BOARD'S GUIDE TO TRUST

THE ESG IMPERATIVE

Edelman

Published in Partnership with NACD
Empowering Directors. Transforming Boards.

INTRODUCTION

Creating long-term corporate value has evolved beyond building the bottom line. Today, new concerns have commanded the spotlight, requiring management and boards to address business risks and societal impacts that impact a wide range of stakeholders. While management remains accountable for setting corporate strategy and running the business, board directors increasingly are expected to devote attention to Environmental, Social, and Governance (ESG) issues affecting the well-being of a company's customers, employees, and society at large.

Indeed, companies' ESG practices - especially those tied to environment and social impact - have lately become elemental touchstones for winning multistakeholder trust and strengthening their franchise and market value. As the importance of “E” and “S” of ESG has risen, companies and their boards are recalibrating their organizational approach to all three. Rather than treat them separately, some companies have extended their governance model to encompass E and S, making them two linchpins of good governance.

However companies choose to act, it is imperative that private sector leaders – and the boards that oversee them – maintain and grow trust in their organizations by demonstrating their ability to perceive and address ESG risks and opportunities. Failing to do so is no longer an option.

What is driving this new set of expectations?

- **First, the COVID crisis intensified corporations' focus on ESG issues.** As the pandemic escalated, many boards found themselves working hand in hand with management, deploying expertise gained from prior crises, such as 9/11 and the 2008 global financial crisis, to make rapid-fire decisions to protect workers and shore up business continuity. Many organizations achieved those aims through employee commitment, agility, innovation, and resilience. As more companies begin to view employees as a critical capital investment rather than as a cost center, boards can expect workforce matters like mental health, flexible work arrangements, and workplace safety to remain on their agendas.
- **Along with the pandemic, a crisis over racial inequality erupted, instigated by the murder of George Floyd in the United States and the pandemic's profoundly disproportionate impact on historically underrepresented and disadvantaged people around the world.** That jolt to the conscience prompted many business leaders to issue calls for greater social justice and pledges to diversify their management teams and workforces. Investors, the media, and the public will watch to see if they make good on their pledges and hold them accountable if they do not.
- **A raft of destructive and deadly fires, floods, and searing heat waves has underscored the perils of rising carbon levels and has brought the climate crisis to the forefront.** With a global movement toward net-zero emissions, tighter regulations, and upcoming global climate summits on the calendar, business leaders will need to take action as policymakers and investors increasingly reward progress toward sustainability – and punish the lack of it.

97%

of investors intend to actively engage with company leaders and boards on ESG

Findings from a recent Edelman study show that 96% of institutional investors said that they expected their focus on ESG to sharpen once the pandemic ebbed. Moreover, 97% of investors said they intended to actively engage with company leaders and boards on business-relevant ESG factors going forward.

Likelihood of Investor Engagement

Percent Selected

Corporate Culture

87% Likely

58% Very Likely

Diversity and Inclusion

94% Likely

54% Very Likely

The Impact of Climate Risk on the Company

95% Likely

64% Very Likely

OF INVESTORS

expect the board of directors to oversee at least one ESG topic

ESG Topic	% Selected
Employee health and safety	52
Social issues in their community	50
Human capital management	46
Data privacy and cybersecurity	45
The impact of climate risk on the company	39
Corporate culture	38
Eco-efficiency of the company's operations	36
Diversity and inclusion	35
Supply chain environmental and social risk	30
Resource scarcity	30

What do these crises mean for boards? In a short time, the agenda for business has irrevocably broadened. As a result, directors are now expected to oversee ESG issues centrally relevant to investors and other stakeholders that had not risen to the board level in the past.

Says Anna Catalano, who serves on the boards of Willis Towers Watson, Kraton Corp. and other companies: "I'm accountable to shareholders, and I am responsible for stakeholders."

