

manage its relationship with wider society, whether for reasons of commercial viability or to add value to society.³⁴

§1.04 IMPACT OF CONVERGENCE ON CORPORATE REGULATION

Rahim observed that the potential convergence of CSR and corporate governance has affected the modes of corporate regulation and that “hierarchical command-and-control” regulation dictated by the state is being replaced by a mixture of public and private, state and market, traditional and self-regulation institutions that are based on collaboration among the state, business corporations, and NGOs.³⁵ In fact, Rahim argued that the impact of the convergence of CSR and corporate governance has mostly been reflected by the development of self-regulatory regimes in the business environment which include both attempts by organized groups to regulate the behavior of its members and efforts by individual companies to exercise control over themselves to maintain the stability of their function and achieve certain organizational goals.³⁶ While self-regulation can be mandated or coerced by the state, most of the self-regulatory initiatives to date relating to CSR have been voluntary systems initiated and operated by corporations, often acting collectively with input from stakeholders. All of this seems to be consistent with the erosion of the authority and power of the nation-state that has occurred due to globalization and the accompanying rise of the influence of non-state actors and transnational bodies in constructing regulatory schemes and devices for businesses.³⁷

Rahim noted that individual companies have been self-regulating their CSR-related activities through their own codes of conduct and/or through incorporation of a multi-stakeholder initiative or guidelines prepared by another social or commercial organization.³⁸ When corporations create their own codes of conduct they are simultaneously acting as both “regulator,” responsible for the rules, and the “regulated,” responsible for implementation of those rules. Acting in this fashion provides the corporation with the flexibility to frame its own internal strategies for pursuit of broader public policy goals taking into account its specific circumstances and resources. On the other hand, when corporations adopt technical and qualitative standards provided by multi-stakeholder initiatives and other external organizations, the regulator is separated from the regulate, although corporations are generally encouraged to get involved in standard-setting exercises to ensure that their concerns

34. M. Rahim, *Legal Regulation of Corporate Social Responsibility: A Meta-Regulation Approach of Law for Raising CSR in a Weak Economy* (Berlin: Springer, 2013), 13, 44 (citing M. Blowfield and J. Frynas, “Setting New Agendas: Critical Perspectives on Corporate Social Responsibility in the Developing World”, *International Affairs*, 81(3) (2005), 499, 504).

35. M. Rahim, *Legal Regulation of Corporate Social Responsibility: A Meta-Regulation Approach of Law for Raising CSR in a Weak Economy* (Berlin: Springer, 2013), 13, 23 (citing A. Gill, “Corporate Governance as Social Responsibility: A Research Agenda” (2008), 464).

36. *Id.*

37. *Id.* at 27 (citing J. Cioffi, “Governing Globalisation? The State, Law, and Structural Change in Corporate Governance”, *Journal of Law and Society*, 27(4) (2000), 572).

38. *Id.*

are heard and addressed. While acting in this manner arguably increases the costs associated with implementation and compliance, it does provide corporations with the opportunity to access emerging best practices amongst their peers and enhance their brand and reputation by being associated with widely respected standards.

The codes of conduct referred to above began to appear during the 1990s, often adopted by large companies with a strong presence in developing economies with weak state-based regulatory systems and companies engaged in sectors where brand reputation and export orientation were critical (e.g., apparel, sporting goods, toy and retail sectors, oil, chemicals, forestry and mining).³⁹ In general, these codes addressed corporate ethics, moral guidelines, and key CSR issues like human rights, labor, the environment and sustainable development.⁴⁰ Notably, the codes generally extended outward to include supply chain participants and included restrictions on doing business with suppliers that did not respect workers’ rights (e.g., freedom of association) and ensure fair pay and treatment for their workers. Suppliers were also expected to support sustainability and use ethical practices to ensure their product quality and processing efficiency (e.g., refrain from using child labor and provide for environmentally friendly manufacturing methods). In many cases, companies supplemented their codes by providing training programs for suppliers and creating mandatory environmental management systems.⁴¹

Codes of conduct have been criticized as tools used by corporations to pursue their own interests rather than public policy goals and for failing to actually improve corporate behavior worldwide absent accompanying changes in business culture and decision making.⁴² Companies have also been criticized for creating codes of conduct that are complex and difficult to interpret and then ignoring them in practice or failing to ensure that they are prioritized through proactive communications from the independent directors and the members of the senior executive team.⁴³ In turn, proponents of codes of conduct argue that the codes can positively affect sales, purchasing and recruitment of new staff, secure the company’s reputation, create innovation, increase motivation among their employees and improve risk management and compliance, all of which ultimately leads to the increased sustainability of their

39. *Id.* at 29 (citing H. Arthurs, “Private Ordering and Workers’ Rights in the Global Economy: Corporate Codes of Conduct as a Regime of Labour Market Regulation”, *Labour Law in an Era of Globalisation: Transformative Practice and Possibilities* (2005), 471; and United Nations Research Institute for Social Development, *Corporate Social Responsibility and Business Regulations: How should Transnational Corporations be Regulated to Minimise Malpractice and Improve their Social, Environmental and Human Rights Record in Developing Economies?* (2004), available at www.unrisd.org at June 29, 2010).

40. E. Wymeersch, “Corporate Governance Codes and their Implementation” (Gent University, 2006).

41. M. Rahim, *Legal Regulation of Corporate Social Responsibility: A Meta-Regulation Approach of Law for Raising CSR in a Weak Economy* (Berlin: Springer, 2013), 13, 29–30.

42. *Id.* at 30 (citing A. Blackett, “Global Governance, Legal Pluralism and the Decentered State: A Labour Law Critique of Codes of Corporate Conduct”, *Indiana Journal of Global Legal Studies*, 8 (2000), 401; and R. Locke and M. Romis, *Beyond Corporate Codes of Conduct: Work Organisation and Labour Standards in Two Mexican Garment Factories* (2006)).

43. *See, e.g.*, P. Smalera, “The Valley’s Mess: Why Codes of Conduct Don’t Work”, *Fortune* (September 1, 2010).

company.⁴⁴ Codes of conduct have also been praised for their potential positive impact on internal governance including clarification of the company's mission, values and principals and their value as a guide and source of reference for the day-to-day decision making of employees.

Rahim noted that another trend in self-regulation has been the growing attention to nonfinancial reporting, a trend that began in the 1990s in response to a series of environmental disasters and continued thereafter to expand to include a wider range of corporate policies and CSR-related issues.⁴⁵ At the beginning, these reports primarily focused on informing the public of the company's existing CSR policies; however, as time went by companies began to use the reporting process as a means for creating channels of communication with their stakeholders. As this so-called sustainability reporting has become more sophisticated, incorporating metrics to be used to track the company's CSR performance, it has become a driver of corporate governance practices and pushes boards toward considering and incorporating better mechanisms for long-term accountability to their constituencies. While sustainability reporting has been largely voluntary, there is now a trend among legislators and regulators to require such reporting alongside traditional disclosures of financial results.

