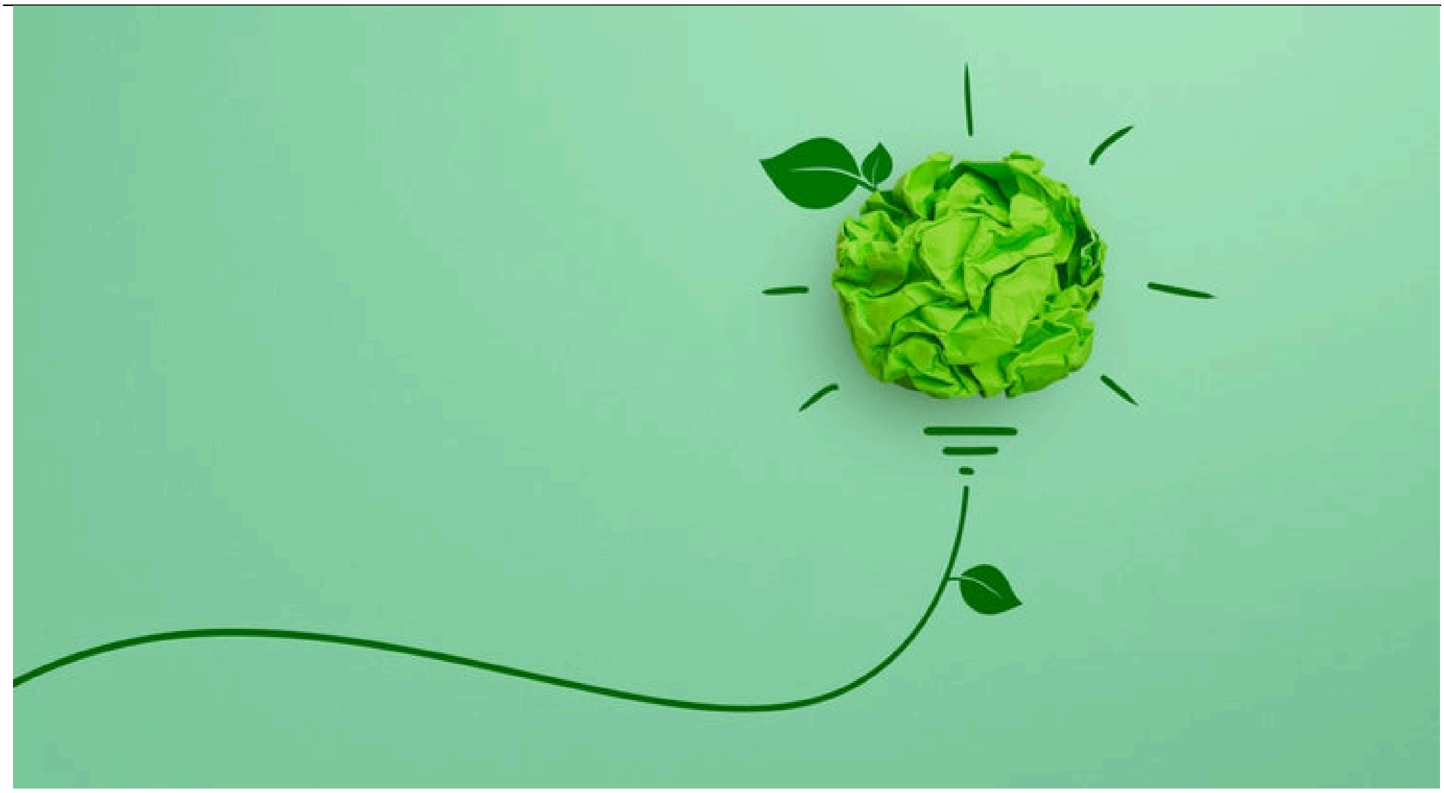
Environmental, Social, and Governance ("ESG") issues pose risks to companies. Can Chief Legal Officers help drive solutions?

Environmental

Corporate, Securities, and Governance



Chief legal officers (CLOs) are assuming expanded roles in guiding corporations through risk management and other fast-moving changes in the global economy. Assessing just one of these changes, Moody's recently published an analysis estimating that the impacts of climate change would cost the global economy an astounding $69 trillion -- by the end of the century. So it's time to ask: As environmental, social and governance (ESG) issues--particularly climate change-- enter corporate consciousness as both risks and opportunities, how does the chief legal officer fit in?

Results from the 2019 ACC Chief Legal Officers Survey provide important insights into this question. For example, the survey shows that CLOs are actively involved in corporate sustainability programs. Forty-seven percent noted that they are "critical influencers" of their companies' sustainability efforts, and a further six percent noted they are the "leaders" of such efforts. However, only ten percent of CLOs surveyed identified environmental issues as being expected to significantly affect corporate decision making in 2019.

These findings appear to be at odds with the mounting evidence on the financial impacts of environmental and social issues on corporate performance. In 2017, 73 companies on the S&P 500 publicly disclosed a material effect on earnings from extreme weather events, and 90 percent felt it was negative. An analysis of food companies found that $459 billion in revenue may be at risk from lack of water available for irrigation or animal consumption, and $198 billion is at risk from changing precipitation patterns affecting current crop production areas. Surveys indicate that the #MeToo movement, also, now impacts decisions professionals make on everything from employment to consumer choices.