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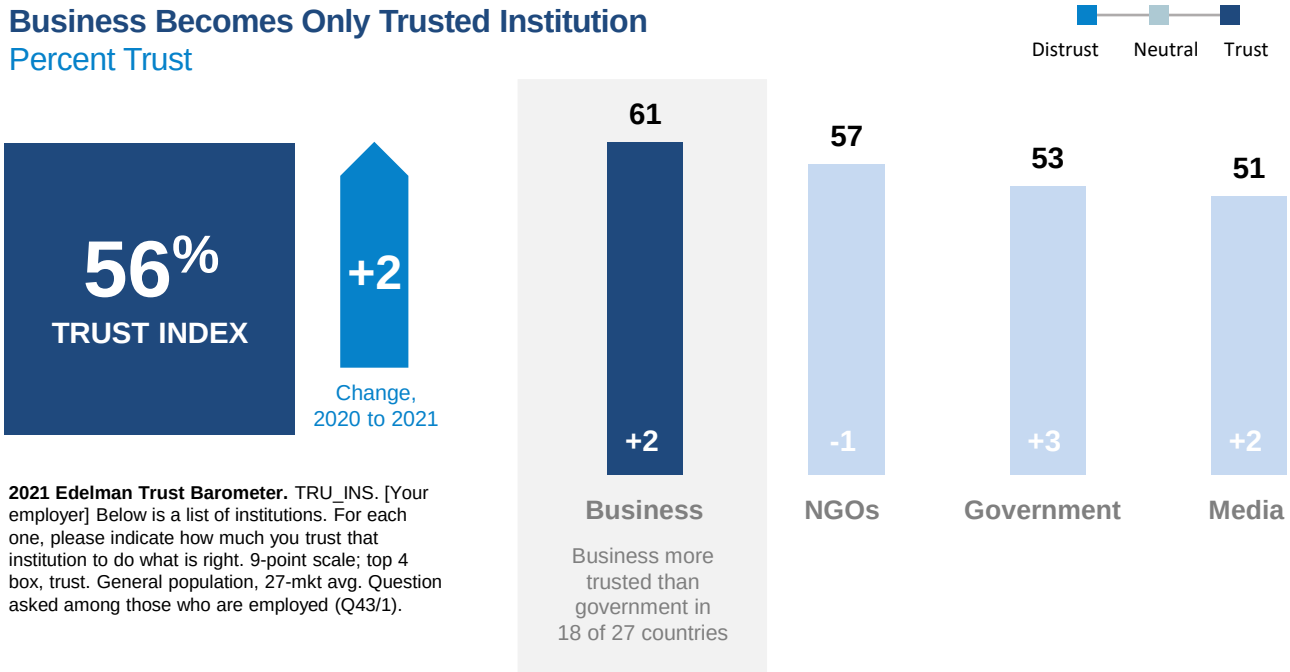
>
> — **Anna Catalano, board director**

Business Becomes Only Trusted Institution

Percent Trust



2021 Edelman Trust Barometer. TRU_INS. [Your employer] Below is a list of institutions. For each one, please indicate how much you trust that institution to do what is right. 9-point scale; top 4 box, trust. General population, 27-mkt avg. Question asked among those who are employed (Q43/1).

Today, words are not enough. As the most trusted element of society, business and its leaders must demonstrate that they understand the significant impact that ESG issues can have on company performance and take concrete action to address them. By encouraging and challenging management to do so, board directors have a unique opportunity – and an obligation – to strengthen trust in the organizations they serve.

In this report, we explore how environmental and social factors have changed the calculus for directors and how boards advise and monitor leadership in this emerging area.

TRUST POST-PANDEMIC: A NEW EQUATION

The COVID pandemic brought to light the private sector's crucial role in providing goods, services, jobs, and public leadership. To maintain and grow trust in the organizations they serve, boards must embrace that broader role in their mission.

The COVID-19 pandemic has challenged companies and boards to rethink their social and environmental priorities and react more assertively to crises in these areas. In past crises, the corporate sector looked to government to take the lead in shoring up the economy, safeguarding workers, and keeping the public informed. With COVID-19, that changed, as many companies took extraordinary action to stabilize their businesses, ensure safe work environments, facilitate work from home, and provide employees with financial and other vital support. More recently, corporations have also become trusted informational sources around COVID recovery and vaccines.

