The state of corporate governance in the era of sustainability risks and opportunities
Introduction

This paper examines the board’s role in creating long-term sustainable value. It pays special attention to how environmental and social related risks and opportunities affect the corporate governance process.

In doing so, it provides a review of the international corporate governance landscape. Our intention is to help boards more fully address the spectrum of challenges they face.

In order to achieve this, it’s important to understand fully why some boards are integrating sustainability issues into their mainstream governance practices and why others aren’t.

The findings presented here are based on a study of international corporate governance, from a regulatory, business and academic perspective.

The qualitative and quantitative research was compiled from secondary data sources. The regulatory research was collated from accredited sources such as Thomson Reuters and The Law Reviews, while the business research was collected from public company information found within annual and integrated reports. In addition, to provide a holistic view of the landscape of corporate governance, the study also included academic research as well as literature published by multilateral organizations.

The research scope covers 12 jurisdictions; Brazil, China, France, Germany, Hong Kong, Japan, The Netherlands, Singapore, South Africa, Thailand, the United Kingdom and the United States.

The research also focused on publicly available information from a sample of 56 companies across these 12 jurisdictions, with a focus on the food and agricultural sector.

This study comments on the ways in which these 12 jurisdictions promote effective governance practices and how companies are meeting these expectations. The paper closes by discussing the ways in which companies can integrate sustainability into their corporate governance systems.

The data in this report was collected and analyzed between July and December 2018.
Sustainability and corporate governance  
- risks and opportunities -

THE GLOBAL GOVERNANCE LANDSCAPE IS COMPLEX
Worldwide there are 580 reporting provisions on governance-related issues

STANDARDS ARE RAPIDLY EVOLVING
11 voluntary corporate governance codes studied were updated in the last 3 years

COMPANIES HAVE TROUBLE KEEPING UP
Only 55% of companies fully complied with their corporate governance codes in 2017-2018

In order for companies to stay competitive, agile and resilient, boards must acknowledge and respond to pressure from:
- Investors
- Regulators
- Customers

BUT THE ROLE OF THE BOARD IS CHANGING
In every jurisdiction, the board has a duty to ensure the longevity and survival of the corporation.

In the past, companies sought to do this by focusing solely on maximizing shareholder value.

It’s important for the board to consider all stakeholders

Boards are acknowledging the critical nature of sustainability, but still struggle with the right policies.

- 65% of companies recognize sustainability as a management agenda item
- BUT ONLY 22% of executives believe that their own boards properly oversee sustainability issues

We’re helping companies implement better governance systems for improved resilience and a more successful, sustainable future.

To find out more on the current governance landscape and how to integrate sustainability, go check out our Governance & Internal Oversight Project and its new paper.
Defining corporate governance

To successfully utilize up-to-date mechanisms for corporate governance, it's important to first ask: what is corporate governance?
At a fundamental level, the word *governance* comes from the Latin root *gubernare* meaning to steer or to pilot. Corporate governance, as first defined by the UK Cadbury Committee in 1992, is "the system by which companies are directed and controlled."

However, corporate governance is more than the system of specific checks and balances that contribute to the responsible oversight of a company. It’s the all-encompassing mechanism that, when implemented effectively, imparts integrity, ethics, transparency, accountability and culture across the company.

It’s a company’s governance strategy that will ultimately steer it towards achieving long-term success and longevity.

Corporate governance has been defined, redefined and interpreted in various ways. The prevailing theory around the purpose of corporate governance has been the "shareholder-value doctrine" – whereby public corporations belong solely to their shareholders and they exist for one purpose only: to maximize shareholder wealth.

Many scholars have stated that the sole fiduciary duty of directors, to place shareholders’ interests above all others – is actually only an ideology and not, in fact, prescribed in law. Moreover, in every jurisdiction across the world, without exception, the board of directors’ primary duty is to the corporation itself, as a legal entity. From a legal perspective, this means that shareholders do not own the company. Instead, the corporation is an independent legal entity that owns itself.

In other words, maximizing shareholder wealth is a managerial decision, not a legal requirement or fiduciary duty.

Shareholders hold a contract with the corporation much like other stakeholders, such as suppliers and employees. Therefore, the board should assume sole responsibility for aligning the interests of all stakeholders with the long-term value creation and direction of the company.

Robust governance arrangements include establishing a clear organizational structure, well-defined lines of responsibility, effective risk management processes, control mechanisms and remuneration policies. In theory, corporate governance controls are designed to address the agency costs that arise from the principal-agent model of the corporation — where there is a separation of ownership and control over an organization.

The past few decades have proven that, in practice, these controls have fallen short of ethical business standards and have incentivised short-term thinking.

As a separate legal person, a corporation has two basic objectives: to survive and to thrive. Shareholder value is not the objective of the corporation; it is an outcome of the corporation’s activities. While shareholders entrust their stakes in a corporation to the board of directors, shareholders are just one audience among others that the board may consider when making decisions on behalf of the corporation.

*Robert G. Eccles and Tim Youmans, MIT Sloan Management Review*
The shareholder primacy doctrine may also be detrimental to the sustainable growth of a firm. The culture of immediacy and placing shareholders’ interest above all else, has had negative consequences on companies themselves and their ability to achieve sustainable economic growth. This has led to an abundance of corporate scandals, white-collar crime, unethical practice and poor treatment of social, human and natural capital.

These corporate scandals show how a lack of effective governance and oversight can have a ripple effect on society and on the company itself.

The long-lasting effect of these high-profile collapses and scandals has resulted in mounting pressure for corporate governance to be more transparent, accountable, responsible and focused on the long-term growth of a company.

Now more than ever, companies are being held accountable for their actions, as their size, power and influence expands across borders and has profound impacts on societies and stakeholders. In our ultra-transparent world, of instant communication and 24/7 media coverage, every flawed corporate behavior is publicly scrutinized and can severely damage a company’s reputation and financial health.

This has led to an increasing focus on the governance and oversight of multi-national enterprises.

Furthermore, global economic events, like the financial crisis in 2007-2008, have shown that poor corporate governance can negatively impact companies and their stakeholders – damaging the economy as a whole.

As such, the board must act as the “appropriate trustee of a firm’s intergenerational commitment,” where the company can create value for society and itself in the present, without compromising its ability to create value for all parties in the future.

Responsible and effective corporate governance should be a means to foster business integrity and generate market confidence both now and in the future.

The financial crisis of 2007-2008 was an important reminder of the repercussions that weak corporate governance and risk management practices can have on asset values. This has resulted in increased demand for transparency from organizations on their governance structures, strategies and risk management practices.

Michael Bloomberg, TCFD
Promoting effective corporate governance practice

Board governance should include the interests of all company stakeholders and should consider the impacts of ESG-related risks and opportunities.
THE LEGISLATIVE LANDSCAPE

Jurisdictions across the world aim to influence the private sector through their own International Corporate Governance frameworks. These are typically comprised of a regulatory mix of company and securities law, as well as listing rules and corporate governance codes. These elements of ‘soft law’ are derived from company law and explain how the responsibilities and obligations of directors are effectively discharged.

Each country has its own unique framework that consists of both hard and soft law, which reflects their own economic, cultural and legal history. Therefore, the desirable mix between legislation, self-regulation and voluntary standards can vary significantly from country to country. See Figure 1 for a visualization of what a corporate governance legislative framework may look like.

The most common regulatory tool used to influence good corporate governance practices is soft law mechanisms such as voluntary codes, principles, guidelines and toolkits.

Data from The Reporting Exchange (shown in Figure 2), highlights that there are 143 reporting requirements and resources that are related to corporate governance across the 12 jurisdictions – of these, 39% were mandatory, 43% were voluntary and 17% were comply or explain.

This data shows that there is a substantial dispersion of corporate governance practices across jurisdictions. This reveals that there is no single regulatory solution that will lead to an improvement in board performance.

However, across the world the underlying goal of corporate governance legislation is to promote transparency and integrity in businesses and local economies. It is the responsibility of companies to apply the voluntary standards to promote their own transparent and responsible business practices.

Figure 1: Corporate governance legislative framework

Figure 2: Mandatory, voluntary or comply/explain reporting provisions
Voluntary legislation and the “comply or explain” approach

Most countries in this sample have adopted a principles-based approach in order to influence the corporate governance of listed companies. Their established principles of good corporate governance act as a benchmark for companies to adhere to.

Almost all jurisdictions that have adopted a Corporate Governance Code or Corporate Governance Principles, have implemented a “comply or explain” approach, where compliance is non-statutory, but a company’s deviations from the code must be explained in their reporting.

Even though investors and regulators are putting pressure on companies to adhere to these standards, it’s up to the company to consider if implementing the principles is in their best interest. Soft law allows companies to do just that.

