Discussion Paper

Board Adoption and Oversight of Corporate Sustainability

Global Compact LEAD

BSR

This paper gives an introduction to the role of corporate boards in overseeing corporate sustainability and implementing the Global Compact principles. It is designed to provide an overview of this fast-changing topic, and present some of the questions that will be discussed at the inaugural LEAD Symposium in Atlanta on the 29th of March.

During the inaugural LEAD Symposium, participating companies will explore a central dimension of achieving sustainable business success: the link between corporate governance and sustainability. We anticipate a lively debate in Atlanta, with the opportunity for companies to share their experiences and challenges in aligning their governance practices with their commitment to integrate social and environmental performance into their core strategies.

We look forward to testing—and building upon—the ideas presented in this paper, and believe that the discussion will enable boards to guide more resilient enterprises that address the world's greatest challenges.

Introduction

Sustainability is increasingly recognized as a strategic imperative for businesses globally. Far more than when the Global Compact was launched in 1999, companies recognize that their sustainability performance affects their strategy, financial performance, resilience, access to essential resources, reputation, and license to operate. Peter Senge, noted strategy theorist and faculty member at the Sloan School of Business at MIT wrote in 2009 that "people are starting to suspect that these are really strategic issues that will shape the future of our businesses." And as sustainability is being recognized more and more as a strategic business question, Boards are increasingly considering sustainability as part of their core responsibility of guiding and overseeing corporate activities.

While this is a truly global development, the ways that governance and sustainability intersect must be understood within the context of the distinct legal charters and traditions practiced in different parts of the world. Two key variables apply. First, Global Compact signatories reflect the full panoply of business structures, including publicly traded corporations, state-owned enterprises, and family-owned or controlled businesses, amongst others, with various governance models in place. Second, different jurisdictions establish different governance requirements. This paper, therefore, references both core Board activities that are commonly found in nearly all companies (e.g., oversight of strategy, compliance, performance and oversight of executives), and the distinct structures and practices that shape how these responsibilities are implemented in different circumstances due to corporate form, legal requirements, and implicit traditions and cultural expectations.

This paper will cover the following dimensions central to the intersection of sustainability and governance: (1) Board roles and responsibilities; (2) Board structure; (3) Board composition; (4) Investor engagement with corporate boards; and (5) Sustainability education for board members. The paper aims to provide a concise overview of the current practice on this crucial topic, as well as emerging trends and opportunities encountered and shaped by the world's leading companies.

Board Roles and Responsibilities

Sir Adrian Cadbury, Chair of the UK Commission on Corporate Governance that produced a landmark report in 1992, said in the report that "Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society."

This paper looks at the myriad ways that Boards help companies achieve the balance about which Sir Adrian wrote. This approach reflects a vision that sees Boards as owing a duty of care to shareholders to one that looks at the company—including its shareholders—as part of a wider web that includes multiple stakeholders. As Allen White, founding director of the Global Reporting Initiative wrote for BSR in a previous paper looking at this topic, "distilling directors' duties to a bilateral (shareholder-board) relationship may be elegant from a legal and analytical perspective, but from a CSR perspective, this elegance gives way to obsolescence. To define the duties of the supreme governance body of a corporation in such a one-dimensional form contradicts the most fundamental tenet of CSR: Corporations are responsible to multiple stakeholders, all of whom are integral to the success of the business."

In a world where sustainability has become more important to business performance, shareholder returns **and** stakeholders' interests, the question for Boards is now more often **how** to address sustainability, rather than **whether** to do so. Boards' responsibilities for sustainability can be categorized as follows: (1) traditional duties, often spelled out by legal requirements, adapted for a world in which sustainability is ever more important; (2) explicit responsibilities for activities related to sustainability performance, and (3) implicit responsibilities related to prioritization and agenda-setting.

Traditional Board Activities Adapted for a New World: Regardless of corporate form or jurisdiction, Boards are understood to be responsible for overseeing business strategy; selecting and overseeing the chief executive and determining executive compensation, and ensuring and legal compliance. Traditionally, Boards have also been seen as the representatives of shareholders, as often expressed through principles of fiduciary responsibility. Finally, Boards are expected to assist management in anticipating material changes to the operating environment, to ensure resilient business strategies.

