Directors&Boards

The Character of the Corporation: Stop Fighting ESG

By Marran Ogilvie and Evan Dunn

Tips for becoming environmental, social & governance board leaders despite the lack of ESG clarity and standards.

Companies, and the boards that run them, are in an ESG quandary.

While funds and activists can set their social responsibility standards, the businesses they invest in are left to make sense of too-often vague or contradictory measures. Environmental, social and governance considerations, by their nature, are subjective. All major ESG standards — ISS, Glass-Lewis, Fidelity, BlackRock and so on — differ; sometimes in crucial ways. Most importantly, they often do not focus on issues that are material, or even applicable, to the companies they are grading.
Key questions loom.

How can you be good for the environment, your communities and your people when the standards are vague and shifting? How can you be sure your company will receive credit for its efforts from ratings agencies and investment funds? In the face of rising investor demand, how can you maintain access to capital when, due to the nature of your company, there may be no obvious ESG issues to work towards?

These need to be answered because the ESG drumbeat is only getting louder.

A new survey by Callen Investment Institute finds 43% of 89 U.S. institutional investors surveyed now integrate ESG factors into their investment decisions, which is almost double the percentage found in 2013. The biggest of mainstream funds, including BlackRock, State Street and Vanguard, have built ESG screens into their investing, launched targeted ESG funds, and actively lobby management teams on responsibility issues. As a result, sustainable, responsible and impact investing in the U.S. is rising sharply, hitting $8.72 trillion in 2016, a jump of 33% from 2014. The largest factor driving this increased demand, according to the survey, is client demand.

It’s time to stop fighting the ESG wave. There are steps directors can take, beyond just focusing on the “E” for environment, which tends to get the most attention. ESG is not just about the planet. If a company doesn’t have a large environmental footprint, directors and management should be able to determine an area within ESG that is important to the organization’s business. A focus on “social,” for example, is appropriate for companies where the employees are a very large resource.

Companies that focus on community and social issues create an environment where employees understand that the company culture cares about the community, and, as a result, cares about employees. By strengthening the company’s commitment to its employees and encouraging employees to take an active role in the community where they work, companies can foster both loyalty and motivation — resulting in an energized workforce that is focused on creating long-term returns for our investors.

A focus on governance should be a priority for all companies because it helps ensure that there are good processes in place to encourage a dynamic environment that results in informed and objective decision-making.

A board can help its company become an ESG leader by focusing on four concrete steps:

Articulate an ESG philosophy. A board needs to set the tone for their company by working collaboratively with company management to create a bespoke ESG philosophy. A successful ESG philosophy must take into consideration what the company is capable of, what industry it operates in, and, most importantly, what financially material risks are posed by ESG-type issues. Intuitively, this makes sense. Regardless of motivation levels, an asset manager is not going to be able to take the same steps to protect the environment as an oil pipeline.

Customize your ESG approach. Once the board has articulated an ESG philosophy, it must then help management develop policies for the company to follow. A board should use this opportunity to take a hard look at whether or not their company is focused on the right issues and confirm that management is accurately reporting material risks to the board and not only reviewing line items on a financial statement. ESG policies designed merely to appease the current trends is bound to come across as inauthentic, so don’t try. Instead, due to the very nature of how ESG issues lack a “generally accepted” standard, each company’s efforts will, and should, differ. If your company is a small company, it might not make sense to spend resources monitoring numerous environmental policies that don’t really apply to the company. However, policies focusing on retaining performing employees would fall under the Social and are also critical to your business. Similarly, strong governance policies ensure the health of your business.

Measure Your Policies. A board must put systems in place to monitor that its ESG policies are being followed by company management. If you have an ESG policy that employee retention is important, the board must monitor employee turnover and understand whether its policies are helping to retain top performers. If having a strong diverse board is a policy, then the board needs to have policies in place to track the diversity of the board and to evaluate the performance of its directors.

Disclose Your ESG Efforts Effectively. A well-thought-out and applied ESG philosophy is only the first step. Companies must document and disclose their efforts in an effective way to receive credit for their actions. Much like how each company should work to create its own ESG philosophy, the disclosure channels utilized by each company will also be different. While one company may prefer to make disclosures in a lengthy sustainability report, others may find it more practical to have a portion of their website devoted to highlighting the company's ESG efforts.

ESG is here to stay. And, instead of fighting against the standards, smart boards that have an eye towards maximizing returns would do well to take an active and nuanced approach to creating effective ESG policies.

Marran Ogilvie *is a director for Four Corners Property Trust, Ferro Corporation, Evolution Petroleum Corporation and Bemis Company.* ***Evan Dunn*** *is the associate general counsel of Four Corners Property Trust.*

Issue:

2019 First Quarter