

C O M M E N T

BOARD OVERSIGHT IN ESG—EVOLVING TRENDS IN THE ERA OF INCREASING DISCLOSURE REQUIREMENTS

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In *Caremark and ESG, Perfect Together: A Practical Approach to Implementing an Integrated, Efficient, and Effective Caremark ESG Strategy*, Leo Strine and co-authors frame a board's duty of oversight for environmental, social, and governance (ESG) issues in light of the common-law duties articulated under *Caremark*.¹ The landmark *Caremark* decision articulated that corporations and their directors have a duty to implement and monitor compliance programs to ensure that the company honors its legal obligations.² However, a number of recent proposed rules from the U.S. Securities and Exchange Commission (SEC) signal that ESG in the United States has reached an inflection point—moving from discretionary actions to regulatory ones. This Comment uses the SEC's recent proposal, The Enhancement and Standardization of Climate Related Disclosures for Investors (the SEC Climate Proposal),³ to examine how the shift to regulatory ESG may impact the board's oversight of ESG issues, potentially rendering Strine et al.'s *Caremark* framework obsolete.

I. What Is ESG and Why Does It Matter for Corporate Boards?

ESG is a widely used acronym that stands for the phrase “environmental, social, and governance.” Over the last few years, the term has been broadly used to refer to a range of factors that have traditionally been considered non-economic risks, but are increasingly recognized to present potentially material risks to public companies.

Increasingly, large investors and proxy advisory services have promoted heightened ESG-related oversight by corporate boards. In recent years, major institutional investors and both proxy advisory services (ISS and Glass Lewis) announced policies articulating their prioritization of certain ESG matters.⁴ Such policies often lead investors to vote in favor of shareholder proposals or against key directors where the proxy advisor or institutional investor feels that a company and its board have not been sufficiently attentive to ESG matters. For example, in articulating its belief that “robust disclosure is essential for investors to effectively gauge the impact of companies’ business practices and strategic planning related to [environmental and social] risks and opportunities,” BlackRock asks companies to, among other things, demonstrate their approach to human capital management and disclose their business plans related to the transition to global net zero.⁵ According to BlackRock’s proxy voting guidelines, if shareholders propose climate plans aligned with BlackRock’s expectations, it may then vote in favor of such proposals.⁶

Companies have faced growing pressure from their shareholders regarding ESG matters in the form of shareholder proposals, as well. Shareholder proposals regarding ESG issues have become much more prevalent in recent years, with 530 environmental and social-related proposals being filed at U.S. companies in 2021, a record amount,

1. Leo E. Strine, Jr. et al., *Caremark and ESG, Perfect Together: A Practical Approach to Implementing an Integrated, Efficient, and Effective Caremark ESG Strategy*, 106 IOWA L. REV. 1885 (2021).
2. *In re Caremark*, 698 A.2d 959, 970 (Del. Ch. Sept. 25, 1996).
3. Release No. 33-11042, The Enhancement and Standardization of Climate-Related Disclosures for Investors, 87 Fed. Reg. 21334 (Apr. 11, 2022) [hereinafter Proposal].

4. See generally BlackRock, *BlackRock Investment Stewardship: Proxy Voting Guidelines for U.S. Securities* (Dec. 2021), <https://www.blackrock.com/corporate/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf>; Cyrus Taraporevala, President & CEO of State Street Global Advisors, *CEO's Letter on Our 2022 Voting Agenda* (Jan. 2022), <https://www.ssga.com/us/en/intermediary/ic/insights/ceo-letter-2022-proxy-voting-agenda>; Vanguard Funds, *Global Investment Stewardship Principles* (Jan. 2022), <https://global.vanguard.com/documents/global-investment-stewardship-principles.pdf>; Glass Lewis, *2022 Policy Guidelines* (Jan. 2022), <https://www.glasslewis.com/wp-content/uploads/2021/11/US-Voting-Guidelines-US-GI-2022.pdf>.

