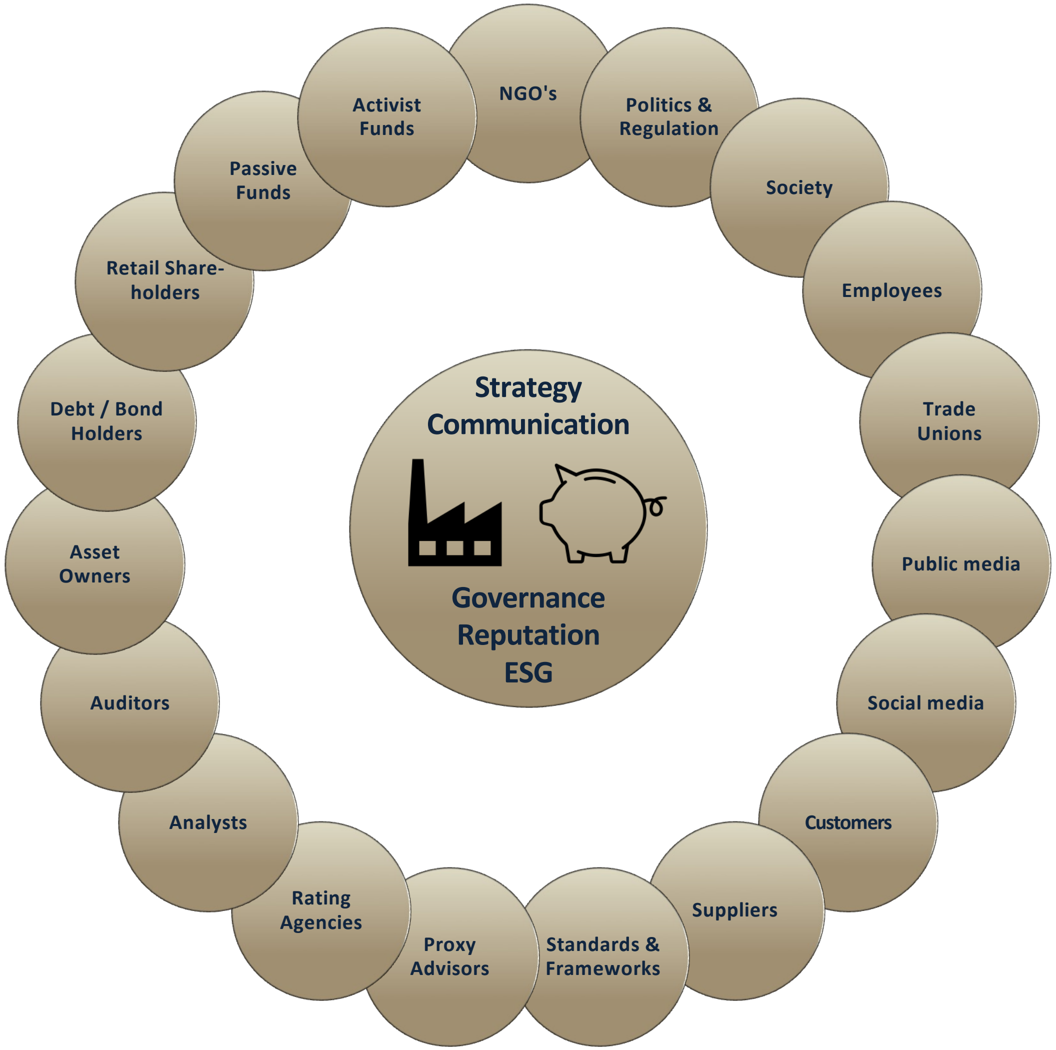
Survey 2022



* Source: SWIPRA Corporate Governance Survey 2022 – UNPUBLISHED

2. What is our response?

Leadership from the top: Do we know our stakeholders and what they want?



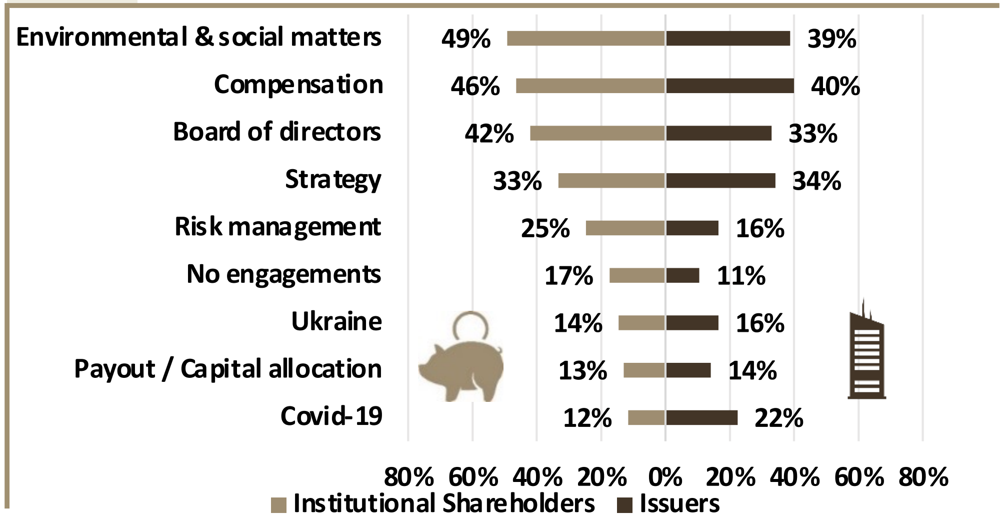
- **ESG reputation** a **key lever** of **stakeholder influence**
- Stakeholders are a **source of spill-overs from regulatory developments and expectations from other parts of the world** and international best practice approaches
- **Know and understand**
  - **expectations** of key stakeholders
  - **interdependencies** between stakeholder groups
  - **influence and potential harm** of stakeholders on **reputation**
- **Board** to take the **lead in stakeholder management** and **evaluate strategy, capital allocation, performance, shareholder base** and **corporate governance of the company like an activist stakeholder would**