Rahim noted that both codes of conduct and nonfinancial reporting have been significantly influenced by external stakeholders eager to be involved in the formulation of codes and reporting practices and "supervise" the way in which businesses have chosen to self-regulate their CSR activities. One important byproduct of all of this has been the development of a "standardization regime" (i.e., "an agreement based on the principles that guide the standards of activities") in both areas including multi-stakeholder codes and principles used as guidelines for codes of conduct and reporting frameworks, such as the Global Reporting Initiative (GRI), available for consultation in presenting the content and results of CSR initiatives and programs.⁴⁶ Rahim explained that the multi-stakeholder initiatives involved companies, trade unions and other workers' associations, government agencies, NGOs and academics and included not only a framework of rules and guidelines for operations but also mechanisms for monitoring and verification and evaluation of the CSR performance of companies.

Williams noted that some stakeholder theorists have argued that the current version of "corporate responsibility," which generally emphasizes disclosure and voluntarism, is too modest and has failed to make a significant impact on addressing human rights issues, many of which remain in an extreme form all around the world in

44. M. Rahim, *Legal Regulation of Corporate Social Responsibility: A Meta-Regulation Approach of Law for Raising CSR in a Weak Economy* (Berlin: Springer, 2013), 13, 31.

45. *Id.* at 31. For further discussion of the evolution of voluntary sustainability reporting, see A. Kolk, "Sustainability, Accountability and Corporate Governance: Exploring Multinationals' Reporting Practices", *Business Strategy and the Environment*, 17(1) (2008), 1; D. Hess, "Social Reporting and New Governance Regulation: The Prospects of Achieving Corporate Accountability Through Transparency", *Business Ethics Quarterly*, 17 (2007), 455, 458; and J. Elkington, *The Triple Bottom Line for 21st-Century Business*, *The Earthscan Reader in Business and Sustainable Development* (2001).

46. *Id.* at 32.

the communities in which corporations continue to pursue their profit-making strategies.⁴⁷ These theorists believe that even though much is made of the "business case" for "voluntary" corporate responsibility (i.e., acting responsibly enhances the "intangible" value of the corporation, which has been estimated to account for anywhere from 70% to 80% of total market value, by improving brand reputation and goodwill and creating intellectual property necessary for innovation), the reality is that substantial economic disincentives remain for corporations and that they are likely to be unwilling to incur higher labor costs and/or make expensive investments in pollution abatement unless there is a supportive regulatory framework that creates a level playing field for competition (i.e., all of the participants in the market will be required by law to increase wages and reduce the harm that their activities cause to the environment).⁴⁸

After evaluating the arguments made by proponents of both the shareholder and stakeholder perspective, Williams praised the corporate responsibility initiatives for the many ways in which they had improved conditions of employment, brought attention to environmental problems and motivated firms to develop innovative products and solutions to address these problems, and noted the empirical evidence that corporate responsibility is generally a good business strategy; however, she cautioned that "corporate responsibility does not fundamentally change underlying power relationships between companies and citizens;" that companies can volunteer to act to address social and environmental problems—or not; and that corporate responsibility may dissuade governments from regulating, thus leaving gaping holes into which corporations may decide to march at great cost to the environment and the lives of millions of people around the world.⁴⁹ Williams also noted that while economic development has improved the overall standard of living, billions of people would benefit from greater access to productive enterprise and it is important that the underlying normative and material conditions of that access matter be managed properly, a role that should not be left to corporations themselves.

For Williams, the solution was to seriously consider more "hard law" regulating social responsibility, thus giving directors more guidance for decisions in the area and satisfying those who have complained that corporate responsibility based primarily on disclosure is too weak, and she suggested that the best place to look for guidance would be the self-regulatory initiatives that businesses had already chosen to participate in.⁵⁰ More regulation is allowed by economic theory when necessary to address market failures such as the negative externalities associated with irresponsible behavior of businesses and, as Williams pointed out, "[e]ven Friedman believed that business has

47. *Id.* at 39.

48. *Id.* at 40. Williams also noted that the business case for corporate responsibility depends on several other assumptions that have yet to be empirically confirmed such as consumers being willing to pay more for goods produced in socially responsible fashion, employees being selective about where they will work and choosing only the most responsible employers, and investors generally investing and disinvesting based on social parameters; however, as time goes by more and more studies are appearing that provide support for the reasonableness of these assumptions.

49. *Id.* at 54–55.

50. *Id.* at 53.

an obligation to conform 'to the basic rules of the society, both those embodied in law and those embodied in ethical custom'.⁵¹ In addition, actions by governments to make environmental and social responsibility a legal obligation for businesses may be necessary in order to ensure that the positive changes associated with corporate responsibility become sustainable.⁵²

§1.05 INVESTOR INTEREST IN CSR AND SUSTAINABILITY AND IMPACT ON BOARD OVERSIGHT

Sustainability has become an important issue for the major institutional investors and asset managers and the marketplace is seeing an increase in smaller, more specialized investment funds that are primarily oriented toward providing capital to companies that excel in their environmental, social and governance (ESG) practices and which focus on ESG-oriented activities such as climate change and impact investing. The goal of investors is to encourage their portfolio companies to contribute to the successful pursuit of environmental and social outcomes which continuing to provide investors with a suitable financial return.

A number of factors have contributed to the surge in the interest of investors in corporate sustainability and the ESG practices of their portfolio companies:⁵³

- Recognition in the financial community that ESG factors play a material role in determining risk and return.
- Understanding and acceptance that incorporating ESG factors is part of investors' fiduciary duty to their clients and beneficiaries.
- Concern about the impact of short-termism on company performance, investment returns and market behavior.

51. *Id.* at 52 (citing M. Friedman, "The Social Responsibility of Business is to Increase its Profits", *New York Times Magazine* (September 13, 1970), 6).

52. One change in hard law has been occurring as support has developed and increased for what Hart and Zingales referred to as the "constituency theory" of governance, which would expand the beneficiaries of the directors' fiduciary duties beyond shareholders to other constituencies, or stakeholders, such as employees, customers, members of the local communities in which the corporation operates and society as a whole. See O. Hart and L. Zingales, "Should a Company Pursue Shareholder Value?" (October 2016), available at https://www8.gsb.columbia.edu/leadership/sites/leadership/files/Zingales-Hart-Share_value.pdf Politicians in a majority of the states and the District of Columbia have endorsed and formalized the constituency theory by adopting statutes that permit the formation of "benefit corporations", a new form of for-profit corporation that explicitly expands the fiduciary duties of directors beyond maximizing shareholder value, which is still one of the primary goals of a corporation, to include consideration of whether or not the corporation's activities have an overall positive impact on society, their workers, the communities in which they operate and the environment. While the rate of adoption of benefit corporation status has been slow, particularly among public companies, the recognition of benefit corporations has contributed to sharpened focus on the separate interests of non-shareholder stakeholders and created a host of new issues and challenges for directors of all types of corporations such as how to measure and compare nonfinancial performance aspects of corporate activities; how to hold corporations accountable to stakeholders who do not have the rights to vote that are held by shareholders; and how to structure incentive packages for executives and managers tied to complex multi-stakeholder goals and commitments.

