



**MOVING UPWARDS:
THE INVOLVEMENT
OF BOARDS OF
DIRECTORS IN THE
UN GLOBAL COMPACT**



United Nations Global Compact Lead (GCLeap)

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Credits

This publication is a collective work, the result of various collaborative efforts. The recommendations and perspectives are not necessarily those of the stated lead authors. Rather the lead authors' responsibility was to capture, integrate and convey the recommendations and perspectives of the GCLeap group.

A first draft of this paper was presented at the Global Compact Lead (GCLeap) Retreat¹ on 22 October 2009. The following representatives of companies, academia and members of the GCLeap Team made contributions to this paper both at the GCLeap Retreat, and afterward with examples and comments. Authorship of this publication is, therefore, duly shared with Dr. Brad Googins (Boston College), Phil Mirvis (Centre for Corporate Citizenship, Boston College), Steven Rochlin (AccountAbility), Susan Stormer (Novo Nordisk), Christian Frutiger (Nestle), Nick Welsh (Shell), Luis Neves (Deutsche Telekom), Vinay Rao (Infosys), Marika Mc Cauley (The Coca Cola Company), Antonio Ballabriga (BBVA), Lisa Neuberger and Michael Nicholus (Accenture), Charles Bartels (Manpower), Belen Izquierdo (Telefonica), Guy Morgan (Boston College), Dr. Maurizio Zollo (Bocconi), Kwang Ryu (Levin Institute), Dr. Paul Beamish (Ivey) and Dr. Steven Davis (Yale University). This publication would have not been possible without the preparatory papers of Dr. Sandra Waddock (Boston College) and Dr. Sean Cruse of the Global Compact Office. Drs. Beamish, Waddock and Cruse, as trusted companions in this endeavor, offered many important comments and edits to the final draft of this paper.

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1. The Global Compact Lead (GCLeap) is a platform for leadership of champion companies. The group meets via webinars and retreats, and invites academics to discuss cutting-edge aspects of Global Compact implementation.

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Executive Summary

This paper provides preliminary arguments regarding how, and in what specific areas, Boards of Directors may act in reinforcing the leadership role of CEOs in advancing corporate citizenship in general, and implementing the Global Compact – the largest international initiative of its kind – in particular.

We believe a stronger hand for Boards in the implementation of voluntary initiatives such as the Global Compact should be understood as a genuine reinforcement of the crucial role played by the CEO. Enhancing the role of the Board in advancing good corporate citizenship supplements the leadership role of CEOs - the most important figure for advancing sustainability within the organization. CEOs must not be acting alone when they commit to advancing sustainability within their organization. Support of the executive management team is not enough. If CEOs are determined to embed sustainability as a mainstream practice, they will need the engagement of the Board of Directors.

The Board is ultimately responsible for the corporation and is central in shaping its values; it approves and oversees business strategy and performance. Unless the Board is engaged in the transformational change towards sustainability, progress could be peripheral and ephemeral.

There are two primary arguments for greater involvement of Boards of Directors in sustainability and the oversight of environmental, social and governance (ESG) concerns:

1) The Board of Directors, led by the CEO, is integral to successfully incorporating ESG concerns into the “DNA” of the company.

Implementation of the Global Compact principles typically progresses through several stages. It must be understood as an internal process of change -- a shift and a redistribution of internal power that extends to all executive lines of the business. ESG oversight from the Board of Directors will provide a powerful signal that sustainability has become a mainstream priority.

The pressure of institutional investors, the recent surge in shareholder activism concern-

ing environmental issues, and new legislative moves are signaling a turning point for Boards towards increased commitment to sustainability oversight. Evidence indicates that Boards are starting to pay attention to non-financial and ESG concerns because of two primary factors:

- An increased attention to ESG issues by shareholders and institutional investors
- Legislative reforms, in part due to mounting social pressure resulting from the financial crisis, are making Boards more independent, transparent and better-suited to encompass ESG concerns in their activities.

The convergence of governance and sustainability has already started. The time is now right to take the Global Compact implementation to the next level, through an alliance for sustainability within the company under the leadership of the Board of Directors and the CEO.

2) Boards, through their compensation responsibilities, are the crucial institution within the corporation to advance a broader and more long-term view of the role of top management.

Among their other powers to influence policy, Boards oversee the compensation of top management. Therefore they are able to change compensation policies so that CEOs are not remunerated only on the basis of short-term share price enhancement and long-term growth performance, but also on the basis of non-financial, environmental and social performance. If Boards can move toward a new metric of CEO payment, they will act as the most powerful driver toward ushering in a new generation of responsible and successful top managers.

Moreover, those new compensation policies would mean that CEOs already committed to sustainability do not have to maintain a dual discourse (non-financial with stakeholders and purely financial and operational with Boards and shareholders), and will feel politically supported by the company's Directors.

CEOs must not be acting alone when they commit to advancing sustainability within their organization. Support of the executive management team is not enough. If CEOs are determined to embed sustainability as a mainstream practice, they will need the engagement of the Board of Directors.

CEO turnover has grown speedier over the last decade. The average tenure of CEOs within global corporations has shortened since 2001 to an average of 6 years. If participation in the Global Compact is only an act of personal commitment by the CEO, it might be left an orphan when the CEO leaves the position. An unambiguous commitment by the Board of Directors to the Global Compact will ensure continuity over the long term, through succession plans and the selection criteria of future CEOs who are equally committed to sustainability.

Milestones toward greater involvement of Boards in ESG concerns

Which are the basic elements that will drive ESG concerns in the Boardroom? What is the roadmap of this transition? In this paper we suggest seven milestones. These elements are indicative and aspirational. Each company, each CEO and his/her management Board contribute a unique story of progress towards sustainability. The involvement of the Board of Directors in sustainability issues seems to be necessary to embed ESG concerns at the strategic and operational levels of the company. While there is no specific one-path-fits-all route to sustainability, there are clear lessons here.

Seven milestones

- Boards should reaffirm their fiduciary duty to oversee the long-term growth of the company, and with it, their duty to account for the non-financial performance of the company.
- A company should “capture materiality,” that is, express the tangible results of social

and environmental commitments on its financial performance. This should involve an objective assessment and a public disclosure.

- Oversight of ESG concerns ought to be in a governance structure intimately linked to the works of the Board.
- Public disclosure ought to demonstrate a clear indication of the Board’s endorsement of the sustainability performance of the company.
- CEO compensation and succession policies based on non-financial and ESG considerations should be a part of the Board’s purview.
- Boards that take on this challenge will have to reconsider their own composition. Directors who are knowledgeable about sustainability issues should be recruited, as well as Directors who represent the diversity of the company itself. A related aspect is the education of senior Board members on sustainability concerns.
- Finally, a wide array of relevant stakeholders should be invited into a systemic dialogue with the Board. Eventually legislative reforms will guarantee stakeholders formal recognition as part of the citizenry that creates value for the corporation.

Engagement of Boards in the Global Compact

The engagement of Boards in the Global Compact should be understood as a gradual process. Engagement of the Board of Directors in sustainability issues is a necessary step to secure the centrality and continuity of the commitment to the Global Compact. Achieving this is a unique experience for each com-

pany. This report provides recommendations for advancement toward sustainability, and even more advanced and aspirational goals:

- The Global Compact should explicitly enhance the role of Boards of Directors in advancing the Ten Principles within its leadership model, literature and other material. CEOs and Boards should be considered an integral part of the leadership coalition for sustainability in the company. This, in itself, will send a powerful signal to participants in the Global Compact.
- The Communication on Progress (COP) policy should encourage disclosure on Board involvement in the strategic oversight and monitoring of sustainability concerns and Global Compact implementation within the company.
- After participating in the Global Compact for a pre-determined amount of time, companies should be encouraged to have their Board publically endorse an internal sustainability report and a COP.
- The sustainability report should include not only traditional reporting metrics, but also new metrics which clearly show the materiality of non-financial performance aspects of the company.
- Boards should commit themselves to a systematic dialogue with stakeholders.
- Performance aspects of the sustainability reporting and the COP should be discussed

in the annual report to shareholders.