2. What is our response?

Leadership from the top: E&S topics #1 in engagements for the first time*

Most discussed engagement topics 2021

Survey 2022



Issuers top engagement topics in prior years

Survey 2018	1. Compensation 2. Board of Directors 3. Strategy
Survey 2019	1. Compensation 2. Strategy 3. Board of Directors
Survey 2020	1. Covid-19 2. Strategy 3. Capital / Payout & ESG

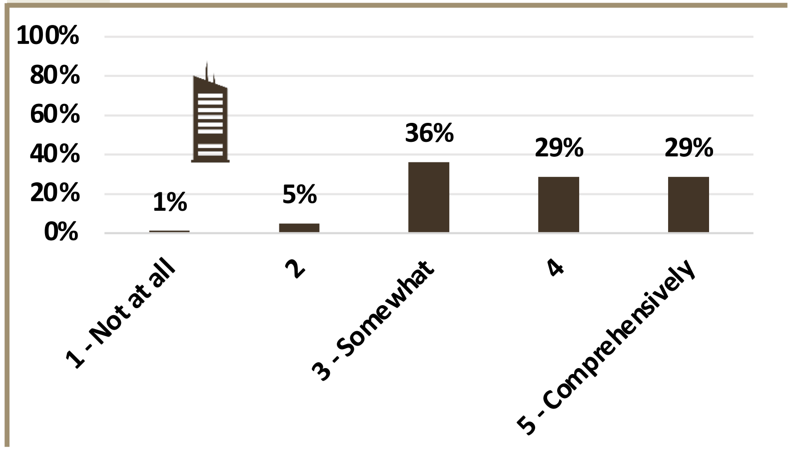
- Environmental and social topics were the most discussed engagements topics, on the corporate as well as on the investor side, towards the 2022 AGMs
- Clear indication that boards, in particular their chairs, need to be able to speak about a company's strategy and its environmental and social ambitions

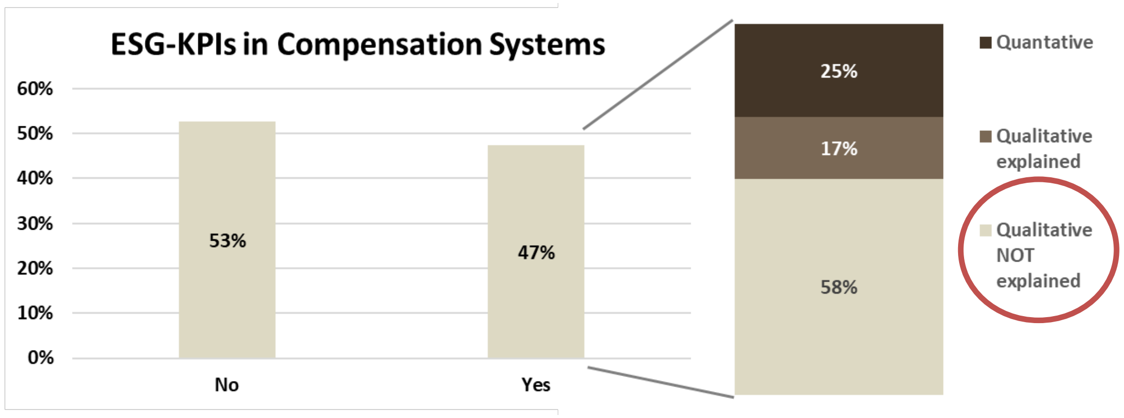
* Source: SWIPRA Corporate Governance Survey 2022 – UNPUBLISHED

2. What is our response?

Leadership from the top: Relevance of corporate culture

Anchoring of ESG ambitions in corporate culture*
Survey 2022





Source: SWIPRA AGM Analysis 2022, SPI®100 companies

- Companies say that ESG ambitions are comprehensively anchored in corporate culture
- Not comprehensible for an outsider: In 60% of annual reports 2021, qualitative ESG ambitions were not explained and compensation schemes not comprehensible
- Limited understanding about Corporate Culture as a key success factor

* Source: SWIPRA Corporate Governance Survey 2022 – UNPUBLISHED

2. What is our response

Leadership from the top: how are we doing it?

- The board of directors is a **key value driver of the company and the guardian of long-term thinking.**
- Boards need to become **more forward looking** and constantly improve their own organizational structures and working methods to ensure effectiveness, informed and independent decision-making.
- Boards must be able to integrate strategy, socially responsible actions, risk & financial management and cultural ambitions through incentives **and communicate accordingly with their stakeholders, internally and externally**.
- Leadership will stay challenging. Do you have **what it takes to lead in a changing world**? Shifting backgrounds and skill requirements need to be better understood and embedded in board composition and refreshment processes.