53. <https://www.unpri.org/about/what-is-responsible-investment>.

- Increased legal requirements protecting the long-term interests of beneficiaries and the wider financial system.
- Pressure from competitors seeking to differentiate themselves by offering responsible investment services as a competitive advantage.
- Increasing activism of beneficiaries who are demanding transparency about where and how their money is being invested.⁵⁴
- Concern regarding value-destroying reputational risk associated with environmental and social issues such as climate change, pollution, working conditions, employee diversity, corruption and aggressive tax strategies in a world of globalization and social media.

The potential benefits to institutional investors have been highlighted by the Conference Board, which has argued that CSR enhances market and accounting performance, lowers the cost of capital, improves business reputation, and fosters new revenue growth when it is channeled toward product innovation.⁵⁵ Similarly, the Chairman and CEO of BlackRock, Inc., the largest asset manager in the world, wrote in his 2016 Annual Letter to the CEOs of BlackRock's portfolio companies that "[o]ver the long-term, ESG issues—ranging from climate change to diversity to board effectiveness—have real and quantifiable financial impacts."⁵⁶ While many investors argue that focusing on corporate sustainability is necessary in order for companies to identify and mitigate the risks to current operations due to climate change, shortages of natural resources and ignoring basic human rights issues, investors also believe that developing and implementing innovating solutions to environmental problems, improving workplace conditions and forging strong relationships with local communities will lead to better economic performance for the business.

As for the specific CSR and corporate sustainability issues that are most important to investors, and which should therefore be priorities for directors and members of the executive team, reference can be made to surveys of CSR-related shareholder proposals

54. Institutional investors are themselves under increasing pressure from their own investors, as well as peers, activist groups and nongovernmental organizations, to proactively embrace CSR and corporate sustainability. For example, in 2006 investors with over \$2 trillion in assets under management pledged to commit to the UN Principles for Responsible Investment ("PRI"), which require that environmental, social and governance issues be incorporated into investment analysis and decision-making and that shareholders committed to the Principles proactively engage their portfolio companies regarding CSR and corporate sustainability issues and goals. By 2016, more than half of all publicly traded debt and equity worldwide was held by investors who were signatories to the PRI, and U.S. signatories accounted for nearly 20% of the total participation and included both traditional backers of environmental and social proposals and mainstream investment companies like BlackRock, Fidelity, State Street and Vanguard. See V. Harper Ho, Director Notes: Sustainability in the Mainstream—Why Investors Care and What It Means for Corporate Boards (The Conference Board, November 2017), 3 and Table 1, electronic copy available at: <https://ssrn.com/abstract=3080033> (based on information available at UNPRI, Signatories, <https://www.unpri.org/signatory-directory/>).

55. M. Tonello, Corporate Investment in ESG Practices (The Conference Board, Inc.: August 5, 2015).

56. Annual Letter from Larry Fink, Chairman and CEO, BlackRock, to CEOs (February 1, 2016), available at [blackrock.com](https://www.blackrock.com).

compiled by organizations such as the Institutional Shareholder Services Inc. Governance Analytics Database. In 2016 and early 2017, for example, the most popular topics among shareholder activists included lobbying disclosure, climate change reporting, political contributions disclosure, gender pay gap disclosure and sustainability reporting, a list that highlighted a decided shift in shareholder engagement toward sustainability and away from some of the issues that had dominated in previous years such as proxy access.⁵⁷ A little more than half of the CSR-related shareholder proposals submitted to companies in 2016 were actually voted upon since some did not meet the criteria for voting established by the company and others were removed from the ballot before the meeting based on undertakings by the company following engagement with the proponents of the proposal to voluntarily provide expanded CSR-related disclosures. Average support for those proposals that were voted upon was around 20%; however, nine proposals focusing on the following topics received majority support: board diversity, political contributions disclosure, methane emissions management, sustainability reporting, animal welfare, prohibition of sexual orientation and gender identity discrimination and gender pay gap disclosure. Companies can gather further insights by closely reviewing the proxy materials of other firms in their industry and the published voting records and pronouncements of their major institutional investors.

Harper Ho suggested that investor activism around ESG issues and investors' growing demand for investment-grade ESG information has important implication for how directors should approach corporate governance, investor engagement, compliance and disclosure practices.⁵⁸ First of all, the broadened scope of risks that directors must consider in light of ESG activism means that boards must have new capacities to support oversight of ESG risk. Second, investors want their companies to integrate ESG performance metrics and long-term benchmarks into executive compensation. Third, directors should ensure that investor engagement encourages dialogue and learning and confirm that senior management and investor relations personnel are aware of the increasing overlap between corporate governance and environmental and social concerns. Finally, directors need to improve the quality and formatting of their sustainability-related reporting and ensure that ESG materiality is being considered as part of their company's financial reporting process. According to Harper Ho, companies that can improve their practices in these areas are likely to see improved financial and operational performance, improved focus on long-term risk and return, better access to "patient capital" (i.e., investors that are less fixated on

57. H. Gregory, "Corporate Social Responsibility, Corporate Sustainability and the Role of the Board", Practical Law Company (July 1, 2017), 5-6 (citing Institutional Shareholder Services Inc., United States 2016: Proxy Season Review—Environmental and Social Issues (October 26, 2016), available at isscorporatesolutions.com (subscription required)).
58. V. Harper Ho, Director Notes: Sustainability in the Mainstream—Why Investors Care and What It Means for Corporate Boards (The Conference Board, November 2017), 13-14, electronic copy available at: <https://ssrn.com/abstract=3080033> (based on information available at UNPRI, Signatories, <https://www.unpri.org/signatory-directory/>).

quarterly earnings and more supportive of R&D and other investments in the company's future) and be able to identify and exploit new sources of value for the company and keep ahead of emerging risks and opportunities.⁵⁹

§1.06 TRANSPARENCY AND DISCLOSURE

As interest in CSR and corporate sustainability has grown, companies have found that they are subject to heightened scrutiny and that the traditional disclosure practices that focused primarily, if not exclusively, on financial information and performance and related risks are no longer adequate. Companies must now be prepared to provide disclosures that address the specific concerns and expectations of multiple stakeholders beyond investors including customers, employees, business partners, regulators and activists. This means that the board of directors must understand existing and emerging disclosure requirements and ensure that the company has the necessary resources to collect and analyze the required information and present it in a manner that is clear and understandable. While certain CSR and corporate sustainability disclosures have now become minimum legal requirements in some jurisdictions, in general such disclosures are still a voluntary matter and directors have some leeway as to the scope of the disclosure made by their companies and how they are presented to investors and other stakeholders.

