ESG

A guide for Directors

June 2022

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Foreword

Environmental, social and governance (**ESG**) issues are critical for all boardroom leaders today who are focused on long-term value creation. The effective management of ESG risks and opportunities is no longer just about 'doing good'; it is a key business imperative.

Over the past five years, we have witnessed a significant expansion of ESG voluntary and mandatory regulation and enforcement activity at the international and domestic level, particularly with respect to ESG reporting and disclosure. Stakeholder expectations with respect to how organisations respond to ESG-related risks and their contribution to ESG impacts have likewise sharpened.

A growing number of investors and shareholders are insisting on demonstrated leadership on, and planning for, the net-zero transition and more robust climate risk management across short, medium and long-term horizons. Socially-conscious consumers are increasingly voting with their wallets, making retail choices based on a company's sustainability profile, ethos and workplace practice. Young employees are placing a premium on whether a company's values align with their own.

There is no question that effective ESG oversight is a key expectation and core competency of the modern company director.

Boards who do not embrace this new reality risk exposing their companies, and in some cases themselves, to significant reputational and financial risk and adverse regulatory action. Conversely, boards that proactively seek to integrate effective ESG management into their decision-making will better position their companies to compete for capital and to realise the associated benefits of enhanced brand reputation, increased shareholder satisfaction and attraction and retention of top talent.

We have developed this guide to assist directors to identify and capitalise on ESG opportunities and to develop a leading ESG risk and compliance culture across their organisation.

I hope you find it useful.

Gavin MacLaren

Senior Partner and CEO
Corrs Chambers Westgarth

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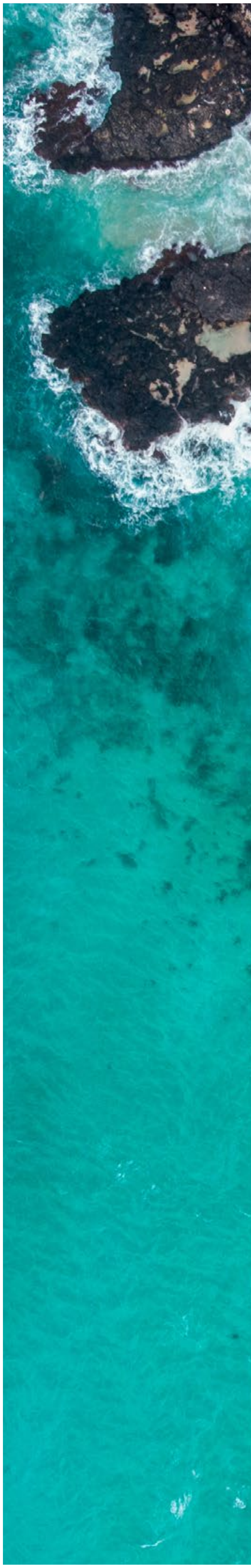


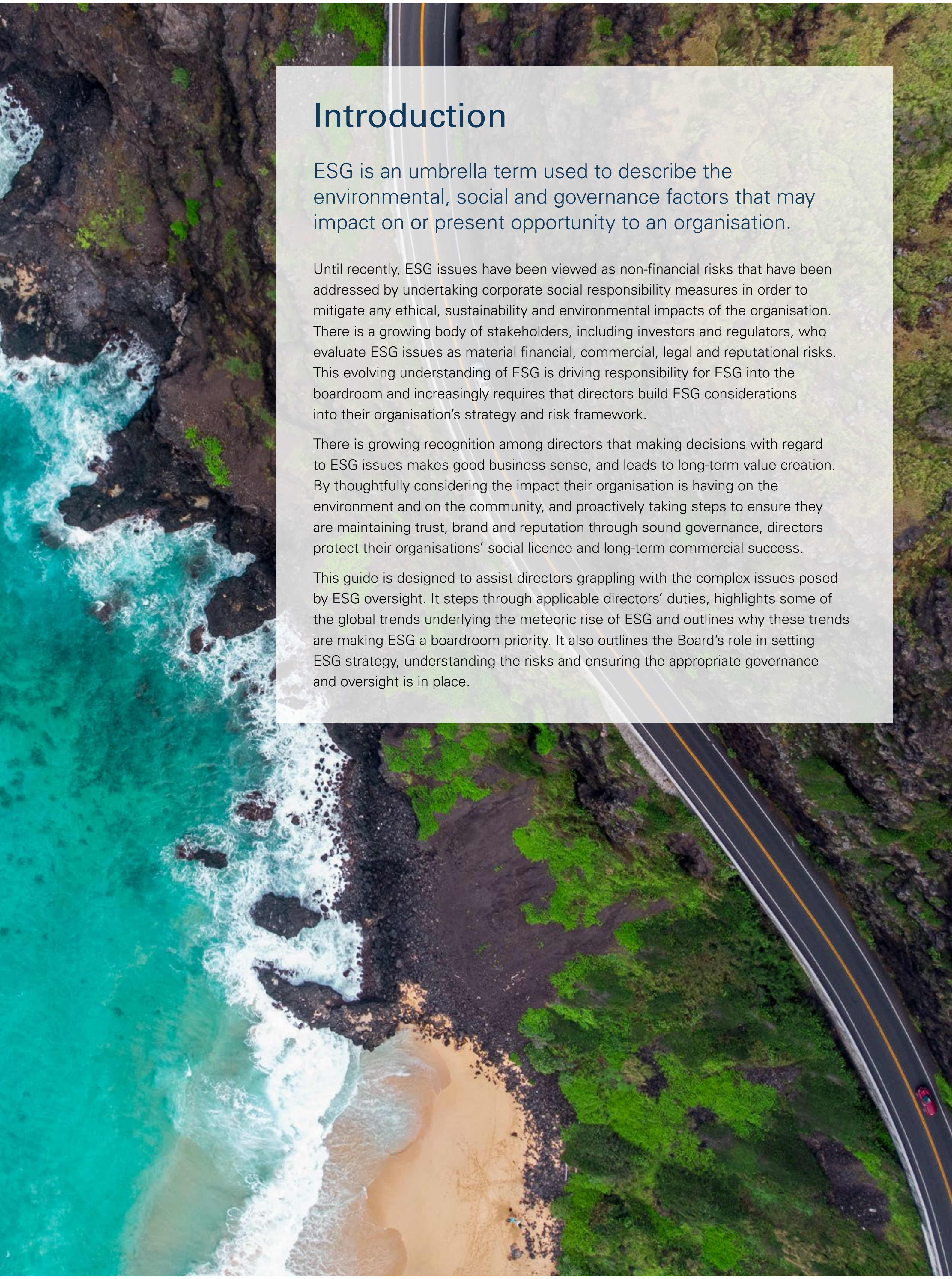
Introduction

ESG is an umbrella term used to describe the environmental, social and governance factors that may impact on or present opportunity to an organisation.

Until recently, ESG issues have been viewed as non-financial risks that have been addressed by undertaking corporate social responsibility measures in order to mitigate any ethical, sustainability and environmental impacts of the organisation. There is a growing body of stakeholders, including investors and regulators, who evaluate ESG issues as material financial, commercial, legal and reputational risks. This evolving understanding of ESG is driving responsibility for ESG into the boardroom and increasingly requires that directors build ESG considerations into their organisation's strategy and risk framework.

There is growing recognition among directors that making decisions with regard to ESG issues makes good business sense, and leads to long-term value creation. By thoughtfully considering the impact their organisation is having on the environment and on the community, and proactively taking steps to ensure they are maintaining trust, brand and reputation through sound governance, directors protect their organisations' social licence and long-term commercial success.

This guide is designed to assist directors grappling with the complex issues posed by ESG oversight. It steps through applicable directors' duties, highlights some of the global trends underlying the meteoric rise of ESG and outlines why these trends are making ESG a boardroom priority. It also outlines the Board's role in setting ESG strategy, understanding the risks and ensuring the appropriate governance and oversight is in place.



