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Practical ESG Considerations for Management & Shareholder Boards

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In an environment of rapid change, the to-do list for public companies keeps getting longer.

For many years, there was a philosophical debate over whether the purpose of a company was to maximize profits for shareholders or, as more recently articulated by the Business Roundtable, to maximize value to a wider range of stakeholders—which, in addition to shareholders, may also include customers, employees, suppliers and communities.

In this debate, it was assumed that shareholders held only one interest—maximizing returns. Recently, the dialogue has shifted as some of the market's largest institutional shareholders, e.g., BlackRock, have begun to focus on social and environmental priorities that go beyond solely maximizing near-term profits. Specifically, BlackRock called on its investments to develop a plan to achieve net-zero carbon emissions by 2050.

Some may rightly note that as public companies are revalued daily, many suffer from an excessive and myopic focus on short-term, quarter-to-quarter profits. They might also observe that BlackRock's imperatives, most recently on climate change risk and environmental justice, provide a necessary course correction to promote longer-term thinking, assuming that focusing on social and environmental priorities is in the company's long-term interests.

Regardless, this shift in priorities, especially when other large shareholders follow suit, poses some challenges and opportunities to boards and executives while ushering in a new era of increased complexity, rigor, and accountability.

Management and directors of public companies are accustomed to dealing with a range of competing internal and external demands, and seemingly competing demands from the same shareholders. Most executive teams and boards are held accountable for results, whether that involves stock price performance, capital allocation plans, dividend income, stability to support retirement plans, or all of the above.

Performance pressures driven by analysts' expectations, changing customer expectations, and competitors' moves are all top of mind for public company boards and executives. This is especially true for small-cap public companies—more vulnerable to a bad quarter, a strategic move by a competitor or an activist investor looking for a quick return. The pandemic has intensified many of these pressures, narrowing or even eliminating the margin for error.

Against that backdrop, executives and board members of small-cap public companies that are not running carbon intensive operations and are generally unfamiliar with the issues—e.g., service-based businesses and software companies—are asking how to reconcile traditional performance pressures with new multi-dimensional shareholder demands on issues such as climate change. There are some relatively simple steps companies can take to get started.

Tectonic Shift

BlackRock, the world's largest asset manager and most public companies' biggest investor, makes the case for stakeholder capitalism, including issues like ESG and, more specifically, climate change). Chief executive Larry Fink said that companies that are sensitive to laying a foundation for a sustainable future will achieve higher valuations and attract more capital than those that are not as attuned. He argued for immediate action, based on a belief that the market will begin to price in climate related investment risks far earlier than the actual risks occur.

To put a finer point on the imperative for action, BlackRock's January 2020 letter to CEOs warned:

Given the groundwork we have already laid engaging on disclosure, and the growing investment risks surrounding sustainability, we will be increasingly disposed to vote against management and board directors when companies are not making sufficient progress on sustainability-related disclosures and the business practices and plans underlying them.

BlackRock is not alone. A number of large pension funds and other investors are in lockstep in requiring more substantive planning, metrics, disclosures, and reduction of greenhouse gases. Major institutional investing firms are bulking up their asset stewardship programs and backing technology to help track the ESG metrics and commitments made by the companies in their portfolios.

There is a tectonic shift in institutional engagement from due diligence outreach programs touching on board oversight and governance to more direct engagement, information seeking, fact checking, and value assessment processes focused on ESG measurements.

According to a recent report from EY's Center for Board Matters, nearly half of the more than 60 institutional investors surveyed say the integration of material ESG and climate opportunities into strategy will be one the biggest drivers of strategic success for companies over the next three years. About two-thirds of investors surveyed said climate risk and environmental issues will be an engagement priority for them.

It's possible that if the survey were held today, mere months later, the numbers might be even higher as the focus on climate risk seems to be increasing by the day. In its first 100 days in office, the Biden administration created a multi-departmental National Climate Task Force, and announced the goal of cutting greenhouse gas emissions by 50% by 2030, an achievement that will require significant changes to U.S. policies, laws, and regulations. And, not surprisingly, Securities and Exchange Chairman Gary Gensler acknowledged investors' appetite for information related to climate change and has made climate risk disclosures and enforcement one of his top priorities.

Perhaps most significantly, the SEC created the Climate and ESG Task Force within its Division of Enforcement to focus on policing companies that mislead investors, or fail to disclose material business risks stemming from climate change such as potential disruption in fossil fuel assets or supply chain disruptions caused by flood or wildfires. Issuers should expect the Climate and ESG Task Force to act quickly in carrying out its mandate, likely resulting in tangible inquiries, investigations, and enforcement actions.

