SLAUGHTER AND MAY/

PUTTING THE "S" INTO ESG

Governance, Sustainability & Society – Part of the Horizon Scanning series

Introduction

Environmental, social and governance ("**ESG**") issues were already gaining great momentum at the start of 2020 when the COVID-19 pandemic hit. As everyday life was turned upside down, a palpable sense of emergency started to dominate. Nature was changing the course of everyone's plans and the climate emergency became too big to ignore. As some of the starkly unequal impacts of the pandemic on society started to show, policymakers, businesses and their stakeholders started holding each other to greater account.

Businesses can no longer rely solely on a simple idea of shareholder primacy to guide their strategy. There is a need for businesses to rethink their priorities, reconsider key stakeholder relationships and redefine their wider purpose in society considering wider impacts on people and planet. In this context, companies would do well to reflect on the "S" in ESG.

The conversation around ESG has long focused primarily on the "E" and the "G". For instance, governance or "G" issues such as Board diversity and executive pay have been part and parcel of the AGM season for many years now, while issues relating to transparent tax strategy are similarly perennial agenda items for large multinationals. Meanwhile, the "E" seems to be "E"verywhere. There is a fast developing regulatory framework – including the FCA's introduction of mandatory TCFD reporting for premium listed companies and the EU's regulatory initiatives through its green Taxonomy and Sustainable Finance Disclosure Regulation (please see our separate publications here) – and the UK's hosting of COP26 later this year is only likely to further embed the centrality of the "E" for corporates.

Middle Child "S"yndrome

But what of the "S"? What exactly is it concerned with? What are the opportunities and the risks? And what can companies do about these?

One of the perceived difficulties with the "S" is that, compared to the "G", there is less consensus on the core issues. Indeed, in BNP Paribas' 2019 Global ESG Survey of individuals across 347 institutions, 46% of respondents reported that they found the "S" the most difficult of the three to analyse and integrate. Different organisations ranging from the UN-backed PRI, the GRI and SASB (through its social and human capitals) have each identified their own examples of "S"-related issues, using different terms and labels.

But should we be too pre-occupied with these differences? They are more of form than of substance and it is clear that certain common themes are emerging in the "S" space too. One possible grouping of those common themes is set out in the graphic below. While there are certainly other possible topics and groupings of common themes, the idea that a common conception of "S" is much more elusive is perhaps overstated.

The range of potential issues encompassed by these themes, each of which is important in its own right, does present challenges for Boards and executive teams seeking to embed "S"-related actions in their strategy. On the other hand, the lack of a prescriptive regulatory framework on many of these "S" issues also represents a flexible opportunity for businesses to effectively set their own agenda.

Common "S" themes

Reconsidering the "S"

As a starting point, companies would do well to reflect on their corporate purpose with a view to identifying their key "S" priorities and setting ambitious targets in respect of these. To that end, it is also worth reflecting on different approaches to conceptualising the "S" and how it might manifest in a company's purpose and strategy.

Given the difficulties of defining a clear perimeter for the "S", one approach is simply to consider, or even relabel, the "S" as being concerned with a company's stakeholders. There is a growing consensus that a business with healthy stakeholder relationships is well placed to enjoy sustainable health itself, so this may be a pragmatic approach. The COVID-19 pandemic has brought into focus key stakeholder relationships, including between companies' and their suppliers and employees. The UK Corporate Governance Code expressly points to the importance of engaging with wider stakeholders, including the workforce; not just shareholders.

A different framework is proposed by the World Business Council for Sustainable Development, which launched its Social and Human Capital Protocol in 2019. The protocol takes a broader view of capital beyond just money, referring to natural, social and human capital (see also SASB's preliminary human capital framework) and emphasising an approach that moves beyond considering not only how we impact on each such capital to also highlighting how we depend on them. Social capital is defined as "networks together with shared norms, values and understanding that facilitate cooperation within and among groups."

The protocol recognises, on the one hand, the importance of effective social dialogue at the enterprise level, including between employer and employee, and, on the other hand, the difficulty in measuring the value of social and human capital resources. In order to provide a more concrete platform for businesses to embed these ideas, it proposes a four-stage framework for businesses to measure and value social and human capital.

It is also important to avoid considering the "S" in isolation (just the same as with the "E" and the "G"). The breadth of the common "S" themes noted above may create blurred lines between the "S", the "G" and even the "E". Businesses must carefully manage activities that promote one of these, if in consequence there are unmitigated negative externalities on the other two.

For example, the Just Transition concept recognises how the "E" may spill into the "S", as the rapid move towards net zero brings a risk that some people are left behind (e.g. those without opportunity to reskill into the low-carbon industries or unable to access the benefits of the new energy system). The European Commission has taken a lead on the issue, setting out the Just Transition Mechanism which aims to provide €150 billion over the period 2021-2027 to alleviate the negative fall-out of a transition to a low-carbon economy in the most affected regions.

There are opportunities for businesses here too. For instance, SSE plc has integrated the Just Transition into the decommissioning of Fiddler's Ferry, its last coal-fired power station. In doing so, the company has made clear that it is well aware that 'generations of working people have built their livelihoods at Fiddler's Ferry.' So, as part of the decommissioning process, SSE noted that it was able to allow workers to transition into work on the decommissioning programme and that various training courses were delivered prior to closure, preparing employees for redeployment in other sectors.

A Regulatory Perspective

What would drive consensus towards a common conception of "S" issues is regulatory initiative. Existing regulatory requirements that touch on the "S" are relatively disparate. For example, companies have obligations ranging from the Modern Slavery Act 2015 to gender pay gap reporting. The European Commission's work (as part of the development of its "Sustainable Finance Strategy"), in potentially extending the EU Taxonomy Regulation beyond climate change to encapsulate social matters, may provide some impetus for standardisation.