01

Directors' duties and ESG

Directors of Australian companies are bound by a number of fiduciary duties defined under general law and codified in the *Corporations Act 2001* (Cth) (**Corporations Act**). It is now widely accepted that environmental, social and governance (**ESG**) issues present myriad risks and opportunities that directors are increasingly expected to identify, consider and ensure their organisation manages in discharging these duties.

There are two principal duties that are relevant to directors' obligations to address ESG risks and opportunities:

- The duty to exercise powers with reasonable care and diligence
- The duty to act in good faith in the best interests of the company

Duty of care and diligence

When assessing whether a director has acted in accordance with their duty of care and diligence, a court will apply an objective 'reasonable person' standard. This involves characterising the director's conduct against what a reasonable person in the director's position **ought** to have done, by reference to the company's circumstances, industry practice and market expectations.

The matrix of factors applied to contextualise and characterise directors' duties will be reflective of, and responsive to, the activities in which the company engages and the ESG risks it faces, societal and stakeholder expectations around best practice management of ESG risks and opportunities. As the ESG landscape evolves, so too does the standard of care directors are expected to meet in identifying, assessing and addressing ESG risks and opportunities. The rapid pace at which the landscape of ESG regulation is developing in Australia and globally, and the shifting sands of market expectations, demands a high degree of vigilance from directors.

Acknowledging that managing ESG will form a core component of director's duties to exercise due care and diligence, the question remains:

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What does the reasonable management of ESG risks look like in the current context?

The degree of care and diligence required of a director will depend upon the nature and extent of the foreseeable risk of harm. ESG matters that carry material and well-understood risks for an organisation will likely be considered by a court to be foreseeable.

It is essential that Boards have the capacity to identify ESG risk and to inform themselves of the standards expected. Board composition should be considered in that light. Importantly, however, as with financial risk, each individual director is required to have a minimum level of ESG literacy. The responsibility cannot be wholly devolved to others. Moreover, the availability of defences such as the 'business judgement defence' will turn on whether the director can demonstrate that they made an informed judgement as to the ESG issues faced by the company.

Duty to act in the best interests of the company

The duty to act in good faith in the best interest of the company extends beyond simply maximising profit.[1]

As Commissioner Hayne observed in the context of the Banking Royal Commission:

> "The duty to pursue profit is one that has a significant temporal dimension. The duty is to pursue the long-term advantage of the enterprise. Pursuit of long-term advantage (as distinct from short-term gain) entails preserving and enhancing the reputation of the enterprise".[2]

This perspective frames the matters the Board needs to consider as encompassing the full spectrum of ESG – from the emergence of a corporate opportunity to the perception of a foreseeable risk of harm, including reputational harm.

Mismanagement of ESG risks and opportunities may have negative reputational consequences and impact the organisation's standing within the global marketplace, which in turn may affect the organisation's short and long-term profitability and operational viability. As such, acting in the best interests of the company will often require directors to advance, or at the very least consider, the interests of the environment and communities in which the company operates, as these stakeholders' interests will have significant scope to impact the company's reputation in an ethically conscious-market.

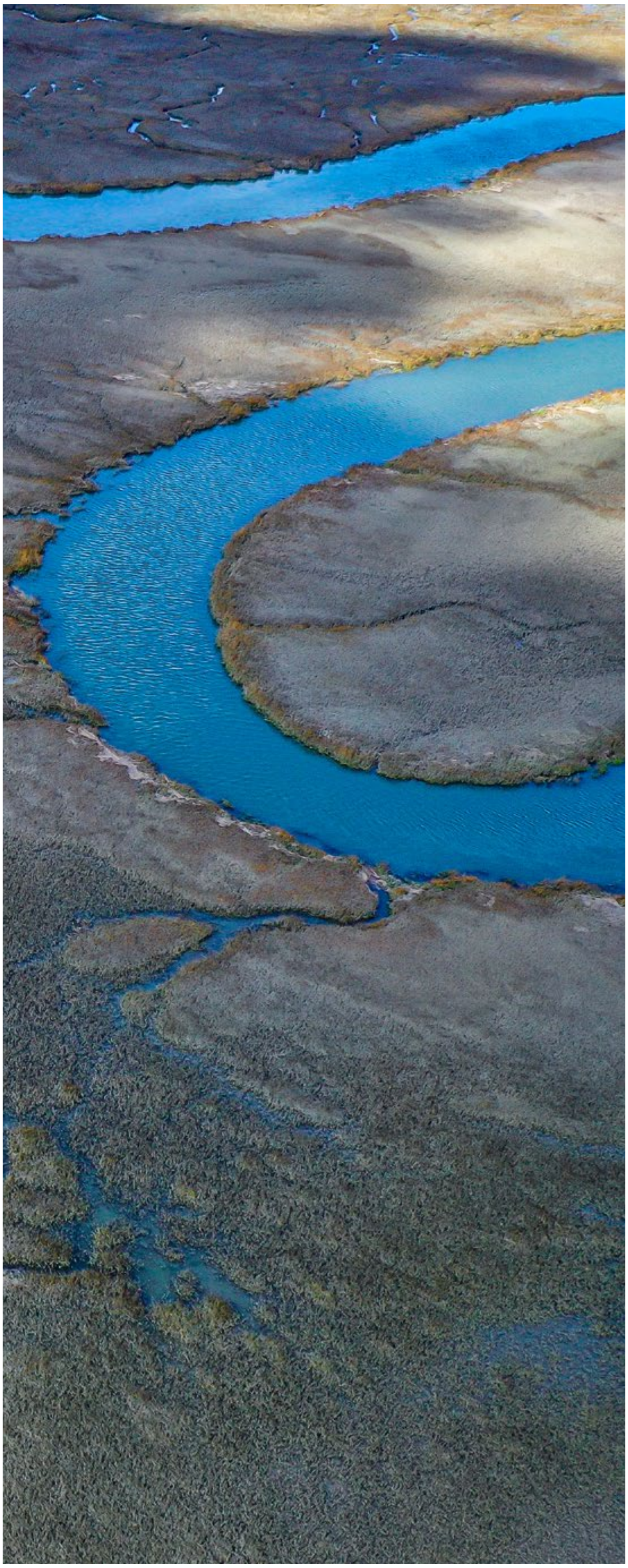
1 See, for example, Noel Hutley SC and Sebastien Hartford-Davis, Centre for Policy Development and Future Business Council Climate Change and Directors' Duties, *Memorandum of Opinion*, 23 April 2021.

2 See Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim Report Vol. 1*, 2019, p 55.

Directors and 'greenwashing' liability risks

Greenwashing

Greenwashing' encompasses a wide range of actions that exaggerate the 'green' credentials of companies and financial service providers. At its most innocent, greenwashing is marketing spin that creates a favourable impression about a company or its products. At its worst, it is conduct that misleads and deceives investors and customers.



Boards globally are facing heightened pressure from consumers and investors to make net zero commitments and establish and enact energy transition strategies aligned to Paris Agreement targets. Similarly, market expectations around ESG reporting are increasing, particularly with respect to disclosure of climate change-related risks and impacts.

While it is important that organisations provide detailed and transparent disclosure of the ESG risks relevant to the organisation and how it is responding to those risks, directors should be cognisant that these disclosures have the potential to give rise to personal liability risks for their involvement in the organisation's misleading and deceptive conduct and false or misleading statements under the Corporations Act and the Australian Consumer Law (**ACL**) in some circumstances.

Overstating an organisation's climate-friendly credentials, or understating its exposure to human rights risks, investors, suppliers or customers – including unrealistic representations about net zero goals or emission reduction targets – are examples of the kind of matters that may expose directors to action by regulators, shareholders and activists.

To safeguard against greenwashing claims and avoid regulatory scrutiny, directors should ensure ESG commitments and ESG-related disclosures to the market are clear, accurate and substantiated by robust verification processes.

Questions Boards and directors should ask of their organisation

01 Set strategy

Is ESG integrated into your organisation's strategy and risk oversight? ESG should no longer be a standalone sustainability initiative separated from broader strategic and operational activities.

02 Understand risks

Has a comprehensive enterprise-wide risk assessment of ESG risks for your organisation been undertaken? Does it also incorporate consideration of the environmental and social impact of your operations and supply chains? Are material ESG risks included in your organisation's risk matrix?