5. BlackRock, *supra* note 3, at 16-18.

6. *Id.*

and 530 being filed by just March 2022.⁷ Voting support has also increased for these proposals, with social and environmental proposals receiving average support of 31.4% and 39 proposals receiving majority support in 2021, up from 21 majority-supported proposals in 2020.⁸

Corporate boards are increasingly⁹ choosing to focus on ESG for three reasons: (1) to capture ESG-focused investors and to appease the aforementioned shareholder demands; (2) to implement risk management/avoidance of adverse ESG events (i.e., to protect shareholder value); and (3) to pursue ESG-related opportunities (i.e., to create value). However, as ESG has grown in popularity, it has also arguably grown past usefulness as a concept due to the ever-expanding category of risks swept under the ESG umbrella¹⁰ and inconsistent methods of measuring and evaluating ESG performance.¹¹

Though the literature on ESG and value creation is somewhat limited, it tends to show that the ESG-value creation link only exists when companies pursue specific elements of ESG that are aligned to their core strategy.¹² However, the ability to generate empirical evidence clearly linking ESG writ-large to corporate value creation is limited because of inconsistencies and lack of precision in how ESG data are measured and reported. For example, in a report to the SEC Asset Management Advisory Committee by its ESG Subcommittee in May 2020, the Subcommittee stated that there was no consistent framework to determine how managers integrate ESG into their investment processes, and as a consequence, they could not compare corporate performance as it relates to ESG.¹³

Capital flows into sustainable funds have grown from 30 billion U.S. dollars in 2016 to 360 billion U.S. dollars in 2020, rising every year.¹⁴ Much of this ESG investing is guided, at least in part, by reliance on external ESG rating systems, including the MSCI, Sustainalytics, and Bloomberg ESG. However, differences between these rating systems and the vast array of measures that can be used in constructing an ESG score lead to significant differences in their scoring of individual companies. Research investigating the divergence of ESG ratings based on data from six prominent ESG rating agencies found that the correlation between ESG ratings ranged from 38% to 71%, with an average of 54%.¹⁵ Credit agency ratings, on the other hand, were correlated at 99%.¹⁶

Corporate boards have largely attempted to address their ESG-related concerns and the vast array of shareholders' ESG demands in broad strokes. However, it is clear that if companies wish to create value in taking up the ESG mantle, the approach to ESG must be more nuanced and strategically focused on company-specific risks.

II. The Pivot to Regulatory ESG and Its Impact on Board Oversight

As ESG issues have risen on the investor agenda in the last few years, corporate boards have addressed them using a variety of practices. As noted by Strine et al., some corporate boards have entrusted ESG duties to their nominating and corporate governance committees, some to their audit committees, and others have delegated the issues to the whole board, “bifurcating, trifurcating, or otherwise splitting up” these duties.¹⁷ Indeed, a recent survey of global corporate leaders found that 43% of companies house primary oversight of ESG with the full board, 30% with their nominating and corporate governance committees, and 15% with ESG or sustainability committees.¹⁸ By and large, ESG governance to date has been shaped by specific investor pressures in certain industries, and is far from uniform. However, 2022 marks a potentially pivotal year for ESG governance in the United States, as a suite of proposals from the SEC requires such granular detail on an issuer's specific management and governance of climate change that issuers may feel compelled to develop robust governance and oversight of such matters regardless of whether climate risks are significant to generating value or managing risks for a particular company.

For example, the SEC's Climate Proposal, proposed in March 2022, contains a set of specific disclosure requirements related to a board's oversight of climate change risks.

7. ISS, 2022 PROXY SEASON REVIEW: UNITED STATES—ENVIRONMENTAL & SOCIAL ISSUES 4 (2022).

8. *Id.*

9. A survey of 590 corporate directors conducted in 2022 on how boards are addressing ESG found that only 4% of respondents rarely or never discuss ESG in the boardroom, which is up from 20% pre-pandemic. DILIGENT INSTITUTE & SPENCER STUART, SUSTAINABILITY IN THE SPOTLIGHT: BOARD ESG OVERSIGHT AND STRATEGY 12 (2022).

