Ceres

Sustainability is the bottom line.

LEAD FROM THE TOP:

BUILDING SUSTAINABILITY COMPETENCE ON CORPORATE BOARDS

ACKNOWLEDGEMENTS

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FOREWORD

Carol Browner

former EPA
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Companies are beginning to experience first-hand the financial impact that unaddressed sustainability risks can have on their business.

Climate change is the clearest example. Nearly every sector of our economy is feeling the effects of a warming planet. Energy companies are dealing with changes to their demand forecasts and insurers are facing record losses from extreme weather events. Food and apparel businesses are struggling to adapt to climate disruptions to their supply chains brought on by drought and changing weather patterns.

Yet, as these issues are hitting companies in their bottom lines, corporate boards for the most part do not have the expertise they need to address the business challenges driven by climate change. Companies must treat sustainability as they do other significant business threats like cybersecurity and financial reform by building up the sustainability expertise on their boards. When sustainability is material to a company, it is essential to recruit directors with expertise to build a sustainability-competent board.

One of the biggest stumbling blocks in building sustainability-competent boards is the selection system. Current practices too narrowly define the traits that constitute strong board members. For boards to serve companies and investors well, that definition must change to include candidates with experience and exposure to environmental and social issues affecting corporate performance.

But recruitment is only the first step. Companies should plan for the future by empowering board members with expertise in sustainability to serve as decision makers. This expertise will empower companies to make informed, smart decisions on climate change policies that impact strategy, risk and corporate business models.

Sustainability should be a primary matter for all board members, not just those with environmental or energy backgrounds. Expanding board expertise on sustainability should be part of every company's board strategy. Boards that are open to hearing from outside influencers, even detractors, make smarter decisions that govern the success of companies. Bring them in, listen to them and let boards be informed as they weigh important decisions. Understanding the material risks and opportunities for the company is inherent in a director's responsibility to ensuring long-term value creation and resilience. As a board member, I have encouraged and helped make these interactions possible. All boards should be utilizing this approach.

This Ceres report lays out practical steps for approaching these and other options that companies can consider ways to make their board competent in addressing climate change and other environmental, social and governance issues.

FOREWORD

Rakhi Kumar

head of ESG Investments and Asset Stewardship at State Street Global Advisors

At SSGA our mission is to invest responsibly to promote economic prosperity and social progress. We do this by helping clients achieve their investment goals, whether it is saving for retirement, funding research and innovation or building the infrastructure of tomorrow. Most, if not all, of these desired outcomes are long-term in nature. As one of the largest global providers of index strategies, we are a supplier of quasi-permanent capital for listed companies. Therefore, we need to monitor long-term risks. We view material environmental, social and governance (ESG) factors as 'low probability, high impact' factors, where the probability of something going wrong from a sustainability or ESG perspective is low but when it does goes wrong, the financial impacts for shareholders are high.

In recent years, incidents such as oil spills, poor food safety management and aggressive sales practices at various companies have highlighted the negative financial impacts that the lack of oversight of sustainability-related risks can have on long-term shareholder returns. In our 2017 letter to the boards of our portfolio companies, we called on directors to incorporate sustainability into long-term strategy. As an investor, our overarching focus is board quality and composition. We want our boards to be strong, effective and independent and recognize that sustainability competency is an important element of board effectiveness. Boards must ensure that they have the skills and expertise to be successful in their oversight of long-term strategy.

The ability to fully and systematically incorporate ESG considerations into our investment process is impacted by the availability of consistent, comparable and material ESG data. This is why we have urged boards to incorporate sustainability issues into their long-term strategy and report in a detailed and consistent way on their actions. We hope that through our continued engagement, more companies will report the kind of data needed to integrate ESG issues into the investment management process.

This report gives boards a practical guide on how companies have enhanced the sustainability competence of their boards. By defining what it means to be a 'sustainability-competent director' and a 'sustainability-competent board,' it helps anchor investor expectations of boards, while giving boards the freedom to pursue their own path to enhancing their sustainability competency.

As explained in the report, there are many ways for boards to improve their sustainability competency. By identifying key principles that focus on the director nomination process, director education and stakeholder engagement, Ceres has provided companies with a roadmap for strengthening board quality as it relates to sustainability.

Finally, the paper also serves as an excellent training tool for investors who wish to understand the many ways in which companies can improve the sustainability competency of their boards.

EXECUTIVE SUMMARY

Environmental and social issues are disruptive forces that companies—led by their boards—must keep at the forefront when assessing their business strategy. Today's directors shoulder a new set of tasks. They need to be able to determine which sustainability risks are the most material to the companies they lead. They also need to help direct their companies to capitalize on the market opportunity created by tackling sustainability challenges.