03 Review requirements and principles

Has a review of the ESG regulatory and compliance requirements that apply to your organisation been undertaken? Did it address relevant stakeholders and their current and future expectations? Ensure that Board approved ESG principles are established in order to guide strategy and decision-making.

04 Build a governance framework

Has a robust ESG governance framework been established? Have appropriate policies and procedures been put in place and are they supported by enterprise-wide implementation, including monitoring and reporting mechanisms, to ensure that appropriate risks are elevated to the Board for consideration?

05 Ensure continuous improvement

Have regular reviews been established to ensure delivery on strategy? Don't be tempted to set and forget. ESG is rapidly developing, the regulatory environment across many jurisdictions is changing and the impact on your organisation will continue to evolve.

02

The rise of ESG

Capital and business opportunities are increasingly flowing to organisations that are seen to hold themselves accountable by considering their environmental and social impacts, and by governing with integrity and transparency.

Beyond the generalised pressure to apply responsible business practice, there are a number of reasons why ESG is of increasing interest to organisations and their directors.

Expanding regulation

ESG regulation in domestic and international settings is increasing in both volume and complexity. The move towards adoption of voluntary reporting is resulting in normative shifts. And now, several jurisdictions are implementing mandatory ESG disclosure requirements while ESG-focused regulation continues to increase, particularly for environmental protections. This trend has been intensified by the redirection of global capital flows in favour of 'ESG positive' ventures creating a strong desire for consistent measurement standards and approaches to disclosure.

In Australia, several influential industry groups have published voluntary guidelines, regulation is expected to increase at State and Federal level and enforcement agencies have indicated their intention to increase scrutiny of ESG issues. Directors and management need to closely monitor these developments to position the organisation to adapt to new regulatory requirements as they arise.

Accelerating regulation of climate change and sustainability, nature and biodiversity, human rights and financial crime such as anti-bribery and corruption, anti-money laundering and counterterrorism require particular attention.

Climate change and sustainability

Climate change-related regulation is developing at a rapid pace, reflecting the now widely-held view that the impacts of climate change and the race to net zero will radically alter the global economy and prevailing social and political structures.

While there is minimal direct statutory regulation of climate risk in Australia at present, reporting of exposure to and management of climate risks is becoming best practice among Australian organisations, and is increasingly expected by corporate regulators. Key developments to note are:

- ASIC has identified 'climate change risk governance and disclosure' and 'sustainability financial reporting and audit' as strategic priorities in its Corporate Plan 2021-2025. ASIC has confirmed that it will seek to engage with the Federal Government, international peer regulators (such as the International Organisation of Securities Commissions) and industry bodies (such as the Task Force on Climate-Related Financial Disclosures (**TCFD**), and the Australian Sustainable Finance Initiative) to develop a clear Australian corporate regulatory response to climate risks. Continued surveillance to identify greenwashing practices in the marketing of financial products will also continue to be a key focus for ASIC.
- The Australian Competition and Consumer Commission (**ACCC**) has identified ESG claims, and green marketing and greenwashing, as a key strategic focus in the context of enforcing the Australian Consumer Law (**ACL**) from 2022.
- The Australian Prudential Regulation Authority (**APRA**) has published its *Prudential Practice Guide on Climate Change Financial Risks*[3] in order to assist APRA-regulated entities in managing material financial climate-related risks exposures. APRA is also due to release information about the results of its climate self-assessment initiative in the near future.
- Industry bodies such as the Australian Institute of Company Directors (**AICD**) and the Governance Institute of Australia (**GIA**) have published guidance to assist boards, directors and officers in understanding and implementing climate-related disclosure obligations.[4] The GIA's Climate Change Risk Disclosure guide was produced in direct response to the ASX Corporate Governance Council's publication of the Corporate Governance Principles and Recommendations (4th Edition), which require ASX-listed companies to consider and disclose any material exposure to environmental or social risks and how they manage, or intend to manage, those risks.

On balance, the position of Australian regulatory and industry bodies is clear – climate-related disclosures will be required wherever climate risk is a material issue that could affect the company's financial performance. At a minimum, organisations should consider whether they have material exposure to physical risks (e.g. changes in water availability, food security or extreme weather events) or transition risks (e.g. policy and legal risks, technological risks and reputational risks).

3 Australian Prudential Regulation Authority, *Prudential Practice Guide - CPG299 Climate Change Financial Risks* (November 2021), accessible here.

4 See the Australian Institute of Company Directors, *Climate Risk Governance Guide* (August 2021), accessible here; the Governance Institute of Australia, *Climate Change Risk Disclosure* (February 2020), accessible here.

Recent international regulatory developments

July 2020

In July 2020, the Hong Kong Stock Exchange (**HKEX**) introduced new ESG reporting requirements for listed companies, with both mandatory disclosure requirements and 'comply or explain' provisions. HKEX-listed companies must provide a statement setting out the Board's consideration of ESG matters, an explanation of the application of various ESG reporting principles and the reporting boundaries of their ESG report. The 'comply or explain' provisions require disclosure of significant climate-related issues which have or may impact the company and disclosure of practices used to identify environmental and social risks in the entity's supply chain.

June 2021

In June 2021, Japan revised its Corporate Governance Code and the Engagement Guidelines to require enhanced climate-related disclosures in line with the TCFD recommendations for 'Prime' listed companies.

March 2022

The International Sustainability Standards Board (**ISSB**), established by the IFRS Foundation at COP26 to develop a global baseline of sustainability financial disclosures for capital markets, launched its first proposed sustainability standards for consultation on 31 March 2022. The ISSB released two exposure drafts – one relating to disclosure of sustainability-related financial information and the other concerned with climate-related disclosures. The proposed standards have the potential to create uniformity in the disclosure of financial information about sustainability and climate-related risks and opportunities. The ambition of the ISSB is to have completed the necessary institutional and technical standard-setting work to establish the core elements of the global baseline by the end of 2022.

March 2021

In the EU, from March 2021, asset managers and other financial markets participants must report under the European Commission's Sustainable Finance Disclosure Regulation.

October 2021

In October 2021, New Zealand passed the Financial Sector (*Climate-related Disclosures and Other Matters*) *Amendment Act 2021* (**FSAA**), which will require approximately 200 reporting entities with a high level of public accountability (such as listed issuers, large banks, licensed insurers and managers of registered investment schemes) to make disclosures in relation to climate-related risks and opportunities in line with TCFD recommendations.

March 2022

In March 2022, the US Securities Exchange Commission (**SEC**) proposed mandatory climate-risk disclosure rules for public companies which are currently open to public comment.

May 2021

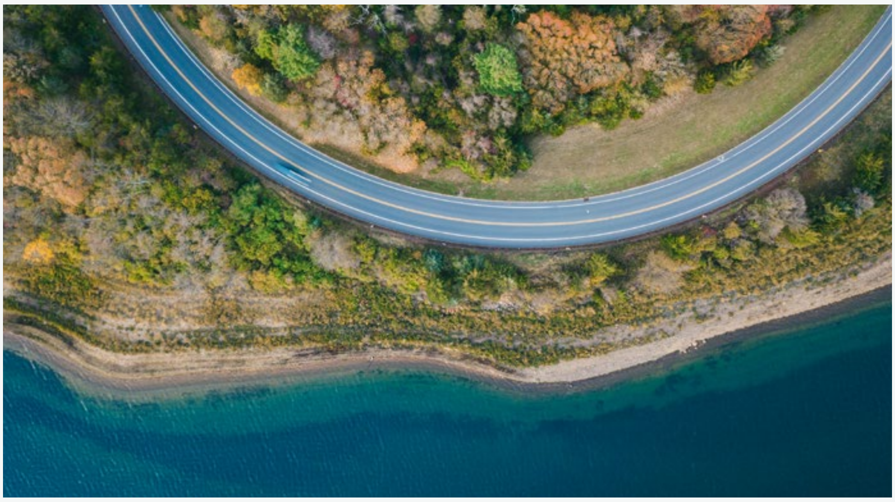
In May 2021, the Securities and Exchange Board of India announced that it would require the top 1000 listed companies to report on their ESG parameters. From FY22/23, these companies will be required to submit a Business Responsibility and Sustainability Report. Disclosure under the reporting framework are classified as either 'essential' (mandatory) or 'leadership' (voluntary).