Many business leaders have been openly supporting this movement, including executives from some of the largest U.S. companies. So far this proxy season, there have been over 135 shareholder proposals on climate-related issues.

Proxy advisory firms also are jumping on board by making adjustments and amending their guidelines to include more allowances and encouragement for climate initiatives. Institutional Shareholder Services, Inc. (ISS) now includes "demonstrably poor risk oversight of environmental and social issues, including climate change," as a governance failure warranting a vote against or withheld from directors individually, committee members or the entire board.

Glass Lewis has noted a concern when boards of companies in the S&P 500 Index do not provide clear disclosure concerning the board-level oversight afforded to environmental and/or social issues. In 2021, Glass Lewis will generally vote against the governance chair of a company in the Index that fails to provide explicit disclosure concerning the board's role in overseeing these issues.

Moreover, the leading corporate governance organization, the National Association of Corporate Directors (NACD), announced its initiative on Earth Day to help guide companies to net zero and signaled that climate risk is a strategic matter requiring board attention.

If you are an executive or board member of a public company, it's not hard to see where this is going. There will be increasing pressure for all public companies to recognize climate risk as a significant enterprise risk and for boards and executive teams to provide top-level attention to reducing a company's carbon footprint with tangible actions and measurable results. Senior management and boards must remain attuned to this evolving landscape, carefully reviewing relevant disclosures, and addressing climate and ESG risks most relevant to their company's business.

Pressure on Directors

Public companies often need the support of key shareholders such as BlackRock for important proposals, including approval of executive compensation and election of directors. Having a say on executive pay was especially important in a year like 2020 when boards had to make often one-time compensation decisions for key executives that may not have aligned with the voting guidelines of proxy advisory firms such as ISS or Glass Lewis.

Are directors really on the chopping block over ESG? With respect to climate change, it certainly sounds like it. BlackRock has been clear that it expects companies in which it invests to disclose a range of emissions data in their net zero plans, as well as short-, medium-, and long-term plans for achieving net zero emissions by 2050. Where a company does not demonstrate urgency or process, BlackRock and other institutional investors may support shareholder proposals that address gaps in a company's approach to climate risk. More to the point, BlackRock's stewardship guidelines indicate that it will vote against directors who are not perceived to be doing enough.

For executives and directors of companies that do not operate in carbon-intensive industries, or for those in small-cap companies, often struggling to survive, this may seem like an unnecessary distraction. However, for many companies' largest institutional investors, climate risk is investment risk, and for executives and directors, a failure to get on board may be job risk as well.

Many large public companies, especially those in carbon-intensive and/or consumer-focused industries, already have net zero goals. Companies like NRG Energy, PepsiCo, Google, Unilever, and Microsoft have been generating headlines on this topic for a while with bold public commitments. In the absence of any universally recognized standard, these and many other companies that have been at this for a while are focused on the reduction of Scope 1, 2, and 3 emissions, using frameworks including those crafted by the Sustainability Accounting Standards Board (SASB), the Carbon Disclosure Project (CDP), and the Task Force on Climate-related Financial Disclosures (TCFD).

Many of these companies have experienced management and board members, large internal employee/staff support, and external experts on retainer to create programs and monitor and report success.

For many small-cap boards, especially those in non-carbon-intensive industries, creating a business model that is compatible with a net zero plan is not as easy as it may seem. But, BlackRock is clear that it is not looking for a glossy marketing piece like many of the current ESG reports posted on some companies' websites. It wants action: clear, unambiguous metrics and a substantive plan that shows significant progress against specific goals.

Companies with limited resources, many of which are unfamiliar with the basic concepts of ESG and climate change, may struggle to provide the details demanded by large shareholders like BlackRock in the absence of a clear reporting framework. Crafting a credible plan that aligns with and enhances the strategic plan will be a tall order for some companies.

Nevertheless, boards of companies of all sizes and industries will need to pay attention, learn, prepare, evaluate how they measure up to their competitors, set goals, develop metrics, and report results to stay in the good graces of their largest shareholders.

What Does a Net Zero Plan Entail?