The “comply or explain” approach is positively recognized as an alternative provision to the “comply or else” approach adopted by the United States through the Sarbanes-Oxley Act.17 The US has implemented a rules-based framework in which the desired corporate governance is mandatory for companies.

It is commonly recognized that soft law mechanisms, such as codes and principles, are a positive alternative as they avoid mechanical “box-ticking” and encourage companies to become more accountable and transparent in the marketplace.18, 19

South Africa has taken the “soft law” approach a step further, shifting from the “comply or explain” approach in the King III Report to the “apply-and-explain” approach in the King IV Report. The most recent South Africa King Report has 17 corporate governance principles (one of which applies to institutional investors), as opposed to its prior code of 75 principles. In the most recent code, the principles are aspirations whereby companies are assumed to apply all or strive towards all principles and explain their implementation and the progress made towards the general governance outcomes. This is the approach adopted by the recently introduced Wates Principles in the UK which can be applied by the very largest privately held companies.

The flexible nature of this legislation acknowledges the individuality of companies, whereby each company has its own distinct institutional profile and unique blend of history and legacy. This acknowledges that there is no “one-size-fits-all” approach to corporate governance and that there are many factors such as national and corporate culture and strategy that can affect a company’s governance structure.

Voluntary codes acknowledge that although governance structures and regimes may vary across countries, there are still fundamental governance practices that can be applied by all firms; encouraging flexibility while also advocating best practices.

Table 1 provides a snapshot of the countries’ (included in this research) respective codes, the year of publication and the year of latest revision. Of the 12 countries reviewed, 11 have updated their codes in the last three years, which indicates that jurisdictions are aiming to improve the effectiveness of corporate governance.

Worldwide, in the period between 2015-2016, there have been 19 new or revised country codes issued.20 In particular, Japan (in 2015)21 and Brazil (in 2016)22 have shifted away from a compulsory governance framework towards the “comply or explain” approach, indicating a convergence towards soft law.

The frequency of new codes indicates that the field of corporate governance is evolving and that globalization and the increase in cross-border activity has not only affected economies but also legal frameworks around the world.

There is no “one-size-fits-all” approach to corporate governance. There are many factors such as national and corporate culture and strategy that can affect a company’s governance structure.
**Table 1: Key national corporate governance codes and principles**

<table>
<thead>
<tr>
<th>Jurisdiction</th>
<th>First code</th>
<th>Latest version</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>Brazil Corporate Governance Code - Listed Companies</td>
<td>2016</td>
</tr>
<tr>
<td>China</td>
<td>The Code of Corporate Governance for Listed Companies*</td>
<td>2002</td>
</tr>
<tr>
<td>France</td>
<td>Corporate Governance Code of Listed Corporations (Afep-Medef)</td>
<td>2003</td>
</tr>
<tr>
<td>Germany</td>
<td>German Corporate Governance Code (DCGK)</td>
<td>2002</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>Corporate Governance Code (Appendix 14 of the Listing Rules)</td>
<td>2005</td>
</tr>
<tr>
<td>Japan</td>
<td>Corporate Governance Code</td>
<td>2015</td>
</tr>
<tr>
<td>Netherlands</td>
<td>Dutch Corporate Governance Code</td>
<td>2003</td>
</tr>
<tr>
<td>Singapore</td>
<td>Code of Corporate Governance</td>
<td>2001</td>
</tr>
<tr>
<td>South Africa</td>
<td>King IV Report on Corporate Governance</td>
<td>1994</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>UK Corporate Governance Code + Wates Principles</td>
<td>1992</td>
</tr>
<tr>
<td>Thailand</td>
<td>The Principles of Good Corporate Governance (PGCG)</td>
<td>2006</td>
</tr>
</tbody>
</table>

* Binding corporate governance code that does not utilize “comply or explain” approach.23

* The US is excluded from this list as the country has not adopted a national code under the “comply or explain” framework.24

The corporate governance requirements and framework is primarily comprised of various federal laws, including the Sarbanes-Oxley Act of 2002, the Dodd-Frank Wall Street Reform and Consumer Protection Act and the federal securities laws, as well as regulations, rules and other guidance promulgated by the SEC.25

Corporate governance codes and legislation differ across jurisdictions due to various factors including the culture of local economies, investors and market demand.26 However, there are still common aspects of corporate governance that are regarded as good business practice.

Although there is no one universal system of effective corporate governance, there are still opportunities for companies to apply commonly accepted international practices that promote market confidence and encourage more efficient global capital markets.

Most notably, the Organization for Economic Co-operation and Development (OECD) and the International Corporate Governance Network (ICGN) have published international principles that can be applied as a supplement to local corporate governance codes. See Figure 3 for a summary of these principles.

These international standards aim to harmonize corporate governance practices across the world and provide further guidance towards effective and responsible practices. Table 2 illustrates the main international guidelines and principles within the field of corporate governance.
### Table 2: Multilateral organization influence on corporate governance landscape

<table>
<thead>
<tr>
<th>Organization</th>
<th>Report/principles</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Organization for Economic Co-operation and Development (OECD)</td>
<td>G20/OECD Principles of Corporate Governance</td>
<td>First published in 1999, then updated in 2004 and 2015, these principles are an international benchmark and reference point for assessing and improving corporate governance, for policy makers, investors and corporations. The OECD has also published their own definition of good corporate governance: Improving economic efficiency and growth and enhancing investor confidence.</td>
</tr>
<tr>
<td>International Corporate Governance Network (ICGN)</td>
<td>Global Governance Principles (GGP)</td>
<td>The International Corporate Governance Network (ICGN) is an investor-led organization of governance professionals with the mission to inspire and promote effective standards of corporate governance to advance efficient markets and economies worldwide. The organization has established their own Global Governance Principles (GGP), which serve as standards for ICGN members for general application irrespective of national legislative frameworks or listing rules. The principles aim to promote the success of the company through sustainable value creation for investors while also having regard to other stakeholders.</td>
</tr>
<tr>
<td>The Committee of Sponsoring Organizations of the Treadway Commissions (COSO)</td>
<td>Improving organizational performance and governance: enhancing board oversight</td>
<td>Published in 2014, this paper describes the standard leadership umbrella for governing and managing a successful organization. The frameworks that COSO publishes are intended to be integrated within the governance and management processes to establish accountability for Enterprise Risk Management (ERM) and internal control.</td>
</tr>
<tr>
<td>United Nations Principles for Responsible Investment (UN PRI)</td>
<td>Fiduciary duty of the 21st century</td>
<td>The Principles for Responsible Investment is a United Nations-supported international network of investors working together to put the six principles for responsible investment into practice.</td>
</tr>
</tbody>
</table>

### Figure 3: G20/OECD corporate governance principles

Academics have argued that corporate governance codes around the world have come together due to attributing factors such as globalization of markets, companies, securities regulation and the increased activity of international institutional investors.27

Despite international convergence, the national bodies that publish and regulate local corporate governance codes vary significantly between countries. These codes and principles are issued by a mix of regulators, stock exchanges, business associations and standard setters.
Figure 4 illustrates the variation in legislative frameworks adopted by the 12 countries and whether a corporate governance code has been published by law / regulation, through a listing rule or a combination of both. This complexity and variability among the corporate governance frameworks may be creating confusion and inconsistency, limiting integration of sustainability into corporate governance practices. Since 2013, the World Business Council for Sustainable Development (WBCSD) has assessed companies on their governance disclosure annually through of Reporting Matters. In six years, only five company reports scored “excellent” on sustainability governance criteria — while this only refers to the way companies disclose their governance information rather than the processes themselves, it could indicate an oversight of the relationship between sustainability and corporate governance.

THE INVESTOR PERSPECTIVE

Investors are recognizing corporate governance disclosure as a critical insight into a company’s practices, culture, data management and authenticity of reporting. An investor survey conducted by WBCSD and PwC, on Enhancing the credibility of non-financial information the - investor perspective, found that the presence of effective governance structures and metrics is a key element that can contribute to investor confidence in non-financial information and can help investors gain a better understanding of a companies’ prospects.

For example, Legal & General Investment Management (LGIM) have recently provided their perspective on how governance regulations and market structures in France “can be reformed to protect market participants and create long-term value” and that good stewardship aims to promote the success of a company in a way that ultimately will allow capital providers to prosper in the long term.

Stock exchanges and regulators have also played crucial roles in responding to growing crucial roles in responding to growing investor and consumer demand for responsible practices around ESG issues. Stock Exchanges, most of which are now for-profit organizations, have recognized this shift and demand from investors and have become powerful influencers in the market. The United Nations Sustainable Stock Exchange Initiative (SSEI) has argued that stock exchanges are key in achieving the Sustainable Development Goals, including: “gender equality, decent work and economic growth, responsible consumption and production, climate action and partnerships.”