10. ESG has been construed to include a wide and diverse array of topics including, but not limited to, climate change, diversity, privacy, workplace relationships, cybersecurity, supply chain concerns, and human rights. See Amanda M. Rose, *A Response to Calls for SEC-Mandated ESG Disclosure*, 98 WASH. U. L. REV. 1821 (2021); see also Stavros Gadinis & Amelia Miazad, *Corporate Law & Social Risk*, 73 VAND. L. REV. 1401, 1414-15 (2020).

11. See Rose, *supra* note 9, at 1825 (stating that ESG performance ratings are inconsistent and difficult to decipher because the variety of ESG issues are factored into a rating, how performance on those issues is measured, and the weight each issue is given are subjective, usually non-transparent determinations that vary across ratings providers.) See also James Mackintosh, *Is Tesla or Exxon More Sustainable? It Depends Whom You Ask*, WALL ST. J., Sept. 17, 2018, at <https://www.wsj.com/articles/is-tesla-or-exxon-more-sustainable-it-depends-whom-you-ask-1537199931> (arguing that ESG scores are “no more than a series of judgments by the scoring companies about what matters”).

12. See Michael E. Porter et al., *Where ESG Fails*, INSTITUTIONAL INVESTOR, Oct. 16, 2019, at <https://www.institutionalinvestor.com/article/b1hm5ghqtxj9s7/Where-ESG-Fails> (stating that there has never been conclusive evidence that socially responsible screens or company positions on lists such as the Dow Jones Sustainability Index deliver value, but arguing that there is compelling evidence that superiority in identifying and harnessing selected social and environmental issues relevant to the business can, over time, have a substantial economic impact on companies and even entire industries).

13. ESG Subcommittee Update: Report to the SEC Asset Management Advisory Committee (May 27, 2020), https://www.sec.gov/files/ESGSubcommitteeUpdate_0.pdf (powerpoint slide 10).

14. *The Tectonic Shift to Sustainable Investing*, BLACKROCK, <https://www.blackrock.com/institutions/en-us/insights/investment-actions/sustainable-investing-shift> (last visited July 7, 2022).

15. Florian Berg et al., *Aggregate Confusion: The Divergence of ESG Ratings*, REV. FIN. 8 (forthcoming 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3438533.

16. *Id.* at 7.

17. Strine et al., *supra* note 1, at 1918.

18. DILIGENT INSTITUTE & SPENCER STUART, SUSTAINABILITY IN THE SPOTLIGHT: BOARD ESG OVERSIGHT AND STRATEGY 4-5 (2022).

Proposed Item 1501(a) of the climate disclosure rule would require all U.S.-listed public companies to disclose:

- The identity of any board members or committees responsible for the oversight of climate-related risks;
- Whether any member of the board has expertise in climate-related risks, including a description of that expertise;
- How the board is informed about and discusses climate risks, including the frequency of those conversations;
- Whether and how the board considers climate-related risks as part of business strategy, risk management, and financial oversight; and
- Whether and how the board sets climate-related targets and how it oversees progress toward those targets.¹⁹

There are a number of features of the SEC's proposed Item 1501 that merit further discussion. First, the proposed rule requires disclosures rather than particular substantive approaches—for example, it does not explicitly require that every board have a climate change expert or committee specifically charged with climate oversight. Nevertheless, numerous commenters have requested clarification that the SEC is not intending to dictate *how* board governance of climate risks is structured.²⁰ Even if such clarification were to be provided in any final rule, as a practical matter, many companies will likely feel the need to develop new board roles and competencies mapping onto these disclosure topics in order to avoid disclosing that they have no such expertise, discussions, targets, etc. regarding climate-related risks. Particularly when viewed in combination with the requirement to describe any climate-related expertise on the board, these disclosure requirements could be read as a suggestion that boards should have a climate expert. Second, the SEC's Climate Proposal does not specify what kind of climate expertise a board should seek to acquire. Instead, the proposed rule simply notes that companies must disclose “such detail as necessary to fully describe the nature of the expertise.”²¹ Still, even an implication that all boards should have climate expertise is a significant departure from the Commission's existing rules simply requiring information about the business experience of a company's board members and their qualifications for serving on the board.²²

