21 Years 2000 – 2021

GOVERNANCE

May 2021 Issue 321

The crisis in governance

'Nevertheless, toothless enforcement against the company directors responsible for scandals and bother still looks likely to remain the order of the day and plague the future nearly as much as it does the present.'

Gerry Brown

Overseeing cyber risk at board level

'Measuring what matters is key. Directors should ask management about the metrics used to identify and manage risk. By measuring the right things, and having adequate governance attention, corporations can better manage their risk environment.'

Roberta Sydney

Content

Feature

ESG revolution in the US

Lyndsey Zhang reviews recent ESG regulation reforms in the US and examines the impact of global ESG trends on US corporations.

Since the concept of ESG – a focus on the societal and environmental impacts of companies – was introduced to the business community in 2005 with the landmark report from the IFC *Investing for Long-Term Value*, ESG has been widely adopted by institutional investors as an important consideration for portfolio risk management. Since the UN launched Principles for Responsible Investment (PRI) in 2006, PRI signatory has been widely recognised as a requirement for obtaining the public status of a responsible investment company, as confirmed by the dramatic increase in the number of PRI signatories – from 63 firms in 2006 to 3,100 firms in 2020, with the total amount of assets under management increasing from $6.5trn to $110trn in the same period of time.

> '… disruption in the global supply chain alone has raised concerns regarding health and safety, diversity and inclusion, climate change and the real purpose of business.'

Discussion of ESG has reached a boiling point recently, as the Covid-19 pandemic, social and political protests and environmental disasters have highlighted the role businesses can and should play in society. Specifically, disruption in the global supply chain alone has raised concerns regarding health and safety, diversity and inclusion, climate change and the real purpose of business. Up until the recent decade, the US has been known for its shareholder primacy, best articulated by the Nobel-prize winning American economist Milton Friedman, who declared that the social responsibility of business is to increase its profits. Recent developments seem to indicate that times are changing, as US regulators and companies start to keep pace with societal trends. Here's a brief look at how the ESG movement is beginning to take hold in the US.

What have US regulators done to drive the ESG movement?

Stakeholder Capitalism Metrics. The World Economic Forum (WEF), together with Bank of America, Deloitte, EY, KPMG and PwC, developed a new ESG reporting framework in September 2020: Stakeholder Capitalism Metrics. The framework provides guidance with criteria to measure a company's performance on ESG factors. The ESG reporting framework draws support from 120 WEF members, and a significant number of companies committed to implementing the reporting metrics immediately. Stakeholder Capitalism Metrics provide a common ground for future consultations with corporations, investors, regulators, NGOs and international organisations. In January 2021, led by Bank of America, KPMG and Mastercard, 60 US companies committed to the new ESG reporting standards. With wide adoption by major US companies, Stakeholder Capitalism Metrics can potentially develop more detailed ESG reporting metrics with reporting standards comparable to those required for companies' financial reports.

Nasdaq board diversity rule. In December of last year, Nasdaq filed a proposal to the US SEC establishing board diversity and disclosure requirements. Upon the SEC's approval, Nasdaq will become the first stock market in the US to require representation from people of colour, women and members of the LGBTQ community. Research shows gender diversity enhances the effectiveness of boards' monitoring and decision-making functions by fostering empathetic thinking and a more probing approach driven by female board members. Although the definition of board diversity is broader than demographic characteristics, and to cover all dimensions of diversity will take more time, further research and regulatory reform, Nasdaq's board diversity rule marks a symbolic first step on the path to greater diversity for US companies.

SEC commitment to ESG focus on climate change. In recent months, SEC has actively highlighted ESG reporting. In February 2021, following the appointment of the SEC's new Acting Chair, the SEC's Division of Examinations announced its 2021 focus on climate and ESG-related risks. In March, SEC formed a Climate and ESG Task Force in the Division of Enforcement and appointed the first senior policy adviser for climate and ESG matters. The Task Force is likely to drive the SEC's ESG initiative by emphasising enforcement of the current legal framework related to ESG investments. Whether SEC will take a principle-based or rule-based path for the new ESG regulation remains to be seen. Since applying a one-size-fits-all ESG reporting standard to companies from various industries may be too complex, most US corporations are expecting a principles-based adjusted approach by regulators. We should know more later in the year.