2. What is our response?

How are we doing it and how do we communicate? – Slido Fragen (1/3)

Frage #1:
Kennt der Gesamt-VR die wichtigsten Anspruchsgruppen und deren teilweise divergierenden Anforderungen?
Nein, wir haben keinen ausformulierten Stakeholder Management Prozess im VR – Nein, das ist operativ und keine Aufgabe des VR – Nein, sollten wir aber – Ja, wir werden regelmässig vom Management dazu gebrieft, der VR ist aber nicht aktiv involviert – Ja, das ist ein regelmässig diskutierter Punkt auf unserer Agenda und der VR ist aktiv involviert

Frage #2:
Ist Ihr VR mit ESG-Themen im Zusammenhang mit der Unternehmensstrategie vertraut genug, um mit Ihren wichtigsten Stakeholdern einen Dialog zu führen?
Ja, Dialog wird durch den VR bereits wahrgenommen – Ja / Dialog wird aber nicht durch den VR wahrgenommen – Teilweise / auf dem Weg – Nein / Zu wenig

Frage #3:
Diskutiert der VR die Reputationschancen und -risiken rund um ESG ausreichend? Sind konkrete ESG-Faktoren im strategischen Risikomanagement verankert (Integrale Sichtweise: Unternehmenskultur, Supply Chain Management, Compliance, Ethisches Verhalten, Political Exposure etc)?
Nein / nicht nötig – Ja / unbedingt notwendig – Wir sind dran, der Prozess ist nicht abgeschlossen

2. What is our response?

How are we doing it and how do we communicate? – Slido Fragen (2/3)

Frage #4 (mehrere Antworten möglich):
«S» in den Führungsgremien:
Wie stellen wir sicher, dass wir im VR und in der GL die richtigen «Talente» haben, Leadership übernehmen können, den zunehmenden Herausforderungen gewachsen sind und wir uns insbesondere zukunftsgerichteten Themen widmen können?
Wir führen regelmässige, extern begleitete Board Evaluations durch – Wir haben einen definierten VR-Erneuerungsprozess – Wir haben ein Skill Mapping entwickelt, das wir regelmässig besprechen und ergänzen, was uns erlaubt, den VR zeitgerecht zu ergänzen/anzupassen – Wir haben ein spezialisiertes Komitee/das Thema ist (zusätzlich) in einem Komitee angesiedelt, das sich regelmässig damit beschäftigt – Der VR bildet sich stetig weiter – Weitere

Frage #5:
Wo im Verwaltungsrat ist das Thema ESG in dessen strategischen Ausprägung primär angesiedelt?
Im Gesamt-VR – Audit Committee – NCC - anderes VR Committee - Nicht im VR

2. What is our response?

How are we doing it and how do we communicate? – Slido Fragen (3/3)

Frage #6 (mehrere Antworten möglich)

Mit welchen ESG-Widersprüchen sind Sie konfrontiert?

a) Politische Risiken vs. Geschäftstätigkeit (z.B. China / Russland Exposure vs. Produktion, Standorte und Mitarbeiter vor Ort)

b) Kapitalallokation in längerfristige Business Transformation / R&D vs. kurzfristige Profitabilität und tieferen Kapitalbedarf

c) Allgemein divergierende Ansprüche unserer wichtigen Anspruchsgruppen

d) CO_2-Kompensation vs. «reale» Investitionen in neue Technologien (und Net Zero)

e) Politische Forderungen vs. die eigentliche Verantwortung des VR für das Unternehmen (Vgl. KVI oder philanthropische Forderungen ausserhalb des Geschäfts etc.)

f) Konsumentenverhalten: Teure Ökoprodukte vs. günstige «Massenprodukte»

g) Menschenrechte / Kinderarbeit vs. lokale Gegebenheiten

h) Menschrechte/Rohstoffabbau vs. Klimaschutz

i) Andere

j) Keine der vorgenannten Widersprüche

Plan for this presentation

1. ESG – What has changed?
2. What is our response?
3. **Take aways**

3. Take Aways

Board leadership and oversight with a focus on ESG

- No “one-size-fits-all”
- Increase board focus to be *more future oriented* (rather than backward-looking and compliance focused), make sure your plans are followed by actions
- Take the lead and make yourselves visible in discussing transition plans, capital allocation and corporate culture as the center of your strategic efforts and long-term value generation
- Discuss whether the board puts enough awareness on reputational aspects of ESG-related risks & opportunities
- Inspire Management success by embedding ESG-related goals in executive compensation
- Discuss to complement the board with skills required (ESG, stakeholder management, social competencies, strategic risk oversight…)
- Discuss *company-specific* roles & responsibilities of the board and your committees with respect to setting targets, accuracy of disclosure, introduce processes and improve oversight along with all other ESG efforts
- Lead to enhance existing information, corporate communication, reporting and engagement processes & structures

Stakeholder and reputation management by the Board of Directors

Disclosure is no-silver bullet – it is a starting point and needs to be complemented by regular engagements and stakeholder outreach to capture the dynamic and complex nature of ESG; including your employees, clients & suppliers

Regulatory developments

Prepare for new requirements and proactively decide what is the right structure/framework for the company in terms of non-financial reporting and how you want to shape your reputation

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October 2022

Viewpoint: The Governance of Sustainability: An Investor View of Board Effectiveness

This Viewpoint will consider the investor view of the board's role in the creation and oversight of the company's sustainability journey in meeting rising global investor expectations. For investors, the discussion of sustainability within the company must effectively link the governance of the board, i.e., its "effectiveness" to the long-term strategy of the company, and its implementation and oversight of policies and targets for sustainability-driven results. The enterprise "value" of a company, which is part of an investor's stake, is embedded into this work. While investors have historically considered board governance as the first pillar of engagement, the issues relating to sustainability have widened the governance umbrella to such a degree that boards will no longer be "effective" if they do not adapt and address these greater responsibilities.

Investors are keen to examine the governance of sustainability through the lens of how boards of directors effectively provide oversight of the company. As part of their fiduciary duty to promote company success and generate sustainable value, boards are now expected to conduct due diligence reviews of the company's impact on environment and address social factors, explore the connection between modern slavery and improperly sourced products in the company's supply chains, engage with relevant stakeholders and set the tone of the company's culture. All of these duties- and more- are now embedded into the wider work of the board.