If your company has yet to begin defining its climate plans, BlackRock's suggestion to use the TCFD framework and metrics provided in the SASB standards is probably the best road map. Together, these frameworks require a company to disclose a credible and tailored plan to reduce Scope 1 emissions (produced directly by the company) and Scope 2 emissions (produced by energy and electricity usage). For companies in carbon-intensive industries, BlackRock expects disclosure of Scope 3 emissions (produced by the company's value chain). It is also helpful to note that many well-established industries with active trade associations have established their own disclosure frameworks, which will assist in benchmarking against competitors and similarly situated companies.

BlackRock wants realistic goals to reduce greenhouse gas emissions over the short-, medium-, and long-term. These goals, along with accurate and transparent results against them, should be publicly available to stakeholders, such as through publication of the plan and a report on the company's website, and should inspire confidence that the company will successfully navigate the transition to a net zero economy. According to BlackRock, this is a risk and opportunity exercise – an evaluation of transition risks and opportunities to adopt renewable energy sources and other energy efficient processes and products.

For companies that have not had climate disclosures or measurements in their ESG reporting this will be a journey to 2050—but a scramble in 2021. Many public companies will have to get up to speed quickly and develop a plan for the plan. While some corporate boards and executive teams may prefer to wait for a consistently accepted disclosure framework, there is too much pressure mounting too quickly to wait and risk financial and reputational damage.

Board & Executive Oversight & Priorities

With new and expanded expectations from both shareholders and the SEC, the role of the executives and board will expand as well. BlackRock states that board and executive level involvement and oversight is a vital part of the process.

For now, if your company's board has never discussed a climate plan, you can begin by educating every director on climate risk and how it will impact the company's business and strategic plan. This climate expertise should be appropriate to the company's industry and business model to ensure adequate consideration of climate risks and opportunities in the right context. According to BlackRock, "We expect directors to have sufficient fluency in climate risk and energy transition to enable the whole board – rather than a single director who is a 'climate expert' - to provide appropriate oversight of the company's plans and targets."

For non-carbon-intensive companies, or companies that are otherwise unfamiliar with the issues, board members and management will have to get up to speed quickly. This means, at a minimum, a crash course to understand the issues, the company's climate plan—when it is developed—and expected SEC disclosure obligations.

The CEO and the board will need to be able to have a dialogue with investors on these issues in a way that demonstrates a knowledge of climate protocols and company strategy. For boards, this means reviewing investors' asset stewardship papers, and preparing to engage with increasingly sophisticated stewardship teams that will come with data—asking tough questions about the company's direct operations and impacts on climate and the environment from purchased electricity, steam, heating and cooling consumed and potentially other indirect emission causing activities such as supply chains, business travel, transportation and distribution downstream, employee commuting, etc.

BlackRock notes that it expects directors to be involved in the dialogue and prepare to demonstrate proper oversight of ESG and, specifically, climate issues. In the end, the board approves the decisions that management executes, so directors should understand the process to create a plan and approve the plan as it moves to monitoring the implementation.

With more complex issues to oversee, there will be increased risk and exposure to executives and board members. The expected increase in climate-related SEC disclosures will likely call for additional controls and procedures to ensure that critical risks are addressed and adequately communicated to shareholders. SEC commissioner Elad Roisman expressed concern about the total cost of these new disclosure requirements and signaled that the SEC could and should recognize that the impact on small companies would be greater, the SEC should allow for flexibility in presenting ESG information, companies acting in good faith should have a safe harbor from litigation, and companies will be uncertain about what level of detail and scope meets SEC requirements.

While it would be unproductive to spend too much time worrying about what the SEC or other institutional investors will or won't do in the future, it would be prudent to take certain proactive steps to prepare for a range of different disclosure scenarios and to set the tone at the top. This is not the time for boards and executives to be caught flat-footed. Given the SEC's stated priorities, significant changes are on the horizon.

How Will This Affect the Bottom Line?

Though BlackRock touts the long-term benefits for companies in its portfolio, adapting a business model to reduce and offset all greenhouse gas could be pricey for some, at least in the near term, and it may prompt some difficult decisions about allocation of resources for a small-cap company fighting to compete on the slimmest of margins quarter after quarter. Change can take time and money to achieve. It would be naïve to think these new demands won't put additional pressure on boards and employees.

Would it mean switching to fleets of EV vehicles? Adding solar panels to reduce dependency on fossil fuels? Increased telecommuting and virtual meetings? Looking to rent space in LEEDS-certified buildings? Developing requirements for downstream suppliers? Or changing energy sources? There is no one right answer.