The Stock Exchanges of London, Tokyo, Singapore and Johannesburg are leading examples. They’re playing a prominent role in influencing corporate governance practices within their jurisdictions. For example, the Singapore Exchange in 2016 introduced a new listing rule, whereby listed companies must produce an annual sustainability report that identifies material ESG factors, policies, practices, performance, targets and a board statement. Companies should also select an appropriate sustainability reporting framework to guide their disclosure.

Furthermore, the London Stock Exchange stated in their recently published guidance to ESG reporting in early 2018, that investors are demanding clear, concise and trustworthy ESG information.
Investor demands are made especially clear in the Climate Action 100+ initiative, which is a five-year plan signed by 289 investors across 29 countries, with total assets under management of USD $30 trillion.34 Investors who have signed on to the initiative are pushing companies “to improve governance on climate change, curb emissions and strengthen climate-related financial disclosures.”35

This is just the beginning. Investor demand and interest in these trends are likely to continue to 2020 and beyond.

THE MANAGERIAL SHIFT TOWARDS INCLUSIVE CAPITALISM

There is growing agreement between companies, investors, academia and society that there needs to be a fundamental change in how capital markets create value and that there needs to be an increasing focus on the medium-to-long-term. More companies are now acknowledging that relationships within corporate governance are not only between shareholders, management and the board, but also with the company’s key stakeholders and the community in which the company operates.

This stakeholder value approach builds on the theory that management must consider the interests and wellbeing of all groups who hold a “stake” with the company and seeks to maximize their benefits and value.36 In this model of governance, shareholders are only one of a number of stakeholders that interact with the company.

Multiple corporate actions and publications prove that there’s a significant movement towards aligning the interests of the company with the interests of society, which entails adopting a stakeholder managerial approach. The UK has recently regulated this area by asking directors to report in their annual report on their compliance with s172 duties in the Companies Act 2006.

An increasing number of senior executives and large corporations are stepping in where governments are lacking. The most notable and recent example is Larry Fink’s address to CEOs in 2018.37 In it, he called for companies to respond to societal challenges and go beyond delivering financial performance by contributing to wider society.

Corporate governance codes are also addressing a pivotal managerial and investor transition away from shareholder centric and short-term thinking towards stakeholder inclusivity, ESG risk integration, corporate citizenship and long-term value creation. A fundamental player in the corporate governance field that has long acknowledged this movement, is the South Africa King Committee. When the first King Report on Corporate Governance was published in 1994,38 it was regarded as both revolutionary and radical in its approach.

The King Report shaped its principles and approach around themes such as integrated thinking, corporate citizenship, long-term horizons, sustainable development and stakeholder inclusivity. The latest report addresses three shifts in the corporate world which underpin their code by: (1) financial capitalism to inclusive capitalism, (2) short-term capital markets to long-term sustainable capital markets and (3) siloed reporting to integrated reporting.

A number of the world’s largest investors are allocating capital to companies that are well equipped to benefit from the transition to the green economy and wish to protect their portfolios against downside environmental, social and governance (ESG) risks.33
Now, the King Report is acclaimed as the world’s standard on corporate governance, as it has attempted to modernize the definition of corporate governance as “the exercise of ethical and effective leadership by the governing body towards the achievement of the following governance outcomes: ethical culture, good performance, effective control and legitimacy.”

This shift has encouraged boards to focus on a longer time horizon that will account for ESG-related risks and opportunities that may only materialize in the next 5-10 years rather than the next financial quarter.

Corporate governance codes in the UK, France, South Africa, Germany, the Netherlands and Singapore are clearly defining the role of the board, the definition of corporate governance and the obligation the board has to ensure the existence of the enterprise within its society.

These jurisdictions clearly define the purpose of corporate governance as:

1. The creation of value and success for the firm in the long-term
2. Value creation for all stakeholders, including its shareholders, employees, suppliers, communities and its contribution to wider society.

In addition, the Japanese Corporate Governance Code requires companies to recognize that their sustainable growth and long-term value creation is a result of contributions from a range of stakeholders. The board should exercise leadership in establishing a corporate culture where the rights and positions of stakeholders are respected. The underlying goal of these codes is to make companies more accountable for their actions. The 2018 UK Corporate Governance Code specifically recognizes that “companies do not exist in isolation,” but as part of a broader ecosystem intertwined with both society and the environment. The integration of sustainability within governance structures is vital to achieving effective and responsible corporate governance.

Despite the transition in some key jurisdictions, there are still countries that are lagging behind. The Brazilian code illustrates the basic pillars that form the foundation for the code and corporate governance which include; transparency, fairness, accountability and corporate responsibility. Yet, the code is still lacking clarity and consistency when promoting long-term value creation and stakeholder inclusivity.

Countries such as China and Thailand are also behind in their efforts to revitalize corporate governance in their jurisdictions and within their corporate governance codes. Their definitions still focus primarily on the protection of shareholder rights and the promotion of ethical standards, rather than implementing a governance system that is more holistic in considering the environment and wider society in its actions.

The UK government has trailblazed the corporate governance landscape with its hard corporate governance legislation in the Companies Act of 2006 Section 172. According to corporate law in the UK, a director has a duty to promote the success of the company, while having regard to likely consequences in the long-term, the interests of employees, fostering relationships with suppliers and customers and the impact of the company’s operations on the community and environment as well as maintaining a reputation for high standards of business conduct and the need to act fairly as between members of the company.

This inclusive and integrated approach to governance requires directors to act in the best interests of the company, by acknowledging the legitimate needs, interests and expectations of all material stakeholders. This is aligned to the multi-capital approach, in which the corporation derives value from human, natural, social, intellectual and manufactured capital, through relationships, interactions and activities.

This argument stems from the Integrated Reporting <IR> Framework, in which the value creation of an organization is directly linked to the value it creates for others, namely its stakeholders.

This paper makes the argument that board oversight should include the interests of all company stakeholders and should consider the impacts of ESG-related risks and opportunities. Additionally, the board should ensure that day-to-day management is aligned with the long-term success of the business, particularly in terms of integrated performance and risk management.
Current state of corporate governance

This section outlines the current business and regulatory environment around corporate governance, as well as how companies are meeting these regulatory and market expectations.
Materiality assessments have identified that corporate governance is a key issue for companies and their stakeholders. Of the 56 companies analyzed for this report, we found that only about half stated in their 2017-2018 reports that they complied fully with their respective corporate governance codes.

In this dataset, the top corporate governance performers in terms of compliance, were in the UK, Netherlands and Japan. According to the Corporate Governance Overview Report published by KPMG, as of July 2017, 25.8% of companies listed on the Tokyo Stock Exchange complied fully with all 73 principles of the Corporate Governance Code of Japan. Companies around the world are addressing the need to strengthen their governance systems and are implementing board operations for improved resilience and agility.

**27% of companies researched identified corporate governance as a material issue**

Nonetheless, corporate governance practices and the corresponding legislation drastically differ across the globe. It is worth noting that effective corporate governance relies to some extent on compliance with laws and codes, but that being fully compliant does not necessarily mean that a company is adopting sound corporate governance practices.45

Local authorities have tried to balance power and increase oversight within governance structures, through principles and provisions regarding division of responsibilities, board composition, independence, risk and internal control measures.

The requirements and recommendations for board structure and composition can vary across different jurisdictions. Regulatory efforts can either be recommended through soft law, enforced by law or required under listing rules of a stock exchange.

**BOARD STRUCTURE**

Internationally, there are two commonly recognized governance structures; (i) a unitary board, that combines oversight and management of the company to one unified board, comprised of executive and non-executive directors; and (ii) a two-tier structure, that creates an additional authoritative body called the "supervisory board" that oversees the "management board." In the two-tier system the day-to-day management and oversight of the company is delegated to the management board which is comprised of executive directors.46 In most cases, the supervisory board is involved in setting the strategy while the management board is responsible for executing that strategy.

Of the 12 jurisdictions covered, only Germany and China have legislation that requires companies to exclusively implement two-tiered board structures separating supervisory and management functions. France and the Netherlands offer companies a choice of either a one- or two-tier structure, whereas Brazil, Hong Kong, Singapore, Thailand and the United Kingdom only allow companies to have a unitary board structure.
According to an OECD report in 2015 that collected corporate governance data from 45 jurisdictions, the most commonly adopted board structure is a one-tier system. Some jurisdictions, like Japan, have opted to allow for even more flexibility and allow companies to choose a hybrid structure introducing an additional statutory body for audit purposes.