19. Proposed 17 C.F.R. §229.1501(a).

20. See Microsoft Corporation, Comment Letter on the Proposed Rule (June 16, 2022), <https://www.sec.gov/comments/s7-10-22/s71022-20131614-301990.pdf> (recommending that the SEC revise proposed Item 1501 to encourage issuers to tailor processes and disclosure to their circumstances with a focus on materiality).

21. Proposed 17 C.F.R. §229.1501(a)(1)(ii).

22. 17 C.F.R. §229.401(e)(1).

Third, proposed Item 1501 seeks granular disclosures of *how* the board is overseeing climate risks, including in the areas of strategy, risk management, and target-setting. In discussing the proposed requirement that issuers disclose whether and how the board of directors considers climate-related risks as part of its business strategy, risk management, and financial oversight, the Commission champions that such information would enable investors to understand how the board considers climate-related risks when reviewing and guiding business strategy and major plans of action, when setting and monitoring implementation of risk management policies and performance objectives, when reviewing and approving annual budgets, and when overseeing major expenditures, acquisitions, and divestitures.²³ The Commission argues that this disclosure requirement could help investors assess the degree to which a board's consideration of climate-related risks has been integrated into a registrant's strategic business and financial planning and its overall level of preparation to maintain its shareholder value.²⁴ As many commenters have noted, the level of disclosure into the board's oversight and decisionmaking sought here is far more detailed than the disclosures companies are required to make regarding fundamental economic issues that relate to the overall financial performance of the company.²⁵

While an approach such as that set forth in proposed Item 1501 has the potential to lead to a set of standard practices for climate change governance, it also has the potential to put a thumb on the scales toward board focus on climate change without consideration of whether it is the most significant ESG issue that would align with generating value or managing risks for a particular company. The SEC's proposed rule regarding disclosure of cybersecurity, Cybersecurity Risk Management, Strategy, Governance, and Incident Disclosure (the Cybersecurity Proposal),²⁶ would similarly require companies to make granular disclosure regarding the board's oversight of cybersecurity risk, including the processes by which the board is informed about cybersecurity risk and the frequency of such discussions, whether and how the board considers cybersecurity risks as part of its business strategy, risk management, and financial oversight, and whether any

23. Proposal, *supra* note 2, at 95.

24. *Id.*

25. See Business Roundtable, Comment Letter on the Proposed Rule (June 17, 2022), <https://www.sec.gov/comments/s7-10-22/s71022-20132191-302705.pdf> (arguing that the extent of disclosure required under proposed Item 1501 far exceeds required governance disclosures about any other topics and is disproportionate to a board's overall responsibilities); Bank Policy Institute, Comment Letter on the Proposed Rule (June 16, 2022), <https://www.sec.gov/comments/s7-10-22/s71022-20131389-301543.pdf> (“The proposal's [governance] requirements are more prescriptive than the requirements for audit committee financial experts, defined in Regulation S-K.”); see also State Street Global Advisors, Comment Letter on the Proposed Rule (June 17, 2022), <https://www.sec.gov/comments/s7-10-22/s71022-20131965-302424.pdf> (“The Commission should only require high-level, qualitative disclosure of the process by which climate-related financial risks are incorporated into governance arrangements and risk management”).

26. Release No. 33-11038, Cybersecurity Risk Management, Strategy, Governance, and Incident Disclosure, 87 Fed. Reg. 16590 (Mar. 9, 2022).

members of the board have expertise in cybersecurity.²⁷ Again, such a level of detailed disclosure could pressure boards to rethink their composition and priorities when doing so may not be in the best interests of the company and creating shareholder value.

