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Get in the ESG Game

Compliance and Ethics

Publicly traded corporations all have one thing in common — ready access to funds from capital markets. It's their life's blood. Financing via stocks and bonds provides firms with the necessary resources to innovate, grow, and thrive. For the last decade or so, access to capital markets has been significantly impacted by environmental, social, and governance (ESG) performance standards.

It all started in January 2004 when former UN Secretary General Kofi Annan wrote to over 50 CEOs of major financial institutions, inviting them to participate in a joint initiative under the auspices of the UN Global Compact and with the support of the International Finance Corporation and the Swiss government. A year later, a report entitled "Who Cares Wins" was published making the case for embedding ESG factors in capital markets. This ultimately led to the publication of the "Principles for Responsible Investment" at the New York Stock Exchange in 2006 and the launch of the Sustainable Stock Exchange Initiative the following year.

Since then, ESG investing has taken hold. Institutional investors that initially resisted taking EGS factors into account when making investment decisions have since embraced it. For hard-nosed investors, their interest in ESG performance is unrelated to the pursuit of any particular social agenda. Instead, it is grounded in data showing that higher ESG ratings are associated with higher profitability and lower volatility. This is like having your cake and eating it too. Rather than having to accept increased risk of losses in pursuing higher returns, by taking ESG ratings into account, investors discovered that they can achieve higher returns while at the same time lowering their risk.

Today, over a thousand asset managers incorporate ESG data into their investment decision-making. To do so, they either perform their own research or they rely on one of a dozen or so agencies who develop and sell ESG ratings to investors. Each ESG ratings agency has its proprietary research methodologies and rating scales. For example, Institutional Shareholder Services (ISS) uses a rating scale of "D-" to "A+" based upon over 800 indicators, 90 percent of which are industry-specific. Some of the more important ESG indicators ISS considers are:

Environment

- Energy Management
- Climate Change Strategy
- Water Risk and Impact
- Environmental Impact of Products

Social

- Equal Opportunities
- Health and Safety
- Human Rights
- Suppliers

Governance

- Board Independence
- Shareholder Democracy
- Business Ethics
- Payments to Governments

The upshot of this ESG investment phenomenon is that corporate executives and directors of publicly traded companies have a great interest in securing favorable ESG ratings to attract investors. This presents an opportunity for corporate counsel and compliance officers to make the case for investments in their company's compliance and ethics program by pointing out that "business ethics" is not just one of hundreds of ESG factors, it is foundational to all of them.

Not all ESG metrics are created equal

There are two ways companies can achieve high ESG ratings. The first is to exaggerate ESG performance in response to rating agency surveys and to produce glossy ESG reports touting the firm's ESG achievements and hiding its shortcomings. The second is to do the hard work necessary to earn a favorable ESG rating and to honestly report the firm's current status relative to relevant rating criteria.

Of course, the problem with the first approach is that even if you succeed in fooling the rating agencies and investors in the short term, it's just a matter of time before the truth emerges and causes significant damage to the company's reputation. This raises, rather than lowers, the cost of capital. It happened to Volkswagen, whose ESG Score and stock plummeted in the wake of the diesel emissions scandal.

To pursue the second, more honorable approach to enhance your firm's ESG rating requires more than a commitment to the environment, social justice, and good corporate governance. It requires an effective compliance and ethics program comprising sound internal controls and a strong ethical culture.

We corporate counsel and compliance officers see the benefit of an effective compliance and ethics program for its own sake — to reduce enterprise risks and enhance stakeholder loyalty. However, as we fight for scarce resources to fund our compliance and ethics programs, we might strengthen our hand considerably by helping our senior executives and directors see that an effective program is essential to achieving sustained access to capital markets. Specifically, we could make the case that achieving ESG performance targets material to our business requires the following attributes that are all essential components of an effective compliance and ethics program:

- Effective policies, procedures, and training programs;
- Internal controls that ensure compliance with legal and ethical standards as well as reporting accuracy;
- A speak-up culture in which employees are listened to and applauded for identifying shortcomings and opportunities for improvement;
- Strong ethical leadership — the tone at the top is accompanied by supervisor reinforcement;
- A value-based culture in which daily decision-making is governed by the principles of honesty, respect, responsibility, accountability, and compassion; and
- A genuine rather than superficial commitment to pursuing selected ESG goals.

By getting into the "ESG game" in this manner, you will be speaking the same language as your finance-oriented executives. In so doing, you may succeed in elevating your compliance and ethics program in the eyes of your colleagues from merely one of many enterprise risk management activities to one that is central to your firm's ability to obtain the financial resources it needs to thrive over the long term.

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