In a climate of unpredictability, building sustainability competence into corporate boards—where directors are skilled at assessing business risks and growth opportunities in light of evolving environmental, social and governance factors —is the way forward.

The Business Case for Board Sustainability Competence

Sustainability risks—including climate change, water crises, human rights and inequality—are creating new challenges for board members to meet their fiduciary responsibilities and ensure long-term shareholder success and overall value creation.

- **Sustainability disruptors could materially affect corporate financial performance.** Environmental and social issues have the potential to impede corporate plans, performance and even business models. The experiences of major global insurers, mining companies and food companies demonstrate the financial impacts of climate change, water scarcity, and stakeholder expectations on supply chains, business expansion and capital investments.
- **Where sustainability is material to a company, boards have a fiduciary responsibility to act.** A key part of the fiduciary responsibility of boards is the duty of care, or the duty to adequately inform themselves of material issues prior to making business decisions. To discharge this responsibility, directors need to be able to understand and evaluate material risks facing the business. When a social or environmental force poses material risks, directors now need to consider those risks in decision-making in order to adequately discharge their fiduciary responsibility.
- **Investors are increasingly focusing on board sustainability competence.** Investors are making connections between sustainability and materiality on one hand, and financial performance on the other. As a result, they are focusing on the critical role the board plays in ensuring the resilience of a company's assets and its long-term business strategy. Consequently, investors are putting pressure on boards to show themselves as "competent" in environmental and social issues.

This report builds upon Ceres' 2015 report, "View from the Top: How Corporate Boards Engage on Sustainability Performance," which recommended two linked approaches for incorporating material sustainability considerations into core board functions: integrating sustainability into board governance systems and into board actions.

This follow on report, "Lead from the top: Building Sustainability Competence on Corporate Boards" provides greater detail on how boards can successfully integrate sustainability into their governance systems by raising their own competence on material sustainability issues to enable effective oversight. This report focuses on the skills and experience needed for board members to provide thoughtful oversight of sustainability risks and opportunities, in addition to the tools and processes that can help foster deeper engagement at the board level around these issues.

What Makes a Board Sustainability Competent?

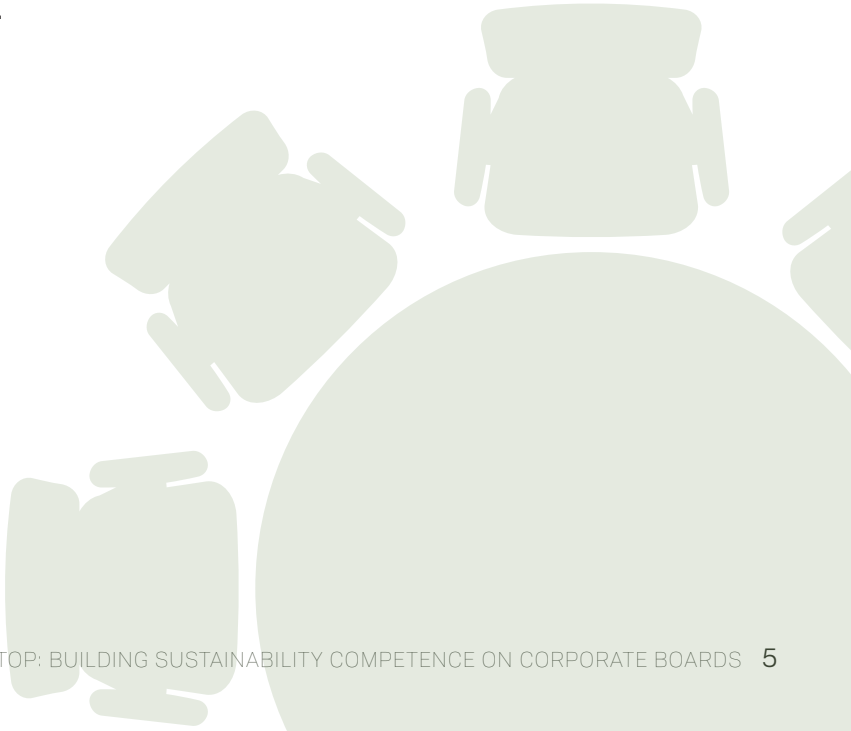
An ideal sustainability-competent board has the requisite knowledge about material environmental and social issues that affect the business. It is able to ask the right questions, support or challenge management as needed, and ultimately make informed and thoughtful decisions affecting strategy and risk.