The variety in board structure reiterates that there is no one-size-fits-all approach to achieving effective corporate governance.

Figure 5 and Table 3 illustrate the structure regimes adopted by the 12 jurisdictions.

**Table 3: Board structure**

<table>
<thead>
<tr>
<th>One-tier</th>
<th>Two-tier</th>
<th>Both are allowed</th>
<th>Hybrid</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>China</td>
<td>France</td>
<td>Japan*2</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>Germany</td>
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<td>Singapore</td>
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<td>United States</td>
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<tr>
<td>Thailand</td>
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</table>

* In South Africa, although the legislation allows a choice between a one-tier and a two-tier system, listing rules require public companies to adopt a two-tier system. (OECD)

*2 In 2014, the Japanese government amended the Company Act, to allow for a hybrid governance structure that gives companies a choice between three varying structures; (1) a company with an audit committee, a nominating committee, and a compensation committee, (2) a company with a board of corporate statutory auditors, and (3) a company with an audit and supervisory committee.
CEO duality

A heavily debated topic is whether it’s good practice to allow the same person to hold both roles of Chief Executive Officer and Chairman of the board. The duality of these roles has long been acknowledged as a potential “threat to the exercise or independent judgement by the board of directors,” as it increases the power that CEOs have over the board and the rest of the company, which may be problematic for shareholders and stakeholders of the company.

Some academics argue that CEO duality can be a conflict of interest, as the CEO acts as his/her own monitor and may be incentivized to pursue a strategy not aligned to the long-term success of the company. For example, Tesla recently faced fines amounting to USD $20 million from the Securities and Exchange Commission in addition to sanctions demanding that the board elect two new independent directors, establish a new independent committee to oversee communications and that the CEO step downs as Chairman of the Board.

Academia suggests that separating the two roles reduces agency costs and reduces the likelihood of a conflict of interest. A contrasting theory suggests that CEO duality enhances leadership potential and “facilitates organizational effectiveness in a potentially dynamic business environment.” Additionally, some argue that the concentration of power to one individual facilitates faster decision-making ability. However, in many cases, the risks outweigh the perceived benefits and advantages, and combining the roles, oversight and management may facilitate an abuse of power.

According to the OECD, nearly two-thirds of jurisdictions with a one-tier board system require or encourage the separation of the board chair and the chief executive officer. Figure 6 reveals that 8 out of the 12 jurisdictions researched recommend in their governance codes, that the roles should be separated to ensure independent oversight and a balance of power. Between 2001 and 2011, the percentage of S&P 500 firms with a separate board leadership structure grew from 26 to 41%.

There is also statistical evidence that the duality of roles has a significant negative impact on firm performance that is positively and significantly moderated by board independence.
BOARD COMPOSITION

Composition of the board of directors is also heavily debated because it has profound implications on business practices and firm performance. Board structuring includes determining the mix of independent and executive directors, designating responsibilities to certain board committees and determining the selection of directors based on their experience, expertise and diversity.

However, there is no international consensus on what a board should look like. Effective governance practices suggest that a diverse and well-balanced board, will be better equipped and more likely to provide “advice, legitimacy, effective communication, commitment and resources for firms.” By adding independent directors, women or employees to the board, the firm can facilitate board discussion that will challenge traditional practices and policies and ultimately make the firm more adaptable to risks.

Independence

When structuring a board, the composition of directors and whether the directors are external to the organization and therefore considered to be “independent” is very important.

A board that is comprised mostly of non-executive independent directors is a commonly recognized practice that promotes effective corporate governance for a public company and can be determined by either hard or soft legislation. Standards for independence criteria facilitates the creation of competent boards that have the capability to exercise independent and objective judgement and oversight.

Figure 7 shows how many countries require or recommend board independence through listing rules, corporate governance codes or a combination of both. Each bar illustrates whether board independence is recommended or required to be one-third, over half or less than one-third.

Table 4: Independence requirement by country

<table>
<thead>
<tr>
<th>Independence requirement</th>
<th>Under the code</th>
<th>Listing rules</th>
<th>Combination</th>
</tr>
</thead>
<tbody>
<tr>
<td>&gt; 50%</td>
<td>The Netherlands South Africa</td>
<td>United States</td>
<td></td>
</tr>
<tr>
<td>50% ≥ x ≥ 33%</td>
<td>France Singapore United Kingdom</td>
<td>Thailand Hong Kong</td>
<td>China</td>
</tr>
<tr>
<td>&lt;33%</td>
<td>Brazil Japan</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* Germany is absent from this data as there is no explicit criteria or minimum requirement for independent directors mentioned in the German Corporate Governance Code. The code provides the constituents for what makes an independent member. However, the code does not stipulate minimum independence requirements, only that not more than two former members of the Management Board shall be members of the Supervisory Board.

Figure 7: Independence requirements or recommendations

50% ≥ x ≥ 33% 2 3 1
>50% 2
<33% 2

- Listing rules
- Under the code
- Combination
As shown in Figure 7 and Table 4, board independence can be recommended by voluntary codes or required under listing rules or a combination of both. For example, in Brazil board independence is influenced by both its stock exchange (B3) and segment listing rules, that require a 20% ratio under the Novo Mercado Segment, as well as the Brazilian Corporate Governance Code, that recommends a 30% ratio. While in the US, through NASDAQ and NYSE listing rules, most of the board must be considered independent. 57, 58

Of the 12 jurisdictions researched, South Africa and the Netherlands recommend that most of the board should be independent. Countries such as the United Kingdom, France, China, Hong Kong, Thailand and Singapore recommend or require for at least one-third to half of the board be independent (see Figure 7). This data is concurrent with research published by the OECD, that the most prevalent voluntary standard recommends that at least 50% of the board is comprised of independent board members. 59

Additionally, the definition of independence and the criteria that determine independence varies considerably across jurisdictions. In some jurisdictions, companies are required to report on the criteria used to assess independence. The definition and circumstances that constitute an independent director have been set out in corporate governance codes to ensure the nomination and election of independent directors aren’t influenced by present or past dealings of the company. Circumstances that may affect a director’s independence include:

1. If the director has been an employee of the company or group within the last five years.
2. If the director has had a material business relationship with the company.
3. If the director has received or receives additional remuneration from the company.
4. If the director has close family ties with any of the company’s employees.
5. If the director has links with other directors through other directorships he/she might hold.
6. If the director represents a significant shareholder.
7. If the director has served the board for over certain number of years.

Along with providing additional oversight and access to the external environment, independent directors can also bring other benefits to firm performance. An academic study examining major governance reforms across 41 countries between 1990 and 2012 found that corporate reforms that increased the independence of the board and on audit committees, led to improvements in firm value. 60

Independent directors bring their expertise from finance, accounting and law, as well as educational backgrounds and international-cultural experiences.

Independent directors are an effective monitoring mechanism, they may challenge executive decisions or actions and “monitor opportunistic behaviors of top executives assumed by agency theory.” 61 If a board has a well-balanced mix of executives and non-executive independent directors, management and organizational performance will prosper from diverse perspectives and challenging board discussions.

External directors on the supervisory board, can actually increase firm performance through innovation. 63 As such, independent directors may have a different CSR orientation from their internal directors as they are more inclined to “broaden a firm’s hearing of stakeholder claims and thus increase their salience.” 64 There is research to suggest that independent directors have stronger employee orientation 65 and compliance with environmental standards, 66 because they have increased interactions with the external environment and key stakeholders.

A board that comprises a mix of executive and independent directors utilizes this diversity of incentives to benefit investors by both the value-commitment of executive directors and the disciplining incentive of independent directors. 62
Diversity - female representation

Another important topic, especially in Europe, is female representation on boards. Research shows that there are financial and non-financial benefits from having females in director and executive leadership positions – including improved governance and performance.\(^6^7\)

In particular, Zhang, J. Q., Zhu, H., and Ding, H. B. (2013) found that board composition factors such as the number of independent and female directors, has a positive effect on corporate social responsibility (CSR) performance within a firm’s industry by enhancing a firm’s management of its stakeholders and improving moral legitimacy among its stakeholders.\(^6^8\)

Labelle, R. et al. (2010) also show that female directors are more likely to be concerned about ethical practices and socially responsible behavior, as well as be inclined to take actions to reduce these perceived risks.\(^6^9\)

A gender diverse board can be of great value to a company that is seeking to mitigate these ESG-related risks.

Academic research has also shown evidence that female directors can have a profound impact on firm-level financial outcomes such as higher earnings quality,\(^7^0,7^1\) stock price informativeness\(^7^2\) and analysts’ earnings forecast accuracy.\(^7^3\) The literature on board diversity broadly supports the view that the presence of female representatives on the board enhances both the firm’s financial performance as well as non-financial material impacts.