- Other concrete actions from the Board will demonstrate an advanced implementation of the Global Compact:
 - › Compensation policies for top management which include sustainability performance targets.
 - › Succession policies conducive to the selection of CEOs committed to sustainability.
 - › The inclusion of new Board members that are familiar and committed to ESG concerns.
 - › The education of Board members on sustainability concerns. The Principles of Responsible Management Education initiative and Principles of Responsible Investment initiative should launch a joint effort with the Global Compact to educate Directors of Boards on environmental, social and governance (ESG) issues.

Introduction

Everywhere we look, economic media, business gatherings, academic conferences, business schools symposia, NGO roundtables, we hear the same buzz: things are bound to change. Although nobody knows what is around the next corner, two outcomes appear certain. First, there can be no doubt that ill-conceived market theories and corporate malpractices have shaped some of the world's problems. Second, the future of corporate governance is much more likely to incorporate notions of responsibility, sustainability and citizenship, and take a more engaged role in issues such as multipolarity, climate change, food shortages, water conservation, energy security and public-private partnerships.

Reality is now ahead of theory: what progressive thinkers and groups of committed citizens have been sensing since the turn of the century is suddenly becoming mainstream. The turmoil of the market collapse of 2008 and the Copenhagen climate change meeting the following year both shone a bright light on the concept of sustainability—used in the broadest social and environmental sense.

Although sustainability has overwhelmingly won the battle of ideas as a result of global recognition of the stresses of natural resources and the mayhem created by irresponsible behavior in the corporate financial world, much remains to be done to ingratiate these ideas into daily business practices. We live at a crossroads and great progress can be made in these times, but new initiatives, insights and smart strategies will be needed to translate these widely shared aspirations into empirically measurable progress.

Against this dynamic background it is important to choose those crucial issues that, if solved, will generate overall progress in the most efficient and decisive way. One of those seminal routes to progress is the empowerment of Boards of Directors and committed CEOs to change their corporations into more responsible institutions that produce positive returns to investors, society and the environment.

This paper makes some preliminary arguments about how, and in what specific areas,

Boardrooms are fast becoming a strategic place where a substantial push toward corporate sustainability can be made. This new role for Boards is not only coming from within companies, but also from the mounting pressure of society, i.e. from interest groups affected by corporations, investors and shareholders.

the active engagement of Boards of Directors can act as a crucial reinforcement of the leadership role of CEOs in advancing implementation of corporate citizenship in general, and of the Global Compact in particular.

This paper presents arguments supporting a more active engagement of non-executive Directors and Boards after the consideration of several changes that have taken place in the ten years since the inception of the Global Compact. Boardrooms are fast becoming a strategic place where a substantial push toward corporate sustainability can be made. This new role for Boards is not only coming from within companies, but also from the mounting pressure of society, i.e. from interest groups affected by corporations, investors and shareholders.

CEOs helped the Global Compact become a highly-regarded and credible initiative over the last ten years. It is now time to move upwards and engage the Board of Directors. Sharing risks and responsibilities with the Board of Directors will result in a stronger commitment for the ten principles of the Global Compact throughout the entire company. In short, a transition from a CEO-led initiative to a combined CEO/Board-led initiative could mark a crucial development of the Global Compact during the next decade.

“In the dynamic world of corporate social responsibility (CSR), remarkably little attention has been focused on the role of corporate boards. This is at once unfortunate, unsurprising and unacceptable: unfortunate because the board is the supreme governing entity of the corporation and should be a major actor in shaping the firm’s CSR strategy; unsurprising because the board, by virtue of law and tradition, perceives its role in CSR to be either negligible or contradictory to its mandate; and unacceptable because the board, the ultimate steward of the well-being and performance of the organization, cannot afford to be a passive bystander in shaping the organization’s CSR strategy.”²

2. Allen White, *The Stakeholder Fiduciary: CSR, Governance and the Future of Boards*, (San Francisco: BSR, April 2006) http://www.bsr.org/reports/BSR_AW_Corporate-Boards.pdf (accessed 22 April 2010)

What Has the Global Compact Said in Terms of Board Engagement?

What, traditionally, is the place of Boards within the philosophy and policies of the Global Compact?

- On the Global Compact website, when the initiative is presented³, it is defined as “a leadership platform endorsed by Chief Executive Officers.”
- The Communication on Progress (COP) policy document⁴ highlights again the role of CEOs: “COPs must contain a statement by CEOs (or equivalent).”

When the Global Compact “Performance Model”⁵ was formulated in 2002, it was an initial approach to implementation of the United Nations Global Compact (UNGC) ten principles, based on the publication *Raising the Bar*.⁶

One of the basic business processes suggested for implementing the Global Compact in the “Performance Model” is the “leadership role.” However, leadership is defined with the very broad notion of top and middle management: “This is about management driving the vision through the organization. It is not just top management but the leaders of every team and function.”⁷ Similarly, *Raising the Bar* does not mention the CEO’s leadership role explicitly.

In the same tradition, the Global Compact publication *After the Signature*⁸, was intended to provide assistance to new Global Compact signatories by introducing the major elements and opportunities for participation in the Global Compact. It talks in general terms about the role of “company leadership” in setting into motion the implementation of the Global Compact. Neither of these documents mentions the role of Boards.

However, the Global Compact Annual Review 2007⁹ (the first year that this publication was prepared) talks in more precise terms about leadership. The 2007 Review specifically states: “The implementation of universal principles into business is a long-term process. This means that the sustained commitment of leadership is critical in guiding the company on a path of continuous improvement. The Global Compact must be a CEO-led initiative if results are to be realized. It

seeks business-statesmen – leaders who are willing to take environmental, social and governance issues into account.”

Although the 2007 publication focuses on the pivotal role played by CEOs in Global Compact leadership, it includes in a vague way other components of leadership: “Signing on to the Global Compact is a significant commitment by a company at the highest level – the chief executive, the board or an equivalent – to mainstream the ten principles into its business activities.” The report says that engagement in the Global Compact entails three elements: leadership commitment, policy development and communication. Concerning the first element, leadership, the Report asserts that leadership commitment means to “involve and ensure buy-in from key senior management and governance bodies, including the board of directors and relevant committees.”

The Global Compact Annual Review 2008¹⁰ advances this notion further, underlining the importance of Boards: “Survey results show that CEO ownership of Global Compact issues is high – an important conclusion given the leadership model at the heart of our initiative. However, (...) it is critical for Boards and other corporate governance entities, which have the ultimate responsibility for the long-term stewardship of an organization, to better integrate ESG issues into their deliberations and policymaking.”

Also, for the first time in 2009, the “Tools and Resources” section of the Global Compact website featured a new category of “Corporate Governance”, with its first publication titled “Corporate Governance: The Foundation for Corporate Citizenship and Sustainable Businesses.”

3. <http://www.unglobalcompact.org/AboutTheGC/>

4. <http://www.unglobalcompact.org/COP/>

5. http://www.unglobalcompact.org/docs/issues_doc/7.3/7.3.4/gc_perfm0d_1102.pdf

6. “Raising the Bar, Creating value with the UN Global Compact,” edited by Claude Fussler, Aron Cramer and Sebastian Van der Vegt, Greenleaf Publishing, 2004, ISBN 1874719829.

7. http://www.unglobalcompact.org/docs/how_to_participate_doc/GC_performance_model.pdf

8. http://www.unglobalcompact.org/docs/news_events/8.1/after_the_signature.pdf

9. http://www.unglobalcompact.org/docs/news_events/8.1/GCAAnnualReview2007.pdf

10. http://www.unglobalcompact.org/docs/news_events/9.1_news_archives/2009_04_08/GC_2008AR_FINAL.pdf

Two important foundational formulations -- the official introduction of the Global Compact on its webpage and the COP policy document -- define the Global Compact as a CEO-led initiative. Only very recently, from 2007 the definition of Global Compact leadership has been broadened to encompass the role of Boards - including, for example, a recently incorporated expectation that the corporate commitment extends into Board-room decision making.