As of 2013, over 90% of the Global 250 companies had decided to voluntarily disclose more ESG information than required by law⁶⁰ and Williams noted in 2016 that "[v]oluntary, transnational standards of best social and environmental practices are proliferating in virtually every industry, many with associated certification schemes and requirements for third-party attestation or auditing ... [and] ... [t]hese voluntary initiatives are increasingly being supplemented by domestic and multilateral government actions to encourage, or in some cases require, companies to pay closer attention to the social and environmental consequences of their actions and to disclose more information about those consequences."⁶¹

The U.S., which has comprehensive reporting requirements relating to a broad range of corporate governance matters, has been a notable laggard with respect to establishing a comprehensive general ESG disclosure framework; however, there are

59. *Id.* at 15.

60. KPMG, The KPMG Survey of CR Reporting 2013, available at <http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/corporateresponsibility/Documents/corporate-responsibility-reporting-survey-2013-exec-summary.pdf>. In addition, in 2013 76% of the top 100 companies in the Americas published a separate corporate responsibility report, as did 73% of top 100 companies in Europe and 71% in Asia. Also, 59% of the Global 250 had their reports "assured" typically by the specialist bureaus of the major accountancy firms. As reported in C. Williams, "Corporate Social Responsibility and Corporate Governance" in J. Gordon and G. Ringe (Eds.), Oxford Handbook of Corporate Law and Governance (Oxford: Oxford University Press, 2016), 5, available at http://digitalcommons.osgoode.yorku.ca/scholarly_works/1784.

61. C. Williams, "Corporate Social Responsibility and Corporate Governance" in J. Gordon and G. Ringe (Eds.), Oxford Handbook of Corporate Law and Governance (Oxford: Oxford University Press, 2016), 2-3, available at http://digitalcommons.osgoode.yorku.ca/scholarly_works/1784 (citing M. Blair, C. Williams and Li-Wen Lin, "The New Role for Assurance Services in Global Commerce", Journal of Corporate Law, 33 (2008), 325).

certain specific federal and state disclosure requirements in certain contexts such as releases into the environment, management through recycling, median employee pay, mine safety disclosure and “conflict minerals” disclosure.⁶² Public companies in the U.S. are required to make certain of their CSR and corporate sustainability disclosures in their SEC filings, which means that those disclosures are being made with a higher potential risk of liability. Apart from mandatory disclosure, several studies have found that about 80% of larger U.S. public companies have voluntarily provided some form of disclosures on their CSR and corporate sustainability initiatives in the form of published CSR/sustainability reports and/or disclosures on the company website; however, the quality of these disclosures has been criticized by the Sustainability Accounting Standards Board (SASB), which found that 52% of a sample of almost 600 companies that had made disclosures of CSR-related risks had done so using boilerplate language and has failed to disclose their plan to address such risks.⁶³

When companies were first attempting to provide voluntary disclosures relating to their CSR and corporate sustainability initiatives they often struggled with the format and depth of their reporting. Fortunately, as time went by, a consensus began to emerge about the benchmarks that companies should use for guidance in preparing their CSR and corporate sustainability reports. Of particular note are the standards for sustainability reporting developed by the GRI (www.globalreporting.org), which is a multi-stakeholder developed international independent organization that helps businesses, governments and other organizations understand and communicate the impact of business on critical sustainability issues such as climate change, human rights, corruption and many others; the International Integrated Reporting Framework developed by the International Integrated Reporting Council, or IIRC (integratedreporting.org), and the resources available from the SASB (www.sasb.org), which publishes the SASB Implementation Guide for Companies that provides the structure and the key considerations for companies seeking to implement sustainability accounting standards within their existing business functions and processes. However, while the efforts of the GRI, IIRC and the SASB indicate that some progress has been made regarding the development of measurement and disclosure frameworks relating to corporate sustainability and ESG practices, companies and their stakeholders are not yet able to rely on universally accepted guidelines.

62. *Id.* at 16–19. See also C. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, Harvard Law Review, 112 (1999), 1197. The federal Securities and Exchange Commission has also occasionally issued guidance on selected ESG topics such as disclosures related to climate change.

63. See Flash Report: Eighty One Percent (81%) of the S&P 500 Index Companies Published Corporate Sustainability Reports in 2015 (Governance & Accountability Institute, Inc., 2016), available at ga-institute.com; and Sustainability Accounting Standards Board, *The State of Disclosure Report 2016*, available at sasb.org. The percentage is particularly striking given that less than 20% of the companies in the same group in 2011 published sustainability reports in that year.

§1.07 CONCLUSION

Corporate governance is the system and structures of rules, practices and processes by which a company is directed and controlled, the goals and objectives of the company are established and the performance of the company is tracked. Traditionally, corporate governance has focused on the owners of the corporation that have supplied the financial capital necessary for the business to operate (i.e., the shareholders), regulation of the duties and responsibilities of the persons that the owners have selected as their agent to deploy their financial capital and generate a reasonable return on their investment (i.e., the directors and the members of the executive team); the control environment, which includes accounting procedures, internal controls and external audits used to track the operational activities of the company selected by the directors as the best means for delivering the anticipated return on investment to the shareholders; and transparency and disclosure, which are needed in order for the shareholders to fully understand how their financial capital has been used and to ensure that their agents, the directors and members of the executive team, have not abused their positions.

As time has gone by, corporate governance has emerged from what often seemed to be an esoteric collection of laws, regulations and contracts to recognition of its role as a primary driver of competitive advantage and profitability and a means for making and executing strategic decisions and ensuring that companies achieve their goals. Writing in 2008, Jamali et al. summed up the importance of corporate governance as follows:

The importance of [corporate governance] lies in its quest at crafting/continuously refining the laws, regulations, and contracts that govern companies' operations, and ensuring that shareholder rights are safeguarded, stakeholder and manager interests are reconciled, and that a transparent environment is maintained wherein each party is able to assume its responsibilities and contribute to the corporation's growth and value creation. Governance thus sets the tone for the organization, defining how power is exerted and how decisions are reached.⁶⁴

In 2010, the IFC described corporate governance as referring “to the structures and processes for the direction and control of companies” and limited the coverage of corporate governance to the areas mentioned above (i.e., shareholders, directors, controls, transparency and disclosure). Notably, the IFC made it clear that it did not consider corporate governance to include, although the IFC said it might reinforce, CSR and corporate citizenship; socially responsible investing and other elements of what had become to be referred to as “corporate sustainability” such as political governance, business ethics, anti-corruption and anti-money laundering.⁶⁵ However, since that time, as the world worked its way through a global financial crisis that called into

64. D. Jamali, A. Safieddine and M. Rabbath, “Corporate Governance and Corporate Social Responsibility Synergies and Interrelationship”, *Corporate Governance*, 16(5) (2008), 443, 444 (citing J. Page, *Corporate Governance and Value Creation* (University of Sherbrooke, Research Foundation of CFA Institute, 2005)).