In the companies researched, the highest performing companies in terms of female representation were in France, where the average was 45%. This outcome does not come as a surprise, as France established a mandatory gender quota of 40% in 2011. Other European countries such as Germany and the Netherlands have implemented a 30% quota, however the Dutch law that requires 30% is established on a comply or explain basis (see Figure 8).

The United Kingdom has taken a different approach through government led initiatives such as the Davies Review and the most recent Hampton-Alexander Review. These have implemented a voluntary business-led approach which has set a target of 33% of women on boards of FTSE 350 and FTSE leadership teams by 2020.\(^7^4\)

According to our research, UK companies are falling short of the voluntary target (33% for FTSE 350 Boards and FTSE 350 Executive Committee by the end of 2020) with an average female representation of 27%.

Figure 8: Examples of soft and hard law for female board representation

<table>
<thead>
<tr>
<th>MANDATORY QUOTAS</th>
<th>VOLUNTARY TARGETS</th>
</tr>
</thead>
<tbody>
<tr>
<td>France – 40%</td>
<td>UK – 33%</td>
</tr>
<tr>
<td>Germany – 30%</td>
<td>Netherlands – 30%</td>
</tr>
</tbody>
</table>

Data Source: Thomson Reuters Practical Law
The UK’s largest listed companies are coming under fire, as the latest review shows little progress towards improving the percentage of female representation towards 33%. According to the 2018 Hampton-Alexander Review, board female representation of the FTSE 100 index now stands at 30.2% up from 27.7% in 2017. Figure 9 is taken from the latest review and shows that the most common number of women on boards is three.

Many companies are under even more pressure from investors who are speaking out and sending a clear message that diversity needs to be a central issue. Some investors have announced that they are “increasingly taking into account gender representation when voting at AGMs” and that they “would vote against the chairs of FTSE 350 companies at annual meetings in 2018, if their boards were not at least 25% female.”According to the latest Hampton-Alexander Review, companies in the UK lag behind those in France, Norway, Sweden and Italy – which all have mandatory quotas and board representation averages of 41%, 39%, 36% and 35%, respectively.

In a recent survey conducted by RBC Global asset management (2018), investors who favor gender diversity on boards, stated that the best method for achieving it was through shareholder action, followed by market forces and lastly, “government intervention.” Furthermore, the study found that 75% of investors believe that gender diversity on corporate boards is important to the organization.

Achieving real change requires committed leadership at the top and sustained effort to shift mindsets and correct hidden biases across the organization. Purpose-driven companies who create value for society as well as for shareholders build from a foundation of diversity and inclusion.

Dominic Barton Senior Partner, McKinsey & Company, Hampton Alexander Review 2018

**Figure 9: Number of women board members in FTSE 100**

Source: Hampton Alexander Review 2018
Employee representation

Certain corporate governance frameworks have also implemented standards for increasing employee representation on boards. The revised UK Corporate Governance Code in 2018 made a major change to increase board representation and participation for employees by recommending that companies choose between three methods: (1) appointing a director from the workforce; (2) establishing a formal workforce advisory panel; or (3) designating responsibilities to a non-executive director.

In Germany, if a listed company has 501-2,000 employees, the company’s supervisory board must, under statutory law, have employee representation equivalent to one-third of the board. For companies over 2,000 employees, representation must be one-half of the board.78

In France, under the Commercial Code articles L. 225-27-1 and L225-79-2, one or two employee representatives must be appointed to the board when a company employs at least one thousand permanent employees in the company and subsidiaries if head office is located in France, or when a company employs at least 5000 permanent employees in the company and subsidiaries if head office is located on the French territory and abroad.79 In the Netherlands, if a company is made up of at least 50 employees, then the company must set up a works council, which may recommend candidates to the supervisory board.80

Additionally, employee directors can serve a critical role of monitoring and constraining self-serving senior executives.81 Employees tend to have strong incentives, due to their own human capital invested in the firm, to ensure management is acting in a sustainable manner. Stakeholder representation on boards, especially when it comes to involving the labor force in board discussion, gives a “voice” in the decision-making process to a value creator of the company and can further mitigate risks, striking a reasonable balance in the firm’s pursuit of maximizing profits and valuing social capital.

Workers can also improve information transfer by bringing company-specific knowledge straight to boardroom discussions, while also providing better motivation for the workforce, converging interests between shareholders and employees and improving stakeholder relationships.82
**Board committees**

Lastly, in the context of board structuring, local jurisdictions are influencing and promoting the establishment of certain board committees within companies that delegate and divide board responsibilities into committees such as audit, remuneration and nomination.

Most jurisdictions require companies to establish an audit committee through law. However, it’s more common for jurisdictions to recommend establishing remuneration and nomination committees through codes or listing rules. Figure 10 shows whether board committees are required or recommended.

Figure 11 reveals that the most commonly adopted board committee is an audit committee. Some common responsibilities of an audit committee include - exercising oversight over selecting auditors, demanding higher quality financial statements, implementing robust internal controls around accounting disclosures and policies.

An effective audit committee is the cornerstone of a successful and credible financial reporting system. Audit committee members should have the authority and resources to protect all stakeholder interests. They can do so by ensuring reliable financial reporting, internal controls and risk management through diligent oversight efforts.

As sustainability reporting becomes more mainstream, audit committees will need to play a pivotal role in the transition from "silied reporting to integrated-ESG reporting.”83 The audit committee must understand for example the challenges presented by climate-related activities and to ensure greater transparency and assurance. The committee can also ensure compliance with new sustainability regulations, as well as identify appropriate long-term strategic financial benchmarks.84

It is common for companies to delegate board responsibilities to specialized committees compensating executives and nominating directors.

Figure 11 shows the widespread adoption of these committees and how companies are adapting their board structure to government regulations that promote better oversight and delegation of responsibilities. It is still uncommon for companies to set up a specific committee that oversees risk, corporate social responsibilities or ethics.

While the landscape of legal frameworks and corporate governance legislation can be varied and complex, there are some key themes and practices that the board must implement to further ensure effective corporate governance that takes account of sustainability risks and opportunities.

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**Figure 10: Establishment of board committees**

<table>
<thead>
<tr>
<th>Committee</th>
<th>Requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Remuneration</td>
<td>Recommend</td>
</tr>
<tr>
<td>Nomination</td>
<td>Recommend</td>
</tr>
<tr>
<td>Audit</td>
<td>Required</td>
</tr>
</tbody>
</table>

* Japan’s requirements/recommendations of board committees depend on the type of board structure adopted. The adoption of a nomination and remuneration committee is only required for a company with the three committees’ model.

**Figure 11: Adoption of board committees for companies researched**

- Risk committee
- CSR/ESG/HSE committee
- Nomination committee
- Remuneration committee
- Audit committee

The state of corporate governance in the era of sustainability risks and opportunities
Integrating governance

In today’s economy, companies are facing intense pressure and scrutiny around their corporate behavior from their own jurisdictions, but also from communities, investors and customers.
Effective governance is far more than the legal formalities around structure and composition, it is the overall implementation of ethical business practices, sound enterprise risk management and, most importantly, it is the shift of focus to long-term value creation.

Since governance is the all-encompassing mechanism that affects everything a business does, it is both prudent and necessary for those engaged in the corporate governance discussion to include the board’s role in overseeing sustainability issues.

A 2014 global survey of over 3,800 senior managers conducted by the MIT Sloan Management Review with the Boston Consulting Group and UN Global Compact, found that about 65% of the companies identified sustainability as a management agenda item.

However, only 22% of executives and managers believe that their own boards are actually providing substantial oversight on sustainability issues.85

Boards must question the effectiveness of their internal controls and evaluate their governance processes by asking in depth and challenging questions such as:

- How well does the board understand the pressing new risks that are affecting their company?
- To what extent is the board considering and actively discussing ESG-related risks and opportunities?
- What does the communication and oversight look like between sustainability and other relevant business functions?
- Are there specific key performance metrics and indicators around ESG-related issues that are being supervised by top-level management?
- Is the board composed of directors with relevant skills, education and expertise?
- Are the remuneration incentives in line with the company’s strategy that promotes long-term growth?

There are a number of ways that companies can begin to integrate these practices into their boardroom and governance processes.

SUSTAINABILITY GOVERNANCE OR SUSTAINABLE GOVERNANCE?

The UN Intergovernmental Panel on Climate Change (IPCC)’s recently released a special report on global warming of 1.5 °C which urges the world that unprecedented changes need to be made now to keep temperatures below 1.5°C – because the effects of global warming of 2°C will be far more catastrophic than previously realized.