The previous emphasis on the leadership role of CEOs can probably be explained on the basis of three logical reasons:

- **Historical:** The most successful examples of pioneering implementation of the Global Compact have taken place under the leadership of committed CEOs¹¹ who decided to set a tone throughout their organization. These CEOs have become real champions, not only internally, but also through collective action and partnerships advocated by the Global Compact. Without the leadership and constant support of many individual CEOs, the Global Compact would not have achieved its current status as the largest international initiative on corporate citizenship.
- **Legal:** At the inception of the Global Compact ten years ago, it was common for the Chairman of the Board to also serve as the CEO in a dual function. It was normal, then, to address the CEO as the senior executive in charge of the company. But legislative changes like the Sarbanes-Oxley Act of 2002 in the U.S. and similar legislation in other regions around the world are initiating a shift towards a new arrangement where CEOs are often overseen by independent Chairs of the Board.
- **The voluntary nature of the Global Compact:** Fiduciary duties, statutory roles and definitions concerning the interface between ethics and Boards of Directors have been developed around the pivotal concept of “compliance.” This explains why a closer focus on the role and potential of Boards has not merited much attention from voluntary initiatives unrelated to compliance, such as the Global Compact.

The 2008 Global Compact Annual Review shows that ownership of the Global Compact initiative among participating companies (where ownership is defined as the hierarchi-

cal level at which corporate responsibility policies and strategies are developed and/or evaluated) occurs at the Board level in 53% of cases. It is difficult to judge the meaning of this aggregated data. Since 50% of companies participating in the Global Compact are small or medium enterprises, it would be reasonable to assume that a majority of publicly traded companies participating in the initiative already have some degree of Board involvement in the development or evaluation of responsible policies and strategies. But their precise degree of engagement and the effectiveness of their engagement are open to further inquiry.

However, an inquiry should not be carried out with an “either/or” mindset. Advocating a greater role for Boards in the engagement and implementation of voluntary initiatives such as the Global Compact should be understood as a genuine reinforcement of the crucial role played by CEOs. To encourage and enhance the role of the Board in advancing good corporate citizenship means to supplement the leadership role of CEOs with the most powerful alliance for sustainability within the company. CEOs do not act alone. If they want business lines and units aligned with sustainability, they need to win over the management board, the executive team within the company. And if they are determined to embed sustainability as a mainstream practice in the long term, they will need the engagement of the Board of Directors.

11. A notable example is Novartis.

Why is the Engagement of Boards Important?

In order to progress, we should define the role of Boards.

The Conference Board in its *Corporate Governance Handbook: Legal Standards and Board Practices*¹² states that the board focuses principally on:

- Guidance and strategic issues
- The selection of the CEO and other senior executives
- Risk oversight
- Performance assessment
- Adherence to legal requirements.

Similarly, Allen White of the Tellus Institute presents a succinct description of the role of Boards. *“As the corporation has evolved from modest-scale private partnerships controlled by family interests and few investors to transnational entities publicly traded by thousands of investors, this oversight function has become more complex and multi-faceted. In the modern corporation, the board is integral to shaping the values and culture of the organization. It approves and oversees business strategy. It reviews and monitors financial performance and capital allocation. It ensures compliance with the law. It sets its own compensation and that of top executives. The board also structures its own governance process, notably, procedures for conducting business and constituting committees – e.g., audit, finance, compensation, governance, nominations, ethics, and, in a few cases, CSR.”*¹³

The report *Rebuilding Corporate Leadership* also states: *“The board of directors has ultimate responsibility for the performance of the corporation. Directors have an obligation to act as stewards of the corporation’s long-term economic health. Directors have a legal obligation and duty to address the long-term performance of the corporation.”*¹⁴

Two key roles of Boards, according to this report, are:

- Choosing the right leadership – which involves selection, compensation and succession policies and activities.
- Having the right plan – which involves company codes, value statements and strategic milestones.

The Board is the body within the company that helps to lead its growth and is ultimately responsible and accountable for it. The Board

is central in shaping the values of the company: it approves and oversees its business strategy and performance. Therefore, unless the Board is engaged in the transformational change towards sustainability, progress in this crucial area could be, as we shall see in this paper, peripheral and ephemeral.

As we shall see, progress along the sustainability path in any given company evolves over time. The active leadership of the Board, with the involvement of the CEO, will clearly be necessary for firms to reach the final stage: where the integration of ESG concerns is a source of smart long-term risk management and a thriving engine for value creation; where all lines of the business are aligned with sustainability criteria; and where the very strategic definition of the company encompasses sustainability and good corporate citizenship.

We will also argue that Boards are increasingly gaining power of oversight, control and leadership. Boards, in coalition with CEOs, are becoming a key decision-making body in publicly traded companies in matters related to strategic plans, risk oversight and long-term growth of the company. With those powers entrusted to Boards, their active support and oversight is crucial for the definitive mainstreaming of CSR and sustainability in any given corporation.

We will also see that if Boards do not incorporate CSR concerns into its functions and responsibilities, progress achieved by the corporation could be ephemeral. If boards do not integrate ESG concerns institutionally within their mission, practices and structures, sustainable practices could be reversed with the exit of a committed CEO.

In the last ten years, the role of Boards has become more crucial than ever before. We will review in the next section the changes which demand a new and crucial role of Boards in the advancement of sustainability within the corporation.

12. *Corporate Governance Handbook: Legal Standards and Board Practices*, RESEARCH REPORT R-1450-09-RR by Matteo Tonello, LL.M., S.J.D. The Conference Board, USA third Edition

13. *The Stakeholder Fiduciary...*, Allen White.

14. *Rebuilding Corporate Leadership: How Directors Can Link Long-Term Performance with Public Goals* ISBN: 0-87186-184-5, COMMITTEE FOR ECONOMIC DEVELOPMENT, www.ced.org

What Has Changed in the Last Ten Years?

Three trends of the past decade point to a higher involvement of Boards in embedding environmental, social and governance (ESG) concerns into the “DNA” of companies participating in the Global Compact. In this section, these trends will be examined.

The role of Boards in mainstreaming ESG concerns in the company

Over the last decade the movement to acknowledge ESG concerns has become an internationally established trend. ESG is now an agenda point for almost all corporations operating with an international scope of markets, operations or procurement.

But this does not mean that all companies are ahead of the implementation curve. Rather, we should regard this trend as a transition path, where a few companies are already champions, others are getting there, and a majority of companies are beginning the process.

The Global Compact establishes some stages of implementation of participating companies¹⁵: “Based on responses to the 2008 Global Compact Implementation Survey, we were able to rank with a high level of confidence the overall level of corporate responsibility performance of participants, using a scale from “beginner” to “advanced.” The results mirror our years of observation, showing that the Global Compact engages with a wide variety of companies – with only 8% identified as advanced performers and the vast majority ranked in the beginner to intermediate range.” Concerning implementation, the Global Compact classifies the total number of corporate participants from a “beginner” (20%) to an “advanced” category (8%), with the bulk of participants falling into intermediate categories:

- Beginner, 20%
- Beginner to Intermediate, 18%
- Intermediate, 31%
- Intermediate to advanced, 23%
- Advanced, 8%

Evaluations and analyses indicate that there is an evolutionary process of learning within the Global Compact which can be illustrated as a three-stage transition towards advanced

and transformative implementation of the Principles into business practices:

- 1) For the newest signatory companies, the Global Compact principles are treated as an “add-on” to business-as-usual. Several modest goals, including philanthropic activities, the revision of codes of conduct and preliminary plans to change practices aligned with ESG concerns form a non-integrated set of activities which tend to become more internalized within the company through the requirement of annual progress reports.
- 2) After two or three years in the Global Compact, most companies have advanced their implementation and will usually demonstrate permanent line and unit activity in alignment with the Principles, in addition to explicit support from the top management. Future development targets are identified to more fully integrate the Ten Principles into business operations. The Global Compact is a learning community and many companies after two or three years of participation would likely identify themselves at this stage.
- 3) A comparatively small part of the business community is ahead of the curve and has managed a full transformation where the integration of ESG concerns is not only a source of reactive long-term risk management but also a proactive engine for value creation. At this advanced stage, all lines of the business are eventually aligned with the principles of sustainability, and hence with the Global Compact principles, and the very purpose and strategic definition of the company are anchored in objectives

15. http://www.unglobalcompact.org/docs/news_events/9.1_news_archives/2009_04_08/GC_2008AR_FINAL.pdf (accessed 22 April 2010)

related to sustainability and good corporate citizenship.