How have US corporations responded to the worldwide ESG trend?

US companies' reactions to ESG reporting and integration pressure. US companies have been trying to embrace sustainable reporting to satisfy regulatory requirements and investors' expectations. Their efforts have been stymied by the lack of universal reporting standards and much-needed clarification on the differences between CSR reporting, Sustainable reporting and ESG reporting. KPMG's 2018 report suggested that ESG integration needed to be a 'top down and bottom up' process, requiring a change in mindset from company leaders to influence changes in corporate culture and enable strategic ESG integration from different levels of an organisation. However, at this time there is no established set of best practices or pragmatic guidance for this method of

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integration. While consulting firms led by the Big Four (Deloitte, EY, KPMG and PwC) are working on establishing ESG-related professional services with research publications on climate-related and ESG reporting and integration related topics, some US companies are trying to find their own path to remain compliant or to stay ahead of the game, and others are simply waiting for new regulatory guidance.

ESG impacts to American corporations. According to a December 2020 report issued by Spencer Stuart, one of the world's leading executive search and leadership consulting firms and headquartered in the US, out of the 413 new independent directors appointed to S&P 500 boards, 59% are women and minority men. These new appointments in 2020 increased representation of women on S&P boards to 28% in 2020 compared with 26% in 2019. And this is the first time in the past 20 years that every S&P 500 board has at least one female director. Also in December 2020, Intel's new CEO appointment demonstrated how activist investors are empowering the voice of capital with active engagement.

In December 2020, Daniel Loeb, CEO of hedge fund Third Point LLC, one of the top 10 activist investors in the US, wrote to Intel's Chair requesting immediate action to improve Intel's human capital management strategy and strengthen its position as a global leader of PC and data center processor chips. Intel's stock price rose 6.1% shortly after the message. After Intel's new CEO Pat Gelsinger took the position, Loeb praised Intel's decision and confirmed Third Point LLC's plan to remain Intel's long-term shareholder. It's clear that shareholder engagement will become another influential driver for the ESG revolution in the US.

ESG revolution in the US banking industry. In February 2021, a US Stakeholder Intelligence company, alva, published its *US Banking ESG Report* based on publicly available information. The report revealed strong ESG performers, including Fifth Third Bank, TD Bank, Ally Financial, JPMorgan Chase and Bank of America. In the same month, US Bank appointed a new head of ESG for Fixed Income & Capital Market business to better develop the bank's business in the sustainable capital market; this incorporated a full range of ESG related options, including Green Bonds, and emphasised the bank's efforts to support diversity and inclusivity on human capital management matters. Moreover, the US banking sector will have the first climate focused bank, Florida-based Climate First Bank, coming in 2021. The bank has already announced its mission to become the largest profitable eco-conscious financial institution in the region, and its internal decision-making and analysis process will be guided by climate-related metrics. As an important stakeholder for businesses, the ESG influence from banks should not be underestimated.

The ESG movement in the US is advancing on all fronts, and the Covid-19 pandemic has only accelerated the advance. Be on the lookout for more changes as regulators further develop new ESG reporting standards and auditing mechanisms.

Whether US companies will embrace the ESG movement in all its facets is a lingering question. But the coming ESG revolution will no doubt redefine corporate purpose and reshape US board governance practices in the decades to come.

Lyndsey Zhang is the author of Amazon new release: The Surge - An Overview of China's Rapidly Evolving Corporate Governance and Coming ESG Revolution https://amzn.to/3bCpRK1. Lyndsey is the founder and CEO of Boardroom&Beyond, a company specialising in helping companies strategically integrate corporate governance and ESG best practice, and promoting leading companies in today's global sustainable movement

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