February 2022

In February 2022, the European Commission published the proposed Directive on Corporate Sustainability Due Diligence (**Directive**). If passed by member states, the Directive will require large organisations registered in, or with significant operations in, the EU to undertake extensive mandatory environmental (and human rights) due diligence on their operations and supply chain. If the Directive is adopted, member states will be required to incorporate the requirements of the Directive into national law.

April 2022

In April 2022, through new regulations, the UK became the first G20 country to require large businesses to disclose climate-related risks using the TCFD framework.



Anti-bribery and corruption

Australia has been a signatory to the Organisation for Economic Co-operation and Development (**OECD**) Convention on Combatting Bribery of Foreign Public Officials in International Business Transactions since 1999, and ratified the Convention by way of Division 70 of the *Criminal Code Act 1995* (Cth) (**Criminal Code Act**). There are significant penalties for bribing a foreign public official. Individuals may face a lengthy prison sentence and/or fine, while corporate offenders are exposed to very significant fines and a requirement to forfeit any benefits obtained.

The OECD Working Group on Bribery in International Transactions conducts periodic assessments of Australia's implementation of the Convention. In its most recent report, the Working Group stated that it remains 'concerned about the continued low level of foreign bribery enforcement in Australia given the size of Australia's economic and the high risk regions and sectors in which its companies operate'.[5]

In response to the Working Group's recommendations, the previous Australian Federal Government introduced the Crimes Legislation Amendment (Combatting Corporate Crime) Bill, which would have amended the foreign bribery offences under the Criminal Code Act to:

- remove impediments to prosecution;
- introduce a new corporate offence for failing to prevent foreign bribery; and
- implement a deferred prosecution agreement scheme for foreign bribery offences.

The Bill lapsed when the May 2022 Federal Election was called and it is not yet clear whether similar reforms will be introduced by the new Federal Government. Policy announcements to date have focused on the introduction of a new federal anti-corruption commission by the end of this year.

Any future requirement for companies to have an effective anti-bribery and corruption compliance program to avoid prosecution under a 'failure to prevent' offence is likely to increase scrutiny of such measures. In the interim, the Australian Federal Police and Commonwealth Director of Public Prospections' *Best Practice Guideline: self-reporting of foreign bribery and related offending by corporations*,[6] offers relevant guidance for directors.

Anti-money laundering and counterterrorism financing

Anti-money laundering and counterterrorism financing (**AML/CTF**) enforcement risks continue to be a key focus for regulated entities in Australia in light of the significant penalties associated with non-compliance.

As AML/CTF regulation in Australia continues to evolve, particularly in respect of emerging regulation for digital currencies, it will be increasingly important for directors to remain informed and engage appropriate expertise to ensure the organisation's internal policies and processes align with current AML/CTF best practice.

In March 2022, the Senate's Legal and Constitutional Affairs Committee published a report recommending an extension of Australia's AML/CTF regime to so-called 'gatekeeper professions' (e.g. real estate agents, lawyers, accountants and traders in high-value goods). When introduced, these professions will need to take steps to identify, mitigate and manage the money laundering and terrorism-financing risks faced by their business. They will also likely be required to make reports about AML/CTF matters, such as suspicious transactions, to AUSTRAC or another regulatory body.

Nature and biodiversity

Of interest to future facing directors will be emerging reporting and disclosure practices in relation to nature-related impacts, opportunities and risks. In 2021, the Taskforce on Nature-related Financial Disclosures (**TNFD**) was established to develop an international standard on nature-related risk disclosure, modelled on the TCFD framework. The TNFD released its Beta framework in March 2022, which includes draft disclosure recommendations and guidance for assessing nature-related risks and opportunities.[7]

Biodiversity risk assessment and regulation will be a focal point of global policy in the second half of 2022, in the lead up to the second half of the UN Biodiversity Conference (COP 15) in October 2022.[8] The Conference convenes parties to the Convention on Biological Diversity (including Australia), and will aim to agree to a new post-2020 Global Biodiversity Framework.

5 OECD, Addendum to Phase 4 Follow-Up Report Australia (1 December 2021), accessible here.

6 CDPP and AFP, *Best Practice Guideline: Self-reporting of foreign bribery and related offending by corporations* (20 December 2017), accessible here.

7 TNFD, *The TNFD Nature-related Risk and Opportunity Management and Disclosure Framework Beta v0.1 Release* (March 2022), accessible here.

8 The Secretariat of the Convention on Biological Diversity released the First Draft of the Post-2020 Global Biodiversity Framework for consultation on 5 July 2021, accessible here.

Human rights

The UN Guiding Principles on Business and Human Rights (**UNGPs**) are the key international standards which have shaped businesses' voluntary reporting on business-related human rights impacts since their endorsement by the UN Human Rights Council (**UNHRC**) in 2011. The unanimous endorsement of the UNGPs by the UNHRC has created an expectation that organisations consider and act on their human rights impacts.

While the UNGPs are voluntary guidance for organisations, they are increasingly being incorporated into mandatory legislation, such as *Australia's Modern Slavery Act 2018* (Cth). In the past five years, a number of jurisdictions have introduced mandatory human rights due diligence and reporting requirements:

- The Australian Modern Slavery Act 2018, modelled off the UK modern slavery act, requires organisations carrying on business in Australia, and with an annual consolidated revenue of more than A$100 million, to report on actions taken by the organisation to identify, assess and address the risks of modern slavery in their operations and supply chains.
- The *Customs Amendment (Banning Goods Produced By Forced Labour) Bill* (2021) was passed by the Senate in August 2021. Similar legislation was passed in the US in March 2022. If passed by the House of Representatives, this bill would prohibit the importation into Australia of any goods made using forced labour. It is likely that the new Labor Government will support this Bill.

International regulatory developments – Human rights

In **France**, the Duty of Vigilance Law, introduced in 2017, goes further and requires organisations to develop and implement an annual 'vigilance plan' describing the steps the organisation is taking to prevent and mitigate human rights and environmental harms caused by a company's operations. The legislation establishes a duty on corporations (by way of their directors and officers) to exercise due care and diligence where undertaking actions which could foreseeably harm human rights or the environment.

In 2021, **Germany and Norway** introduced legislation requiring large organisations to undertake mandatory human rights due diligence on their operations and supply chains. The laws impose regular reporting obligations requiring organisations to identify risks, business responsibilities and the measures taken to mitigate the human rights impacts of their operations.