The transition from a company immersed in the daily competitive struggle, indifferent to the externalities it inflicts, to a responsible company that embeds sustainability at the core of its strategy is a process that, in a company as in any other human organization, requires power shifts and redistribution.

These power shifts within the company have a clear objective: the alignment of all operations, lines of business and production units of the company with the values of sustainability and corporate citizenship. It is quite normal that, in the first stages of implementation of the Global Compact, executives in charge of its implementation are headquarters staff and not line executives. But the true transformation of a company happens when implementation of the Global Compact extends from staff to executive and operational lines of the business.

This organizational change cannot take place without the active commitment of the CEO of the company and its management board. But the definitive signal that ESG concerns have been institutionally embedded in all the operational lines of the company will be their embrace by the Board of Directors, the ultimate accountable body within the company. From that moment on, sustainability will be the normal state of affairs and the only acceptable way to operate within the company.

Researchers from the Center for Corporate Citizenship¹⁶ at Boston College undertook a survey of 25 companies in the Fortune 500 and analyzed the three identified stages at which Boards of Directors are embedding ESG concerns in their activities. Their tentative conclusion was that Boards progress through these stages in a sequenced transition towards full corporate citizenship governance. Their conclusions are quoted here, with our commentary:

a) Traditionally, the core function of corporate governance has been to provide a check on management's power and ensure that shareholders' interests are served. At this earlier stage corporate governance deals with protecting shareholders rights and equitable treatment of all shareholders, and some strategic guidance and effective monitoring by the Board of Directors.

At this stage, the Board might have an enterprise code of conduct and disclosure of Board's roles and responsibilities. Evidence suggests a generalized use of these practices in the sample of companies researched.

b) In a second stage the Board's mandate is to ensure that controlling shareholders treat the firm's other constituencies in a fair and non-preferential fashion. The corporate governor's agenda has expanded from assuming fiduciary responsibilities to establishing comprehensive regulatory frameworks toward adopting a holistic, inclusive stakeholder governance model.

At this stage, practices include a governance structure to oversee and support codes of conduct as well as an oversight of financial and non-financial results. Unfortunately, there is little evidence of implementation of non-financial oversight.

c) On the horizon is "next generation" corporate citizenship that involves action on both the strategic and operational front (Googins et al., 2007). This takes a firm beyond compliance to mitigating potential risks and looking for opportunities in the relationship between business and society. (...) It calls on corporate Boards (...) to actively engage stakeholders, including critics, and to face today's economic, social, and environmental issues while monitoring and preparing to address those approaching in the longer term.

At this stage, Board practices would include creating an explicit oversight responsibility for CSR, as well as establishing disclosure mechanisms for engaging and protecting stakeholders. The preliminary evidence shows little implementation of this principle so far.

The transition to advanced sustainability practices by Boards is still fragile and often lags behind the sustainability practices of their own companies. It is likely that a very large number of companies engaged in the Global Compact, after two or three years of active engagement, are near or within the intermediate level of implementation; that is, operating from a staff unit placed at or near the top management of the company and developing strategies of sustainability aligned

16. "Leading corporate citizenship: governance, structure, systems", Guy Morgan, Kwang Ryu and Philip Mirvis, Corporate Governance, Vol. 9 No. 1., pp. 39-49, (London: Emerald Group Publishing Limited, 2009)

with line activities and discrete business units within the company.

But as the Boston College Survey also shows, Boards are generally not seen at an intermediate level of engagement. Although many companies may have already established a Board-level governance structure to oversee codes of conduct, they are still not putting into practice other beneficial practices, such as the oversight of both financial and non-financial results within the company, let alone more advanced practices, such as setting up an explicit oversight function to monitor environmental and social impacts or creating a systematic dialogue with stakeholders on ESG matters.

However, the time is still ripe for advancing implementation of the Global Compact to the next level. We are now in a dynamic international scenario, where the process of rethinking the role of business in society has already underway and Boards are under significant new pressure to improve their performance and progress on sustainability practices. Two additional drivers are:

Institutional investors are calling for action.

As the Conference Board of Canada¹⁷ summarizes in a recent publication: *Shareholders are perceived as the chief driver of CSR governance – particularly institutional investors with their quest for long-term value creation. The mainstream institutional shareholder community is starting to ask companies for greater consideration of social and environmental concerns.*

Two initiatives which reflect the growing importance of this trend are:

- **The UN Principles for Responsible Investment**, in which signatory investment firms sign on to embed environmental, social, and governance (ESG) aspects in their assessment of companies and to engage actively with companies on these matters. There are currently over 560 signatories to the PRI and over US\$18 trillion in assets signed up to the PRI six principles.
- **The Carbon Disclosure Project**, in which institutional investors with a current combined \$57 trillion of assets under management seek information on business risks and opportunities, presented by climate change and greenhouse gas emissions from the world's largest companies (3,000 firms in 2008).

The publication concludes: *Institutional investors and the socially responsible investment community are looking for greater corporate disclosure of ESG factors to facilitate their stock analysis. These developments are driving boards to increasingly consider CSR as a business concern. The degree to which boards adopt a clear CSR governance framework can be an indicator to the investment community of the significance with which a firm treats these risks and opportunities.*

Although retail investors are often not considered in this context, the tools of social networking are fusing with the retail investor community, giving them a bigger voice. For example, www.shareowners.org is a website mainly for markets with widely held companies.¹⁸

Growing activism of shareholders and pressures stemming from the financial crisis.

Although data are not systematic and comprehensive, the Committee for Economic Development¹⁹ reports that over the last five years the number of Fortune 500 companies with a Board committee overseeing environmental impacts jumped from 10 to 25%²⁰. The Economist Intelligence Unit (EIU) of The Economist magazine also says that globally 26% of companies locate responsibility for “sustainability performance” with the Board²¹.

This data reflects the fact that the involvement of Boards in non-financial aspects of the performance of companies is on the rise, and that closer attention should be paid to this crucial development.

“(In 2008) leading U.S. investors have filed a record 54 global warming shareholder resolutions with U.S. companies that face far-reaching business impacts from climate change. The resolutions are nearly double the number filed just two years ago. Com-

17. The Role of the Board of Directors in Corporate Social Responsibility by Coro Strandberd (Ottawa: The Conference Board of Canada, 2008).

18. Stephen Davis in the GLead Retreat, 22 October 2009. He is a Senior Fellow at Yale University School of Management's Millstein Center for Corporate Governance and Performance

19. *Rebuilding Corporate Leadership: How Directors Can Link Long-Term Performance with Public Goals*, (Washington, D.C.: Committee for Economic Development, February 2009). http://www.ced.org/images/library/reports/corporate_governance/cgpt3.pdf (accessed 21 April 2010)

20. Joann S. Lublin, “Environmentalism Sprouts Up On Corporate Boards,” *The Wall Street Journal*, 11 August 2008. <http://online.wsj.com/article/SB121840356252128043-email.html> (accessed 21 April 2010).

21. Paul Kielstra, “Doing Good: Business and the Sustainability Challenge,” Pg. 5. (London: Economist Intelligence Unit, 2008). http://graphics.eiu.com/upload/Sustainability_allspnsors.pdf (accessed 21 April 2010).

“Shareholders are more active on environmental issues, too. The number of investor proposals related to the environment nearly doubled between 2004 and 2008, RiskMetrics Group Inc. says. Many proposals urge increased board attention to the issue.”²²

panies targeted in the 2008 proxy season include electric power companies, oil and coal producers, airlines, homebuilders and other businesses that investors believe are not adequately dealing with potential climate-related business impacts, whether from physical changes, emerging climate regulations or growing global demand for low-carbon technologies and services. Resolutions were filed with dozens of companies in eight industries, including Dynegy (NYSE:DYN) in the electric power sector, Massey Energy (NYSE:MEE) in the coal sector, ExxonMobil (NYSE:XOM) and ConocoPhillips (NYSE:COP) in oil and gas sectors, U.S. Airways (NYSE:LLC) in the airline sector and Standard Pacific (NYSE:SPF) in the building sector.”²³

Further evidence shows an additional trend, whereby shareholders are converging with other stakeholder interest groups, thus, increasing the plurality of interests of shareholders themselves.

