The ESG Mindshift in the World of Boards

BY **TURID ELISABETH SOLVANG,** Founder & CEO, FutureBoards

In the post-Covid-19 era, companies are navigating a transformative landscape, with the ESG megatrend reshaping boardroom strategies to address the growing demands of investors, consumers, activists and regulators. Boards need to extend their responsibility beyond shareholders, embracing a holistic approach that considers the broader impact on all stakeholders in an increasingly interconnected and conscientious global community.

As we adjust to "life after Covid-19", we find a world reshaped by geopolitical instability, climate changes, digitalisation, inflation and other structural shifts that have irreversible consequences for the world around us. This is the society in which our companies operate.

In these rough waters, the fiduciary duty of board directors is to steer the company in a way that creates long-term value for all.

And that is what the ESG (Environment, Social, Governance) agenda is all about. And to remind ourselves:

- The "E" is about how your company affects and is affected by our physical surroundings. A topic, by now, familiar to most of us.
- The "S" is about your company's relationships with people and institutions in the communities you operate. A bit less focused area than the "E", but on the rise, linked to human rights, labour conditions, diversity and inclusion.
- The "G" addresses the internal decision-making system. A much less-debated area, but increasingly more important to shareholders.

The challenge

The challenge is that even if ESG has been a driving factor for many companies and organisations, research has found that while it is often enthusiastically embraced, it is frequently not fully understood.

However, despite criticism of ESG as being "woke" capitalism, ESG is a top priority for large institutional investors as well as a rapidly growing part of the capital markets at large.

If they are not happy, they will use their power at the annual general meeting (AGM) to vote against the boards' proposals or, ultimately, not renew the board directors' mandate. Or they will simply walk away to put their money elsewhere.

And they are being transparent about their views.

The power of money

In an article in the *Financial Times* earlier this year, Nicolai Tangen, head of the Norges Bank Investment Management – the world's largest sovereign wealth fund – tells boards to sharpen up.

In addition to his criticism of executive pay and the combined role of the chair and the CEO, Mr Tangen focuses on climate risk and board composition. He warned that the Fund will vote against board members in the future if they see material failures in disclosing, managing or overseeing climate risk.

Furthermore, he said, "Another vital ingredient for strong boards is a broad range of perspectives, competencies and backgrounds. We expect boards to have at least 30 per cent representation of each gender, and we will increasingly vote against those that fail to meet this condition."

A recent move from the Norwegian Oil Fund is to back shareholder proposals at Exxon's and Chevron's annual meeting to introduce targets for cutting greenhouse gas emissions.

Another leading voice in the investment community is Larry Fink, CEO of BlackRock, the world's largest asset manager. He writes annual letters to BlackRock's clients and the CEOs of their investee companies to express his expectations.

In 2020, he told the CEOs that BlackRock will be increasingly disposed to vote against management and board directors when companies are not making sufficient progress on sustainability-related disclosures and the underlying business practices and plans.

However, this year's letter marks a shift as it was addressed to all their stakeholders. Among others, Mr Fink encourages asset owners to cast their own votes at the AGMs instead of using proxy advisers. He predicted that how the voting ecosystem changes over the next decade can be a transformative force that reshapes corporate governance.

However, all this requires having access to accurate and understandable information.

Larry Fink also points to the importance of corporate culture and talent management, as BlackRock research shows a strong correlation between companies with better culture and values ratings compared to industry peers and their stock returns. So, yet another crucial point on the board agenda.

The "other" stakeholders

In addition, a growing number of "other" stakeholders, including the millennials as well as various activist groups, are keeping a close eye on how business leaders act.

And if they are not happy, they will stop buying your products, they will not seek employment with your company, and ultimately, they may sue you for ill conduct.

This was the case with ClientEarth's world-first lawsuit against the board of directors of Shell for failing to manage the material and foreseeable risks posed to the company by climate change. The court dismissed the lawsuit, but it has certainly placed the topic high on the agenda of board directors and their stakeholders.

The regulators

Regulators do what regulators do – they regulate.

But they are not happy, either. A vast number of national and international legislations and recommendations are already in effect, and more are underway – to ensure that the companies also create value for the society in which they operate.

Some call it a "tsunami", indicating you would be lucky to survive the regulatory pressure. However, I would suggest that board directors should at least consider these three areas to be life vests to keep them afloat:

- The shift of the board's responsibility from shareholders to stakeholders.
- Board diversity.
- Integration of financial and sustainability reporting.

More details are in the box, "The Regulatory Tsunami".

Board structures

According to an INSEAD/BCG study, 91 per cent of board directors think their boards should devote more time to strategic aspects of ESG issues,

This will only be possible if they have the right structures and practices in place.

The Regulatory Tsunami

The responsibility of the board

The paradigm shift is from shareholder to stakeholder focus.

The revised *G20/OECD Principles Of Corporate Governance* was published in September 2023. Among others, the amendments include implications of climate change concerning shareholders' rights, high-quality corporate disclosures and the responsibility of companies' boards.

That is a development reflected in many national corporate governance codes.

In Singapore, for example, the 2018 code states: "Corporate governance refers to having the appropriate people, processes and structures to direct and manage the business and affairs of the company to enhance long-term shareholder value, whilst taking into account the interests of other stakeholders."

The Norwegian Corporate Governance Code is on the same page, adding in 2022 that the board should ensure that the company creates "value for shareholders in a sustainable manner".

Board competence and composition

Diversity is top of the list for many shareholders. However, progress is slow in many jurisdictions, and regulators are becoming impatient.

In the UK, the Financial Conduct Authority has introduced targets for gender balance and ethnic minority representation on boards. And the UK Corporate Governance Code has recently been revised for the first time in five years.

In 2022, the EU directive for gender quotas was finally approved by the EU Council - more than 10 years since it was launched. The implementation processes in the member countries are ongoing.

Norway is once again ahead of the game with the Minister of Trade's proposal to implement gender quotas for boards of approximately 400,000 private companies. Large and mid-size private firms must have boards comprising at least 40 per cent women.

Reporting

Perhaps the most frequently discussed topic for boards is reporting – and how to integrate financial and sustainability reporting.

In 2021, the IFRS Foundation announced the formation of the International Sustainability Standards Board to develop sustainability disclosure standards to meet investors' information needs.

At the same time, several new EU legislations are being rolled out, such as:

- The Corporate Sustainability Reporting Directive.
- The Sustainable Corporate Due Diligence Directive.
- The EU Taxonomy.

In the US, the Securities and Exchange Commission is considering new rules that would require more detailed disclosure of climate-related topics, as well as on other facets of ESG.

Norwegian regulators are on a fast regulation track, too. The Transparency Act, as well as the Activity duty and the duty to issue a statement, are already affecting the boards' work.

So, what is the right structure? An ESG champion on board, a dedicated ESG committee added to an existing committee, multiple committee responsibilities, or fully integrated at the board level?

What we do know is that this is a work in progress. And to quote former UK Prime Minister Winston Churchill, "This is not the end. It is not even the beginning of the end, but it is perhaps the end of the beginning!"