The success of those measures has raised the bar on stakeholder expectations. More than ever, CEOs must demonstrate public leadership in order to maintain trust across the spectrum of social and environmental needs. Because boards hold CEOs accountable to their agendas and actions, directors are similarly being held to a higher standard of action and response. In addition, detailed disclosure of ESG policies and actions has become critical to establishing trust.

CHECKLIST

- ❑ Has there been a discussion of what lessons were learned from the pandemic and how they can be applied to future crises?
- ❑ Has the company conducted a post-pandemic scan of its ESG objectives and strategy, and made any required adjustments?
- ❑ Will there be long-lasting changes in employee behavior and expectations for which management and boards should be ready?

Today's expansive mandate for leaders and boards is rooted in stakeholder capitalism – the movement to redefine the purpose of corporations and the constituents they serve, which many large investors and major companies now espouse. As a result of the pandemic, what companies must do to serve key stakeholders – not merely stockholders – has evolved.

Corporations face intensifying pressure from activist investors and other stakeholders to fulfill their broader societal roles. They are being urged to engage with government officials to ensure constructive steps tied to ESG issues are taken. Post-COVID, the big priorities will run the gamut from climate change to income equality and foreign trade policy, and everything in between.

The pandemic drove home the fact that companies that already had strong ESG policies in place were better able to weather the social upheavals of the last 18 months and faced less pushback from stakeholders.

If a company has ESG ingrained in its strategy, observes Catalano, the outcome will be "a stronger track record, and as a result of that, strength in share price, in performance, and greater resilience when times are tough."

AN EVOLVED BOARD MANDATE: GOVERNANCE OF E&S

Designing and executing an effective ESG program starts with establishing trust at three levels: among board members, between the board and management, and between management and stakeholders. A strong trust mandate allows directors to work across constituencies to create a shared value system that facilitates discussion of environmental and social issues that may be newer to management, or whose impacts are difficult to assess.

Says Eugenia Ulasewicz, who serves on the boards of ASOS, Signet Jewelers, Vince Holding Corp., and Dufry AG : "ESG can't be a result of external pressure. It must be part of the company's strategy, its mission, purpose and culture and part of everyone's responsibility – that is the only way it will work. It can't be a 'check the box and move on' exercise."

It is critical that board members coalesce around a common ESG program, a framework for discussion, and aims that reflect a company's core values. Uniting the board behind a shared philosophy is an essential first step to establishing an approach to ESG that company leaders and employees trust and embrace. A shared trust framework, says Jane Sadowsky, who serves on the boards of two mining companies, Nexa Resources and Yamana Gold, "gives [directors] a shared support" system and a strong foundation for action.

Once the foundation is set, boards are responsible for instilling it in the organization, starting with company leadership.

Boards must work in concert with leadership to create governance and oversight mechanisms for environmental and social matters – and to ensure those issues are integrated into decision-making and strategy development. That may entail tasking certain directors with ESG oversight or forming new board committees that focus specifically on defining ESG goals and tracking progress in achieving them.

> "A [shared trust framework] gives directors a shared support system and a strong foundation for action."
>
> — **Jane Sadowsky, board director**

Particularly with regard to environmental and social issues, boards help set performance metrics and closely evaluate information presented to them by management.

Boards also play an important part in ensuring that, in addition to the C-Suite, company officials in key financial and human resources roles communicate with each other on ESG issues.

Increasingly, boards also facilitate dialogue between companies and investors about ESG-related matters, particularly around questions regarding executive compensation or E and S metrics.

In some cases, with management's support, directors now reach out to rank-and-file employees for feedback on E and S matters. They may pay on-site visits to company outlets, stores, and manufacturing facilities to talk with workers and supervisors to verify that E and S programs are being implemented across the organization. Forward-thinking directors have long made such visits a priority, as a way to validate the information they receive from management about other leading concerns.

Additionally, board directors have elevated their role in communications around sustainability and other ESG issues. As companies' communications tools have expanded, directors have encouraged companies to use multiple channels, including websites, social media, and internal messaging to spotlight ESG efforts, reinforce their values, and foster trust with stakeholders.

Ulasewicz added, "ESG issues will be different for every company, but there needs to be agreement on what are the most important issues and how you'll measure and communicate your progress to different constituencies."

