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Smaller Public Companies and ESG

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Editor's note: Jurgita Ashley is a partner at Thompson Hine LLP. This post is based on her Thompson Hine memorandum. Related research from the Program on Corporate Governance includes Socially Responsible Firms by Alan Ferrell, Hao Liang, and Luc Renneboog (discussed on the Forum here).

When State Street Global Advisors erected the "Fearless Girl" statute on Wall Street in March 2017, it ignited a dialogue regarding gender diversity on corporate boards and further fueled the focus on environmental, social and governance ("ESG") issues. Securities laws provide a mechanism for shareholders to submit proposals for inclusion in a company's proxy materials, for distribution to, and to be voted by, the company's shareholders. Hundreds of proposals are submitted annually, and review of such proposals is informative as to issues which are significant to at least some investors, potentially contributing to their investment decisions. Over the past three years, the number of environmental and social proposals has significantly increased, surpassing more traditional corporate governance proposals and covering such themes as board and employee diversity, gender pay equity, political contributions, plastic waste, climate change, guns, medications and human rights issues. With the vast majority of shareholder proposals submitted to S&P 500 companies, to what extent, if at all, should smaller public companies take into account ESG issues?

Foreshadowing of Future ESG Impact on Companies of All Sizes

Some significant corporate governance reforms, such as annual director elections, were driven by shareholder proposal initiatives. Similar to current environmental and social proposals, shareholder proposals calling for annual director elections were first directed at the largest companies, with this practice spreading to smaller companies over time. While adoption of any new "best" corporate governance practices by smaller companies tends to be slower and more gradual, the current ESG landscape might be foreshadowing what is eventually to come on the ESG front for companies of all sizes.

Reviewing the issue of board gender diversity as an example, legislative and institutional pressure to have diverse boards has been mounting. Institutional Shareholder Services (ISS) and Glass, Lewis & Co. (Glass Lewis), both prominent proxy advisory firms whose voting recommendations many institutional investors follow, have amended their policies to indicate that they would generally recommend voting at least against the chair of the nominating committee when a company has no female directors on its board. Institutional investors such as State Street and BlackRock have adopted similar policies, and many companies have been contacted by their investors regarding these issues. The State of California has passed legislation that requires publicly traded, stock exchange-listed corporations with principal executive offices in California to

have at least one female director on the board by the end of 2019 (with that number increasing to two or three by the end of 2021, based on the board size). The State of Illinois has legislation (subject to the governor's signature) requiring disclosure of board and management diversity by 2021. Despite court challenges regarding California's legislation, similar legislative efforts are ongoing in some of the other states. As a result, as of mid-2019, all S&P 500 companies have at least one female director.

Assuming that the issue of the board gender diversity is at all reflective of ESG issues more generally, and that, in turn, ESG concerns are not going away anytime soon, is there value to be realized by being at the forefront of these issues? Admittedly, perhaps being disproportionately impacted by the current regulatory regime, smaller public companies are already stretched to comply with numerous regulations, procedures and "good" corporate governance practices. Smaller public companies infrequently receive shareholder proposals and are generally less subject to any new social pressures. They often have larger insider ownership and lesser following by institutional investors, and consequentially are less impacted by voting recommendations issued by ISS and Glass Lewis. As is often noted, there is no "one size fits all" when it comes to the corporate governance of smaller public companies, and the same applies to ESG issues. Nevertheless, ESG analysis is merited.

Creating Value by Integrating ESG Issues into Long-Term Strategy and Leading ESG Initiatives

Some ESG issues might closely align with a company's strategic and operational goals, potentially creating synergies for the company, enhancing its reputation and providing it with competitive advantage. Smaller public companies should consider assessing their day-to-day operations with a view towards identifying ESG areas—both opportunities and risks—that are likely to have the greatest financial impact on the company in the long-term. Are the company's customers concerned about any particular ESG issues, and would addressing them provide the company with any advantage over its competitors? Are customers looking for environmentally-friendly products or services provided in a sustainable manner? Could some human capital driven initiatives assist with hiring and talent retention, reducing turnover rates and related expenses? Does being proactive on environmental and social issues reduce costs for compliance with future regulations?

Smaller public companies should also review the company's investor profile, whether that profile reflects where the company is heading, and the views of the company's investors on ESG topics. Has the company engaged with its shareholders on these issues, and what feedback has the company received to date? What is the profile of the company's peers and their stance towards ESG issues? How would an activist look at the company and its ESG profile? Armed with this information, the company can then focus on the ESG areas that are material to it, making real, impactful adjustments and integrating them into its long-term strategy. Positive developments in the ESG field are likely to result in some enhanced visibility, especially if the company is taking these actions ahead of its peers and has a comprehensive messaging plan for its investors, customers, regulators, vendors, suppliers and other constituencies.

If the ESG engagement is coming sooner or later, there might be some value in taking a leadership stance on these issues. Being at the forefront of these issues may generate goodwill

with the company's employees, customers and community at large and lead to reputational benefits. In addition to being a "good corporate citizen," leading on an ESG issue may set the company apart from its competitors and create financial value to its investors.