The tactics companies may take to get there are not entirely clear and it may be easy to make missteps, though BlackRock has indicated that it is less enthusiastic about seeing companies discontinuing certain operations, divesting businesses, or purchasing carbon offsets.

There are several factors working in the favor of companies that must address climate change. Innovation and the shift in perspective arising out of the pandemic—including reduced office space, travel, paper consumption, etc.—present significant opportunities for reducing carbon footprints. And, as the pace of innovation in renewable energy and efficiency standards continue to accelerate, more-efficient options will become available and affordable over time.

What To Do

While your company cannot afford to ignore climate risk, you can begin to take measured steps that are consistent with your business model and create minimum disruption to your operations.

- Continue to keep a tight focus on your core business strategy. While climate change is something that cannot be ignored, management's highest priority must be on succeeding at its business model or there will not be a management team to implement any climate plan.
- Know your shareholder base and what is important to your investors. Regardless of shareholder base, the board should be prepared to face emerging and escalating expectations around ESG from other stakeholders, including your customer base.
- Understand what is standard for your industry and understand your competitors' plans to address climate change. Know "what is market" for this issue in the arenas of your various business activity.
- Understand your carbon footprint and that of your supply chain.
- Put climate planning and disclosures on your next board agenda. Note recommendations from the NACD on board engagement. Even if developing a net zero plan is not critical to your shareholders, you can still expect new SEC rules requiring climate change disclosures.

Your company will need to make sure its disclosure controls and procedures cover climate and that related disclosures will be sufficient to comply with any new SEC rules. Provide the education that the board needs to anticipate expected SEC disclosures and determine whether to create a plan to reach net zero by 2050 or sooner.

- In time, as you contemplate future strategic planning cycles, look for opportunities to reduce costs and use resources in a way that is consistent with a greener future—e.g. consuming less paper might be a common issue for many service businesses.

If the board decides that the company should transition to net zero within a certain timeframe—e.g., 2050 being a popular target at the moment:

- Create a cross-functional team to develop a process to craft a plan. Ensure that this team includes members of the company's disclosure committee.
- Consider retaining an outside consultant to help craft your plan and reporting framework—preferably someone with experience assisting companies in the same industry.
- Work with industry trade groups to learn what your peers are doing with respect to climate plans and preparations for disclosures.
- Review policies and procedures to ensure they address ESG and climate risk and then continue to evaluate how effectively the company has executed on these policies. The board should be satisfied that implementation of the policies and procedures effectively aligns with the board's overarching strategy and is moving the company towards net-zero.
- Require reporting throughout the company so that managers know that corporate executives are focused on climate change as a business imperative.
- Continue board education on frameworks for the plan and related disclosure obligations. Education is not a one-time event, and effectively should trickle throughout the organization.
- Establish regular board review cadence and oversight of the planning process, the plan itself, and progress against the plan.

- Document steps, process and progress in a way that does not create an undue distraction for your company. Many small-cap companies will not be able to devote a large staff or resources to climate issues. The roadmap and the goals must be credible and authentic to what the company can realistically deliver.

- Develop reasonable and attainable project timelines and deliverables, along with real targets that are measurable and achievable.

- Communicate with all stakeholders – customers, employees, communities, suppliers, and shareholders – on this topic. Seek input and demonstrate responsiveness and progress.

- Pursue opportunities to honor ESG-related stakeholder interests; companies can often create goodwill from effectively communicating the measures the company has taken in these areas.

Conclusion

BlackRock and other shareholders, the SEC, proxy advisory firms, and trade groups will undoubtedly continue to pressure companies to address climate risk. The steps needed to craft a comprehensive plan for reaching net zero emissions by 2050 may, at times, seem daunting. However, taking small steps today with additional steps planned for the future can put your company on the right path to stay aligned with various stakeholders.

There is no rule prohibiting creativity. In fact, looking at your business through a different lens may offer some opportunities for reframing your basic assumptions and unlocking value in hidden corners. In many cases, striving for net zero emissions is a journey that may produce long-term benefits for many companies. Good sustainability can sometimes produce savings over time and satisfy some of your company's most-important constituencies. It could also create a value proposition and a marketing narrative to bring in new investors, along with new capital.

"The creation of sustainable index investments has enabled a massive acceleration of capital towards companies better prepared to address climate risk," Fink wrote in the 2021 letter to CEOs, adding that he has "great optimism about the future of capitalism and the future health of the economy—not in spite of the energy transition, but because of it." Hopefully, he will be proven right.