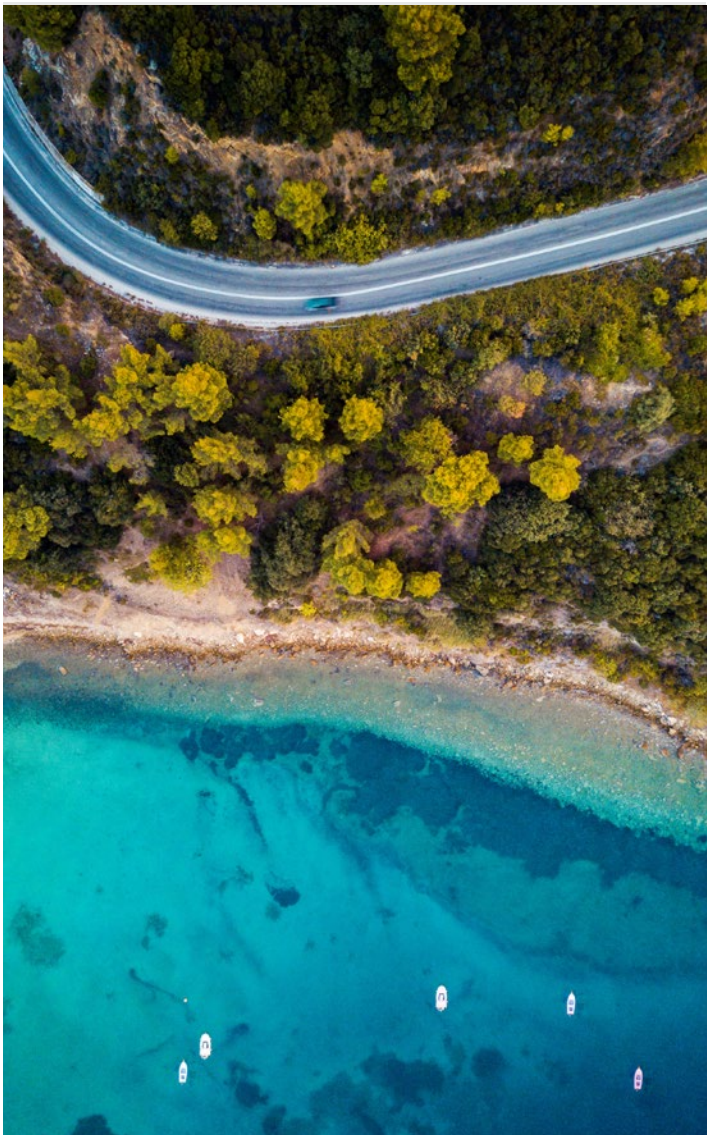
Introduced in 2022, the **European Commission's** proposed Directive on Corporate Sustainability Due Diligence will, if passed by member states, require large organisations registered in or with significant operations in the EU to undertake extensive mandatory human rights due diligence on their operations and supply chain.

In the **US**, the Uyghur Forced Labor Prevention Act was passed in 2021 and will come into effect on 21 June 2022. The Act introduces a rebuttable presumption that all goods produced or manufactured in Xinjiang were made using forced labour and are therefore prohibited from being imported into the US. Any organisation seeking to import goods from Xinjiang must establish that the goods were not produced with forced labour for the purposes of section 307 of the Tariff Act 1930. The Act also requires the Forced Labor Enforcement Task Force to develop and submit to US Congress a strategy to better support the enforcement of section 307 of the Tariff Act by US Customs and Border Protection.

Litigation and shareholder activism on the rise

The demand for responsible business conduct in the context of ESG, and recognition of the material financial and operational risks that accompany failures to adopt best practice ESG risk management, has led to a surge of ESG-related litigation and shareholder activism.

Growing stakeholder awareness of ESG issues combined with the urgency with which we are now required to respond to climate change, has created the conditions for a significant global increase in climate-related litigation. This trend is complemented by a growing appetite among shareholders to ensure the organisations they invested in reflect their values, and where they fail to do so, to influence corporate decision-making through shareholder activism.



Litigation

The number of climate change litigation cases has more than doubled since 2015. Five key categories of claims are emerging which require the attention of Boards and directors:

1. Claims against governments – challenges to policies, government approvals and/or funding grants and transnational contractual disputes[9] may impact or curtail corporate strategy, undermine social licence or retrospectively affect approvals or grants issued in respect of specific projects or proposals.
2. Actions against major greenhouse gas emitters – akin to the recent action brought against Royal Dutch Shell Plc in the Netherlands, which alleged that Shell owed a duty of care to reduce its emissions in line with the Paris Agreement targets, the Dutch court found that Shell's corporate policies and proposed emissions reductions goals would not meet the standard of care, in part due to the fact that they did not conform to the Paris Agreement targets.
3. Actions against companies and directors for greenwashing and climate-related misrepresentations – as stated above, misleading and deceptive conduct (**MDC**) claims under the ACL and Corporations Act are currently a key regulatory focus for ASIC and the ACCC.
4. Actions against companies, directors and advisers regarding directors' duties and disclosures – alleging failures to identify, assess and disclose material climate-related risks. It is anticipated that breach of fiduciary duties, resulting from an alleged failure to act in the best interests of the organisation and its shareholders, will be the primary vehicle for claims in this category.
5. Challenges to project approvals and/or proponent appeals – where a proposed project is associated with significant greenhouse gas emissions.

As fiduciaries and corporate leaders, directors have power with respect to, and are seen to be responsible for, their companies' ESG performance. Therefore, they may be exposed to personal liability and heightened scrutiny of decisions on ESG issues.

9 For example, host State-investor disputes.

ClientEarth legal action

In March 2022, ClientEarth commenced novel legal proceedings against the directors of an oil and gas super major, alleging that they failed to adopt and implement a climate strategy aligned with the Paris Agreement targets in breach of their directors' duties under the UK Companies Act. The first-of-its-kind litigation will consider whether directors can be held personally liable for failing to take steps to adequately manage climate risk and prepare for the energy transition under UK law.

ClientEarth alleges that the directors breached their duty to act in a way that promotes the company's success, and to exercise reasonable care, skill and diligence by pursuing a corporate strategy that endangers employees' jobs and the long-term viability of the company.

The non-government organisation (**NGO**) is pursuing shareholder litigation to compel the Board to put in place sufficient targets to reduce emissions over the next three, five and ten years, to meet net zero targets and protect the enduring commercial success of the company.

Shareholder activism

In Australia, shareholder activism is on the rise and predominantly manifesting in two approaches:

1. Economic activism – where shareholders seek to influence the corporate strategy of an organisation or specific business decisions to increase value.
2. Social activism – where shareholders seek to influence a company's operations, corporate strategy or business decisions relating to ESG risks, opportunities or impacts.

Shareholder activism can cause significant business disruption and reputational risk to organisations that fail to proactively engage. Australia's regulatory regime is broadly conducive to shareholder activism in that clear statutory rights are afforded to shareholders with a relatively small shareholding, such as calling shareholder meetings, nominating and removing directors, mandated votes on remuneration and requisitioning resolutions. This has been a particularly popular mode of action for activist shareholder groups seeking to promote the uptake of Paris Agreement-aligned emissions reductions targets.

ESG reporting and assessment is being utilised as a proxy to evaluate management, identify the risk and value of actual and prospective investments, and make decisions regarding the allocation of capital. As a result, it is essential that directors remain aware of the shareholder activist 'toolkit', and promptly and meaningfully engage with activist shareholder groups to minimise and mitigate the potential financial and reputational risks associated with activist shareholder campaigns.

Shifting expectations

Corporate investor, shareholder, consumer and employee expectations regarding what constitutes responsible business and best practice management of ESG matters has shifted markedly in recent years.

While the drivers of this shift have been broad and diverse, key influences have included:

- increasing scrutiny of the conduct of governments and corporates on ESG issues, resulting from the increased accessibility of information and mass communication tools like social media in the internet age;
- the impacts of climate change and other sustainability risks becoming realised in extreme weather and climate events such as floods, fires, droughts, coral bleaching and extinctions;
- climate change-related health implications for affected communities;
- the increasing popularity of socially-conscious consumer choices; and
- the recognition of robust management of ESG risk and opportunity as a proxy for good governance.

As a result, in 2022, boardrooms globally are being called on to respond to demands from investors and other stakeholders to assess and manage their organisations' ESG risks, opportunities and impacts, and ensure responsible business conduct.

Beyond shareholders, there are a range of stakeholders seeking to exert influence on corporate conduct on ESG issues using different levers, including:

- leveraging capital;
- voting against the re-election of directors at AGMS where those directors have failed to engage on key ESG issues;
- proposing shareholders resolutions including constitutional amendments;
- commencing strategic litigation;
- advocating for changes in corporate conduct on specific ESG issues through campaigns and briefings;
- demanding robust and transparent disclosures of material ESG-related risks; and
- exercising purchasing power to make socially-conscious choices and boycott the opposite.

Attracting human and financial capital

ESG is not just important for the purpose of managing risk. It is also a critical aspect of corporate feedstock: human and financial capital – the stuff that keeps business turning.

The allocation of **financial capital** to ESG funds is increasing at a rate that demands attention. Over US$500 billion flowed into ESG-integrated funds in 2021, contributing to a 55% growth in assets under management in ESG-integrated products. Momentum is projected to continue, with investors anticipated to, on average, double their allocation to sustainable assets under management in the next five years.[10] This effect is likely to intensify as ESG-related financial risk disclosures and reporting becomes more and more rigorous and standardised, indicating that access to capital will be increasingly contingent on robust engagement with ESG.

