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BEYOND ESG – AN INTEGRATED APPROACH TO GOVERNANCE, INVESTING AND REGULATION

by John C. Wilcox, Morrow Sodali Chairman Emeritus

"Time for a Name Change" is the title of a thought-provoking article posted recently on LinkedIn (**https://www.linkedin.com/posts/stephen-davis-6282424_360investing-activity-6931001273143934976-ho5w?utm_source=linkedin_share&utm_medium=member_desktop_web**) by Stephen Davis, Senior Fellow and Associate Director at Harvard Law School's Program on Corporate Governance. Davis argues that the acronym "ESG" has outlived its usefulness and needs to be replaced. Writing largely from the viewpoint of investment professionals, he suggests a new term: "360-degree investing."

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I agree with Davis that a new term to replace ESG is urgently needed. But while "360-degree investing" works for asset managers, it does not work for companies. Even so, Davis's key point makes sense – "ensuring that both investors and companies take account of risks and opportunities that lie outside conventional accounting."

To replace "ESG" for companies as well as investors I would propose use of the already familiar term "integrated." One of the dictionary definitions of integrated is: *with two or more things combined in order to become more effective*. Applied to evaluating business enterprises, an integrated approach could effectively combine environmental, social and governance considerations together with traditional financial and accounting metrics.

In addition to inclusiveness, an integrated approach could lead to more realistic regulation aligned with the way businesses are run day-to-day. Corporate managers must constantly keep their eyes on the road, juggle multiple risks and opportunities, monitor competitors, listen to customers and stakeholders, adjust to market changes and react to ad hoc events. Managing a business enterprise is itself an exercise in integrated thinking and organization.

In support of the proposed integrated approach, here are a few points to be considered:

1. We should build on the concept of "integrated reporting" that has already achieved widespread acceptance globally. The International Integrated Reporting Council (IIRC) has long promoted efforts to reduce companies' siloed organizational structures and encourage holistic corporate management and reporting. The IIRC is now a part of the Value Reporting Foundation, which also includes SASB and which through the IFRS Foundation has established the International Sustainability Standards Board (ISSB).

2. We need to eliminate the "zero-sum" thinking that pits ESG against traditional accounting and financial metrics. One of the most important lessons we have learned from the emergence of ESG is that these so-called "intangibles," "externalities" and purportedly "non-financial" factors do in fact have measurable financial impact on companies.

3. It is no longer appropriate to refer to E, S and G collectively or to treat them as a separate category of issues distinguishable from the traditional business considerations captured in spreadsheets and financial reports.

4. Instead of pitting shareholders against stakeholders, we should recognize that they share a common interest in companies' wellbeing, financial success and sustainability. Indeed, the new generation of millennials and GenX shareholders together with leading institutional investors such as BlackRock are already asserting that ESG issues are integral to their evaluation of the companies they own.

5. We need to put an end to the pushback against ESG that is coming from a variety of sources, including academics, hardline capitalists and politicians. Ideology and politics should not play a lead role when we are considering what is best for businesses, stakeholders and the capital markets.

6. It is time to reexamine the traditional prescriptive, investor-based definition of "materiality." ESG has made us aware that financial materiality needs to be addressed from multiple stakeholder perspectives. An integrated approach to materiality can best be accomplished by companies internally, using what Uber Technologies in a comment letter to the SEC on climate change describes as an individual "company-specific materiality assessment"[1] to supplement legal standards. We need to admit what has always been true: companies, not regulators, ultimately decide what is material to their business. An integrated approach to materiality would require a more flexible legal definition, including a comply-or-explain option, that could accommodate "company-specific materiality."

ESG has had a transformative effect on companies, redefining the corporate social compact, highlighting the materiality of E, S and G issues and introducing important new criteria such as corporate purpose and culture, human capital management and sustainability. Companies are learning how to factor these issues into their business strategy and how to disclose them. Investors in turn are adapting to these demands and looking more deeply into the inner workings of the companies they own.

Standardization and comparability are still needed. Regulators in the EU and the United States are not far behind with new laws and proposed new disclosure requirements. The hope is that global regulators, NGOs and independent standard-setters in collaboration with the IFRS Foundation and the ISSB will work together to promulgate disclosure requirements that encourage an integrated approach to management and governance, thereby enabling companies to "tell their own story" to stakeholders and the capital markets.

1. John C. Wilcox, *"Should Companies Take a Stand?"*, https://morrowsodali.com/insights/should-companies-take-a-stand

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