In this evolving area, there is room for innovation to enhance board effectiveness. As investors seek to fulfil their own fiduciary duties, they are looking to companies to disclose how the boards are dealing with the inherent risks within their business models and their long-term plans for sustainable growth within the realm of many finite resources. In addition, investors would like boards to disclose information on their self-assessment processes for evaluating board effectiveness, and efforts to increase board awareness and oversight of sustainability matters.

Numerous strategies to measure board effectiveness with respect to sustainability have been developed. Investors recognize that boards are not monolithic; they are as unique as the company is to its peers and competitors. While the Viewpoint does not attempt to analyse each strategy, there are commonalities amongst them that are provided in the Appendix.

Global Reporting Directives and Guidelines

The heightened role of boards of directors in addressing the "governance of sustainability" is a rising global topic among investors, stakeholders, regulators and companies, as we collectively contribute to the global economy. Within the European Union and the United Kingdom, for example, regulations and standards relating to the sustainability of companies have been enacted, bringing the need for comprehensive board action into the forefront. At the same time, other jurisdictions and markets (such as the US and Asia) have begun to pay attention to the sustainability issues that should be addressed by a board of directors, including their oversight of a company's strategic direction for sustainable value creation. Investors are asking important questions to ensure that the makeup of the board provides the requisite knowledge and experience amongst the board members to address sustainability issues, and whether the governance structure in place is the most effective one to increase the likelihood that the board acts responsibly.

Many national corporate governance codes require that companies provide reporting on their efforts to meet these provisions under a "comply or explain" standard. Companies are expected to comply and if not, explain why they are not able to meet the full requirements in the code at that time. Under a "comply or explain" standard, it is essential that companies provide explanations detailing why they are not yet able to comply fully with the regional standards. The "explain" part is important because investors and relevant stakeholders will expect that boards are aware of the reasons why the companies are unable to comply at this time and what is required to become compliant. These explanations are a key piece for engagement dialogues between investors and board members.

The European Union's (EU) Corporate Sustainability Reporting Directive (CSRD) will require that certain large companies "disclose information on the way they operate and manage social and environmental challenges."[1] This requirement is a milestone for disclosure of what has been typically considered "non-financial" information and as such, was not previously readily available to investors in a common framework. With the release of these reports, commencing on January 1, 2024, companies in the EU will be disclosing their approaches to business practices that impact the environment and social factors. Under Directive 2014/95/EU, large companies have to publish information related to:

- environmental matters;
- social matters and treatment of employees;
- respect for human rights;
- anti-corruption and bribery; and
  diversity on company boards (in terms of age, gender, educational and professional background).[2]

In a recent development, the European Union cited the ICGN Global Governance Principles in the CSRD, Recital 44, as an authoritative global framework of governance information of most relevance to users.[3] The tie between the CSRD and the ICGN GGP is unmistakable; both documents align on the necessary disclosure on governance factors. Supervisory bodies, including boards of directors, are directly responsible for undertaking sustainability matters on behalf of their companies. As such, the CSRD and ICGN GGP require that board members have the expertise and skills to address sustainability and risk factors to be effective. [4] [5]

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[1] Corporate sustainability reporting (europa.eu)
[2] Corporate sustainability reporting (europa.eu)
[3] ECSRD, Recital 44, pages 35-36 pdf (europa.eu)
[4] "Users need information about governance factors. Governance factors that are most relevant to users are listed by authoritative reporting frameworks such as the Global Reporting Initiative and the Task Force on Climate-related Financial Disclosures, as well as by authoritative global frameworks such as the Global Governance Principles of the International Corporate Governance Network and the G20 OECD principles of Corporate Governance. Sustainability reporting standards should specify the information that undertakings should disclose on governance factors. Such information should cover the role of an undertaking's administrative, management and supervisory bodies with regard to sustainability matters, expertise and skills to fulfill this role or access to such expertise and skills, whether the company has a policy in terms of incentives offered to members of these bodies which are linked to sustainability matters, and information on an undertaking's internal control and risk management systems in relation to the sustainability reporting process." Ibid, page 35.
[5] The CSRD will be mandatory for over 50,000 of the largest EU companies and will be phased in from 2024 onwards, starting with the EU listed companies and financial institutions with more than 500 employees, as well as to some non-EU companies with branches or subsidiaries in the EU. It extends the scope of existing requirements under the 2014 Non-

In addition, the European Financial Reporting Advisory Group (EFRAG) has issued its own European Sustainability Reporting Standards (ESRS). The standards specify corporate reporting requirements in accordance with the CSRD to underpin the requirements of the directive. As a consequence, the standards will be mandatory, too. By 30 June 2023, the European Commission must adopt the first set of reporting standards covering environment, social and governance matters. ICGN responded to EFRAG's consultation on the draft reporting standards alongside the International Sustainability Standards Board. This follows ICGN's commentary to the US Securities and Exchange Commission, Canadian Securities Regulators and Statement to Cop 26 in 2021.

These requirements have reset expectations for *actual* board involvement and decision-making as part of their ongoing responsibilities from regulators, investors and relevant stakeholders. The boards that are able to adapt and ensure that they are *effectively* preserving and creating sustainable value for investors, with regard to other stakeholders, will be more favourably positioned to meet global challenges.[6] This may be the first time in history that such a comprehensive set of standards have been introduced as mandatory disclosures. It emphasises how serious policymakers in key markets are taking the role of driving a just transition to a more sustainable economy.