Human capital refers to the knowledge, skills, and health that people invest in and accumulate throughout their lives, enabling them to realise their potential as productive members of society and as productive contributors to a business whether as employees or consumers.[11]

An organisation's stakeholders are more equipped with knowledge on the operations and actions of companies than ever before. This heightened sensitivity is reflected in direct action by employees and consumers alike, demanding change by withholding labour, boycotting products, initiating action for greenwashing and misleading or deceptive conduct, launching social media campaigns and leveraging reputational damage to create change. Potential employees are also choosing where they want to work based on the organisation's alignment with their social and environmental values, and this flow of human capital to companies that are seen to be managing ESG risks and opportunities well is having a profound impact on investors.

The culture of an organisation, and its ability to deliver on the promise of being a safe, diverse and ethical workplace, should be front of mind for directors wanting to ensure that financial and human capital flows into their organisations.

10 S&P Global market Intelligence, *Most ESG funds outperformed S&P500 in early 2021 as studies debate why*, 16 June 2021.

11 The World Bank, The Human Capital Project, 8 October 2021.

Climate change and biodiversity loss as irreversible trends

Extreme weather events and other climate crises have highlighted the urgent need to rapidly decarbonise the global economy, and it is incumbent on boards and directors to act and adapt accordingly or face regulatory and market sanctions (such as the loss of social licence).

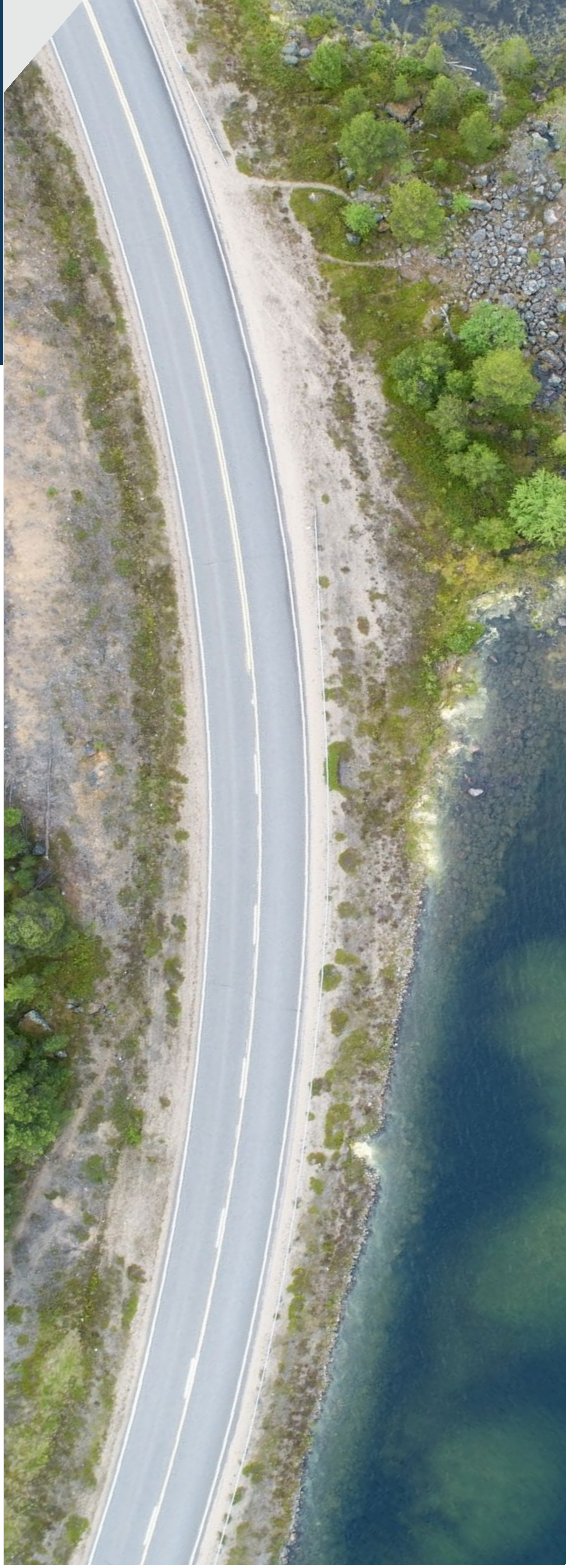
Concurrent and repeated hazards are making visible myriad climate change and biodiversity loss-related impacts and risks, and generating new sources of vulnerability for organisations. Hazards and risks cascading across sectors and regions can trigger tipping points, being a critical threshold at which point a change in systems, including to ecosystems, may be abrupt or irreversible.[12] For directors and officers, the key question becomes:

?

Do we have the requisite knowledge to make a decision in the best interests of the organisation?

Boards will need to engage relevant, multi-disciplinary expertise in order to equip themselves to assess the natural capital-related risks facing their organisation in the short, medium and long term. In addition to pursuing meaningful emissions reductions and decarbonisation strategies, organisations and their directors must simultaneously consider how to adapt to and mitigate the harms which may flow from the physical risks which may manifest if a material tipping point is reached.

At present, best practice risk assessment of the physical risks associated with climate change is robust scenario analysis and stress testing, where directors, management and external experts consider scenarios in which various global emissions tipping points material to their business are reached and assess the likely consequences for the organisation.



12 IPCC, Working Group II, Sixth Assessment Report, Impacts, Adaptation and Vulnerability (2022), accessible here; IPCC Glossary, accessible here.

03

The role of the Board

In recent years, the recalibration of ESG away from corporate social responsibility to addressing what are often material and foreseeable risks places ESG strategy directly in the boardroom.

Organisations should develop a coherent narrative in relation to ESG issues. This should be in a form that is easily communicated to both internal and external stakeholders in order to manage expectations and ensure communication is consistent in the face of constant and changing demands.

> We continue to see both internationally and in our own market an increasing focus on company matters that sit outside of traditional evaluative metrics and in particular, those matters concerning the environment, sustainability and/or governance...
>
> A salient question for boards and directors to ask now is therefore: 'how do we identify the risks and opportunities presented by this new environment and respond in a manner that is both consistent with the social contract under which we operate and nurturing of long-term business success?
>
> ASIC Commissioner John Price
> Keynote at the Centre for Policy Development: Financing a Sustainable Economy, 18 June 2018

Understanding the context and setting the strategy

Keeping up to speed with ESG issues, requirements and expectations is challenging given the rapidly evolving landscape. Trends draw attention and focus to certain concerns at different times but boards and directors must be across the range of ESG issues. Understanding the ESG context for the organisation is the first step to developing a strong ESG strategy. The Board should seek to understand the impact of the organisation's operations and strategy on the environment and community, and remain alert to the regulatory trends, shareholder activism and litigation risks that may impact them.

Once the Board has a robust understanding of the ESG environment relevant to the organisation, it should turn its mind to setting and enacting a coherent and integrated whole-of-organisation strategy for ESG engagement.[13]

An effective ESG strategy will be founded on a set of core principles which embody an organisation's position in relation to ESG issues, and how it will conduct itself in managing social, human and environmental capital. These principles should be supported by a cascading ESG framework of policies and guidance which inform risk assessment, due diligence, internal systems and processes, and disclosure and reporting by the organisation.

While each organisation's ESG framework must necessarily be bespoke and responsive to the risks and opportunities relevant to the market, sector or industry in which the organisation operates, an effective ESG strategy will generally:

- define the organisation's ESG principles and performance goals;
- articulate clear, measurable performance targets for each ESG goal (including defining the metrics for measuring progress against those targets);
- identify, assess and describe mitigation action plans for key ESG risks faced by the organisation;
- establish an ESG framework (made up of policies, systems and procedures, working groups and oversight committees, and allocate accountabilities to key roles) to drive progress towards the organisation's ESG performance goals and to oversee implementation; and
- establish internal processes for monitoring, auditing and reporting on ESG performance, and embedding ESG in the organisation's existing corporate reporting and stakeholder engagement processes.