A Sustainability-Competent Board:

- **Integrates knowledge of material sustainability issues into the board nominating process to recruit directors that ask the right questions;**
- **Educates all directors on material sustainability issues to allow for thoughtful deliberation and strategic decision-making at the board level; and**
- **Engages regularly with external stakeholders and experts on relevant sustainability issues.**

It is important to make the distinction between a sustainability-competent director and a sustainability-competent board: A sustainability-competent director has relevant expertise in or exposure to the material environmental, social, and governance issues that affect the company. The distinguishing feature of a sustainability-competent board, on the other hand is its ability to engage thoughtfully on material social, environmental and governance issues as one cohesive deliberative body. A sustainability-competent board integrates sustainability into broader board conversations and functions. Rather than being isolated or marginalized, sustainability becomes part of the fabric of board oversight and is integrated into decision making on strategy, risk and compensation.

> "The biggest challenge is that we as directors don't always know what we don't know. When sustainability issues come up, directors believe in being environmental stewards but most people in the board room do not know the right steps to take. It's difficult for the board room to assess how they are doing, what are the trade-offs, and what lines of business are being impacted. There is a lot that is needed beyond the broad commitment to sustainability."
>
> **— HELENE GAYLE**
> chief executive officer at McKinsey Social Initiative; board member at The Coca-Cola Company; board member at Colgate-Palmolive



How to Build a Sustainability-competent Board: Leading Practices

Integrate sustainability into the nominating process by:

- **Creating regular opportunities to bring new directors with relevant expertise onto corporate boards.** To remain relevant, especially with a view to including sustainability priorities, boards must be periodically "refreshed." The board nominating or governance committee could affirm the importance of board refreshment in their charters by developing mechanisms that ensure consideration of refreshment, for example, through a regular board evaluation process.
- **Incorporating material sustainability issues into qualifications for potential board candidates.** By thinking about recruiting for sustainability in a systematic way, boards can look beyond their short-term needs. Nominating committees can make sustainability issues important qualifications they consider when recruiting new directors and track the qualifications via a board skills matrix.
- **Finding directors that can make the connections between environmental and social issues and the business context.** Nominating committees should recruit effective sustainability-competent directors that can assess the potential impact of sustainability issues on a business and "translate" it to provide context for a board's decision-making. Directors who cannot make the connections between the appropriate social and environmental issues and the relevant business context risk being marginalized.
- **Identifying directors who represent key stakeholder groups relevant to a company's sustainability impacts.** Nominating committees should recruit directors who have experience with interacting or representing stakeholder groups that offer insights into a company's material sustainability impacts. This provides the advantage of bringing both relevant expertise and background diversity to the boardroom.
- **Recruiting candidates representing a diversity of backgrounds and skills to improve decision-making.** Nominating committees should seek out candidates who bring a range of attributes, expertise and desired skills to the table, and

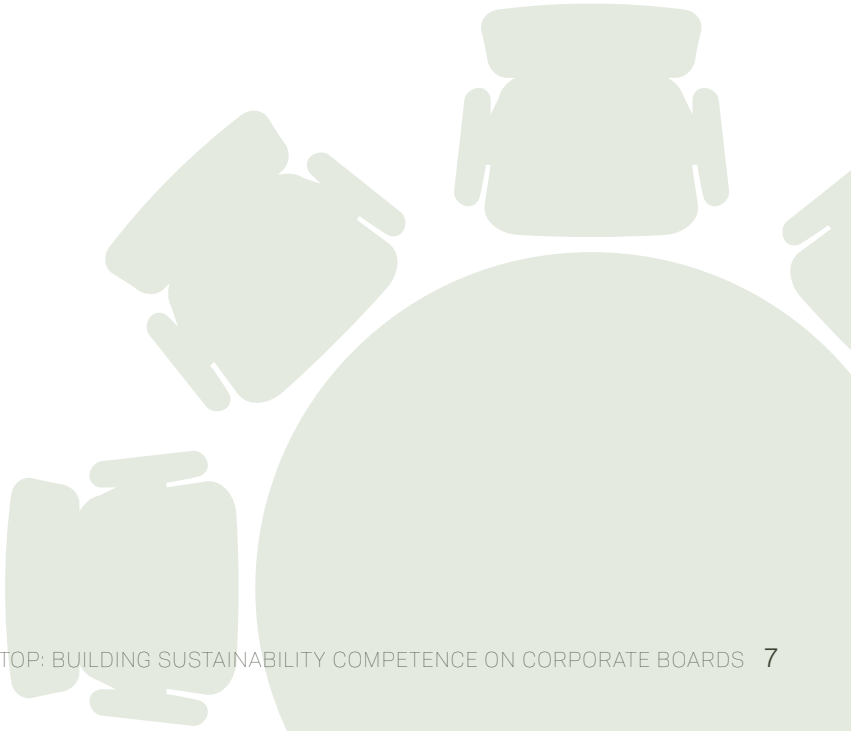
> "At the end of the day, sustainability must be integrated into core business strategy. Sustainability competent directors need to be bilingual: able to speak the language of both sustainability and business."
>
> — **KARINA LITVACK**
> board member at Eni