However much influence a board can exert to set ESG goals and monitor adherence, the responsibility for delivering results lies with management. Says Sadowsky: "Board members are not going to give answers to problems. They can raise and discuss the issues and they can assess management's response. But there's a limit to what they can do."

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>
> — **Eugenia Ulasewicz, board director**

CHECKLIST

- ❑ Is there a clear and agreed upon set of principles, norms, and behaviors that board members share?
- ❑ Are directors and management aligned on a shared understanding of the potential for environmental and social factors to impact the performance of the business?
- ❑ Is oversight of ESG matters reflected in the company's governance documents?
- ❑ Has management established clear ESG objectives as part of its corporate strategy? Are the right people accountable for execution and progress?
- ❑ Does management provide regular reports to the board on ESG matters?
- ❑ Has leadership developed a consistent narrative around environmental and social goals and implemented it across stakeholder channels?
- ❑ Are there clear channels of communication between the board and all stakeholders (where appropriate, blessed and supported by leadership)?

PAYING THE PIPER: THE E+S+G OF EXECUTIVE COMPENSATION

As investors press companies to proactively address environmental, social, and governance issues, they've given teeth to that demand by persuading companies and boards to tie top executives' compensation to ESG performance. Even though the proportion of large companies that now do so is a minority, their ranks are growing, and those companies that incorporate progress on commitments to E and S are viewed as more credible.

Thirty-eight of Fortune 100 companies used ESG criteria to help set bonuses and other compensation for the C-Suite, according to the research firm Equilar. Reflecting the increasing attention that investors and companies are taking in social impact, nearly 39 percent of the ESG metrics commonly used to determine pay related to diversity or cultural issues.

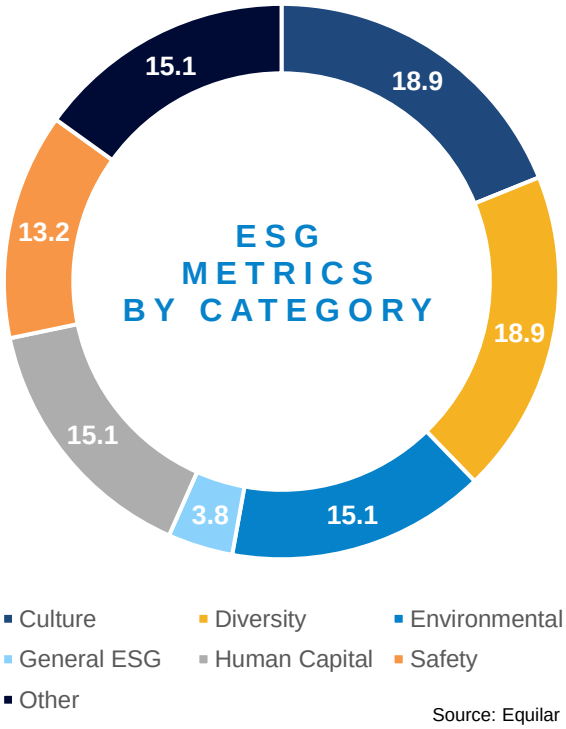
At the same time, the push for companies to harness ESG metrics – not solely as a tool to set pay – is a work in progress. The best ESG methodologies and the most reliable performance metrics are topics of ongoing debate. Of the ESG metrics that Fortune 100 companies invoked as a basis for executive pay, most were discretionary and not quantified.

The numerical fuzziness has meant that many boards lack a baseline understanding of what needs to be measured and how often. But as clarity builds around ESG issues, a consensus around reliable ESG metrics will develop.

Even now, many diversity-related metrics – such as minority and female representation in the workforce, in the executive ranks, or on the board – aren't matters of conjecture.

As that consensus develops, the utility of metrics as an analytic tool will grow. Boards and company leaders will have a better understanding of how to gauge progress towards setting and achieving ESG goals, and where organizations fall short. Executive accountability will improve.

In the meantime, boards of directors today have a vital responsibility to address shortfalls in implementing ESG goals when they arise, and to dig deep to understand their causes and seek remedies.



