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Board Oversight of ESG: Preparing for the 2022 Proxy Season and Beyond

Last year's proxy season saw investor support for an unprecedented number of ESG proposals, on issues ranging from climate change to human capital management to diversity, equity and inclusion. Proxy advisory firms increasingly recommended that shareholders vote for such proposals. We also saw the emergence of ESG-driven withhold campaigns targeting individual directors. This upcoming 2022 proxy season will likely remain hotly contested as investors, proxy advisors and other stakeholders further scrutinize companies' ESG credentials. The Securities and Exchange Commission's recent guidance limiting exclusion of Rule 14a-8 proposals and proposed new rules on climate-related disclosures, and the new ISS and Glass Lewis proxy voting guidelines on climate, board and workforce diversity and "responsiveness" will continue to lend support to ESG-related shareholder proposals. As a result, companies and major institutional investors will need to continue to focus on the relevance, impact and risks of a proposal on an individual company.

Boards now face heightened expectations for how they oversee ESG, with some investors prepared to hold directors, particularly committee chairs, directly accountable (through director specific withhold / against votes and targeted public commentary) for a company's perceived ESG underperformance, shortfalls versus peers or failures of oversight.

We set forth below some key considerations for companies and directors as they continue to prepare for the upcoming proxy season and beyond:

1. The board is a core part of a company's ESG narrative. Over the past year, we have seen the growing integration of ESG into corporate communications and disclosures, whether it be discussion of ESG in earnings calls, transaction announcements, 10-Ks, proxy statements or press releases. Companies are also increasingly taking a fresh look at how the business of the board is allocated, organized and prioritized across the full board and individual board committees, especially as it relates to ESG matters. The proxy season has become another opportunity for companies to convey their ESG positioning and progress to investors, including especially the board's involvement with those items. Investors want to understand with which ESG issues the board engages, what efforts have been made to identify ESG risks and opportunities that are significant to the company, whether and how often the board is getting updates from management on ESG matters, and whether ESG considerations have been woven into key strategic decision-making. Investors are looking for boards that comprehend and are

transparent with their company's progress, targets and aspirations on ESG. Directors and management teams that are able to tell their company's ESG story can demonstrate the scope of their ESG oversight and confirm that the board is equipped to oversee and address material ESG issues.

2. Understand what is material and why. Materiality as it applies to ESG continues to be debated, with the EU and certain ESG disclosure frameworks used by investors calling on companies to consider material impacts on stakeholders alongside the financially material impact of ESG items on the company, while the SEC (and U.S. securities law) continues to view materiality through the lens of a reasonable investor. Directors should understand how their company has assessed materiality, including whether it has done a materiality assessment that considers issues from long-term and downside risk perspectives, and be conversant, in particular, with the ESG issues have been identified as material to the short-, medium- and long-term financial health of the company's business.

3. Seek quality data. While ESG data has proliferated in recent years, investors continue to voice concern regarding the quality of the data that is publicly available. When overseeing their company's ESG disclosures, directors may wish to consider with management whether the data disclosed would be decision-useful and comparable for investors and whether there is an appropriate balance between quantitative and qualitative disclosures. Directors should also consider whether sufficient processes and internal controls are in place for tracking and reporting key ESG metrics, bearing in mind that the SEC has indicated it expects ESG metrics to be treated with a comparable degree of scrutiny as financial metrics. In engagement sessions with investors, a company may find it useful to inquire as to perceived data gaps that may be holding back investment or other specific concerns in the company's sourcing, confirmation or choice of ESG data. Whether or not a company is externally disclosing ESG data, directors are increasingly seeking to understand and receive material ESG data to support their decision-making, and companies are working on accommodating this desire.

4. Search for blindspots. Integrating ESG issues into business decisions will also require boards and management to regularly assess potential blindspots, given the multi-faceted nature and impact of many ESG issues: for example, the net zero transition raises questions regarding timing, feasibility, expectations regarding technological solutions, access and affordability. Diversity, equity and inclusion affects not just a company's workforce but also customers and suppliers. Cybersecurity and data privacy implicate operational, product and service safety and consumer welfare issues. More recently, the Russian war in Ukraine has exposed geopolitical blindspots in risk management practices and medium- to longer- term consequences of the war may require many companies to conduct a more fulsome

review of their global business activities and supply chain dependencies. As the war continues, the consequences on companies' near-term energy resilience and medium to long-term transition plans should also be closely monitored. Boards and management should recognize that ESG issues will continue to evolve and look for ways to identify and adapt to changes.

5. Focus on goals and progress; not ratings. While ESG ratings may in some cases be useful to help companies hone in on potential opportunities, they are, at best, a historical snapshot, and because of their reliance on publicly disclosed data (and sometimes inconsistent methodologies), may not provide a full or useful picture of the company's comparative ESG performance. The different proprietary methods to assess ESG performance can also result in inconsistent outputs. The ultimate test of a company's ESG performance is whether it can sustainably generate return over the long-term. Each company will need its own strategy for doing so, and management and directors should remain focused on evolving and adapting the business while recognizing the limitations of ESG ratings.

6. Demonstrate accountability and credibility. When companies commit to net zero, diversity and other ESG targets, investors and other stakeholders look for evidence of accountability and credibility. Boards can help management parse between goals that have achievable pathways and those that are still aspirational. Particularly where targets include commitments over multiple decades, boards should increasingly appreciate that they will be expected to monitor progress and consider interim reporting and goal-setting. Compensation committees should also be judicious when approving the addition of ESG metrics into executive compensation plans and engage on the metrics being used, and companies will increasingly be considering financing solutions linked to ESG metrics. Companies should prepare for enhanced pressure for independent or other third-party verification of the measurement of performance against metrics.

As ESG issues continue to evolve, expand and become increasingly integrated into business strategy and decision-making, boards will continue to adapt their oversight—and even board evaluation and recruitment processes—to align with business needs and investor, stakeholder and regulator expectations.

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