This report could give investors, companies, consumers and governments a further push to strive towards achieving the United Nations 2030 Sustainable Development Goals (SDGs).

2018 was a watershed year for governance, as shareholder advocacy for sustainability was at its highest. During the year, boards received a record number of shareholder proposals requesting the consideration of environmental and social matters.86

Multi-lateral organizations have also stepped in to provide frameworks, principles, research and toolkits, that aim to help companies in this transitional shift of governance by integrating sustainability into governance structures.
International and national bodies are striving to foster dialogue between companies and investors in the rapidly evolving ESG landscape, by developing guidelines and research over the subject, including the European Voice of Directors (ecoDa), the Canadian Coalition for Corporate Governance, and the Institute of Directors.

For instance, the Task Force on Climate-related Financial Disclosures (TCFD) has addressed the importance of governance in their disclosure recommendations, where they urge companies to describe the board’s oversight of climate related risks as well as management’s role in assessing and managing these risks and opportunities. Furthermore, one of the most prevalent and useful frameworks has been presented by the United Nations Environmental Protection Financial Initiative (UNEP FI).

In their 2014 report, they argue that companies still tend to compartmentalize sustainability within governance structures and processes and in some cases just outright ignore ESG issues. The UNEP FI framework guides companies on how to improve their sustainability governance and internal oversight by ultimately embedding sustainability into the processes and mechanisms of corporate governance. It is the responsibility of the directors to determine whether the board’s discussion, oversight and control over ESG issues and opportunities are robust enough.

A company must first determine its own approach for managing and overseeing sustainability within their organization. This could be through a singular board-level committee or through a business function that is solely focused on sustainability implementation.

However, UNEP FI argues that the most successful governance mechanism that will enable a strong sustainability strategy is through its “integrated governance” model – where a mature governance structure would not have any specific committee dedicated to CSR/sustainability or ESG, but rather have sustainability successfully integrated throughout all board-level committees and throughout all business functions including accounting, finance, strategy and operations.

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**Figure 12: The relationship between sustainability and governance**

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Sources: UNEP FI (2014)
It’s critical for companies to define the highest sustainability decision-making authority and to understand how these reporting lines fit into the wider corporate governance structure, as well as how ESG is governed at group level. A board charter for the committee can demonstrate its commitment to these issues, as well as define accountability, targets and performance measures. These are all crucial steps that will ensure there can be substantial advancement towards a sustainable strategy.

According to WBCSD’s *Reporting matters* 2018 data, over a third (40%) of companies still don’t disclose board responsibilities on sustainability decision-making, and over two-thirds don’t link executive remuneration to sustainability goals. Interestingly, there is a positive correlation between a company’s score on sustainability governance, with their overall quality score of their report, which suggests that “those with appropriate governance mechanisms in place also have a clear board commitment to sustainability strategies, targets and commitments.”

**Figure 13: UNEP FI’s three phase approach:**

<table>
<thead>
<tr>
<th>PHASE 1</th>
<th>Sustainability outside of board’s agenda</th>
</tr>
</thead>
<tbody>
<tr>
<td>• There is little to no discussion of sustainability risks and opportunities at the board level</td>
<td></td>
</tr>
<tr>
<td>• The responsibility of any sustainability projects lies with small isolated teams</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>PHASE 2</th>
<th>Governance for sustainability</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Establishes a sustainability committee</td>
<td></td>
</tr>
<tr>
<td>• Measures their performance through KPIs and targets</td>
<td></td>
</tr>
<tr>
<td>• Issues a sustainability report</td>
<td></td>
</tr>
<tr>
<td>• Appoints a Chief Sustainability Officer</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>PHASE 3</th>
<th>Integrated governance</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Holistic integration of sustainability into the corporate strategy</td>
<td></td>
</tr>
<tr>
<td>• No need for a specific committee dedicated to sustainability/CSR/ESG</td>
<td></td>
</tr>
<tr>
<td>• Each board committee integrates sustainability issues in their charter which replaces the action of compartmentalizing sustainability</td>
<td></td>
</tr>
<tr>
<td>• Integrated reporting is used to measure financial and non-financial performance</td>
<td></td>
</tr>
</tbody>
</table>
Creating a board-level committee that is responsible for ESG or sustainability oversight is a well-known approach for improving corporate governance and internal controls over sustainability issues.

By restructuring boards and adding a specialized committee, a company can establish accountability for the oversight and consideration of ESG issues, as well as a line of responsibility throughout the various business activities and day-to-day operations. However, creating this committee does not absolve the board of directors of its obligation to oversee the company’s performance around this area.

There is broad agreement among multilateral organizations that a sustainability committee should have a clear mandate that aims to support value creation throughout all business functions by implementing a top-down approach and clear responsibilities on the issues and risks. The committee can provide appropriate and valuable knowledge and expertise around the subject and provide insightful questions, offer varying perspectives, propose alternatives and challenge management’s thinking.

This committee can foster accountability through regular meetings with key executives as well as managers from different business areas. It’s pivotal for other board directors and the chief executive to attend every meeting to avoid the committee being marginalized and to ensure collaboration and unification. The committee can also be responsible for assessing and tracking performance towards sustainability targets and metrics.

To further foster integration, the sustainability committee should collaborate with key business functions such as finance, innovation and supply chain, to build a more fundamental sustainable business model that is implemented throughout the whole organization. Most importantly, this committee should be collaborating with the audit committee to integrate financial and non-financial information and reporting as well as involve ESG issues in the company’s risk assessment.

Figure 14 outlines the value-adding activities a sustainability committee can bring to a governance project.

A regular report from the committee to the full board, comparable to reports from other standing committees, can help raise the board’s level of understanding and ensure that critical issues receive the scrutiny they require. Given the litany of economic, social and environmental problems plaguing societies around the globe, issues of corporate responsibility and sustainability are likely to become ever more salient.

Harvard Business Review
A US survey in 2014 suggested that no more than 10% of US public companies have a stand-alone committee dedicated to CSR or sustainability.\textsuperscript{94} 39% of the 56 companies researched across 12 jurisdictions for this report have adopted a specialized committee for either corporate social responsibility (CSR), sustainability, or health, safety and environment (HSE) matters. The statistic is even higher among WBCSD member companies, where 41% of member companies have a specialized committee. Companies across the globe are setting up a specialized committee because it allows them to focus more intentionally on ESG issues that would otherwise not be given the attention needed.

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{sustainability_committee.png}
\caption{How a sustainability committee can add value to governance}
\end{figure}
Case Study A  
Company: Nike Inc.  
Country: USA  
Maturity: Phase 2 – governance for sustainability

Sustainability Committee as a custodian of the long-term view, to mitigate labor and reputational issues.

Leading up to the 21st century, the firm was facing intense scrutiny from the public, including consumers and protestors, over the maltreatment of its employees in factories across Asia.

Since then, Nike has been known for its extensive CSR activities in efforts to transform the reputation that preceded them throughout the 90s, that associated them with, as their CEO pointed out in 1998, “slave wages, forced overtime and arbitrary abuse.”

By creating a board-level corporate social responsibility committee and by recruiting a director with expertise in social effects of industrialization, the company was able to pioneer innovation and mitigate their material social and environmental issues.

According to an article in the Harvard Business Review called Sustainability in the Boardroom (2014), Nike’s experience showcases how restructuring the board to include sustainability is beneficial to the overall strategy and how useful a sustainability committee can be:

1. As a source of knowledge and expertise
2. As a sounding board and constructive critic
3. As a driver of accountability,
4. As a stimulus for innovation
5. As a resource for the full board

Case Study B  
Company: SAP Global  
Country: Germany  
Maturity: Phase 3 - integrated governance

Executives have clear responsibilities and oversight over sustainability, organizational culture and safety.

In their integrated report, SAP provide a narrative on how “sustainability is at the heart of [their] strategy,” explaining that the CFO is the sponsor for sustainability on the Executive Board. In addition there is a dedicated individual responsible for embedding sustainability into business practices in each board area. SAP have also established a Sustainability Advisory Panel, comprised of a diverse group of international stakeholders, to discuss how sustainability can be better embedded into SAP’s core business.

Their governance framework outlines the responsibilities over sustainability for board members, the leadership team and the regional operational sustainability networks. Their framework also outlines clear reporting lines in which the Vice President of Sustainability provides clear and frequent reports directly to the CEO.
Sustainability education, skills and expertise at board level

Boards often seek directors who have expertise and relationships that could facilitate challenging and innovative decision-making. However, our research reveals that sustainability or ESG-related skills and experience are rarely taken into consideration, even though domain-specific knowledge and relationships are as relevant for those areas as for any others. From the companies researched, only a quarter of the boards had at least one director with relevant experience in ESG, ethics or social responsibility. Furthermore, the cases where such directors were found were geographically narrow, with the concentration being in European countries such as France, the UK and the Netherlands.