represent a mix of gender, ethnicity, nationalities, and backgrounds. This will help the board avoid "group think" and foster robust, thoughtful deliberations when making a decision. Research also shows that diverse boards are better boards.

Educate directors on material sustainability issues by:

- **Integrating new directors with sustainability competence into current board deliberations, especially on strategy and risk.** For sustainability-competent directors to be effective and for sustainability to be integrated into board decision making, they must participate in board functions, structures and processes. Mentoring by existing directors is another effective method of helping new directors succeed in their roles.
- **Requiring regular education on material sustainability issues for the whole board.** Boards and company leadership could mandate that all directors need to be up-to-date on material sustainability issues. Education, training programs, and site visits should build knowledge over time and make connections to operational or management realities.
- **Providing boards with information on the materiality of sustainability to their business.** Boards need information to help them understand the materiality of specific sustainability issues to their business, so they can make the connection between sustainability and corporate strategy and risk. Materiality analyses could prove useful in helping directors understand how certain environmental and social issues relate to business strategy and how they may materially affect operations.
- **Driving board discussion on how sustainability impacts corporate risk, strategy and business models.** Identifying risks and opportunities created by environmental and social issues helps companies adapt their models. By becoming more resilient, integrated and circular, businesses can tap into more sustainability-related business opportunities.

> "You can be an issue expert on climate, water, or toxic chemicals but that doesn't mean you can think about those issues in a way that is strategic to a business. Some level of sustainability expertise should be foundational to recruiting new members of a corporate board—but that knowledge must also be fundamentally linked to meeting the needs of the company."
>
> **— JEFF HOLLENDER**
> co-founder and former chief executive officer at Seventh Generation; member of Institute for Sustainable Investing Advisory Board at Morgan Stanley



Deepen engagement with stakeholders and experts on relevant sustainability issues by:

- **Finding regular opportunities for boards to engage stakeholders on environmental and social issues.** Regular participation in stakeholder engagements with internal and external stakeholders—including investors and advocacy groups—can help boards gain a holistic understanding of the key issues that affect a company. This can help the company not only mitigate adverse impacts on external shareholders, but also pinpoint opportunities for creating long-term value.
- **Leveraging sustainability advisory councils as a critical board resource.** To deepen communication between a sustainability advisory council and a company's board, board members could be involved in the deliberations of these councils more systematically. Such councils could also provide recruitment opportunities for new board members.
- **Incorporating material sustainability issues into board-investor dialogues.** Investors increasingly expect boards to engage directly and systematically with them on critical issues. Given the growing focus of the investor community on sustainability writ large and the role of boards for sustainability in particular, material environmental and social factors should be made a part of any board-investor dialogue.

Sustainability has never been more important. Business leaders have never been so engaged. As fiduciaries to the corporation and stewards for its long-term performance, boards have a fundamental responsibility to be able to engage on relevant sustainability issues in a thoughtful manner. Competence in sustainability is the bedrock to all of this.

This report points to concrete, actionable recommendations on how boards can raise their overall sustainability competence in both the short term and the long term. Now is the time for boards to rise to the challenge and use their positions as opportunities to be leaders.

> "Having the company's sustainability experts present at board meetings on a regular basis and enabling the board to undertake site visits and meet with external stakeholders helps to develop a shared understanding of the company's material sustainability risks and opportunities, and provides opportunities for the full board to discuss these together."
>
> **— JANE NELSON**
> director of the Corporate Responsibility Initiative at the Harvard Kennedy School; board member at Newmont Mining; board member of the Abraaj Group

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Ceres is a sustainability nonprofit organization working with the most influential investors and companies to build leadership and drive solutions throughout the economy. Through powerful networks and advocacy, Ceres tackles the world's biggest sustainability challenges, including climate change, water scarcity and pollution, and human rights abuses. For more information, visit www.ceres.org and follow us on Twitter at @CeresNews.

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