It's not only about risks. There is also mounting evidence that proactive action on sustainability and social issues positions companies for improved financial returns. Studies from a range of groups including Bank of America, Morgan Stanley and JP Morgan demonstrate that serious corporate attention to climate and other environmental or social issues delivers higher stock returns, lower capital costs and lower volatility risks.

Recognizing these connections and the impact on their portfolios, investors have been taking action. In 2018, investors filed nearly 400 shareholder resolutions on sustainability issues, many of them related to climate change. The median level of support for such proposals rose to a record of 24 percent in 2018, and recent proxy seasons have witnessed the first majority votes on climate change proposals at companies like Exxon Mobil, Kinder Morgan and Anardarko. Wall Street heavyweights such as BlackRock, State Street Corp. and Fidelity Investments are among those proactively engaging companies on climate and other environmental and social issues.

A Patchwork of Risks

In light of these company and investor trends, CLOs have a unique opportunity--and responsibility--to help guide companies through an increasingly demanding risk landscape. The ACC survey notes that CLO attention to sustainability issues is largely motivated by the reputational impacts associated with environmental and social issues. While reputational risk and the social license to operate are indeed critical factors, environmental and social issues create a patchwork of risks that CLOs should be aware of and, when necessary, elevate to the attention of other company leaders. Examples of these many concerns are:

- **Operational risks:** Extreme summer temperatures led to the shutdown of nuclear plants across Europe in 2018 as warmer-than-normal seawater could not be used as coolant. Record flooding in North Carolina, also last year, caused operational losses for meat and poultry producers, as well as litigation losses due to nuisance complaints stemming form water and air pollution.
- **Value chain risks:** A 2018 HSBC Global Research study highlighted price spikes for key agriculture commodities including wheat, soybeans and maize due to more frequent droughts and heatwaves; these spike led to an escalation of worldwide food prices.
- **Disruption risks:** The rapid growth in electric vehicles and ride share programs like Uber and Lyft, as well as the growing disinclination of millennials to even drive, poses risks to the auto manufacturing sector.
- **Litigation risks:** The past five years have witnessed a surge in climate change litigation both globally and in the United States with over 500 cases filed. While many cases target governments, a growing number of private legal climate change claims are being filed against corporations.
- **Regulatory risks:** The number of climate change-related regulations has grown from 72 in 1997 to over 1500 globally in 2018, and this trend is expected to continue as more countries start to implement the Paris Climate Agreement. Additionally, a number of US cities and states, notably Atlanta, Seattle, California and New York State have adopted strong regulations on climate change. In September, California passed a law putting the state on a path to 100 percent carbon free energy by 2045.

So What Should CLOs Do?

The convergence of environmental and social risks and how corporations can respond was the focus of discussions at the recent ACC Global General Counsel Summit this past May. My co-panelists (Ricardo Cortés-Monroy, Group General Counsel, Nestlé; Melissa Kennedy, Executive VP, Chief

Legal Officer & Public Affairs, Sun Life Financial Inc.; and Meryam Omi, Head of Sustainability & Responsible Investment Strategy, Legal and General Investment Management) and I concluded that CLOs can play a critical role in elevating both companies' and their boards' understanding of and focus on climate and other important ESG challenges. This elevation can help integrate these issues into corporate planning and decision making.

Here are a few ways CLOs can get started:

1. Deepen the understanding of how sustainability issues affect your company: CLOs could drive the process of identifying which sustainability issues are most directly relevant to the company, and thus need to be addressed as priorities. The materiality map developed by the Sustainability Accounting Standards Board identifies key issues investors consider most relevant for various sectors and is a great first resource. CLOs could build on sector-specific issues and drive an internal materiality exercise to uncover impacts on their specific companies. Such materiality exercises will help companies elevate issues for immediate action at the C-suite and board levels.

2. Engage with internal and external stakeholders: A growing number of companies are starting to pull together cross-functional ESG teams – and the legal teams of most companies are already represented in these efforts. The CLO could work to ensure this group considers sustainability impacts across operations, keeping in mind the risk overlaps identified earlier – and could also secure the focus of the C-Suite on identified priorities and actions taken.

Practicing proactive engagement with shareholders and other external stakeholders is also a good method to identify the many ways in which sustainability issues could impact the enterprise. Research has shown that companies that successfully engage with investors on sustainability issues demonstrate superior returns and higher sales growth compared to their peers.

3. Integrate issues into risk and strategy deliberations: Enterprise risk management (ERM) is a good practice for elevating issues that arise from both internal and external engagements. The Committee of Sponsoring Organizations of the Treadway Commission ("COSO") recently released a tool that helps organizations integrate ESG issues into ERM processes. Shareholders are also looking for companies to use scenario analyses to think through how issues like climate change should be integrated in organizational strategies.

4. Involve the board: Expanding board fluency and oversight on ESG issues should be a high priority, especially on material issues. Understanding material risks and opportunities is inherent in a director's responsibility to ensure long-term value creation and resilience. Ceres' report Lead From the Top includes detailed recommendations for how boards can enhance their fluency on ESG issues. These recommendations include bringing in board members with exposure to ESG issues and ensuring that ESG issues are systematically on the agenda. Opening up meetings to outside experts that all board members can learn from will also generate smarter decisions.

Proactively managing the risks and opportunities of ESG "what if's" is now critical for all companies – and, as the guardians of risk management within their enterprise, more than ever, CLOs should be leading the way.

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Ceres is a nonprofit organization working with the most influential investors and companies to create a just and sustainable global economy.