Source: Equilar

CHECKLIST

- ❑ Has the company established KPIs for measuring progress on its ESG goals?
- ❑ If so, is the company incorporating those KPIs into its executive compensation plans?
- ❑ Are the metrics and their impact on compensation decisions clearly understood by management and investors?

WHO SHOULD LEAD?

The trust mandate has transformed one of the most important roles board directors play – the responsibility to choose the CEO. As the scope of directors' obligations toward shareholders has expanded to include a broad array of stakeholders, boards are giving increased weight to CEO candidates' ESG credentials.

In the lifespan of a company, different types of leadership are called for. Directors think about succession planning in the context of where a company stands today and what lies ahead. While classic leadership skills and business acumen remain a constant, and factors like temperament and cultural fit remain key, the rising emphasis on social and environmental issues has enlarged the set of qualities that boards now seek in a CEO.

How directors approach CEO succession increasingly takes into account candidates' history of successfully advocating and instituting ESG initiatives, including a record of establishing clear ESG performance and accountability metrics, and advancing opportunities for underrepresented minorities and women. Boards, says Catalano, "can no longer afford to talk about how the world was 20 years ago."

In addition to probing candidates' views on diversity and environmental issues, more boards are examining their involvement in their communities and the impact they've had on people's lives.

CHECKLIST

- ❑ Is the board aligned on the qualities they look for in the CEO? Are these preferences clearly articulated? How often does the board review?
- ❑ Has the board done enough to develop a CEO and/or leadership pipeline that includes underrepresented groups?

To cite Ulasewicz, boards today are looking for a combination of "brains, heart, soul, and muscle" in anointing a new CEO. In essence, trust is built on four pillars – purpose, ability, integrity and dependability – and to ensure that those they select will instill it, directors are looking for leaders who have led by example.

RACIAL JUSTICE AND DIVERSITY, EQUITY, AND INCLUSION

Board directors are more conscious than ever of the central place that racial justice, diversity, and inclusion have in their organizations. The twin crises of 2020, when the pandemic took a grave toll on minority communities and calls for racial justice swept the world, laid bare the corrosive impact of structural inequality on sustainable economic growth. As they guide leadership, boards now recognize Diversity, Equity and Inclusion (DE&I) issues as pivotal to mitigating risk, setting strategy, and elevating companies' long-term value.

In many respects, last year's events were a tipping point: a moment of reckoning that compelled corporate leaders, and society at large, to confront the injustice and destructive effects of long-standing structural racism. In the intense public debate that followed, the private sector was painted as either a savior or a profiteer – a wake-up call that has led companies and boards to redouble efforts to address racial inequity.

The heightened attention has persuaded most large companies, some of which previously paid lesser heed to the S element of ESG, to elevate the consideration they give social issues, making them a critical part of their ESG initiatives. Framed another way, many boards and company leaders have come to view societal imperatives as vital to their organizations' purpose and to responsible governance.

As a result, more boards are asking management for enhanced diversity, equity, and inclusion metrics that show measurable, rather than merely anecdotal, performance improvements.

Furthermore, for this one issue more than any other, board members are becoming more personally involved. To many employees, boards can be a distant authority to which they're not exposed. Some directors seek to bridge that gap.

For example, Kenneth Gilbert, who serves on the board of Wendy's, says he solicited feedback from mid-level managers at the company, with a particular focus on Black managers, to connect the board with their challenges and experiences.

Those challenges can take various forms, including a lack of promotion opportunities, unconscious bias and, crucially, the diversity of boards and selection committees.

Says Catalano: "It's very important to have a conversation around how diverse your selection committees are. When selection committees are not diverse, you have a tendency to have very similar biases around the table, and it's more difficult for those biases to be called out."

Gilbert strongly believes that management should prioritize diversity throughout an organization, from the C-Suite and boardroom to the rank-and-file. "If you don't have a [diversity] program in place right now, the board should be having a meeting about firing the CEO," he says.