65. International Finance Corporation, *Corporate Governance: List of Key Corporate Governance Terms* (2010), 4.

committee: (i) accept any consulting, advisory, or other compensatory fee from the issuer; or (ii) be an affiliated person of the issuer or any subsidiary thereof.³

- Each audit committee shall establish procedures for: (a) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and (b) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.⁴
- Each audit committee must have the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties.⁵
- Each issuer must provide for appropriate funding, as determined by the audit committee, in its capacity as a committee of the board of directors, for payment of compensation: (a) to the registered public accounting firm employed by the issuer for the purpose of rendering or issuing an audit report; and (b) to any advisers employed by the audit committee as contemplated above.⁶

The SEC subsequently adopted rules (Exchange Act Rule 10A-3) putting Sarbanes-Oxley Act §301 into effect and both national securities exchanges adopted listing standards regarding the independence of audit committee members of listed companies and a wide array of other matters consistent with the requirements of Sarbanes-Oxley Act §301 and the SEC rules.⁷ For example, there are now specific rules regarding the structure and composition of audit committees, and such committees have now been given broad responsibilities with respect to oversight of various activities and procedures include engagement of outside auditing firms, establishment and monitoring of internal controls and creation of procedures for receipt and investigation of complaints regarding questionable accounting or auditing matters. The audit committee is also a key participant in the company's efforts to assess risks and develop and implement risk management strategies. Minimum qualifications for service on an audit committee have been promulgated by the SEC and the major exchanges and place a premium on independence, education and experience in the accounting and finance areas and the ability to critically evaluate the recommendations and decisions of senior management and the independent auditors with respect to financial reporting issues. In light of the importance of the audit committee, it is not surprising that SEC rules expanded the disclosure requirements regarding the makeup and activities of audit committees.

3. 15 USC §7240(3).

4. 15 USC §7240(4).

5. 15 USC §7240(5).

6. 15 USC §7240(6).

7. See NYSE Listed Company Manual §§303A.02-303A.07 (the Commentary to NYSE Listing Manual § 303A.06 provides that the Exchange will apply the requirements of Rule 10A-3 in a manner consistent with the guidance provided by the SEC in SEC Release No. 34-47654 (April 1, 2003)); NASDAQ Marketplace Rule 4350.

§6.02 CHARTER AND ACTIVITIES OF AUDIT COMMITTEE

Given the enormous responsibilities of the audit committee and its members, close attention should be given to establishing and maintaining appropriate procedures relating to committee activities. First and foremost, the audit committee, as well as the entire board of directors, should draft and adopt a written audit committee charter that specifies the main purposes of the committee, the duties and responsibilities of the committee, and the structure, processes and membership requirements associated with the committee.⁸ When drafting the charter, which should appear in the company's proxy materials and be posted on the company's web site, it is important to consider the specific requirements of the Sarbanes-Oxley Act and any relevant listing requirements applicable to the company. In that regard, both the NYSE and NASDAQ have adopted requirements mandating that audit committees have a written charter that covers the matters set out in the applicable listing standards.⁹

NASDAQ has integrated a number of provisions included in the Sarbanes-Oxley Act by requiring that the charter describe the audit committee's authority over and responsibility for, as provided by the Act, overseeing the accounting and financial reporting processes and the audits of the financial statements of the company; hiring, determining the funding for and overseeing the independent auditors; preapproving all audit and permissible non-audit services; establishing procedures for receipt and handling of complaints relating to the company's financial reporting and internal controls; and engaging and determining funding for independent counsel and other advisors to the committee. The audit committee charter for NASDAQ-listed companies must also specify the scope of the committee's responsibilities, including structure, processes and membership requirements and the responsibilities of the committee for ensuring the receipt from the independent auditor of a formal, written statement delineating all relationships between the auditor and the company, consistent with auditor professional responsibility standards (I.S.B. No. 1); actively engaging in a dialogue with the auditor with respect to a disclosed relationship or services that may impact the objectivity and independence of the auditor; and taking, or recommending that the board take, appropriate action to oversee the independence of the auditor. The charter must also specify all audit committee responsibilities set forth in Rule 10A-3(b)(2), (3), (4) and (5) under the Exchange Act including Rule 10A-3(b)(3)(ii) requiring that each audit committee must establish procedures for the confidential, anonymous submission by employees of the listed company of concerns regarding questionable accounting or auditing matters.¹⁰

NYSE-listed companies are subject to somewhat more comprehensive requirements regarding the content of their audit committee written charters and such

8. For examples of audit committee charters and additional commentary on preparation of such charters, see "Board Committee Charters" in the management tools available as part of "Governance: A Library of Resources for Sustainable Entrepreneurs" prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

9. See generally NYSE Rules Section 303A.07 of the Listed Company Manual and NASDAQ Rule 5605(c)(1).

10. NASDAQ Listing Rule IM-5605-3.

companies must have charters that specify the purpose of the committee, with special reference to assisting board oversight of the integrity of the company's financial statements; the company's compliance with legal and regulatory requirements; the independent auditor's qualifications and independence; the performance of the company's internal audit function and independent auditors; and preparation of an audit committee report as required by the SEC to be included in the listed company's annual proxy statement.¹¹ In addition, the NYSE requires the charter to describe the details of the long list of audit committee duties and responsibilities described below.¹² Both the NASDAQ and the NYSE contemplate that audit committees will do an annual assessment of the sufficiency of their charters and provide certifications that such assessments have been completed.

[A] Statement of Purpose

The primary purpose of the audit committee is oversight of the integrity of the company's financial statements; however, additional issues typically included in the statement of purpose include oversight of the company's risk management and internal control arrangements; oversight of compliance with legal and regulatory requirements; making recommendations to the entire board of directors regarding the selection of the company's independent auditors and the compensation payable to the auditors; oversight of the performance, qualifications and independence of the company's independent accountants; promulgation and enforcement of policies and procedures relating to the work performed by the independent auditors; and oversight of the performance of the company's internal audit function. A Global Compact publication recommended that the purpose statement of the audit committee charter also include ensuring the integrity of the company's sustainability performance statements and sustainability information communicated externally and conducting oversight of compliance with the company's sustainability policy or commitments (e.g., via an internal audit review).¹³ The potential scope of the areas of concern for the audit committee is obviously quite large and may be reduced significantly in situations where the board has created separate board-level committees to oversee issues relating to compliance and risk management, disclosure and reporting and CSR; however, even when such committees have been created it will be necessary for the audit committee to collaborate closely with them in areas related to the content and integrity of the company's financial statements.

[B] Composition, Meetings and Procedures

The SEC, as well the various exchanges, has adopted rules and regulations relating to the composition of audit committees, as well as the specific skills and background of

11. NYSE Listing Manual § 303A.07(c)(i).

12. NYSE Listing Manual § 303A.07(c)(iii).

13. The Essential Role of the Corporate Secretary to Enhance Board Sustainability Oversight: A Best Practices Guide (United Nations Global Compact, September 2016).

members of such committees. Under the Sarbanes-Oxley Act, every member of the audit committee must be independent, with "independence" determined by reference to detailed definitions promulgated by the SEC and the exchanges. Most public companies have provided that a majority of their audit committee members be independent for a number of years and the NYSE and NASDAQ have both historically required that all listed companies must have an audit committee, composed of at least three members, all of whom must be independent (subject to limited exceptions under NASDAQ rules). However, the hurdle for establishing independence has never been as high as it is now after the adoption of the Sarbanes-Oxley Act. The overriding objective is to ensure that audit committee members will no longer be beholden to senior management and that they will be comfortable exercising authority that, in a number of cases, may result in decisions that are at variance with the wishes of management.