By mapping principal responsibilities and identifying key issues, a company can reveal the areas of knowledge and experience that would be particularly valuable to the board and the business.

Not every director or member of senior management can be an ‘ESG expert’ but directors and appropriate company personnel should educate themselves on the key ESG issues facing the company and be able to converse comfortably on those issues that matter or present significant risks.

Wachtell, Lipton, Rosen and Katz

A diversified board with a wide range of relevant skills and experience can bolster effective and innovative decision making that can ultimately make the company more agile, sustainable and competitive in the marketplace.

Nominating committees should consider whether appointed directors have a holistic understanding of stakeholders’ expectations and the company’s governing standards. The guidance published by WBCSD and COSO, on applying enterprise risk management to environmental, social and governance-related risks, suggests raising matters to the board by nominating or electing directors with ESG-related knowledge or expertise to the board or relevant committee. This will create a well-rounded and diverse understanding of ESG risks at board level.

Including ESG-related issues in enterprise risk management and internal control processes

Another vital element of any corporate governance structure is how it identifies and reacts to operational risks and opportunities. There has been an evolving discourse that has petitioned for the inclusion of ESG-related risks within governance processes such as Enterprise Risk Management (ERM) and internal control mechanisms. Now, more than ever, the public, regulators and investors are playing a major role in this discussion.

The board is responsible for assessing all risks and opportunities that the company currently faces in the marketplace as well as what they may face in the future. ERM must enable the identification and assessment of material ESG risks, to ensure the company is resilient against all risks that may materialize in the next 5-10 years and subsequently impact the future success of the business. Many codes have suggested that this responsibility be allocated to an audit committee or a separate board risk committee, both composed of independent directors.

As part of this process, some large multinational enterprises are even combining their risks and compliance functions to include ESG factors. This will ensure that there is a coordinated and integrated response to ESG-related risks that may tarnish the company’s reputation or affect the company’s operational and financial performance.
In order to act in the best interests of the company, directors should be expected to consider and identify the long-term risks to a company’s interests and to take steps to mitigate them. Specifically, directors should have an explicit duty to identify and mitigate all the economic, social and environmental factors that materially affect the long-term life of a company and the attainment of any specific social objectives (which may, for example, be enshrined in its articles of association or by-laws). The focus of the duty would be internal (e.g. risks to the company) rather than external (i.e. impacts on stakeholders).\textsuperscript{101}

Frank Bold, Redefining directors’ duties in the EU to promote long-termism and sustainability

Regulators in the UK, South Africa, France and the Netherlands alike, are utilizing both hard and soft legislation to influence boards on this matter.

The French government has confirmed that climate change is a material risk for companies. Article 173 of the Energy Transition and Green Growth (adopted on 17 August 2015) requires asset management companies and institutional investors to disclose information on the manner in which they incorporate environmental, social and quality of governance (ESG) objectives into their investment and risk management policies.

The Article includes a specific focus on their exposure to climate risk and the steps they have taken to play a part in achieving the objectives of the energy and ecological transition (including limiting the rise in global temperatures to below 2°C).\textsuperscript{102} Furthermore, a bill on business growth and transformation which is currently being discussed by French legislators introduces the notion of the company’s “social interest, taking into consideration the social and environmental issues of its activity” (Amendment, Article 1833 of French Civil Code). The bill also introduces the possibility for the company’s shareholders to introduce in the company’s statutes “the rationale for which the company intends to carry out its activities” with the objective of encouraging companies not to be guided only by the quest of profits (Amendment, Article 1835 of the French Civil Code).\textsuperscript{103}

In September 2018, England’s Prudential Regulation Authority, issued a thought-provoking report calling for insurers and banks to have a credible plan and management processes to mitigate the exposures from climate-related risks. According to our research on governance reporting and disclosure, companies are failing to discuss their identified ESG risks at board level. This reveals that boards may lack the necessary tools and training to integrate ESG risks into their ERM practices. The TCFD recommends that ESG issues should be discussed in the board room and should not be treated as separate issues only managed by sustainability teams. There should be specific roles within the board, management and operations for managing risks and opportunities related to climate change.

To provide the board and relevant sub-committees with management information on their exposure to the financial risks from climate change and the mitigating actions the firm proposes to take. The management information should enable the board to discuss, challenge and take decisions relating to the firm’s management of the financial risks from climate change.\textsuperscript{104}

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Bank of England Prudential Regulation Authority

Integrating governance

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Bank of England Prudential Regulation Authority

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The Article includes a specific focus on their exposure to climate risk and the steps they have taken to play a part in achieving the objectives of the energy and ecological transition (including limiting the rise in global temperatures to below 2°C).\textsuperscript{102} Furthermore, a bill on business growth and transformation which is currently being discussed by French legislators introduces the notion of the company’s “social interest, taking into consideration the social and environmental issues of its activity” (Amendment, Article 1833 of French Civil Code). The bill also introduces the possibility for the company’s shareholders to introduce in the company’s statutes “the rationale for which the company intends to carry out its activities” with the objective of encouraging companies not to be guided only by the quest of profits (Amendment, Article 1835 of the French Civil Code).\textsuperscript{103}

In September 2018, England’s Prudential Regulation Authority, issued a thought-provoking report calling for insurers and banks to have a credible plan and management processes to mitigate the exposures from climate-related risks. According to our research on governance reporting and disclosure, companies are failing to discuss their identified ESG risks at board level. This reveals that boards may lack the necessary tools and training to integrate ESG risks into their ERM practices. The TCFD recommends that ESG issues should be discussed in the board room and should not be treated as separate issues only managed by sustainability teams. There should be specific roles within the board, management and operations for managing risks and opportunities related to climate change.

Frank Bold, Redefining directors’ duties in the EU to promote long-termism and sustainability

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Bank of England Prudential Regulation Authority

Integrating governance

In order to act in the best interests of the company, directors should be expected to consider and identify the long-term risks to a company’s interests and to take steps to mitigate them. Specifically, directors should have an explicit duty to identify and mitigate all the economic, social and environmental factors that materially affect the long-term life of a company and the attainment of any specific social objectives (which may, for example, be enshrined in its articles of association or by-laws). The focus of the duty would be internal (e.g. risks to the company) rather than external (i.e. impacts on stakeholders).\textsuperscript{101}

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Bank of England Prudential Regulation Authority
Executive remuneration: pay for sustainability performance

In the absence of well-defined metrics and targets tied to tangible plans, ESG integration becomes vague and less likely to be achieved. One way in which a board can facilitate ESG integration is to establish executive remuneration incentives that take into account social and environmental factors.

Linking ESG performance measures to remuneration metrics is an emerging trend and is still an anomaly in the market. So, to what extent are climate-related targets or performance measures being taken into consideration for remuneration?

• In 2017, only 2% of companies within the S&P 500, tied environmental metrics to executive compensation and the most common sustainability metric used was for safety at 5%. Furthermore, the study found that the energy industry was the largest sector that links sustainability metrics to compensation, which accounted for 25% of companies that had them.

• According to research conducted by WBCSD’s Reporting Matters, about 39% of member companies have links between sustainability performance and executive remuneration.

• According to Ceres’ progress assessment data, in 2017 8% of companies linked executive, compensation to sustainability issues beyond compliance, this is a 5% increase from 2014.

In general, there is a positive link between incentive-based management compensation that includes non-financial and ESG measures with the environmental and social performance of a company. High level executives have stated they believe that the integration of sustainability targets in remuneration policies is one of the most effective methods to improve sustainable development, as they will help align executives’ self-interests with sustainability efforts.

These incentives can be regarded as good corporate governance, as it makes directors explicitly accountable for the environmental behavior of a firm and pressures them to set measurable performance-based goals. Examples of these metrics include: safety targets, emissions reductions, water and energy consumption, employee retention and diversity.

In 2016, the Principles for Responsible Investment (PRI) issued a guide on Integrating ESG Issues into Executive Pay, outlining recommendations around three key areas of discussion; identifying ESG metrics, linking metrics to executive pay and remuneration disclosure.

However, executive remuneration linked to sustainability faces challenges on accurate measurements/metrics and effective time-horizons. For example, ESG measures are usually associated with a longer time frame and are not easily measured in the short-term. Studies have found that long-term executive incentives are positively associated with CSR and short-term bonuses are negatively related to CSR. Accurately measuring the targets and metrics for these incentives can also pose challenges, as they are not always easily quantifiable.