On top of these developments, the recent financial meltdown is generating additional pressures, coming from public opinion and from legislators, to change and update the role of Boards.

The economic collapse of 2009 has made clear the need for a risk management group or Board-level committee. Boards have the important role of providing risk oversight and, thus, have been viewed as partly responsible for the financial meltdown that began in 2008, for having insufficiently overseen risk. Boards are rethinking risk now, defining and clarifying for Board members the ESG risks that the company faces. This may be an excellent entry point to embedding ESG in the boardroom.²⁴

Some progress has been made recently concerning the composition and practices of Boards. The progress achieved so far through compulsory legislative measures, like the Sarbanes-Oxley Act of 2002 and similar exercises, has increased transparency, disclosure, independence of the Board from management, and responsiveness to shareholders rights and proxy proposals.

Current trends in Europe seem to point to a mandatory disclosure of companies on sustainability aspects in their annual report. A recently-passed Danish law requires more than one thousand large companies to include information on CSR in annual reports, including information on guidelines or standards used by the company, how the

company implements the CSR processes and how they communicate the impact of their CSR Programs. Since 2007, France, Sweden and the UK have approved similar measures. In that sense, legal provisions are already placing the oversight of non-financial ESG concerns in the hands of the Boards.

Conclusion

Progress in the implementation of the Global Compact goes through several stages and has to be understood as an internal process of change, and a shift and redistribution of internal power. Implementation originally under the jurisdiction of some staff executives with the support of the CEO extends finally to all executive lines of the business. The assumption of ESG oversight by the Board of Directors will signal the moment when sustainability becomes the normal, mainstream way of business.

- The involvement of Boards in ESG concerns is still clearly insufficient. However, the pressure of institutional investors, the new surge in shareholders activism concerning environmental issues and some new legislative developments are signaling a turning point towards increased commitment to sustainability oversight from Boards. Evidence gathered indicates that Boards are starting to pay greater attention to non-financial and ESG concerns, for two reasons: An increased attention to ESG issues by shareholders and institutional investors.
- Legislative reforms, which should be understood as a mirror image of mounting social pressure, are making Boards more independent, transparent, and better suited to encompass ESG concerns in their activities.

We conclude that the merger of corporate governance with sustainability concerns has already started. The time is now right to take Global Compact implementation to the next level, through an alliance for sustainability within the company under the leadership of the CEO and the Board of Directors.

23. “Investors File Record Number of Global Warming Resolutions with U.S. Companies,” *Ceres*, 6 March 2008 <http://www.ceres.org/Page.aspx?pid=854&srcid=705> (accessed 21 April 2010)

24. Stephen Davis in the GLead Retreat, 22 October 2009. Stephen M. Davis is a Senior Fellow at Yale University School of Management’s Millstein Center for Corporate Governance and Performance

The role of Boards in changing the managerial model

Without the involvement of the Board of Directors, CEOs and management teams seriously committed to the Global Compact will not find the support they require to mainstream sustainability within the company. The managerial model that dictates the yardstick for success of CEOs of many publicly traded corporations is too often a narrow and short-term measure of shareholders value maximization. This model has shown its shortcomings in light of the financial crisis.

The work of Sumantra Ghoshal provides a powerful critique of the prevailing model of managers and ensuing bad management practices²⁵ that some business schools have spread and legitimized, based on agency theory, transaction costs theory, and the “negative approach” to economics defended by Milton Friedman’s brand of “liberalism”.

In 2005, Ghoshal characterized prevailing theories taught in business schools in the following way: ...*We have taught our students that managers cannot be trusted to do their jobs – which of course is to maximize shareholder value – and that to overcome “agency problems”, managers interests and incentives must be aligned with those of shareholders by, for example, making stock options a significant part of their pay.* He concluded: *Combine agency theory with transaction costs economics, add in standard versions of game theory and negotiation analysis, and the picture of the manager that emerges is one that is now very familiar in practice: the ruthlessly, hard-driving, strictly top-down, command-and-control focused, shareholders-value-obsessed, win-at-any-cost business leader.*

What is shocking about Ghoshal’s dissection of the prevailing managerial model is its accuracy in characterizing bad management, almost four years before the devastating effects of the financial meltdown.

It is no wonder, then, that the global havoc wreaked by financial mismanagement and excessive risk-taking has undermined the legitimacy of the basic underlying theory of the managerial model: shareholder value maximization.

As the Financial Times reported in 2009, *Jack Welch, who is regarded as the father of the “shareholder value” movement that has dominated the corporate world for more than 20 years, has said it*

RECENT MOVES IN THE U.S.

Some bills currently before Congress point to a mistrust of the current financial system:

- Shareholder Bill of Rights Act of 2009 (Sen. Charles Schumer, D-N.Y.)
- Shareholder Empowerment Act of 2009 (Rep. Gary Peters, D-Mich.)
- Excessive Pay Capped Deduction Act of 2009 (Sen. Dick Durbin, D-ILL.)

These bills propose changes in policy on Board structure, director elections, risk management, executive compensation, “say on pay,” and proxy access.

The Securities and Exchange Commission has proposed changes in policy on disclosure for investors, proxy infrastructure, beneficial ownership reporting, accounting, and technology for filings.

was “a dumb idea” for executives to focus so heavily on quarterly profits and share price gains. The former General Electric chief told the Financial Times the emphasis that executives and investors had put on shareholder value, which began gaining popularity after a speech he made in 1981, was misplaced. Mr. Welch, whose record at GE encouraged other executives to replicate its consistent returns, said that managers and investors should not set share price increases as their overarching goal. He added that short-term profits should be allied with an increase in the long-term value of a company. “On the face of it, shareholder value is the dumbest idea in the world,” he said. “Shareholder value is a result, not a strategy... Your main constituencies are your employees, your customers, your products”²⁶

A telling analysis in *The New York Times*²⁷, aligns very well with changes we are beginning to witness concerning the managerial model:

Times of turmoil also bring changes in social attitudes and politics, which ripple into new management practices. Labor unions, for example, rose to prominence during the Depression. Unions brought large companies a needed dose of industrial stability, as the earlier ideological wars between labor and capital receded. If the workers were less likely to be

25. Sumantra Ghoshal, “Bad Management Theories Are Destroying Good Management Practices,” *Academy of Management Learning and Education*, 2005, Vol. IV, no 1, pgs. 75-91.

26. Francesco Guerrera, “Welch condemns share price focus,” *Financial Times*, 12 March 2009.

27. Steve Lohr, “How Crisis Shapes the Corporate Model,” *The New York Times*, 28 March 2009. http://www.nytimes.com/2009/03/29/business/29unbox.html?_r=1&scp=1&sq=how%20crisis%20shapes%20the%20corporate%20model&st=cse (accessed 21 April 2010)

A shift is at hand: the managerial model, whose supreme goal is to balance the interests of a diverse group of interested parties, seems to be ascendant, while the prevailing model and its underpinning theory of maximizing shareholder value is being redefined into a broader concept.

radicals, the days of robber-baron owners were in eclipse as well. Their power was supplanted by “a new subspecies of economic man — the salaried manager,” wrote Alfred D. Chandler Jr., in his Pulitzer Prize-winning history, The Visible Hand: The Managerial Revolution in American Business (Harvard, 1977). Chandler called the model “managerial capitalism,” and the role of management was to balance the interests of a diverse group of stakeholders including workers, government and shareholders. That model held sway until the 1980s, when the stagnation of economic growth and corporate profits of the 1970s brought a narrowed focus on stock-market returns as the primary measure of management performance (...). Today, the pendulum is swinging back to a model in which corporations will be regarded more as social organizations, whose obligations extend well beyond Wall Street.

A shift is at hand: the managerial model, whose supreme goal is to balance the interests of a diverse group of interested parties, seems to be ascendant, while the prevailing model and its underpinning theory of maximizing shareholder value is being redefined into a broader concept.

