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The Age of ESG : new issues for corporate governance ?

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For 40 years or so, corporations listed on stock markets were expected to pursue diligently, if not exclusively, value creation for their shareholders. A number of factors had pushed corporations away from an earlier "stakeholder model," prime among them the revolution in executive compensation.

Then, in the new century, a perennial criticism of business corporations and "capitalism" suddenly took on new urgency, with the capitalist system being held responsible for the wealth and income inequality it produces and the environmental havoc it has wreaked. This time around, though, the complaints did not issue from some leftist organization but from the very heart of the system, from large institutional shareholders who have recently converted to the church of ecological sanctity and social responsibility. In this new view, corporations should henceforth be accountable for their financial performance, yes, but also for achieving set targets in matters of environment (E), society (S) and governance (G). The ESG triplet, tacitly fostering a "stakeholder" doctrine on corporations, has created new challenges for corporate governance.

A year ago, this revised doctrine received a surprising endorsement when 181 CEOs of large American companies signed on to a new "purpose" for the corporation: *a fundamental commitment to all of our stakeholders* (customers, employees, suppliers, communities and shareholders). "*Each of our stakeholders is essential. We commit to deliver value to all of them, for the future success of our companies, our communities and our country."*

So, institutional funds and others now require specific ESG action plans, target metrics and linkage of executive compensation to these metrics.

But there are unresolved issues with this "stakeholder" model of the corporation: *When the interests of various stakeholders are divergent, how should the interests of the corporation be understood? How should the board proceed in determining a fair trade-off between the interests of various stakeholders and which of them are entitled to such consideration?*

A second concern*: How are business corporations to cope with ESG demands when facing tough competitors, domestic and international, who are not subjected to these same pressures?* A recent study shows that activist hedge funds treat ESG targets as a signal of management's less than absolute devotion to shareholder interest. Firms spending more than average on corporate social responsibility activities have double the probability of being targeted by "activist" hedge funds.

At a more fundamental, philosophical, level: *Should ESG targets go beyond what government regulations call for?* In a democratic society, is it not, rather, the role of governments, elected to protect the common good and represent the general will of the people, to regulate business corporations so as to achieve society's social and environmental goals? But, perhaps the recent ESG focus and re-discovered "corporate purpose" are but maneuvers to fend off popular pressures on governments to impose stringent regulations.

In any case, the achievement of ESG targets will require changes in management incentives. Executive compensation in its current format is in large part linked to financial performance, with major components highly sensitive to stock price. Linking compensation to some ESG targets will call for re-tooling the way executives are compensated, a difficult task. In 2019, 67.2% of S&P/TSX 60 firms incorporated at least one ESG metric in their incentive plans, but only 39.7% related to environmental factors. Some 90% of the firms include ESG metrics in their annual executive incentive programs but rarely in their long-term incentive programs. Willis Towers Watson also noted in a recent study that only four per cent of S&P 500 firms used ESG metrics as part of their long-term incentive awards.

Finally, *if a company is to be stakeholder-driven, why only shareholders get to elect board members?* That nagging question may come to haunt some of the promoters of the "stakeholder model" as it opens the door to board membership by other stakeholders, such as employees. It may not be what the institutional funds had in mind when pushing their ESG agenda.

A sharp debate is now raging (in academia at least) about the pros and cons of the stakeholder model. Be that as it may, in the business world, the relentless pressure from investors has converted most corporate management and boards of directors to the ESG religion despite many unresolved issues.

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