The integration of sustainability and governance is in part, then, about the application of traditional governance activities to a 21st century operating environment in which sustainability has become significantly more important. Numerous companies have learned over the past two decades how topics not previously considered relevant to business, such as human rights and climate change, can shape business success. Some Boards have, for example, invited John Ruggie, UN Special Representative on Business and Human Rights, to brief them on human rights risks and opportunities. Many businesses have seen their hard-won reputations damaged by campaigns led by an ever-more vigorous civil society, fueled by the internet and now social media. And many businesses have found it difficult to maximize the value of core assets when social and environmental questions can affect the legal license to operate. Moreover, the primacy of shareholder value, especially in the context of publicly-traded companies, is subject to increasing debate. In this context, even the traditional responsibilities of Directors are being redefined to include environmental, social and governance (ESG) considerations. This is seen through the rewriting of charters for Boards and Board committees to include explicitly these topics.

Specific Sustainability-Related Activities Undertaken by Boards: As Board deliberations concerning sustainability have expended in recent years, there are several specific activities related to the topic that have become common practice. These include: (1) integration of strategy and sustainability; (2) attention to stakeholder perspectives and engagement; (3) approval of sustainability reports, and (4) ensuring that management is appropriately accountable for sustainability performance, and compensated properly in light of that performance. In contrast to the section just above, these activities generally go beyond legal requirements in most cases. As governments consider an expansion of the concept of materiality to include climate change and other sustainability factors, some of these activities could find themselves on Directors' required "to do lists" in the years ahead.

In undertaking these activities, new questions arise, and new sources of information rise in importance. The already complex subject of setting executive compensation has grown more complex for companies aiming to integrate sustainability factors as they decide how to reward senior management. In the past year, large global companies have, for example, chosen to use the Dow Jones Sustainability Index (DJSI) as a key element in rewarding top management, only to withdraw this criterion as questions arise about how accurately the index gauges performance. This example should be understood as highlighting the relative immaturity of such measures, rather than a critique of one particular index.

Approval of sustainability reports further illustrates changing dynamics. Many Boards now sign off on their company's sustainability reports before publication. These reports do not raise the same kinds of legal attestation requirements associated with financial reports—yet. In some jurisdictions, notably South Africa's Johannesburg Stock Exchange, listing requirements now mandate financial reports that include sustainability considerations. In China, the largest state-owned companies are expected to issue reports, thanks to the State-owned Assets Supervision and Administration Commission (SASAC), which creates a *de facto* expectation for Directors of such companies. These developments concerning sustainability reporting coincides with rising interest in "integrated reporting," a melding of financial and sustainability reporting now adopted by a handful of companies, notably in Europe. Should this movement gain steam, it will raise the importance of this function, and Boards will devote more time and attention to how their companies report on energy use, water use, labor issues, and other topics directly related to Global Compact principles.

For these and other examples of new activities, Boards benefit from accessing new forms of information, from sources not traditionally heard in the boardrooms across the world. How Boards do this is discussed more fully in the next section.

Implicit Responsibilities: In addition to mandatory responsibilities and practices that have gained widespread adoption with a degree of formality, there are also informal activities Directors undertake that have a high degree of relevance and importance to sustainability performance. Indeed, it is widely understood that Boards have the implicit duty to set agendas, raise questions, and shape mindsets. This relates directly to the "duty of care" discussed above. Indeed, it is possible to reduce effective governance to the concept of stewardship, and good stewards of corporate assets ensure that management considers all relevant risks and opportunities.

Doing so effectively means a close look at topics including societal and regulatory acceptance of new technologies and business process, entry into new markets, and an understanding of the impact of "externalities" on business success. Over the past two decades in particular, we have seen multiple examples of the costs of overlooking such questions, from the introduction of genetically modified organisms, to the development of certain forms of energy, to the outsourcing of jobs from developed to developing countries. In many cases, companies' ability to leverage the value of their innovations can rise and fall on how well they anticipate society's determination of risk and reward. The Board's ability to anticipate public responses, while not typically found in corporate governance charters, may be one of the best ways a Board can support the company it stewards.