Audit committees of NYSE-listed companies must have a minimum of three members¹⁴ and all audit committee members must satisfy the requirements for independence set out in Section 303A.02.¹⁵ NASDAQ Listing Rule 5605(c)(2)(A) requires that each company must have, and certify that it has and will continue to have, an audit committee of at least three members, each of whom must: (i) be independent as defined under NASDAQ Listing Rule 5605(a)(2) described above; (ii) meet the criteria for independence set forth in Rule 10A-3(b)(1) under the Exchange Act (subject to the exemptions provided in Rule 10A-3(c) under the Exchange Act); and (iii) not have participated in the preparation of the financial statements of the company or any current subsidiary of the company at any time during the past three years.

Another interesting development has been the promulgation of functional qualifications for service as a member of the audit committee. Companies must disclose in their annual and quarterly reports whether or not the audit committee includes at least one member who is a "financial expert" (and, if not, the reasons for the lack of such an expert), subject to certain exceptions. This requirement applies not only to "listed companies," but to all companies whose securities trade in the United States (even if none of the company's securities are listed on a national exchange).¹⁶ SEC rules define an "audit committee financial expert" as a person who has all the following attributes:¹⁷

- an understanding of generally accepted accounting principles (GAAP) and financial statements;
- the ability to assess the general application of GAAP in connection with the accounting for estimates, accruals, and reserves;
- experience in preparing, auditing, analyzing, or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by a company's financial statements, or

14. NYSE Listing Manual § 303A.07(a).

15. NYSE Listing Manual § 303A.07(b).

16. Sarbanes-Oxley Act § 407(a), 15 U.S.C.A. § 7265, and SEC Release No. 33-8177, Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002 (January 23, 2003).

17. See 15 USC §7265(b); 17 CFR §229.407(d)(5)(ii).

- experience actively supervising one or more persons engaged in such activities;
- an understanding of internal controls and procedures for financial reporting; and
- an understanding of audit committee functions.

The SEC rules mention the following alternative means for a person to have acquired the necessary attributes listed above:¹⁸

- education and experience as a principal financial officer, principal accounting officer, controller, public accountant, or auditor or experience in one or more positions that involve the performance of similar functions;
- experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor, or person performing similar functions;
- experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing, or evaluation of financial statements; or
- other relevant experiences.

Both the NYSE and NASDAQ also have “financial literacy” requirements that must be satisfied by each member of the audit committee of a listed company. For example, audit committee members of NASDAQ companies must be able to read and understand fundamental financial statements, including a company’s balance sheet, income statement, and cash flow statement at the time that they are appointed, while the NYSE gives new committee members a reasonable period of time following their appointment to become financially literate. In addition, both the NYSE and NASDAQ require that at least one member of the audit committee have accounting or related financial management experience or expertise consistent with the characteristics associated with a “financial expert” (i.e., past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual’s financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities).¹⁹

As a result, audit committee members must now come prepared to understand the complex rules that generally apply to preparation of financial statements and determination of accounting policies. This can be a challenge even to the most experienced directors, including those that have background in the accounting field, since requirements and practices are changing rapidly on a regular basis. Companies should initiate training and educational programs for their directors or, at a minimum, require that audit committee members attend and complete similar programs conducted by the NYSE or NASDAQ.

18. 17 CFR §229.407(d)(5)(iii).

19. See NYSE Rules Section 303A.07 and NASDAQ Rule 5605(c)(2).

Members of the audit committee must be prepared to spend a substantial amount of time in discharging their duties and obligations in relation to the company. For example, commentators are advising that audit committees should schedule full-day meetings on no less than a quarterly basis. The schedule for the meetings should allow sufficient time to review earnings releases and proposed 10-Q filings. The chairperson of the audit committee plays a key role in ensuring that the time of the committee members is invested wisely and efficiently and he or she needs to be prepared to work on the committee agenda to make sure that meetings run smoothly and coordinate with other committees, such as the compliance and risk management committee and the disclosure and reporting committee, to avoid unnecessary waste of effort through duplication. The committee chairperson should also have a good understanding of the business, its risks, and controls; be professionally skeptical and possess integrity and confidence; have strong communication and interpersonal skills; and be prepared and willing to set aside large amount of time to overseeing the committee’s agenda and projects and meeting with management, other board members, the independent auditors, members of the internal audit function and representatives of key stakeholders.²⁰

At each meeting, members should be prepared to engage in lengthy and detailed discussions with senior management, as well as the company’s internal and external auditors, to understand the financial reporting system of the company and the decisions that are to be made relating to the accounting treatment of various transactions. Under no circumstances can any of the audit committee members fail to achieve a clear understanding of any transaction, the manner in which it is presented, and the economic effect it will have on the financial position of the company. Audit committee members should be able to review and evaluate the results that would have been reached if alternative accounting methods had been elected.

In addition, the audit committee should schedule extra time to allow for discussion of all financial information and other disclosures that are to be made in response to regulatory requirements, including financial statements, press releases and earnings guidance and other financial information given to analysts and rating agencies. Discussions with the company’s independent auditors are particularly important in this process, especially given the oversight responsibilities now vested in the members of the audit committee. The auditors should be quizzed about the procedures and decisions that they themselves might have used or made had they been given complete authority over the preparation of the company’s financial statements. This inquiry is designed to focus on differences from the approach taken by management toward the reporting process. The auditor should also be asked to put itself in the shoes of senior management and opine as to whether or not the auditor believes the company’s internal controls are sufficient for the auditor to be comfortable in delivering the certifications required of senior managers. Finally, the auditor should be asked

20. See P. Loop, What to Look for in an Effective Audit Committee Chair, National Association of Corporate Directors (March 13, 2018), <https://blog.nacdonline.org/2018/03/what-to-look-for-audit-chair/>.

whether it would be satisfied with the financial information provided by the company if it were an investor.

Given the time required by audit committee members to complete the necessary consultations, it is more important than ever that audit committee meetings and activities be carefully scheduled. This requires proper advance planning for meetings, including timely dissemination of the materials to be discussed at the meeting, and sufficient time during the meetings to accomplish all the work that needs to be done. In addition, audit committee members must anticipate the need to devote additional time for follow up on questions and issues that arise at the meetings. All of this means that each prospective audit committee member should evaluate carefully the existing demands on his or her time before accepting this important assignment and the Commentary to the NYSE listing standards actually includes conditions that must be satisfied before an audit committee member will be allowed to simultaneously serve on the audit committees of more than three public companies.²¹ Audit committee members should also be expected to be tapped for assignment to other board-level committees that handle topics that overlap with the traditional responsibilities of the audit committee in order to ensure that there is effective coordination and collaboration between those committees. For example, audit committee members are good candidates for service on the board's compliance and risk management and disclosure and reporting committees.