A report from the Committee for Economic Development entitled *Rebuilding Corporate Leadership: How Directors Can Link Long-Term Performance with Public Goals* takes note of such an attempt at reformulating shareholder-value theory as it applies to the role of Boards. In this report Robert C. Clark, distinguished Professor at Harvard Law School, underscores the critical role that Boards can play. He accepts the mainstream view that directors have a fiduciary duty to maximize shareholder value, subject to three important constraints: 1) Directors should ensure their corporation obeys all relevant laws; 2) Directors should cause the corporation to meet all of its legal obligations to non-shareholder constituencies; and 3) Directors should cause their corporation to respond to market, social, and normative

forces to keep constituents optimally involved in the corporation’s business.

Clark adds two caveats, which he calls “matters of conscience exceptions”: 1) Directors may order their corporations to engage in charitable giving; and 2) Directors may order their corporations to cease any association with abhorrent practices, such as genocide and apartheid, even when those actions are profit-maximizing and not illegal under applicable law.²⁸

The former prevailing model of managers obsessed with shareholder value, when put into practice by Boards through their compensation policies, has had two important effects:

- It has presented an obstacle for CEOs committed to a broader strategy incorporating ESG concerns.
- It has hindered mainstreaming of ESG concerns in global companies.

The current financial crisis has shown the sorry results, for companies and society, of the dysfunctional model of management. Even at the theoretical level, the “shareholder value” model is being rapidly delegitimized and a more balanced role of top management encompassing a broader view of the role of managers as maximizers of both value and positive impacts on society, and the environment, is starting to gain ground.

Boards, via their statutory compensation responsibilities, are the crucial body within the corporation that has the power to advance a broader view of the role of top management. Specifically, Boards should change their compensation policies so CEOs are not remunerated primarily on the basis of short-term share price enhancement, but also on the basis of measures of: a) long-term growth performance, and b) non-financial, environmental and social performance.

If Boards of Directors move in this direction, they will act as the most powerful driver enabling a generation of responsible and successful top managers. This is needed now.

Moreover, new compensation policies will mean that CEOs already committed to sustainability do not have to maintain a double discourse (non-financial with stakeholders and purely financial and operational

28. Robert C. Clark, “Robert Clark’s Corporate Law: Twenty Years of Change,” *Journal of Corporation Law*, Spring 2006 (quoted in *Rebuilding Corporate Leadership*)

with Boards and shareholders), and will feel politically supported in their efforts by the company's Directors.

Conclusion

The managerial model that dictates the yardstick for success of CEOs is a narrow and short-term measure of shareholders value maximization. This model has shown its shortcomings in light of the financial crisis.

Even at the theoretical level, the model is being rapidly delegitimized and a more balanced role of top management, encompassing a broader view of the role of managers as maximizers of both value and positive impacts on society and the environment, is starting to gain ground.

Boards, through their statutory compensation responsibilities, are the crucial body within the corporation that can advance a broader and more long-term view of the role of top management.

A complementary trend that points to the importance of increasing the Board's oversight of sustainability issues is CEO tenure. Specifically, embedding sustainability oversight at the Board level assures continuity of related programs and projects, because the amount of time CEOs remain in their job is becoming particularly short.

The average tenure of CEOs²⁹ has varied from 9.5 years in 1995, to 7.3 years in 2001, 7.8 in 2006 and 7.9 in 2008. If the analysis eliminates tenures that ended in non-forced retirement, or, in other words, if we only

consider tenures that end because of performance-related reasons, the reported average tenure for 2001 decreases to 4.6 years. Adjusting for a slight increase in average general tenure during the last seven years, we can conclude that the time of permanence of a CEO in his/her position in a company is today, on average, 6 years.³⁰

As we discussed in the previous section, there is a transition process for any company making sustainability a fully embedded responsible practice. That transition takes time and, according to our conclusions, more than six years are necessary to completely embed ESG concerns into the core strategy of the company in such a way that there is no turning back.

There are undoubtedly cases of companies where ESG-committed CEOs are succeeded by new CEOs who may or may not be committed to that transition process. An effective solution to preventing this breakdown and ensuring the long-term permanence of the corporation's commitment to the Global Compact would be to make certain that such a commitment is not only endorsed by the CEO, but by the Board of Directors in a collective manner. This commitment from the body that is statutorily responsible for the strategic plan of the company would ensure permanence beyond the tenure period of any given CEO.

29. Booz Allen reports, 2001, 2006, 2009.

30. Matthew Boyle, "The Art of CEO Succession," *Business Week*, 30 April 2009.

A Roadmap for the Involvement of Boards in ESG Concerns

Boards are susceptible to external pressures — like the judgment of investors, the increased proxy initiatives of shareholders on specific issues like climate change, or the assessment of credit rating agencies. They are able to learn from internal demonstration effects, like hearings on specific issues from employees or stakeholders. However, Boards typically are comprised primarily of financial experts, for whom the materiality of non-financial issues may be unknown territory. They are usually still heavily focused on shareholder supremacy.³¹ In sum, Boards are subjected to conflicting forces and now face a defining moment. It is important at this juncture to substantiate any attempt at real reform with specific proposals, thus creating a roadmap for effective progress.

We would argue, at this stage, that Boards of privately-owned companies should be faced with the same obligations as Boards of Directors of publicly-listed companies. In fact, both are subjected to the same pressures to undertake oversight of sustainability concerns at the highest level of the company. As the Committee for Economic Development argues, “Private equity firms are, like public corporations, dependent on capital markets. Because the sources of capital are essentially the same in all markets, the lack of certain formal shareholder rights in private equity investments does not mean that providers of

capital—notably public and union pension funds—will be less assertive in private markets than they are in public ones.”³²

But how will the process of greater involvement take place? What are the basic elements that will drive corporate governance to take on ESG concerns at the Board level? What is the roadmap of this transition? Here we suggest seven milestones. These elements are indicative and aspirational. Each company, each CEO and his/her Management Board have a very specific and unique story concerning corporate progress towards sustainability. While the involvement of the Board of Directors in sustainability issues seems to be necessary to secure a satisfactory insertion of ESG concerns at the core of the strategy and operations of the company, there is no specific one-path-fits-all route, but, at the most, some plausible benchmarks of progress. These are our suggestions:

EXTENDING OVERSIGHT AND BOARD PRACTICES TO A LONG-TERM PERSPECTIVE, INCLUDING ESG CONCERNS

Boards must reaffirm their fiduciary duty to oversee the long-term growth of the company, and with it, their duty to take into account the non-financial aspects of the company’s performance.

The most obvious pressure that Boards are experiencing is to act as guardians who cooperatively guarantee the long-term growth of the corporation. The long-term perspective takes into consideration issues related to the environment, access to natural resources (including carbon emissions), human rights, labor standards, community relations and corruption.

To maintain their legitimacy, Boards face a basic challenge: to integrate short-term oversight of financial performance with a long-term strategy of growth for the com-

LONG-TERM VALUE CREATION AT NESTLÉ

At Nestlé, long-term value creation for shareholders, but also for society, has become part of the company’s core business strategy. Key ESG policies, initiatives and reports are jointly introduced and underwritten by the CEO and the Chairman of the Board. This is the case for the company’s annual Creating Shared Value Report, which includes Nestlé’s global Communication on Progress (COP) for the Global Compact. Another example is the new version of the Nestlé Corporate Business Principles, which guide the company’s business practices globally and which explicitly state the company’s commitment to each of the ten Global Compact principles.

31. This is true in countries like the U.S. to such an extent that boards might be afraid of extending their oversight to non-financial issues because of the possibility of shareholders suing them for breaches of their fiduciary duties.

32. *Rebuilding Corporate Leadership*, Pg. 46.

pany, including non-financial aspects. This emphasis comes from the drivers we have suggested earlier: the recent trend of activism of shareholders and from the demands of institutional investors practically concerned about a sound prognosis for the sustainability of returns over the long term.

The Report from the Committee for Economic Development³³ states: *Directors have a legal obligation and duty to address the long-term performance of the corporation. Directors' fiduciary duties include broader societal concerns that affirmatively affect the corporation's performance and long-term sustainability. To meet that duty, directors must consider the concerns of all – not just current shareholders, managers, or other powerful constituents – who are in a position to affect a company's long-term performance. In today's environment, boards must know that they are empowered to reject actions that produce only short term financial results at the expense of the long-term interests of the corporation.*

Allan White summarized this aspect persuasively when addressing the USA Global Compact network: “Boards must recognize that a company’s long-term wealth comes from a range of capital providers, including human capital, natural capital and social capital.”^{34,35}

REPORTING TO THE BOARD: MATERIALITY EVIDENCE AND METRICS OF THE NON-FINANCIAL ASPECTS OF COMPANY PERFORMANCE

An important prerequisite to secure institutional involvement of Boards in the sustainability agenda of the company is upgrading reporting mechanisms to “capture materiality” - that is, the tangible impact of the company’s social and environmental commitments on financial and economic performance.