Questions for discussion on the roles and responsibilities of Boards:

1. What specific roles and responsibilities of the board appear most important to driving corporate sustainability progress?

2. How can boards integrate sustainability criteria into incentive schemes for CEOs and executive teams, in order to sustain focus and commitment to corporate sustainability?

3. What challenges have you faced—or do you anticipate facing—in relation to these board roles and how might they be overcome?

Structure of the Board

Boards are increasingly creating formal structures to address key sustainability issues. The Global Compact's 2010 annual survey found that 39% of the 1300 companies responding to the survey have Boards that "routinely address corporate sustainability issues" with the mechanism used by companies varying widely. Three models are encountered most frequently: (1) tasking the entire Board with oversight, (2) creating new committees dedicated exclusively to sustainability, and (3) using of existing committees that assume responsibility for sustainability as one aspect of their activities.

Board Committees: While the numbers of large companies resting responsibility for oversight of sustainability continue to grow, there is no current consensus about the best model to apply. In a 2009 survey by Deloitte of 220 directors of American companies with over $1billion in revenues, 37% of respondents thought that some committee should have oversight responsibility of sustainability. When asked which committee should have oversight, Risk and Governance committees where each chosen by 24% of respondents, 22% chose the Strategy committee, and 15% chose the audit committee. For those companies preferring existing committees, similar numbers expressed support for risk, governance and strategy committees. These figures suggest that thinking continues to evolve, and that the future may deliver not a single model, but rather a range of options for companies.

The mechanics of how board committees operate vary widely. As with other committees (e.g., audit, nomination), Board committees focused on sustainability interact with the full Board. In many cases, sustainability committees (or those charged with oversight of sustainability as part of other responsibilities) also present to and interact with the full board. In many cases, the lead executive with responsibility for sustainability is included in these discussions. BSR's survey of its member companies with such committees reveals that the frequency of committee presentations to the full Board ranges from once per year to four times annually.

Committee Mandates: Whether focused on sustainability in whole or in part, Board committees have been moving steadily towards defining their sustainability mandate broadly, shifting away from a more narrow focus on single issues or topics that many Committees originally assumed. In a survey undertaken by BSR in 2010, it was discovered that Board charters for committees focused on sustainability have evolved to adopt broad descriptions of duties related to sustainability. Typical descriptions include review of policies, practices and positions, review of performance against sustainability goals, and review of trends in legislation, regulation and public debate.

Some companies, however, have a more specific focus for their committees. One company in the automotive sector, for example, specifies Greenhouse Gas emissions and fuel economy standards as areas to be monitored by the committee. This charter also defines "sustainability" in terms both taking into account the needs of future generations' and 'long-term preservation of and enhancement of financial, environmental and social capital.' Many companies' committees explicitly include attention to stakeholders in their mandates. These definitions tend to include a mix of shareholders, employees, customers, and communities. One large conglomerate's "Public Responsibilities Committee" charter instructs consideration of the company's impact on "employees, citizens and communities." Indeed, the inclusion of public policy is a relatively common feature of the mandates of committees focused on sustainability. One consumer products company explicitly acknowledges this link in its mandate, citing "the need to identify any external developments which are likely to have an influence upon [the company's] standing in society and to bring these to the attention of the Board" as the rationale for this approach.

Companies implement these responsibilities through a mix of activities broadly reflective of overall Board responsibilities. Reflecting the dual Board purposes of advice and oversight, companies report different modes of interaction. Activities most commonly encountered include audit-style review of commitments and date included to sustainability reports, to an annual review of performance and goal setting, to frequent and informal engagement on strategy development. As the lead sustainability executive at one large global company put it: "When [the committee] started it was more like a report card. Now it feels more like collaboration, or discussion around how we think about these complex issues."

Opinions vary also on whether to bring external experts in to meet with Directors. One large global retailer does so, with a senior executive saying that this "happens all the time," while a senior executive at a large IT company with a strong focus on sustainability says the opposite: "We don't bring in external advisors for sustainability, because the Board would not for other committees. Our approach is seamless integration, not something special."