Given the broad array of duties and responsibilities that have been vested with the audit committee, and the corresponding need for interpretation of applicable rules and regulations, it is not surprising to find that the audit committee will often require focused advice from independent counsel. Recognizing this need, SEC rules now provide the audit committee with authority, as discussed above, to engage independent counsel and any other advisors the committee determines may be necessary in order for it to carry out its duties and obligations. For example, it can be expected that counsel will be consulted for interpretation of basic issues, such as whether a nominee for the audit committee is "independent" or whether a particular service provided by an accounting firm falls within the scope of the audit committee's approval requirements. Counsel will also be required to assist the audit committee in the development of rules and procedures, including written charters that must be developed to define the scope of audit committee activities. Finally, counsel will be required to assist the committee in overseeing and conducting internal investigations that may be brought to the attention of the committee through the professional standards requirements imposed on attorneys.

[C] Scope of Duties and Responsibilities

As a general rule, regardless of the relevant listing requirements, the charter should cover each of the key activities and duties of the audit committee, including supervision of the company's relationship with its independent auditor, including such

21. Commentary to NYSE Listing Manual § 303A.07.

matters as selection, evaluation, and auditor staffing; development of policies regarding non-audit services; review and discussion of the company's financial statements and critical accounting policies with management and the independent auditor; review of all related-party transactions; oversight of the company's internal controls; development of policies for hiring former auditor personnel; and development of policies regarding the declaration of dividends and other distributions to shareholders.

NASDAQ Listing Rule 5605(c)(3) requires that the audit committee must have the specific audit committee responsibilities and authority necessary to comply with Rule 10A-3(b)(2), (3), (4) and (5) under the Exchange Act (subject to the exemptions provided in Rule 10A-3(c) under the Exchange Act), concerning responsibilities relating to: (i) registered public accounting firms; (ii) complaints relating to accounting, internal accounting controls or auditing matters; (iii) authority to engage advisors; and (iv) funding as determined by the audit committee. The NYSE requires that the charters of audit committees describe the details of a long list of audit committee duties and responsibilities including:²²

- retaining and terminating the independent auditors of the company;
- at least annually, obtaining and reviewing a report by the independent auditor relating to the auditor's internal control procedures and all relationships between the auditor and the company;
- discussing the annual audited financial statement and quarterly financial statements with management and the independent auditor and the company's disclosure in the related "Management's Discussion and Analysis of Financial Condition and Results of Operations;"
- discussing earnings press releases, as well as financial information and earnings guidance given to analysts and rating agencies;
- obtaining the advice and assistance of outside legal, accounting or other advisers, as appropriate;
- discussing policies with respect to risk assessment and risk management;
- Meeting separately, periodically, with management, with the internal auditors, and with the independent auditors;
- reviewing with the independent auditor any audit problems or difficulties and management's response;
- setting clear hiring policies for employees or former employees of the independent auditor;
- reporting regularly to the board on any issues that arise within its oversight responsibilities including the quality and integrity of the company's financial statements, the company's compliance with legal or regulatory requirements, the performance and independence of the auditors and the performance of the company's internal audit function;
- preparing the report of the audit committee that SEC rules require to be included in the company's annual proxy statement; and
- conducting an annual evaluation of its performance of its responsibilities.

22. NYSE Listing Manual § 303A.07(c)(iii).

[1] *Oversight of the Integrity of the Company's Financial Statements*

The audit committee is the primary group within the board of directors with respect to overseeing the integrity of the company's financial statements and most of the committee's duties and responsibilities will be focused on ensuring that all material information regarding the company's financial and business performance is collected, analyzed and presented in a manner that satisfies not only regulatory requirements and industry standards but also fulfills the needs and expectations of each of the company's stakeholder groups. Specific activities to be performed by the committee with respect to the integrity of the financial statements include:

- Regularly reviewing the company's internal and external financial reporting systems.
- Reviewing significant accounting and reporting issues and how these issues are being addressed including any significant changes in accounting principles; the methods used to account for significant or unusual transactions where different approaches are possible; and whether the company has been following appropriate accounting standards and made appropriate estimates and judgements taking into account the views of the company's independent auditors.
- Reporting to the entire board of directors when the committee is not satisfied with any aspect of the company's proposed financial reporting.
- Reviewing any material off-balance sheet transactions, arrangements, obligations and other relationships with unconsolidated entities or other persons that may have a material effect on the company and its related entities.
- Reviewing and approving the publication of the company's quarterly and annual financial statements and related reports regarding the overall business of the company (including clarity and completeness of disclosure) to ensure that, taken as a whole, they are fair, balanced and understandable.
- Reviewing the company's practices with regard to the release and publication of financial and other business information to the markets.
- Reviewing dividend proposals including any annual or other proposal in relation to the amount of the quarterly or other periodic dividend.
- Reviewing and approving the expenses policy for the executive team of the company, reviewing the process for the claiming of expenses by executives to ensure that it is appropriate and effective and reviewing the annual aggregate expenses claims of the members of the executive team.
- Overseeing the assurance of the financial and nonfinancial key performance indicators in the company's financial and sustainability reports.

[2] *Relationships with Auditors*

Historically, the selection of the independent auditor for a public company was managed by senior management, generally with little input from the audit committee

or other outside directors. As a result, concerns arose, often legitimately, that independent auditors might be beholden to senior management and would be subject to undue influence with respect to determination of accounting policies and reporting of financial results. It is not surprising, therefore, that one of the most important changes implemented in the Sarbanes-Oxley Act was to provide that the audit committee (composed entirely of independent directors as described above) must have authority over, and be made "directly responsible" for, appointing, compensating and retaining the company's independent auditor and for overseeing the work of the auditor in connection with the preparation or issuance of any audit report.²³ Among other things, this authority includes the right to determine the funds to be allocated to compensate the independent auditors for audit work and any related work, as well as the funds needed for other audit, review or attest services provided by a public accounting firm. In addition, these duties include the resolution of any disagreements between the auditor and company management relating to financial reporting.

The rules and regulations also require that the audit committee (or the full board of directors) must approve all audit services (including delivery of a comfort letter in connection with an offering of securities) and, subject to certain de minimis exceptions, all permitted non-audit services to be provided by the auditor or its associated persons before the services are provided. This requirement applies not only to "listed companies," but to all companies whose securities trade in the U.S. (even if none of the company's securities are listed on an exchange or NASDAQ.²⁴ When considering approval of non-audit services, deference should be given to the restrictions on such services included in SEC and exchange rules and regulations. Examples of non-audit services that might impair the independence of a registered accounting firm include bookkeeping or other services related to the issuer's accounting records or financial statements; design and implementation of financial information systems; appraisal or valuation services, including fairness opinions; actuarial services; auditor service in a management role, including as a director, officer or other employee with decision-making or supervisory authority; legal services; broker-dealer, investment advisor or investment banking services; expert services; and tax services. Reference should be made to the specific rules applicable to each type of service. While some services are prohibited outright, others can be provided as long as they are preapproved by the audit committee and the committee has conducted sufficient investigation to verify that the services do not fall within a "prohibited category." For example, tax services may be provided; however, the audit committee must be sure that the auditor does not serve in an advocacy role for the issuer-client.