Despite these minor hurdles, when implemented effectively, linking ESG performance to pay can help hold executives and management accountable to delivering sustainable business goals and targets.

Royal Dutch Shell has announced that in 2019 they will link executive pay and senior incentives with carbon emissions targets – a first for this sector. Earlier in 2018, the Financial Times stated that Shell’s executive found emissions target to be a “superfluous” exercise that would expose the oil major to litigation should it fail to meet them. However, after intense pressure from shareholders, Shell recently stated that they will link their energy transition targets to their long-term incentive plans of their senior executives. Hoping to systematically drive down their emissions and carbon footprint over a period of time.
TOP-DOWN INTEGRATION: FROM BOARD DISCUSSIONS TO KPIS AND CULTURE

Since the board of directors sits at the apex of a corporation, governance plays a central role in the implementation of a sustainable strategy. By altering board composition and board structure, a company can foster effective corporate governance that integrates ESG-related risks and manages stakeholder interests.

However, to successfully achieve sound corporate governance, a company should look beyond the structural and compositional aspects. In order to fully comprehend effective corporate governance in its entirety, a company should understand that corporate governance is only as good as the sum of its parts and processes, that impart culture, integrity, respect and reliability. Table 5 illustrates some key attributes of a high-performing board.

All of these decisions and processes start at the top, with executive and board-level discussions and decisions made about the overall strategic direction.

An effective governance process can enable a company to achieve specific goals and targets for business units across the organization and can help align the company’s sustainability strategy with its day-to-day operations.

Boards can better integrate sustainability throughout the systems and process:

• By establishing clear lines of responsibility, between executives, committees, managers and regional business functions. In doing so, a company can encourage accountability towards certain targets and goals.

• By establishing oversight and monitoring mechanisms such as frequent assessments, evaluations or reports to the board or committee responsible.

Strong leadership is key to effective sustainability. For example, Kering attributes their success in overcoming key challenges to the support and strong leadership of its CEO, François-Henri Pinault. He empowers the company to continue down a path towards integration and innovation around ESG measures. The CEO vision sets the tone, signaling that sustainability is to be seen as a business imperative. This is also reflected in the way senior executives behave and the actions they take, which helps to create an environment that supports ethically sound behaviors and accountability among employees.

### Table 5: Attributes of a high-performing board

<table>
<thead>
<tr>
<th>Key attributes of high-performing boards</th>
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<tbody>
<tr>
<td><strong>Reliable information flow</strong></td>
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<tr>
<td>Implements processes that regulate the way data is collected, shared and stored accurately. This creates transparent and timely information which is vital in the decision-making process.</td>
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<tr>
<td>Discusses material ESG issues and risks at the board meetings.</td>
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<tr>
<td>Accurate measurement, valuation and reporting of ESG performance.</td>
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<tr>
<td><strong>Regular reviews and evaluations</strong></td>
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<tr>
<td>Evaluates and manages performance, utilizing key performance indicators and targets.</td>
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<td>The board carries out constructive evaluations on the effectiveness of individuals and board committees.</td>
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<tr>
<td><strong>Forward-looking decisions</strong></td>
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<tr>
<td>Board and executive directors that have the ability to think and act with a long-term view.</td>
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<tr>
<td><strong>Strong leadership</strong></td>
</tr>
<tr>
<td>A strong leader has the ability to set the tone and culture throughout the whole company.</td>
</tr>
<tr>
<td><strong>Culture</strong></td>
</tr>
<tr>
<td>Create a culture that fosters mutual respect, professional behavior, stakeholder engagement and a responsible working environment that aims to resolves conflict.</td>
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</table>
Culture, ethics and values

In the wake of multiple high-profile scandals of corruption, bribery, and ethical conduct, boards are drawing more attention to the culture that is embedded throughout the organization.

A common approach to standardizing and controlling the culture throughout a company is to establish a “code of ethics,” “code of conduct” or a set of “internal rules.” These adopted codes enable clarification for all parties, internal and external to the organization, the standards that govern its conduct and actions and can thereby convey its commitment to responsible practice wherever it operates.

These codes are considered to be commonplace in most firms across the world, because they have proven successful in imparting ethical culture and behavior. Figure 14 summarizes the advantages of having a code of ethics.

Figure 14: Advantages of a code of ethics

- Sets the tone on top.
- Instills integrity and responsibility throughout the whole organization.
- Can help define the values of a company and what it stands for.
- Can provide a common frame of reference and serves as a unifying force across different functions, lines of business and employee groups.

In this world of 24/7 media, ethical issues will normally emerge quickly and spread even quicker, exacerbating reputational risk. Prevention is far more effective than cure.\(^{115}\)

Anthony Carey, Mazars
In 2017, 93% of the companies researched for this project disclosed that they established codes for all employees and in many cases external stakeholders such as suppliers and partners, must also agree to a company’s code of ethics/conduct. Some stock exchanges, such as NASDAQ, have made it compulsory for listed companies to adopt a code of conduct for all directors.

The UK’s 2018 Corporate Governance Code encourages boards to implement a culture that will “promote integrity and openness, value diversity and be responsive to the views of shareholders and wider stakeholders.” The code also recommends that the board align culture to incentive schemes that will drive and influence behavior that is consistent with the company’s purpose, values, culture and strategy. In the South African King IV Code, the second principle is dedicated to clearly defining the role of the board as promoting an ethical culture.

A company can support its ethical culture by providing training on ethical conduct and a means of reporting misconduct in confidentiality.

It is the responsibility of the board to ensure that corporate culture and every day decision-making is aligned with long-term sustainable strategy and the purpose of the business. The code of conduct allows directors to steer and influence the employees to make ethical and responsible actions that will promote a long-term sustainable strategy.

Accounting for Sustainability regards culture as the single most important thing within a company. It is commonly accepted that the overall culture around compliance and ethics starts with the tone at the top. Furthermore, the board should foster a culture of openness and transparency, which will enable and encourage rigorous debate between directors and managers.

In today’s business world, the most advanced companies are those that have developed a coherent culture of sustainability, which ensures that everyone in the company understands what sustainability means to the business, has a voice, feels involved and is proud of his/her own contribution.

Sir Win Bischoff,
Chairman of the Financial Reporting Council
Conclusion

This paper maps the current international landscape of corporate governance on both a country-specific and company-specific level with a focus on 12 jurisdictions.

First and foremost, we addressed the common misconception that the duty of directors is to solely maximize shareholder value and how this ideology has led to short-termism. It is evident that in this age of 24/7 media and increased transparency, companies can no longer act in this fashion without coming under considerable criticism from government regulators, media, consumers and employees.

The demand for better governance practices is driven by investor and consumer expectations. Companies now understand the benefits that can be realized through responsible oversight and decision-making that considers environmental and social factors.

The findings in this report show that each country-specific corporate governance paradigm is different from the next, as it is an outcome of a country’s specific economic, political, cultural and judicial make-up. This reveals that there is no ideal type of governance, but there are common themes and practices that can be found across jurisdictions to help companies work towards having more effective and responsible governance and internal oversight. This paper outlines what aspects and practices of corporate governance promote the long-term sustainable success of a company as well as generate value for all stakeholders, including shareholders.

In the international corporate governance paradigm, South Africa has emerged as a trail blazer, with its King IV Code providing an extensive and robust corporate guide to promoting inclusive capitalism, integrated thinking, stakeholder inclusivity and corporate citizenship.

Other jurisdictions such as the UK, the Netherlands, France and Singapore have also addressed the need for boards to adopt a long-term view of value creation. London and Singapore Stock Exchanges have addressed the investor demand for better integration of ESG into business practices and are now requiring more reporting and improved transparency.

Despite regulatory advancements, it is still in the hands of the company to truly integrate the corporate governance principles, as the most common legislation around corporate governance practices is through soft law. Failing to meet these corporate governance standards can be detrimental to the long-term sustainable success of the organization.

WBCSD’s Governance & Internal Oversight project will build on existing work and literature on corporate governance, to support companies in the integration of sustainability-related topics into their overall governance practices.
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ABOUT WBCSD

The World Business Council for Sustainable Development (WBCSD) is a global, CEO-led organization of over 200 leading businesses and partners working together to accelerate the transition to a sustainable world. WBCSD helps its member companies become more successful and sustainable by focusing on the maximum positive impact for shareholders, the environment and societies.

WBCSD member companies come from all business sectors and all major economies, representing combined revenues of more than USD $8.5 trillion and 19 million employees. The WBCSD global network of almost 70 national business councils gives members unparalleled reach across the globe. WBCSD is uniquely positioned to work with member companies along and across value chains to deliver impactful business solutions to the most challenging sustainability issues.

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