It may be valuable for the Board to engage with expert advice, or directly with industry and regulatory bodies, to ensure the ESG strategy is responsive to the current market expectations and 'best practice' standards in the relevant sector.[14]

13 Boston Consulting Group, Interview with BlackRock CEO Larry Fink (June 2021), accessible here.

14 See, for example, APRA's *Prudential Practice Guide CPG 229 Climate Change Financial Risks* (November 2021), accessible here, and the Task Force on Climate-Related Financial Disclosures *Final Report* (June 2017), accessible here, among others.

Understanding the risk

The Board (and each director) has a critical role to play in incorporating ESG risks and responses into their organisation's overarching strategy and risk framework. Early implementation of a broad range of ESG risk identification and mitigation strategies will position an organisation well to respond to changes in global conditions and emerging or heightened ESG risks.

Given the complexity and rapidly shifting nature of ESG risks, it may be appropriate for Boards to engage external experts to undertake an independent review of the organisation's existing governance structures, policies and frameworks, operations, supply chain and existing ESG-related disclosures or representations to the market.[15]

Consideration should be given to the risks and opportunities facing the organisation across all facets of ESG, which include:

- regulatory and compliance risks;
- the organisation's impact on the environment and society throughout its value chain; and
- the potential impact of ESG risks and dependencies on the long term performance and viability of the organisation, or aspects of the organisation's operations.

The asset holding and operations of the organisation may also necessitate ESG risk assessment and subsequent due diligence on a portfolio or transactional level, so that existing or prospective investments, acquisitions and other transactions, major procurement decisions and other business activities are periodically evaluated for ESG risks.

ESG management review

Once the organisation's material ESG risks are identified and understood in-depth by the Board, it will be necessary for the Board and its legal advisors to consider whether the organisation's ESG risks are appropriately reflected in:

- the organisation's risk appetite statement;
- governance structures;
- ESG principles and performance targets;
- regulatory responses, including compliance with evolving regulatory requirements in the ESG space that may vary across different jurisdictions; and
- reporting processes, particularly in the scenario that specific ESG risks are identified as material risk exposures for an organisation.

To understand this, the Board should initiate a formal ESG review of the organisation as a whole, extending to its operations and supply chain. An ESG review can be undertaken internally or with the assistance of an independent third party. The ESG review should generally involve:

- consultation with the organisation's key stakeholders, including workforce and relevant community stakeholders, to ensure the strategy is developed in a way that is consistent with organisational priorities and responsive to stakeholder priorities and expectations;
- a review of the internal processes and policies underlying any existing ESG framework, ESG risk management and mitigation measures, and an assessment of the implementation and operational effectiveness; and
- identification of any gaps or blockers in the implementation of the organisation's ESG strategy, including in respect of whether the strategy and key actions are responsive to stakeholder expectations.

The ESG review process allows Boards to understand and prioritise the organisation's most salient ESG risks and opportunities, and thereby gives Boards the information they need to proactively manage ESG risks, ensure implementation of proportionate organisational responses and update (as appropriate) the organisation's ESG strategy. It will also help identify whether additional policies, procedures or personnel are required to facilitate collaboration and cross-functional expertise within the organisation, and whether investment is required in the development of appropriate internal expertise to support the ongoing maturity of the organisation's ESG risk management capabilities.[16]

15 This is noted particularly in respect of the elevated risk of greenwashing. 'Greenwashing' encompasses a wide range of actions that intentionally or inadvertently exaggerate the 'green' credentials of companies, financial service providers and their products or services. For a detailed discussion of corporate greenwashing, please see Corrs insight *Corporate 'greenwashing' the latest target for climate change litigation* (September 2021), accessible here, and ASIC's Corporate Plan 2021-2025, which cites greenwashing as a particular point of regulatory focus.

16 This may include ensuring appropriate education and training is available to upskill Board members, senior management and relevant employees, and that suitable cross-sectional expertise is engaged to advise upon relevant metrics, measurement and reporting of ESG performance targets, and to carry out due diligence, audits and compliance reviews as necessary.

Establishing governance and oversight

Boards and relevant board committees should receive periodic and ad hoc briefings and reports from management on material and emerging ESG risks, and on the risk controls and mitigation measures that management has put in place to address those risks.

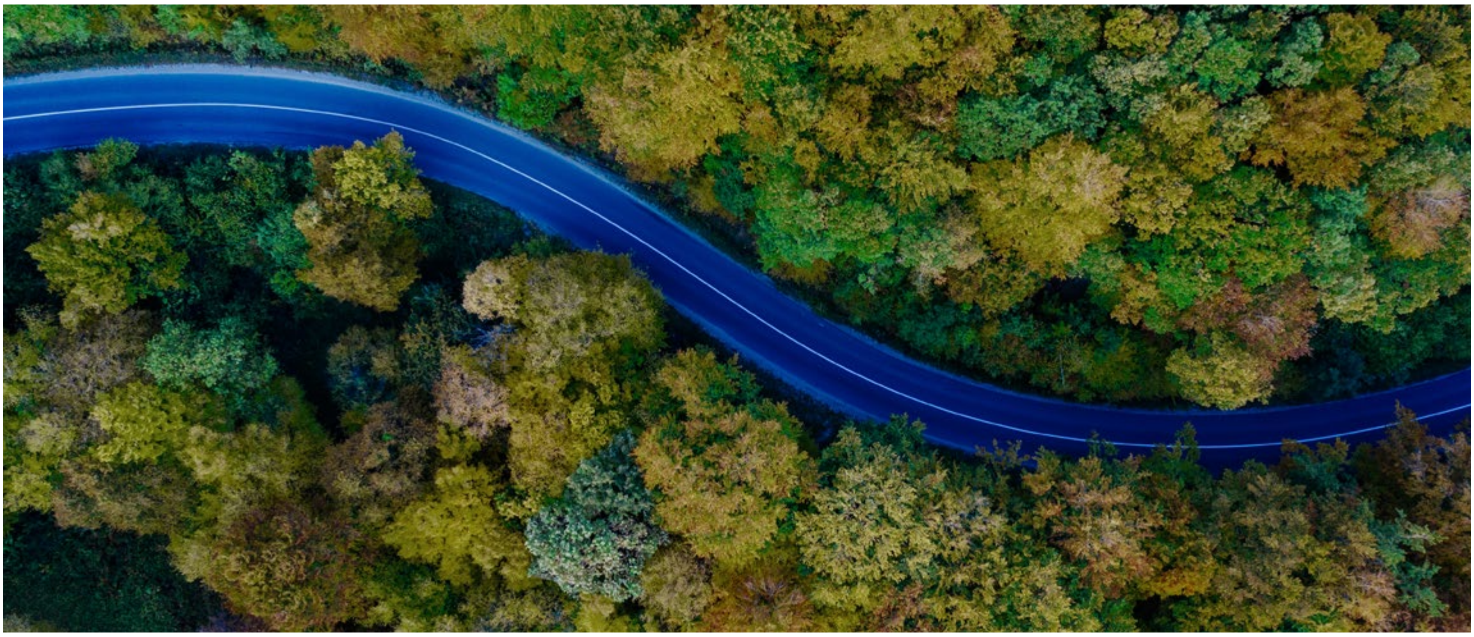
Investors and other stakeholders are increasingly stipulating that accountability for ESG management should be managed both top-down and bottom-up, including clear designations of responsibility for ESG issues across Board committees, executive or advisory committees, management and throughout the organisation. Accordingly, Boards should assess how ESG is integrated across their organisations' governance structures and whether those structures reflect best practice oversight of ESG strategy, risks and opportunities.

At a Board level, appropriate allocation of ESG accountability will require consideration of the organisation's material ESG risks and how ESG risks and opportunities are integrated within the organisation's corporate strategy. Some options include dedicated ESG committees, integration of ESG responsibilities into existing board committees (such as the audit, risk, strategy, nomination and remuneration committees) and full board oversight of material risks, as appropriate.