Boards are not the sole subject of efforts by regulators seeking to address sustainability standards. , Regulators have also pressed investors to create and publish their own sustainability standards as regional stewardship codes are adopted. In many of these codes, the standards have been set for institutional investors to "apply and explain" their actions to adopt the requirements in these markets and explain the reasons, acting as fiduciaries, why they may not be able to apply all of the stewardship code provisions. In a related development, the European Union's (EU) Sustainable Finance Disclosures Regulation (SFDR) was passed, requiring sustainability-related disclosure in the financial services sector, commencing in January 2023.[7] The regulation is aimed at increasing transparency and limiting the ability of the participants in the financial sector to participate in greenwashing.[8] The EU Taxonomy is part of the effort to create more sustainable investment strategies by identifying enterprises that will qualify as "sustainable".[9]

The end result is that the governance of sustainability has come full circle. Boards of directors and investors will be part of the continuum of sustainability reporting, one that is interdependent and focused on long-term value for society and our collective world.

In the discussion on sustainability and board effectiveness, what should come first?

How does the focus on sustainability create long-term value for investors and who is responsible for ensuring that sustainability discussions ensue? Investors will first look to the board of directors. In the eyes of most investors, directors should have a commitment to uphold a company's focus on sustainable practices, thereby creating returns on capital, and maintaining constructive relationships with investors and relevant stakeholders, including its employees, customers, suppliers, and society as a whole. This requires that companies focus on

financial Reporting Directive with more detailed reporting requirements and ensures that large companies are required to report on sustainability issues such as environmental rights, social rights, human rights and governance factors.

[6] ICGN Global Governance Principles 2021.pdf, p.4. (Italics added for emphasis.)
[7] European Commission (europa.eu)
[8] Greenwashing Definition & Meaning : expressions of environmentalist concerns especially as a cover for products, policies, or activities Merriam-Webster
[9] REGULATION (EU) 2020/852 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32020R0852&from=EN

financial aspects related to preserving and building a company's financial capital, as well as factors impacting human and natural capital.

In its comment letters and through member outreach, ICGN has consistently highlighted that *Governance* comes first. A foundation of good governance practices relating to the duties of directors and the legal requirements for their service can be effective mechanisms to promote the governance of sustainability. [10] A principles-based approach, in the form of a "comply or explain" voluntary code of governance, has been a preference expressed by ICGN.

International standards and frameworks, such as the Task Force on Climate-related Financial Disclosures (TCFD), the Global Reporting Initiative (GRI) and the International Sustainability Standards Board (ISSB) are already utilized by many companies.[11] Regulatory action in some jurisdictions has required that companies disclose details on their sustainability activities to investors and relevant stakeholders. In the past, companies focused on "financial materiality" for disclosure purposes without generally disclosing other factors that were not considered financially material. The more recent regulations, particularly in the European Union, relating to disclosure of sustainable value creation have raised the expectation that a company's assessment should consider double materiality,[12] thereby providing more of a 360-degree review for investors.[13]

The Role of the Board

The role of a board of directors is a critical element in the sustainability discussion. Global systemic occurrences and events such as climate change, the COVID-19 pandemic, supply chain disruption, and rising geopolitical threats, to name a few, have further emphasized the need for corporate boards to understand the nature of these risks and the degree to which they may impact issues such as human rights abuses in the supply chain, poor environmental and health and safety standards, and other practices that are adverse to society and investors.

Governance, even with the recent significance placed on environmental and social factors, is still the main driver of board effectiveness. While new code provisions and regulations are requiring that companies disclose risks related to corporate social responsibility, one of the biggest drivers of risk is an ineffective board.

A role of a director is multidimensional and to achieve best results should be fulfilled by people whose skills and expertise spanning a number of areas deemed essential for the success of the company and for quality oversight at the board level. While all corporate board members should be well versed in sustainability topics of relevance to their companies, this knowledge and expertise can come from different channels, including regular trainings, advisory bodies, direct interaction with key stakeholders, and broadening of the directors' induction programmes to include sustainability issues.[14]

By way of reference, the ICGN Global Governance Principles (GGP) provide a comprehensive description of a strong governance structure for boards and to whom they are to account, which is:

> The board is accountable to shareholders and relevant stakeholders for preserving and enhancing sustainable value over the long-term in alignment with a company's purpose and long-term strategy. In fulfilling their role effectively, board members are responsible for:

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[10] 3. ICGN response to Sustainable Governance EU Consultation 2021.pdf, 8th February 2021 European Union (EU) sustainable corporate governance consultation.
[11] Including SASB, consolidated under the IFRS Foundation.
[12] Double materiality means consideration of how a company impacts its stakeholders and broader society in addition to considering how social and environmental factors might impact the company's own enterprise value. The concept of double materiality has not been adopted by the US SEC as of this date.
[13] International Framework - https://www.integratedreporting.org/resource/international-ir-framework/)
[14] Second letter_ EU - Consultation on Corporate Sustainability Due Diligence, May 2022.pdf (icgn.org)

(e) accountability for the *governance of sustainability* ensuring the integration of human capital (particularly the workforce) and natural capital management in strategy, innovation and risk[.][15]

Fiduciary Duty

Of all the responsibilities of a board, one of the most essential responsibilities is to fulfill its own fiduciary duty, which is a key element of a board's effectiveness. The ICGN GGP affirms this role:

> The board should promote the long-term best interests of the company by acting on an informed basis, with good faith, care and loyalty, for the benefit of shareholders, while having regard to relevant stakeholders.