CHECKLIST

- ❑ Are there clear strategies and resourced operational plans in place to execute on social objectives?
- ❑ Are there clear key performance indicators that track not only inputs and outputs but also outcomes to support systemic progress on specific diversity issues?
- ❑ Are there clear channels of information flow in order for the board to be able to understand why certain metrics are or are not being met and to course-correct?

DOING AS YOU SAY

The duties and pressures boards face are growing. Among the lessons that 2020 drove home to boards and corporate leaders, the most important may have been this: companies need to make environmental and social concerns matters of urgency.

For directors, the events of last year underscored their fiduciary duty to advise companies on establishing meaningful and measurable E and S goals that are reflected throughout the organization, and on how to act vigorously to realize them. Paying lip-service to social problems no longer suffices. Boards and leaders must walk the walk.

Today, as social and environmental matters attract intense scrutiny, investors and other stakeholders have come to expect CEOs to step up on issues of public good, including, but not limited to: workers' happiness, health, and safety; sustainability and climate; democratic principles; and racial and social justice. That scrutiny has meant boards also must step up and provide the C-Suite frequent, fully informed and actionable advice on the critical issues of the day.

Ultimately, the starting point for that discussion is board culture – the diversity of the board itself. Periodically replenishing boards with new skills and life experiences makes them better-rounded governing bodies that can guide leadership on today's challenges. A diverse board's commitment to shared ESG goals sets a strong foundation to create the multiple layers of trust – between directors and management, between management and employees, and between companies and stakeholders – needed to build consensus around a plan of action and deliver desired results. Boards must set the groundwork. As Gilbert observes: "If you can establish a base level of conscience to drive the soul of a company, and if you get that right, lots of other things are easy to get right."

CHECKLIST

- ❑ When looking at potential and future board members, is there a commitment to seeking a variety of perspectives and backgrounds?
- ❑ Is there a robust evaluation process between how the board is doing as a whole, and how individual directors are doing on KPIs?
- ❑ Is there a board refreshment process that is in line with wider ESG goals?
- ❑ Has the board conducted a self-assessment in the context of the industry it operates in and/or best practices across industries?
- ❑ Is the board prepared to change its composition in the face of rapid business and societal transformation?

Gilbert adds, "Don't look for a board member that makes you feel comfortable because they are like you. For many boards, diversity stops at gender, color, or ethnicity. But it goes much deeper than that. Diversity is about diversity of thought, experience, and culture – *that's* what adds to the board."

THE BOARD'S GUIDE TO TRUST SERIES

Board's Guide to Trust—Building Trust With Institutional Investors

Board's Guide to Trust – The Trusted Employer

ABOUT EDELMAN TRUST BAROMETER

The 2021 Edelman Trust Barometer is the firm's 21st annual trust and credibility survey. The survey was powered by research firm Edelman Data & Intelligence (DxI) and consisted of 30-minute online interviews conducted between October 19 and November 18, 2020. The 2021 Edelman Trust Barometer online survey sampled more than 33,000 respondents, which includes 1,150 general population respondents across 28 countries and 200 informed public respondents in each country, except China and the U.S., which have a sample of 500 informed public respondents each and Nigeria which has 100 informed public respondents. All informed public respondents met the following criteria: aged 25-64, college-educated; household income in the top quartile for their age in their country; read or watch business/news media at least several times a week; follow public policy issues in the news at least several times a week. For more information, visit https://www.edelman.com/trust/.

ABOUT EDELMAN

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ABOUT NACD

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NACD empowers more than 22,000 directors to lead with confidence in the boardroom. As the recognized authority on leading boardroom practices, NACD helps boards to strengthen investor's trust and the public's confidence in business by ensuring that today's directors are well prepared for tomorrow's challenges. NACD members can also take the next step to elevate their individual and board performance by becoming NACD Directorship Certified®.

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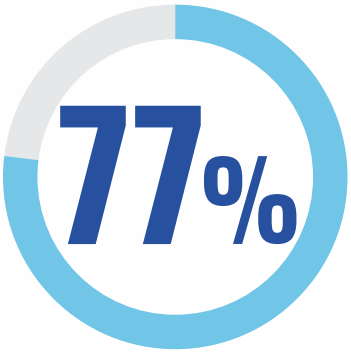

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