To further establish effective ESG oversight, Boards should also ensure that ESG responsibility is embedded at management level, whether through the organisation's CEO, chief ESG / sustainability officer, an ESG-specific management, executive or advisory committee, or other structures.

Boards should also review and adopt appropriate internal oversight procedures in respect of ESG, which will generally:

- ensure ESG commitments are realistic and achievable, and that the organisation's policies, guidance and processes appropriately reflect the organisation's ESG governance framework and the delineation of ESG responsibilities;
- mainstream inclusion of ESG considerations into existing risk and compliance policies, processes and due diligence tools at organisational, portfolio and transactional levels to ensure that assets, projects and prospective acquisitions do not present unchecked ESG risks;
- incorporate ESG considerations into the board's decision-making processes, including in respect of strategy setting, business plans, risk management and annual budget;
- regularly monitor the organisation's ESG strategy, progress and maturity by reference to measurable criteria and targets; and
- ensure the quality and transparency of their reporting practices meet stakeholder expectations and disclosure obligations, and prepare for more prescriptive reporting requirements in the future.



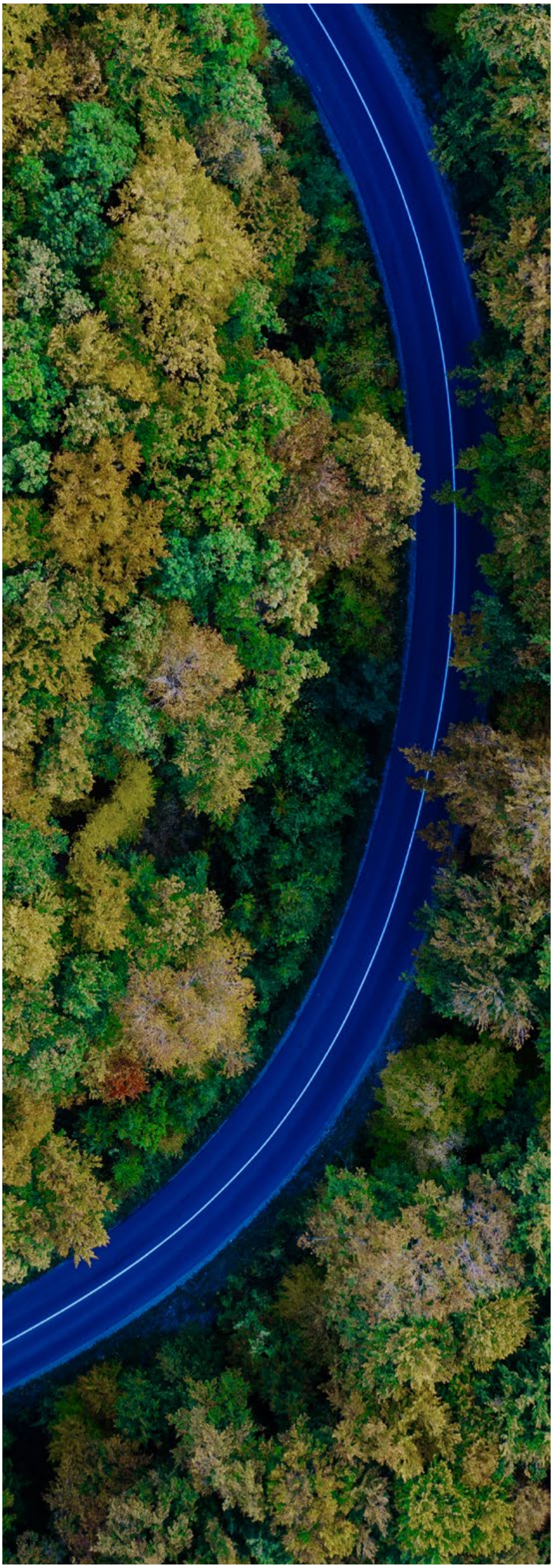
Ensuring continuous improvement

Good Board oversight requires that directors ensure the entities they lead both respond and describe how they are responding to the potential short and longer term implications of ESG risks, opportunities and impacts.

ESG governance is not a 'set and forget' exercise, but requires ongoing oversight and regular review and evaluation to ensure continuous improvement. Directors must be constantly horizon-scanning across a range of issues to remain ahead of the curve and raise developments at the board and with senior management. Early adoption and implementation of innovative practices for identification, monitoring, reporting and mitigation of ESG risk exposures will ensure that an organisation is able to adapt to new ESG developments promptly and efficiently.

Directors should:

- ensure the organisation's commitments remain fit for purpose and that there are systems and processes in place to measure their relevance and appropriateness;
- regularly review the processes through which the Board remains informed as to the organisation's ESG obligations, including legal and policy developments and the results of monitoring / measuring the organisation's ESG performance;
- ensure relevant and regular training on material ESG issues is provided regularly to Board members, and that individual directors are upskilled on ESG matters on an as-needs basis;
- ensure the organisation schedules periodic reviews of and updates to ESG policies and guidance, and a mechanism to trigger a review of key ESG policies and guidance in the event of material developments (such as new regulatory requirements) is embedded in the ESG framework (this will ensure these processes remain fit for purpose and effective); and
- periodically engage with external specialist legal and financial audits of the ESG framework and ESG-related disclosures, to ensure the organisation's ESG framework is aligned with industry best practice and disclosures are accurate and verifiable.



Strategic guidance

Keeping abreast of the wide array of emerging and established ESG issues is a challenge for any director.

We have identified a number of important questions that directors can ask to identify, assess, and be confident that their organisation is mitigating and addressing ESG risks and opportunities.

Environment	Social	Governance
Considerations	**Considerations**	**Considerations**
• How does your organisation's operations, its supply chain and downstream activities (for example, scope 3 greenhouse gas emissions) impact on the environment? • What does your organisation have in place to assess, monitor and mitigate any environmental impacts and dependencies it may have, including for example in relation to water sources, biodiversity loss and climate change? How are those impacts and dependencies identified, measured and reported? • Does the organisation understand its exposure to both physical and transition risks in relation to climate change? How are those risks assessed, measured and reported? • Are there any governance or human rights risks associated with environmental compliance?	• Who may be affected by the organisation's activities along its value chain, and are those people and / or communities positively or negatively impacted? How is the organisation assessing, addressing and mitigating those impacts? • Is there an effective grievance mechanism to hear concerns or complaints from employees, contractors, suppliers and customers? Is the mechanism accessible and has the organisation responded with appropriate remedies where raised concerns are validated? • How does the organisation interact with the wider community, including relationships with First Nations people? • How does the organisation manage and report on the risks of modern slavery and other human rights concerns in the supply chain?	• How does the board make decisions, how are directors appointed, remunerated and how does it provide risk management and strategic oversight? Are ESG considerations incorporated into those decision making processes? • Does the organisation have robust internal controls in place to mitigate the potential for harmful conduct by those involved in (or with) the business, or who may pose an external threat to the business, and otherwise to identify and manage the risks of the business? • Do climate-related and sustainability disclosures and commitments reflect the processes in place, and include measurable and verifiable actions and targets thereby ensuring statements are not open to misrepresentation? • Does the board have a good understanding of the types of issues which could drive shareholder activism for their organisation? • Is there a clear view of community expectations and emerging issues in your sector, and is there a clear strategy in place to ensure the organisation addresses/meets those expectations?
Guidance tools	**Guidance tools**	**Guidance tools**
• Global Reporting Initiative Standards • Organisation for Economic Cooperation and Development, Guidelines for Multinational Enterprises • Governance Institute of Australia, Climate change risk disclosure: A practical guide to reporting against ASX Corporate Governance Principles and Recommendations	• United Nations Guiding Principles on Business and Human Rights • The Australian Business Guide to Implementing the UN Declaration on the Rights of Indigenous Peoples • Blueprint for Finance against slavery and trafficking	• Australian Institute of Company Directors, Guiding principles of good governance • ASX Corporate Governance Council, Corporate Governance Principles and Recommendations (4th Edition) • Australian Competition and Consumer Commission, Green marketing and the Australian Consumer Law

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