Both common law and civil law jurisdictions have requirements for directors to act as fiduciaries to the company. For example, in the United Kingdom (UK), the passage of the Companies Act 2006 (Act) consolidated pieces of common and civil law to codify the duties of directors, among other company requirements.[16] A seminal piece is the work of the UN PRI, which worked over several years to produce a report on fiduciary duty in the 21st century.[17] In addition, in the ICGN response to the EU on "Corporate Sustainability Due Diligence", it was stated:

> We support this Article (Article 25- Directors' Duty of Care) in the Proposal, which requires that Member States ensure that directors of companies take into account the consequences of their decisions for sustainability matters, including, where applicable, human rights, climate change and environmental consequences, including in the short, medium and long term. In our view this is a matter of governance within the context of the overarching fiduciary duty of directors to promote the success and resilience of the company to preserve and enhance corporate long-term value for the benefit of shareholders and relevant stakeholders, and ultimately contributing to sustainable economies, societies, and the environment. In this way we see a (positive) resemblance with Section 172 of the UK's 2006 Company Act, which similarly articulates the need for directors to 'have regard for' stakeholder interests as part of their duty to promote overall company success.[18]

Balancing interests

In the past, directors were perceived to owe a duty solely to the company and its shareholders. A newer consideration is the inclusion of "relevant stakeholders". When the GGP was revised in 2020, language was specifically added for boards to have *regard* for relevant stakeholders. In seeking out the opinions and views of stakeholders, a board may receive unique or divergent perspectives than those expressed by shareholders. This type of 360° review can help a board identify risks that may not be apparent in the investment chain and lead to greater understanding of how stakeholders view sustainability. Regulators across the world are reviewing and revising existing codes to adopt broader requirements for companies and their boards.

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[15] ICGN Global Governance Principles 2021.pdf, Principle 1: Board role and responsibilities. p.4. (Emphasis added)

[16] The Act provided seven duties for directors, including:

- Duty to act within powers.
- Duty to promote the success of the company.
- Duty to exercise independent judgment.
- Duty to exercise reasonable care, skill and diligence.
- Duty to avoid conflicts of interest.
- Duty not to accept benefits from third parties
- Duty to declare interest in proposed transaction or arrangement.

[17] Fiduciary duty in the 21st century final report | Thought leadership | PRI (unpri.org)

[18] EU - Consultation on Corporate Sustainability Due Diligence, May 2022 (1).pdf, May 23, 2022.

As companies are commercial enterprises, investors understand that companies will seek to make profits and deliver fair returns to their owners, the shareholders, as well as fulfil their obligations to other providers of capital. Understanding and finding a sustainable balance of interests of all relevant stakeholders in a company (e.g. shareholders, creditors, employees, suppliers, customers, communities, regulators, etc.) is part of a board's oversight role. It is important to encourage independent directors to *directly* communicate with relevant stakeholders, as well as shareholders.

It is important that directors act in the long-term interests of the company, understand the impacts that their decisions will have on investors and key stakeholders and seek to minimize these impacts. It is implicit in this concept that sustainable success requires companies to find an acceptable, and sustainable, balance of investor and stakeholder interests. To be effective, each company must follow the approach that best suits its circumstances and its governance structures. The focus should be on the desired outcomes and not on prescriptive processes.

Enhancing Board Effectiveness

There are several key areas which investors consider when determining how a board is handling its obligation to address sustainability for investors and relevant stakeholders and provide the opportunity to enhance its own governance and effectiveness:

1. Board Diversity- one prominent issue for investors is the makeup of the board, including information on the rationale for all director appointments (executive and independent) be disclosed, including how their experience relates to a Skills Matrix with indicators that are clearly defined as aligned with the company purpose, long-term strategy, succession plan, Diversity Policy and any factors affecting their independence.

2. Board Evaluations- Board effectiveness can be enhanced by conducting individual director evaluations not just of the CEO. Investors would like to understand the board process for its evaluation, the relevant communication flows and decision-making be clearly disclosed and, as far as reasonably possible, information around the discussion topics, the conclusions (including any material issues arising from the evaluation) and actions taken forward by the board. ICGN recommends that the Nomination Committee charter, approved by the Board, be mandatorily disclosed and include provisions related to board evaluation, succession planning, diversity policy, director appointment process, independence criteria and engagement with shareholders. Names of committee members and independence status should also be disclosed as well as a summary of key subjects discussed and committee member attendance records.

3. Board Skill Set- Investors are keen to understand the experience and skill sets of the board members who serve on the board. In addition to financial, audit, legal or sector experience, investors are asking boards to consider "new" skill sets for potential or incoming directors. New skill sets would depend on the nature of the business but may include experience in environmental and social factors, such as climate change, biodiversity, human rights, workplace conditions, technology and data security, among other disciplines. Investors seek more information in the skills set matrix to assess the competency and relevant ESG expertise of board members. The most important skill set may very well be a director who has the ability to consider a broadly informed perspective and so to judge the unintended consequences and geopolitical risks of a board's approach to sustainability-driven decisions.

4. Strong Chair and Lead Independent Director (LID)- Investors will look to see whether the Chair is committed to overseeing an inclusive and effective board. They will ask if the Chair is setting aside time on the meeting agendas for regular discussion on sustainability-related issues, whether the board

incorporates ESG factors when considering strategic issues, who are the individuals or organizations that are presenting these issues to the board, and the disclosed financial or business decisions that are made. In some jurisdictions, a CEO may sit on the board. It is important in these jurisdictions that the Chair and non-executive directors provide their independent views for board discussions, providing for perspectives different than management.

5. Board Committee Involvement- Investors recognize that board committee meetings are where most of the initial policy development and discussion on issues will occur. Stand-alone committees usually include Audit, Risk Oversight, Nominating and Governance, Remuneration and Compensation Committees, with perhaps slightly different regional titles. A new issue for investor advocacy on board effectiveness is whether the board has considered the creation of a separate committee to consider sustainability considerations and ESG aspects for which the board has a responsibility to review. Investors will usually defer to the board's decision on which committee will consider sustainability issues as long as there is a clear path for reporting and action from the committee to the full board.