Unless the company produces metrics and material evidence on non-financial aspects of performance, the Board will not have a solid base to incorporate those concerns into its risk assessment or performance oversight. Plainly said, if there is no report to the Board on the financial aspects of non-financial concerns, Boards will not have much to think about.³⁶ The challenge is, however, that this type of reporting has historically been underdeveloped. This is a crucial set of data that, if tabulated correctly, will deliver measurable aspects and metrics of the ESG performance

THE EXAMPLES COME FROM EMERGING COUNTRIES.

Today's most inspiring and innovative cases of Board engagement in sustainability issues are from Brazil, South Africa and other emerging economies. The King Report on Corporate Governance for South Africa (2002), in the view of many, is the world's leading statement of enlightened, sustainability-oriented governance.

of the company to the Board.

Reporting must go through a transformation just as corporate governance goes through a transformation. However, no institution has the solution, competence, or legitimacy to transform reporting alone. It must be a collaborative learning process.³⁷

ESTABLISHING EXPLICIT OVERSIGHT STRUCTURES ON THE BOARD FOR ESG CONCERNS

Another important element is to set up a structure intimately linked to the works of the Board, which specifically oversees ESG related matters.

To move in this direction, interim steps could consist of establishing a CSR committee, that includes Board members, i.e. chaired by the CEO or the Board member responsible for CSR, and composed by top company executives, or alternatively establishing a CSR Committee which reports to the Board.³⁸ Eventually the Board might decide to incorporate the oversight of questions such as the definition of non-financial issues, materiality and metrics to its own agenda. To incorporate ESG matters into the agenda at this stage without previously conducting the necessary ground work would be ineffective: there is the need for a specific subcommittee of the Board of Directors focused on this task and linked to the efforts of materiality reporting undertaken by executive directors and

33. Rebuilding Corporate Leadership, pg. 2

34. Allen White, “The Big Picture,” United Nations Global Compact, U.S. Network Symposium, San Francisco, 18 October 2009.

35. King Report II, Institute of Directors in Southern Africa, 2002. http://www.ecgi.org/codes/documents/executive_summary.pdf (accessed 21 April 2010)

36. U.S. Network Symposium, “Summary of Key Points,” 18 October 2009.

37. U.S. Network Symposium, “Summary of Key Points,” San Francisco, October 18 2009.

38. This point was made by Luis Neves of Deutsche Telekom at the GCLead Retreat, 22 October 2009.

TELEFONICA ON MATERIALITY REPORTING

Telefonica is stepping up its overall practice by introducing three steps to their annual sustainability reporting:

STEP 1: Establishment of a common floor, comparable and verifiable, based on the Global Compact principles and crossed with the Global Reporting Initiative (GRI) and its Key Performance Indicators (KPIs)

STEP 2: Assessment of what elements are relevant for their industry sector

STEP 3: Assessment for what is relevant for the company in all countries where it operates.

At Step 2 Telefonica is introducing metrics on the materiality of non-financial aspects of the performance of the company, based on the sector-specific guidance provided by GESI, the Global E-Sustainability Initiative.

top management of the company. However, this preparatory work does not preclude, but presupposes, that actual oversight is exercised by the Board itself.

Here are the thoughts of several panelists at the Global Compact U.S. Network Symposium in San Francisco:³⁹

Should the full Board oversee sustainability performance or should it be reposed with a subcommittee (a pre-existing risk-management or governance body)?

- The breadth of challenges requires both means of oversight.
- Where there is no full Board oversight, several things fail to happen:
 - a) Sustainability issues are not addressed in annual meetings and annual reports
 - b) No criteria or performance measures are set
 - c) Issues and goals are not embedded in board calendars with incentives.
- At the same time, sustainability subcommittees of the Board can be effective because they will meet and deliberate for longer periods of time, and then distill information for the full board.

INCLUDING ESG CONCERNS IN PUBLIC DISCLOSURE

When the Board decides to exercise oversight of sustainability and ESG concerns -- and creates structures for this activity -- the logical extension of this oversight will be the Board's endorsement of the sustainability and ESG

performance of the company.

Public disclosure of sustainability and ESG performance can take different forms, such as Board publication of the company's sustainability report, inclusion of ESG aspects or sustainability data in corporate financial reports and the relevant integration of the sustainability progress into the company's annual report

Disclosure has various consequences for different countries. In the U.S. if a Board signs the sustainability report of the company, from that moment on sustainability oversight takes the form of compliance. However, new trends in corporate governance are leading in this direction. As stated earlier, in Europe there is a shift towards mandatory disclosure on sustainability aspects in corporate annual reports. Even in the U.S., there is a thrust, both in political and government institutions, such as the Securities and Exchange Commission, toward placing more accountability of sustainability issues with Boards.⁴⁰

In the long run, comprehensive sustainability reporting should be integrated into financial reports in order to have maximum influence. Integrated reporting is the future of sustainability disclosure. Strong working examples include reports by Novo Nordisk, and Novartis.

NOVO NORDISK: AN IRREVERSIBLE STEP

Integrating ESG into the Novo Nordisk annual report was a crucial step in the process of mainstreaming sustainability throughout the company. The self-created obligation to provide sustainability oversight and report those results to shareholders brings more attention and commitment to these issues.

39. "Retooling the Boardroom for the 21st Century," panel discussion at U.S. Network Symposium, San Francisco, 19 October 2009.

40. U.S. Network Symposium, "Summary of Key Points," San Francisco, 18 October 2009.

CHANGING COMPENSATION AND SUCCESSION PRACTICES TO INCLUDE SUSTAINABILITY PERFORMANCE

If non-financial issues become a crucial part of the Board's oversight practices then compensation policies based on financial, operational and non-financial (or ESG considerations) will logically follow.

This would be a step toward achieving a significant positive change concerning the role and the definition of top management -- away from the narrow definitions which have prevailed in the past.

This trend will bring with it some energizing consequences, including the increased support of sitting CEOs and a change of criteria for CEO selection and succession. The trends we have been analyzing here, that collectively put pressure on Boards to incorporate non-financial matters in their agenda, extend also to succession planning policies. The Financial Times noted in 2009 that activist shareholders in the U.S. are now questioning companies on their succession plans.⁴⁰ Notes the piece: "The move takes advantage of a recent decision by the Securities and Exchange Commission to relax rules that prevented a shareholder vote on succession".

Diversifying the Boardroom

One question that will have to be addressed by Boards that include sustainability oversight in their practices is the composition of the Board itself. New members who are knowledgeable about sustainability issues must be recruited, as well as Directors who represent the diversity of the company itself.

Observers have contended that a failure leading up to the recent financial crisis was the lack of channels of communication between Boards and shareholders. Boards in many companies have scant dialogue with major investors (though managers may have such dialogue), and even less with other stakeholders. This lack of contact is an indicator that Boards are generally insulated from stakeholder and investor pressures. This comes back to the question: "who is serving on the board?"⁴²

Board members may also be undereducated on sustainability issues, and, more broadly, may be disconnected from learning about the social and environmental impact of the company. To really fulfill their statutory duties concerning the long term growth of the company and the impact of ESG concerns

ROYAL DUTCH SHELL COMPENSATION POLICY

This strategic change in compensation policies could happen in the near future as there are already some pioneering examples. For instance, the bonus remuneration component of the five top executives at Royal Dutch Shell are calculated estimated a scorecard in which financial results weigh 25%, operational aspects 55% and "sustainable development" performance weighs 20%.

in the company's performance, Boards must have optimal information on these matters.

Boards respond to external pressures extraordinarily well. Therefore, inviting outside experts and NGOs to speak to Boards on sustainability can effectively raise the bar. Management and employees must educate the Board, and Boards must listen. Business conduct officers and committees should have time to present and inform Boards on these matters.