Turning to the question of *how* boards should implement climate oversight in light of the SEC Climate Proposal, it is important to note the breadth of quantitative and qualitative disclosures that are called for under the Proposal. The SEC Climate Proposal would amend Regulation S-K to require every public company to disclose its own greenhouse gas emissions and adopt a series of qualitative disclosures on climate change strategy and risk management modeled after the Task Force on Climate Related Financial Disclosures. It would also amend Regulation S-X to require the incorporation of climate risks into a company's financial reporting. This means that simply to provide oversight of the disclosures that would be required under the SEC Climate Proposal (let alone the actual climate risks that a company may face), a board will have to develop some capacity for oversight of greenhouse gas emissions calculations, the identification and management of climate risks, and the integration of measures to address or respond to climate impacts into the company's financials. Even the proposed disclosure requirements that hew more closely to some of the traditional oversight of specific board committees may require that boards develop new areas of expertise. For example, audit committees are charged with reviewing a company's annual financial reporting and typically include among their members former corporate auditors or Chief Financial Officers. These board members are selected for their important qualifications in financial accounting that are necessary to carrying out the board's oversight function. However, they may not have experience with issues such as the accounting for and auditing of greenhouse gas emissions inventories. When assessing the breadth of the SEC's Climate Proposal, it appears that boards may need to assess how the individual disclosure requirements would overlap with responsibilities of board committees or the board as a

whole to determine how to best situate these responsibilities within their board structures. In so doing, boards will need to respond to any requirements in the SEC's final rule, with the regulatory requirements for disclosure being a primary factor in driving future organization of oversight efforts.

However, this does not mean that the board itself must have expertise regarding climate risks, or be granularly involved in the relevant measurements or management of those risks, to meet its oversight duties under *Caremark*. It is well established under Delaware law that directors are not required "to possess detailed information about all aspects of the operation of the enterprise," as "[s]uch a requirement would simpl[y] be inconsistent with the scale and scope of an efficient organization size in this technological age."²⁸ Rather, the board is entitled to rely on the work and technical expertise of officers and others within the organization—so long as the board (i) implements a reporting system to monitor the key risks facing the company, and (ii) ensures that the company responds to problems that are flagged by that reporting system. But regardless of what *Caremark* independently requires, to the extent that a company discloses pursuant to proposed Item 1501(a) that the board is involved in climate-related issues, it is important under *Caremark* (and the federal securities law) that the board in fact diligently fulfills the roles it has undertaken.

Strine et al. argue that an efficient and effective method for corporations to embrace quality ESG standards that does not simply pile ESG responsibilities on top of existing duties of managers and the board would be to build ESG responsibility into thorough and thoughtful compliance policies that corporations already maintain via satisfying their *Caremark* duties. The rigid and detailed requirements of the SEC's proposed ESG-related rules, however, seem to mandate the sacrifice of efficiency and strategy in favor of satisfying prescriptive disclosure requirements. While Strine et al. make a compelling argument for corporations to embrace ESG while still building shareholder value, the rise of regulatory ESG begs the question of whether this approach is still feasible.

27. Proposed 17 C.F.R. §229.106(c)(1); §229.407(j).

28. *In re Caremark*, 698 A.2d 959, 971 (Del. Ch. Sept. 25, 1996).

C O M M E N T

DIRECTOR ENGAGEMENT: NECESSARY FOR ESG SUCCESS

by Todd Phillips

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Leo Strine, Kirby Smith, and Reilly Steel make an important contribution to the corporate governance literature. In their article, *Caremark and ESG, Perfect Together: A Practical Approach to Implementing an Integrated, Efficient, and Effective Caremark and EESG Strategy*,¹ they make the compelling case that *Caremark's* obligation that directors “be reasonably informed concerning” the activities of their corporations—and be subject to legal liability if they are not—provides a foundation upon which directors can and should inform themselves as to whether their companies are acting in ESG-forward or otherwise ethical manners.²

While Strine, Smith, and Steel include discussions of *Caremark* liability and associated legal gloss, the practical “takeaway” from their article is that directors must be engaged with their companies’ ESG (or, as the authors write, EESG)³ efforts, addressing those matters that pose moral risk to their firms as well as those that only pose legal ones. And importantly, director engagement on ESG should not just be something that corporate boards implement, but that shareholders should be demanding.