6. Board Commitment to Disclosure- Investors rely on boards to utilize their oversight responsibilities for developing the company's strategy for short and long-term sustainability plans, including climate transition plans, capital allocation strategies for implementation, and Scope 1, 2 and 3 emissions (if material or part of the company's Net Zero Plan), biodiversity, natural resources, pollution, and water usage. The company's disclosure of financial information that is material, as considered under the GRI and SASB standards, is expected as well. Investors may ask about the identification of relevant stakeholders to disclose any issues raised during the course of engagement, and the company's response or action.

7. Board Training Programmes- Investors would like to see that the board as a whole and individual members are updated regularly on sustainability issues, through the organization of tailored educational sessions on issues that could impact the company, new financial and legal requirements, and standards that require reporting and disclosure on sustainability and/or climate risks.

8. Evaluation of CEO- Investors rely on the board to evaluate the CEO on at least an annual basis and determine whether the CEO met, failed to meet or exceeded the KPIs, including sustainability-based KPIs, set by the board in the previous year. Investors would like the Nomination/Compensation or relevant Committee that conducts the evaluation to share the results with the full board for review and approval. The evaluation should be tied to KPIs and/or metrics to align executive pay with the long-term sustainability of the company.

Measuring Board Effectiveness

Investors are looking for information on a board's process for evaluating its own effectiveness and how its governance structure is working. Investors have encouraged boards to take baseline measurements of how boards are functioning, followed by regular board evaluations to ensure that they are making progress.[19] The ICGN GGP provides:

> The board should undertake a rigorous review of its performance (as a collective body), the company secretary (where such a position exists), the board's committees and individual directors prior to being proposed for election. The board should periodically (preferably every three years) engage an independent outside consultant to undertake an external evaluation.[20]

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[19] A sample checklist is provided in Appendix A as a reference.

[20] ICGN Global Governance Principles 2021.pdf. Principle 3 Composition and Appointment, 3.3 Evaluation, p. 15.

A board can demonstrate its effectiveness by leading on key matters for the company, thereby fulfilling its fiduciary duties. Investors look to the following as examples:

- Setting the Culture, Values and Strategy of the Company

A company's culture, ethics, purpose, vision and values should be reflected by the board. Investors expect the board to play a major role in ensuring that company policies provide a positive culture as well as the direction to management on how policies for human capital management are implemented. Corporate identity is key to avoid greenwashing; it is the main reference for decision making. In fact, the UK's Corporate Governance Code provides:

> The board should assess and monitor culture. Where it is not satisfied that policy, practices or behavior throughout the company are aligned with the company's purpose, values and strategy, it should seek assurance that management has taken corrective action. The annual report should explain the board's activities and any action taken. In addition, it should include an explanation of the company's approach to investing in and rewarding its workforce.[21]

The appropriate hiring, supervision of, and oversight of the CEO's performance are important ways a board can help distinguish the culture and integrity of the company. The ICGN GGP, Principle 4 states, "The board should instill and demonstrate a culture of high standards of business ethics and integrity aligned with the company's purpose and values at board level and throughout the workforce."[22]

- Setting Board Agendas to Include Time for Risk and Sustainability Discussions

Investors have an expectation that boards routinely discuss matters that relate to risks in the company's business model and will make decisions on the sustainable direction of the company. As a frame of reference, the ICGN GGP provides:

> The board should adopt a comprehensive approach to the oversight of risk which should be enterprise-wide and include threats to the company's business model, cyber-security, supply chain resilience, performance, solvency, liquidity and reputation. Risk oversight should extend beyond financial capital to include human capital and natural capital and in particular, systemic risks identified in the United Nations Sustainable Development Goals, where these are relevant to the company's business model and strategy. Fundamental to this is the board's agreement on its risk appetite, and the board should seek to publicly communicate this in basic terms.[23]

Investors like to see a company's Corporate Risk Matrix complemented with an ESG Materiality Matrix.

- Approval of Key Policies, Security of Financial Information and Budget Priorities

Investors expect that boards will make decisions on whether new or revised policies should be approved to enhance or support the company's sustainable value creation. Investors will seek confirmation that the board provides senior management with direction for the overall budget priorities and capital allocation strategies that support its sustainability approach and long-term plans. Investors would also like to see policies and plans to protect the company's IP, the security of its financial information, customer and employee data and other company records.

As an example, investors will expect that the board has taken action to ensure that the company's policies and programs are addressing cybersecurity risks, both internally and with regard to employees, suppliers, and customers. Part of the financial allocations should include necessary upgrades, staffing and external support services. For example, some companies have developed

[21] UK Corporate Governance Code 2018, Provision 2, p. 4.
[22] ICGN Global Governance Principles 2021.pdf, p. 18.
[23] ICGN Global Governance Principles 2021.pdf, p. 24.

Cybersecurity or Disaster Recovery Plans that are tested regularly, trained employees to limit email phishing attempts and hired Chief Information Security Officers to manage these programs.

- Compliance, Conflicts of Interest, and Ethics

Investors require information on how a board is made aware of risks, including third-party risks and how conflicts, both potential and disclosed, are handled. The public disclosure of policies and actions taken by the board and management can provide investors with information to compare companies in the same sector and see if the company is effectively addressing risk and conflicts. Setting policies on ethics and ethical conduct for boards, senior management, employees and suppliers, and ensuring compliance with companies' Codes of Conduct are essential actions for boards to undertake.

- Geopolitical risks

Investors are concerned with geopolitical risks across the world, that can result in supply chain disruption, resource constraints, political inaction on climate change, and instability within governments. The ways in which boards navigate these concerns, within ethical and legal requirements, are important for investors to understand as they consider these factors in their evaluation of companies in their portfolios.