External Advisory Panels: In addition to the formal committees comprised of company Directors, one more model merits attention: external advisory panels. These bodies are growing in number, and while they do not qualify as formal governance mechanisms, they represent an interesting innovation that in effect create a "soft governance" model in cases where they serve in an advisory role and/or provide a public oversight mechanism. These panels are generally comprised of experts either on sustainability in general, or on specific topics of particular interest to a company, such as health, nutrition, renewable energy, etc. Where such bodies are established with a direct line to company Boards, they augment formal governance processes, and provide a direct means through which Boards can implement their mandate to consider stakeholder opinions about sustainability performance and strategy. Over the coming decade, it is possible that this mechanism will develop further, with some companies experimenting with a further melding of the "soft governance" of external panels with the "hard governance" undertaken by the formal Board of Directors.

Questions for Discussion on Board structure:

1. What do you see as the main pros and cons of a board committee dedicated to oversee corporate sustainability?

2. What specific board structure(s) do you see as most supportive of corporate sustainability progress? (If structure is a "sustainability committee," what should be the committee's mandate, population, and relationship to the board?)

3. What do you see as the ideal integration between sustainability issues and other functions of the board, such as nomination, auditing and compensation?

Board Composition

The topic of Board composition has received considerable attention over the past decade. Two topics in particular, independence and diversity, have been the subject of global debates. This has led to developments such as quotas to remedy the under-representation of women on Boards, separating the Chief Executive and Chair positions, and a steady globalization of Boards for companies operating globally.

The principles of independence and diversity have clear relationship to sustainability. It is not yet the case that Board composition has undergone a significant transformation, either in general, or specifically related to sustainability. Stakeholder groups of the sort represented on external advisory panels are not yet widely seen on Boards. In jurisdictions like Germany, where co-determination models are in place, a distinct set of Directors may be in place, but this is to date the exception to the overall rule. In many cases, Boards have taken a more evolutionary approach, asking Directors with the most relevant experience and networks to take the lead on sustainability. In many cases, this results in Directors with public sector experience taking on this role.

While not widely adopted, the notion of the "stakeholder director," or a Director elected to a Board specifically for the reason of representing the perspectives and/or interests of key stakeholders, in addition to the overall direction of the company, is a logical development for companies that see sustainability as a strategic imperative. If the shift in thinking described above, from a "pure" focus on shareholder value to one that aims to balance the interests of multiple stakeholders, takes hold, then it stands to reason that Boards would evolve in a manner that ensures that stakeholder perspectives are, literally, in the room when decisions are made. This shift has not yet occurred, but will likely get more attention in the years ahead, especially if public policy takes steps to redefine fiduciary responsibilities to include material sustainability matters.

One can imagine four possible futures for Board composition:

- Status quo: A slow but steady effort to increase Board diversity, focusing primarily on gender and globalization, but with little change to existing governance models.
- New Voices: Governance models remain very similar to what they are today, but with a rapid diversification of Board composition, to include Directors chosen in whole or in part because of their knowledge, networks and perspectives on material sustainability issues. This model integrates the "stakeholder director" concept described above.
- Formalizing the Advisory Panel: One could also see the maturing of the external advisory panel as a parallel body that enables maintenance of existing governance models with a formal channel to expertise that would enrich Boards' abilities to anticipate and manage key sustainability questions. This hybrid model might represent the "path of least resistance" to progress.
- Bi-cameral Models: As in Germany and some other jurisdictions, a dual Board structure could yet emerge to balance shareholder and stakeholder interests in a more formal way than the hybrid advisory panel model described above.

The Atlanta LEAD Symposium represents an opportunity to explore these models further, debate the relative merits of each, and discuss how best to shape Board structure, purpose and composition to meet a fast-changing set of business conditions redefining commercial success in the 21st century.

Questions for discussion on Board Composition:

1. How, if at all, does board diversity benefit corporate sustainability progress?

2. What kind of stakeholder engagement by the board or stakeholder representation on the board do you see as most supportive of corporate sustainability progress?

3. What are the main challenges with respect to ensuring that stakeholder views and concerns are represented on the board and how can they be overcome?