I. Informed Corporate Directors

Both primary theories of corporate governance today—whether to be operated in the interest of stakeholders or shareholders—require directors to be informed as to their corporations’ activities. Under “stakeholder capitalism,” a company should operate in manners that benefit all it affects. For example, a 2019 letter from the Business Roundtable and signed by the CEOs of some of America’s largest corporations made “a fundamental commitment to all of our stakeholders,” including customers, employees,

suppliers, communities, and shareholders.⁴ However, the perhaps most significant criticism of stakeholder capitalism is that it “means reducing CEOs’ responsibility to shareholders, not increasing their responsibility to workers or society or anyone else.”⁵ Accordingly, for stakeholder capitalism to be effective, chief executives must not be given carte blanche and directors must provide appropriate oversight that ESG commitments are being fulfilled.

The other theory of corporate governance is “shareholder primacy,” meaning that a company should operate solely to benefit its investors. Although this has traditionally meant a focus on profits (Milton Friedman famously wrote, “there is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits”)⁶ this is not necessarily the case as shareholders increasingly care about investing in corporations that are stewards for ESG values. Today, investments in ESG funds total roughly \$8 trillion worldwide with inflows only growing⁷ and the largest shareholder of public companies, BlackRock’s Larry Fink, annually writes to corporate executives encouraging them to “act as a powerful catalyst for change.”⁸ Clearly, whether because they believe companies that have ESG focuses will be more profitable than those who do not,⁹ or because they generally want their companies to act more ethically without regard for profit,¹⁰

Editors’ Note: All opinions are the author’s own and not of any affiliate or employer.

1. Leo Strine et al., *Caremark and ESG, Perfect Together: A Practical Approach to Implementing an Integrated, Efficient, and Effective Caremark and EESG Strategy*, 106 IOWA L. REV. 1885 (2021).
2. *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996).
3. EESG stands for “employee, environmental, social, and governance.” Strine et al., *supra* note 1, at 1885.

4. Business Roundtable, *Statement on the Purpose of a Corporation* (last updated July 2021), <https://s3.amazonaws.com/brt.org/BRT-StatementonthePurposeofaCorporationJuly2021.pdf> (emphasis removed).
5. Matt Levine, *Money Stuff: When Can Bond Investors Lie to Banks?*, BLOOMBERG (Apr. 13, 2020), <https://www.bloomberg.com/news/newsletters/2020-04-13/money-stuff-when-can-bond-investors-lie-to-banks> (emphasis removed).
6. Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES MAG. (Sept. 13, 1970).
7. Evie Liu, *ESG Investing Could Quadruple by 2030*, BARRON’S (Dec. 3, 2021), <https://www.barrons.com/articles/esg-investing-outlook-2030-51638493803>.
8. Larry Fink, *Larry Fink’s 2022 Letter to CEOs: The Power of Capitalism*, BLACKROCK (2022), <https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter>.
9. See Jon Hale, *Sustainable Equity Funds Outperform Traditional Peers in 2020*, MORNINGSTAR (Jan. 8, 2021), <https://www.morningstar.com/articles/1017056/sustainable-equity-funds-outperform-traditional-peers-in-2020>.
10. See Lauren Migaki & Andee Tagle, *Understanding the Promises and Limits of Ethical Investing*, NPR (Jan. 22, 2022), <https://www.npr.org/2022/01/11/1072207126/ethical-investing-with-esg-funds>.