- Liability for Directors

In recent legal developments, some shareholders have turned to the courts rather than utilize further engagement with board members and management. These shareholders have pursued legal action against boards of directors and management to seek court decisions that would require companies to take greater action, for example / also on sustainability issues.[24]

Pursuing legal action may be considered a matter of last resort after discussions between the board and investors have failed to resolve outstanding issues. Notably, there are protections in place for board members to limit their personal liability as long as they are exercising reasonable care in the performance of these actions. The UK Companies Act requires boards to promote the company's success, and to "exercise reasonable care, skill and diligence,"[25] including the provisions that companies may adopt to protect directors from liability.[26] [27]

Engagement questions of investors for company boards with regard to the governance of sustainability[28]

We conclude this Viewpoint with questions that investors may wish to pose to board directors when engaging on the governance of sustainability and board effectiveness. For board directors, these questions can be interpreted as expectations by investors that they should consider in their board oversight.

[24] On March 22, 2022, ClientEarth filed a derivatives action lawsuit against the Board of Shell, "arguing that the Board's failure to properly manage climate risk to Shell means that it is breaching its legal duties. The Board has failed to adopt and implement a climate strategy that truly aligns with the Paris Agreement goal to keep global temperature rises to below 1.5°C by 2050; breaching its duties under sections 172 and 174 of the UK Companies Act, which legally requires it to act in a way that promotes the company's success, and to exercise reasonable care, skill and diligence."[24] https://www.clientearth.org/latest/latest-updates/news/we-re-taking-legal-action-against-shell-s-board-for-mismanaging-climate-risk/
[25] UK Companies Act, Sections 172 and 174.
[26] Chapter 7, *Provision protecting directors from liability,* Companies Act 2006 (legislation.gov.uk), revisions 2016.
[27] In addition, in the US, the business judgement rule provides a legal defense that is recognized in several jurisdictions. business judgment rule | Wex | US Law | LII / Legal Information Institute (cornell.edu). See also "The Tort Foundation of Duty of Care and Business Judgment (ufl.edu)', by Robert J. Rhee, 2013.
[28] From *Governance, Stewardship and Sustainability,* G Dallas and M Lubrano, ICGN 2021.

- Stakeholders—who are the company's most important stakeholders? How have they been identified? How does the company interact with them?

- Has the company undertaken a materiality analysis or stakeholder mapping exercise? How did the company come to understand and communicate its most material Governance and E&S risks? What is the process? Who is involved?

- Does the company measure, evaluate and disclose its roadmap to meeting ESG-related targets and its annual progress against targets?

- Is the company committed to a net-zero business model, and, if so, does its financial and sustainability reporting disclose underlying assumptions and scenarios that align with a net zero strategy?

- What policies surrounding ESG does the company have? Labour and human rights policies? Environmental policy? Supply chain policy?

- Is the company prepared for current and future regulatory requirements on ESG matters? How? Is the company proactive about these issues? Is there a strategy or internal mechanism for assessing country-specific conditions and future financial risk due to environmental and social issues?

- Are there any issues with such overwhelming risk/impact that financial models should be altered to adjust for such risk? Are sensitivity analyses needed?

- Is disclosure adequate compared with peers? How does the company measure up compared with other firms in their industry?

- How does the company fare in ESG ratings, and how could the company improve?

- What does a best-practice company look like within the same industry?

- To which international standards/certifications relating to sustainability does the company apply? To which should it apply?

About ICGN Viewpoints

ICGN Viewpoints are produced by Secretariat and by our member-led Policy Committees. While not defining a formal ICGN position on the subject, they provide opinion on emerging corporate governance issues and are intended to inform and generate debate.

The drafting of this ICGN Viewpoint was led by Carol Nolan Drake of ICGN, and was reviewed and supported by ICGN's Global Governance Committee.

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Good Practices Related to Board Effectiveness

Examples of good practices by boards of directors from disclosed reports and public filings:[29]

- Commitment to growing sustainably by aligning a company's mission and business strategy to help create long-term economic impact for investors and the consideration of relevant stakeholders.
- Effective consideration of governance practices that are tailored to the business to promote the long-term interests of the company.
- Commitments to reporting on environmental, social, and governance ("ESG") factors that enhance sustainability. The inclusion of a business strategy that reflects a positive economic, social, and ecological impact on the world while advancing and complementing the business strategy.
- Adopting a reporting Framework- for example, the Task Force on Climate-Related Financial Disclosures ("TCFD") framework, or using the Sustainability Accounting Standards Board's ("SASBs") framework.
- A sustainability report issued annually by the board and senior management.
- Building confidence in the supply chain and with suppliers, including regular audits to ensure that suppliers are adhering to regulatory requirements related to forced labor.
- A thorough review of risks, both financial and non-financial, that could impact a company's sustainable business practices. Examples include the lack of adequate infrastructure, human capital management, and operational resources that may not sustain continued growth. Consideration of the continued impact of the COVID-19 pandemic on global business operations.
- Action by the board to prepare and action taken if there is a cyber-attack or failure of the company's IT infrastructure that results in a loss of financial information, personal data or sensitive information about the company, its employees, and/or third-party providers. The lack of action may lead to market consequences, negatively impacting the company, its financial performance and confidence level of investors, customers and employees.
- Action taken by the board to be aware how economic downturns, natural disasters, public health crises, political turmoil, geopolitical risks or other macroeconomic conditions may negatively impact the company, its financial performance and confidence level of investors, customers and employees.

[29] Filings with the US SEC from several companies taken as representative samples.