As Cecily Joseph, Director of Corporate Responsibility of Symantec, concluded at the U.S. Network Symposium on Boards:⁴³

DIVERSITY IN BOARDS

Pictures of Boards show a similar demographic configuration. Sometimes they even are the same group of interlocked people. One typical room might include 11 white males, averaging 62 years of age, one female and one member of a minority group. Boards typically represent "old boy networks," nominated and dominated by people that existing board members or managers already know. This ingrained problem is now under scrutiny because of the financial crisis. Boards tend to be parochial even when companies are global; they are insufficiently diverse. Boards need a fair statistical representation of the companies' stakeholders; inclusive of gender, with geographic and expertise diversity. Old school thinking makes Boards miss new trends and changes in the marketplace -- like the move toward ESG.

41. Francisco Gurrero and Joanna Chung, "Activists Target CEO Succession," Financial Times, 17 December 2009

42. Stephen Davis at the GLead Retreat, 22 October 2009.

43. U.S. Network Symposium, "Summary of Key Points," San Francisco, 18 October 2009

Board training and education is critical.

- Include CSR and sustainability experts on the Board.
- Ensure the Board hears from a range of voices, including employees and external stakeholders.
- Boards need to be reflective of global society.
- There is no longer an issue of should Boards be engaged. The issue is now how Boards should engage with issues of CSR and sustainability.

There is a collateral need for business schools in the field of executive education to introduce in their programs the array of issues related to sustainability and non-financial concerns, and to pioneer educational and training programs specifically for Boards.

ENHANCING STAKEHOLDER GOVERNANCE

According to Allen White⁴⁴, the relation of companies to stakeholders is also evolving through three different stages:

- Stakeholder management: the “recognition” of non-financial stakeholders in fashioning strategy and management.
- Stakeholder engagement: the approaches to not only “identify” stakeholders but also to build and sustain relationships.
- Stakeholder governance: a “third stage of integration into formal governance structures.”

These three stages reflect the three stages of sustainability transformation in companies and their governance structure suggested earlier. Of course, the stage of “stakeholder governance” has not been reached by the bulk of companies engaged in progressing sustainability practices.

Non-financial issues which are relevant to long-term growth vary from company to company. The only way to manage them, in terms of risk-oversight, and in positive terms of value creation opportunities, is through engagement in a systemic dialogue with the stakeholders of the company.

This implies that the Board holds, as part of its regular practice, hearings with the relevant company stakeholders, from employees to communities. If and when this dialogue becomes systematic, the next logical step -- a step still very far ahead in the future -- will be the integration of stakeholder groups on the Board and, eventually, those legislative reforms which will guarantee stakeholders formal recognition as part of those that create value for the corporation. When achieved, this will signal the definitive consolidation of the corporate paradigm shift to sustainability. It will reflect that the Board has become statutorily accountable not only to shareholders, but also to stakeholders.

44. White, *The Stakeholders Fiduciary*, Pg. 7

SYSTEMATIC ENGAGEMENT OF STAKEHOLDERS AT DEUTSCHE TELEKOM

The Management Board of Deutsche Telekom keeps a continuous, direct and open dialogue with all stakeholders interested in the implementation of the ten Global Compact principles. Furthermore the Management Board gets regular information from the CSR Department and the high-level CSR Board on the company's ecologic and social measures. Deutsche Telekom launched a new approach to including its customers into its implementation of social and environmental objectives: a long term sustainability campaign seeking customers support and raising customers' awareness for sustainable behavior with the Motto: “Big Changes start small” (www.millionen-fangen-an.de)

The Engagement of Boards of Directors in the Global Compact

Voluntary initiatives have played a decisive role in the advancement of ESG concerns and sustainability. They will continue to play a central role in the transition to the next level: to the stage where the Board of Directors ensures the long term growth of the company, incorporating and fully integrating sustainability into the mission, strategy and daily operations of the company.

In this respect, the Global Compact, with its convening power and aspirational objectives, is well positioned to play a leading role. Its call will be matched with success. Companies actively participating in the Global Compact, under the leadership of committed CEOs, are already striving to progress along the path of corporate citizenship and provide a fertile ground to advance progress towards the widespread acceptance by Boards of the ESG and sustainability goals of the company.

The full engagement of Boards in the Global Compact will be gradual. A higher level of engagement from the Board of Directors in sustainability issues seems to be a necessary step to secure the centrality and continuity of the commitment to the Global Compact. Exactly how this is achieved is a matter for each company to determine, given their unique operational components.

Below are our final recommendations -- from basic moves advocating the involvement of Boards in the Global Compact, to more advanced and aspirational goals

- a) The Global Compact should continue to upgrade the place it assigns in its literature to the role of Boards of Directors within the leadership model. CEOs and Boards should both be considered an integral part of the leadership coalition for sustainability within the company. The consequences should include greater attention to the process by which, under the leadership of the company's top management and CEOs, Boards increase their involvement and engagement in the sustainability aspects of the company's performance, and specifically, in the progress achieved in the implementation of the Global Compact principles. The role
- of Boards should be further researched and explored in the annual review exercises of the Global Compact. The official introduction of the Global Compact webpage, the Communication on Progress (COP) policy document, the publication *After the Signature* and the "Performance Model" of the Global Compact should be updated accordingly, to include the role and commitment of the Board. This, in itself, will send a powerful signal to Global Compact participants.
- b) Deeper engagement of Boards of Directors in the Global Compact is a dynamic process, whereby each company has to write its own history. A salient conclusion of this paper is that the engagement of the Board represents an irreversible step in the process of mainstreaming sustainability within the company. As a good example of championship, the COP policy should encourage disclosure on how the Board is involved in the strategic oversight and monitoring of sustainability and the Global Compact implementation within the company.
- c) Leading companies participating in the Global Compact should be encouraged to have their Board endorse the sustainability report -- and the COP -- of the company. A signature on behalf of the Board will serve as a de facto statement that the Board has started to integrate ESG concerns into its oversight, or at least is aware of what the company is doing in this regard.
- d) The report should include not only traditional sustainability reporting measures, but also new metrics which clearly show the materiality of the non-financial per-

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formance of the company. As participants in GCLead have suggested, the emergence of a new generation of reporting which captures the materiality of non-financial aspects of the company's performance must be a collaborative learning process within the Global Compact.

e) There are other important actions which would signal an advanced level of Board implementation of the Global Compact. They relate to the need to take ESG aspects into account within the fiduciary roles of the Board, specifically, in four important areas:

- Include sustainability goals as criteria in compensation policies for top management.
- Draft succession policies that are conducive to the selection of CEOs who are fully aware of the challenges and opportunities of pursuing sustainability.
- At the time of renewal, Boards should strive to include new members that are familiar and committed to ESG concerns, and create a fair representation of the geographical, gender and cultural diversity of the company.
- Educate and train Board members on ESG and sustainability matters. The Principles for Responsible Investment and the Principles for Responsible Management Education should launch a joint effort with the Global Compact to train Directors of Boards on ESG concerns.

f) The extension of the role of Boards to create a systematic dialogue with stakeholders should be considered an important milestone.

g) Finally, while the good practices of publishing a separate sustainability report (and COP) of the company should be observed, in the longer run, the Global Compact should advocate the integration of relevant performance aspects of the sustainability reporting and the COPs into the annual report that the company presents to its shareholders. An integrated report should be considered a signal of the complete integration of sustainability into the "DNA" of the company.

The Ten Principles of the United Nations Global Compact

HUMAN RIGHTS

- Principle 1 Businesses should support and respect the protection of internationally proclaimed human rights; and
Principle 2 make sure that they are not complicit in human rights abuses.

LABOUR

- Principle 3 Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining;
Principle 4 the elimination of all forms of forced and compulsory labour;
Principle 5 the effective abolition of child labour; and
Principle 6 the elimination of discrimination in respect of employment and occupation.

ENVIRONMENT

- Principle 7 Businesses are asked to support a precautionary approach to environmental challenges;
Principle 8 undertake initiatives to promote greater environmental responsibility; and
Principle 9 encourage the development and diffusion of environmentally friendly technologies.

ANTI-CORRUPTION

- Principle 10 Businesses should work against corruption in all its forms, including extortion and bribery.