Investor Engagement with Corporate Boards

The UN-backed Principles for Responsible Investment (PRI) provide a framework for helping investors integrate environmental, social and corporate governance considerations into investment processes and decision-making. The objective is two-fold: one, to help achieve better long-range investment returns; and two, to better align investor priorities and broader societal goals. The PRI now includes nearly 900 signatories representing more than US$20 trillion in assets under management who have committed to incorporating ESG issues into their investment policies and their ownership practices, thus creating a culture of "active ownership."

Whereas the motivation and practice of investors vis-à-vis ESG issues can vary, the growth of PRI represents a general trend towards mainstream investors factoring non-financial issues when evaluating companies. In doing so, more and more investors are looking for corporate boards to steward corporate sustainability in order to both adequately manage risks and maximize business opportunities related to sustainability. Indeed, engagement activities are on the rise in many quarters, and like-minded investors are increasingly pooling resources to create a stronger and more representative shareholder voice and to ensure that company engagement becomes more effective.

As sustainability leaders within their industries, companies in Global Compact LEAD can undoubtedly benefit from increased engagement with the mainstream investment community -- provided this is done in a strategic, consistent and efficient manner. There is thus a potential for PRI and Global Compact LEAD to collaborate and inform the ways in which investors and boards interact, while also better preparing boards to meet growing investor demand for better oversight of corporate sustainability.

To that end, the questions to be discussed on the role of investors include:

1. What are the experiences -- positive and negative -- that your board has had with investors with respect to corporate sustainability?
2. What are the most important ways in which you as corporate sustainability leaders would like to see investors engage with corporate boards?
3. What are the information and disclosure needs and bottlenecks in relation to such engagement? What are likely to be the implications for the future of integrated reporting?
4. How can corporate boards best prepare for a future in which more investors are expected to give greater priority to ESG issues and engage more actively with boards?

Sustainability Education for Board Members

More than 350 business schools that are members of the Principles for Responsible Management Education (PRME) have committed to incorporate social and environmental sustainability into their curriculum and research. The purpose of these efforts is to better serve the business community in assessing and responding to global sustainability concerns in ways that enhance traditional business goals and ensure that commerce creates broadly shared sustainable prosperity

There are several reasons why board-level sustainability training is seen as important:

- Experience has shown that failing to recognize and respond to sustainability issues can pose substantial risks to an organization's reputation, brand and right-to-operate. Board duties and diligence thus require an understanding of the potential sustainability and compliance risks confronting the organization without which some of these issues may continue to be neglected by the board. The more an executive knows about sustainability's management implications, the more he or she is likely to judge them as key, indicated an MIT Sloan Management Review survey.
- Boards, through their responsibilities of selecting and incentivizing senior leadership, influence how sustainability is perceived organizationally. Indeed, the survey published in MIT Sloan Management Review indicates that boards are the most influential driver of a company's attention to sustainability, second only to regulation. Similarly, the board's role in strategic oversight and capital allocation is important for identifying sustainability opportunities. To take informed leadership decisions, directors need to understand how strategic management of sustainability and innovation can improve business performance.

PRME member schools are prepared to respond to these board-level needs, in collaboration with LEAD companies if there is interest. The idea is to form a partnership of PRME member schools that will collaborate with Global Compact LEAD to develop training curriculum for board members, which would be offered by individual schools under the Global Compact and PRME brands. Preliminary interest to participate in this partnership has been expressed by Thunderbird School of Global Management (US), INSEAD (France/Abu Dhabi/Singapore) and Deusto Business School (Spain). Other PRME member schools will be invited to participate in the partnership based on the outcome of the discussions in the Atlanta LEAD Symposium.

An effective training curriculum is enhanced by the informed input from LEAD companies, which can also ensure that the training fully meets member company needs.

To that end, the questions to be discussed on education of board members include:

1. What are the most important current deficiencies in board understanding and knowledge of sustainability issues?
2. Would a board-level education program be an effective way to respond to any perceived deficiencies?
3. How should a program for education of board members be designed to bring most value to boards and their corporations (curricula, duration, location, certification, etc)?