Other regulation is also in the pipeline - the European Parliament recently called on the Commission to introduce a new directive that would require all companies (which may include non-EU companies) operating in the EU internal market to conduct due diligence on their supply chains, focusing on activities that harm human rights, the environment or the good governance of a region. Companies that fail to comply would be liable to a fine.

While the precise shape of the regulatory landscape is still developing, clearly companies that are already considering the "S" and setting their own targets and KPIs will be better placed when the regulation coalesces and comes into force.

Opportunities and risk"S"

Companies that have clarified their thinking around the "S" and how it ties to their corporate purpose are well placed to capitalise on a range of "S"-related opportunities. For example, in the capital markets space, more and more companies are issuing social bonds, which link their use of proceeds to a range of social outcomes. For example, we recently worked with Burberry Group plc on their first sustainability bond, which will be used to finance and/or refinance eligible sustainable projects as described by Burberry's Sustainability Bond Framework. This includes meeting goals on tackling educational inequality, supporting social and economic development and community cohesion, all of which are clearly "S"-related matters.

The "S"-related opportunities in the financing space more widely are worth noting. The bond market saw $180bn of issuances between October and December 2020, over $100bn of which was attributed to social or sustainable projects and assets. There is scope for companies to harness such market dynamism in utilising the "S", particularly given the inherent flexibility of the concept. We have also seen a number of sustainable debt products, including sustainability-linked debt facilities which build in KPIs based on the "S". These KPIs link the price of the debt to the degree of attainment with those KPIs. For example, KPIs which include the proportion of women in senior leadership roles or aligning targets with the UN's Sustainable Development Goals.

A further illustration of the different kinds of "S"-related opportunities now being taken by companies is seen in those who are able, and have decided, to repay business rates relief and other forms of Government support provided during the COVID pandemic. While various factors are at play here, including certain brand and reputational opportunities in the context of a rise in socially conscious consumers,

the Tesco PLC chair's statement that "we are conscious of our responsibilities to society" reflects a wider theme of companies considering their position in society and moving beyond a pure profit purpose.

Similarly, some companies have publicly committed to a vision of a more just society, supported by concrete commitments. For example, earlier this year, Unilever announced its intention to help build a more equitable and inclusive society, backed in part by a commitment to spend €2 billion annually with suppliers owned and managed by people from under-represented groups, by 2025. It will be interesting to see to what extent the fostering of such healthier stakeholder relationships results in wider benefits for the business.

One of the key ways in which companies can demonstrate commitment to the "S" and focus performance is through the setting of clear and measurable targets around priority "S" issues. This is likely to be more effective where companies focus on where they can have the most beneficial impact on the "S" in a way which is complimentary to their purpose and strategy. These can then form the basis of relevant objectives. In the incentives space, we see more and more companies aligning pay with the "S" through the introduction of an employee engagement score in the balanced scorecard for annual bonuses. For example, Vodafone introduced an "S" measure into their 2021 executive pay award, which is based on an overall ambition to achieve 40% of women in management by 2030.

However, businesses must also manage "S"-related risks. Companies may face a range of challenges, not always easy to predict, including due to the growth and diversification of ESG-driven activism and litigation. One example of this extending in the "S" space is the ongoing Nestle USA, Inc. v. Doe case in the USA relating to alleged issues with Nestle and Cargill's supply chains and the alleged aiding and abetting of violation of child labour laws.

In the UK, a ripple of similar "S"-related litigation is set to gain momentum in the midst of a 'perfect storm' of contributing factors. Specialist claimant law firms, supported by a sophisticated and cash-rich litigation funding market are increasingly interested in pursuing group litigation that seeks to build on the Supreme Court decision in *Lungowe v Vedanta*, as well as in *Okpabi v Shell* (on which see our separate publication available here), which held that it is at least arguable that liability can be attributed to UK-headquartered parent companies for wrongs allegedly committed by their foreign subsidiaries in jurisdictions where labour and environmental protections are weaker.

Clearly there is scope for such risks to have a material impact on the business and so it is important for Boards to factor in both risks and opportunities in their strategies and, most importantly, recognise that they will need to stand behind, and deliver on, any commitments or promises as to future intention they make: these are not just warm words. It is also important for companies to consider how their stakeholders are likely to develop their expectations around companies and the "S".

Conclusion

The broad nature of the "S" may be a current challenge to companies that prefer to deal with clear performance metrics. And there is a need to agree at least some of the core matters which form part of a company's consideration of "S" issues. However, the current absence of consensus on key "S" metrics or a focused regulatory framework provides an opportunity for companies to take the initiative.

Certainly, corporates would do well to reflect on how the "S" may fit into and be complimentary to their broader purpose and strategy, as well as to consider both the risks and opportunities it presents. On one view, the point of business, its purpose, is to address human needs without unacceptable cost to people and the planet. At the company level, managers will need to reflect on how the company's purpose informs strategy and culture in the context of their specific industry and business, as well as the wider market context in which they operate.

In approaching this, it may be unhelpful to try as an end in itself to categorise an "E", "S" or "G" at all. The better approach is to identify priority issues, whatever they are, based on the company's purpose and strategy. It may boil down to a company and its Board working hard to "do the right thing" by its customers, employees and suppliers, as well as the community in which it operates and wider stakeholders. A company may do well if it simply aims to foster a culture where its treatment of both human and social capital, and its impact on wider society, is front and centre with its own chosen priorities, rather than try to fit within generic "S" targets in order to demonstrate its social credentials.

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