[3] *Disclosure Controls, Compliance and Risk Management*

The Sarbanes-Oxley Act vested several significant compliance responsibilities in the audit committee. Perhaps most importantly, the audit committee was given a central

23. See generally SEC Rule 10A-3, 17 C.F.R. § 240.10A-3; NYSE Rules Section 303A.06, 303A.07 of the Listed Company Manual and NASDAQ Rule 5605(c)(3).

24. Sarbanes-Oxley Act §§ 201 & 202 and Exchange Act Rules 10A(h) and (i).

role with respect to review of the company's disclosure documents and ensuring that all the financial and other information included therein has been properly prepared. Many companies retain oversight responsibility for disclosures and disclosure controls with the audit committee; however, in this publication it is assumed that the board creates a separate disclosure and reporting committee, often staffed with directors who are also service as members of the audit committee.²⁵ In order to fulfill these tasks, audit committee and disclosure and reporting committee members must have a keen understanding of the company's internal controls, as well as the current state of the art with respect to financial accounting principles. The responsible committee must consult regularly with the company's independent auditors and senior managers, and should also meet with heads of various business units to verify that the company's control systems are being used throughout the organization. While emphasis should certainly be placed on the company's period reports, the procedures should be broad enough to include earnings releases and earnings guidance that is supplied to analysts and rating agencies. In addition, unless the board has created a separate compliance and risk management committee, the audit committee must assume various responsibilities relating to the company's compliance program including establishing codes and policies with respect to legal and regulatory compliance, risk assessment and risk management.²⁶

[4] *Approval of Related-Party and Conflict-of-Interest Transactions*

NASDAQ rules require that any "related-party transaction" be approved by the audit committee (or a comparable independent body of the board) as part of the company's obligation to conduct an appropriate review on an ongoing basis of such transactions. For purposes of these rules, a "related-party transaction" refers to a transaction that would have to be disclosed under Item 404 of SEC Regulation S-K.²⁷ No specific provisions on this subject are currently included in the NYSE rules; however, it is common for audit committees of NYSE-listed companies to take on oversight responsibility for such transactions in their written charters. As part of this authority, the audit committee must oversee compliance with § 402 of the Sarbanes-Oxley Act, which provides that no public company may make, extend, modify or renew any personal loan to its executive officers or directors except for loans made in the ordinary course of the company's business, on market terms, for home improvement and manufactured home loans and for consumer credit, or extension of credit under an open-end credit plan or charge card.²⁸

25. For further discussion, see Chapter 13 (Disclosure and Reporting Committee).

26. For further discussion, see Chapter 11 (Compliance and Risk Management Committee).

27. See generally NASDAQ Rule 5630(a). A body will be considered to be "comparable" to the audit committee if all the directors that are members of such body are both "independent" under NASDAQ rules and disinterested in the transaction.

28. Sarbanes-Oxley Act § 402(a), 15 USC § 78m(k).

[5] *Internal Audit Function*

The NYSE listing rules require that each listed company must have an internal audit function that is subject to the overall oversight responsibility of the audit committee.²⁹ The internal audit function must provide management and the audit committee with ongoing assessments of the company's risk management processes and system of internal control. A company may choose to outsource this function to a third party service provider other than its independent auditor.³⁰ The audit committee should expect to regularly receive and review status reports from the head of the internal audit function on controls and actions taken to resolve the issues raised; review of internal audit's function including development of a charter and scope of duties and responsibilities, annual plan and associated timetable and budget and resource requirements; review the effectiveness of the internal audit function (including management's responsiveness to internal audit's findings and recommendations); approve the appointment and removal of the head of the internal audit function and meet with the head of the internal audit function at least annually without management.

[6] *Sustainability*

The audit committee, working in collaboration with the board's CSR committee, should be expected to play an important role in overseeing the company's sustainability policy, commitments, procedures and reporting.³¹ Some of the specific duties and responsibilities of the committee in this area include:³²

- monitoring compliance with sustainability policy, commitments and regulations; ensure internal audit procedures are in place to assess cross-company compliance with sustainability commitments, policies and management systems; review results of internal audits of compliance with sustainability policies, commitments and regulations;
- reviewing integrity of the organization's sustainability information systems and reporting processes, both internal and external; ensure the company has implemented adequate systems, controls and processes to support the compilation of key sustainability performance metrics appropriate for reliably tracking performance, setting targets, benchmarking, compensating executives and external reporting;
- ensuring sustainability information is consistent across corporate websites, social media and voluntary reports and that provided in government filings, financial statements, investor presentations and other corporate disclosures;

29. See generally NYSE Rules Section 303A.06 and 303A.07 of the Listed Company Manual.

30. Commentary to NYSE Listing Manual § 303A.07(d).

31. For discussion of the duties and responsibilities of the board-level corporate social responsibility committee, see Chapter 9 (Corporate Social Responsibility Committee).

32. The Essential Role of the Corporate Secretary to Enhance Board Sustainability Oversight: A Best Practices Guide (United Nations Global Compact, September 2016).

plans and various organizational development issues including succession planning, organizational structure and leadership development. As is the case with the audit and other board-level committees, compensation committees should expect to conduct an annual evaluation of their performance.

In promulgating their listing standards relating to compensation committees, the national securities exchanges were required to take into account Rule 10C-1 of the Securities Exchange Act of 1934 (Exchange Act), adopted by the SEC in June 2012 in accordance with the requirements of Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which directed the national securities exchanges to develop listing standards which required each member of a listed company's compensation committee to be "independent;" established independence standards for compensation committee members; required the compensation committee to have authority to retain compensation advisers and required listed companies to fund the engagement of those advisers; and required the compensation committee to assess the independence of compensation advisers using, at a minimum, six independence factors described in Rule 10C-1.²

The requirements of the national securities exchanges are not identical; however, there are common principles that can and should be applied regardless of the exchange upon which a company's securities are listed. In addition, all listed companies should consider what it means to "provide advice to the compensation committee," a concept not specifically defined in Rule 10C-1; take steps to create policies and procedures for collecting of information about prospective compensation advisers in order to evaluate the services available from such advisors and the reasonableness of their fees and make the required determinations regarding the independence of such advisers; and, finally, ensure that their directors' and officers' questionnaires adequately collect the information necessary to establish the independence of members of the compensation committee, including information on whether a member has any business or personal relationship with any compensation adviser and employer of a compensation adviser.

§7.02 CHARTER AND ACTIVITIES OF COMPENSATION COMMITTEE

Both the NYSE and the NASDAQ require that the responsibilities of the compensation committee be explicitly spelled out in a written charter that should be included in the company's proxy statement and posted on the company's web site.³ While the specific

2. While not discussed herein, Section 952 of Dodd-Frank required that listed companies must disclose in their proxy statements for their annual meeting of shareholders whether their compensation committees retained or obtained the advice of a compensation consultant, whether the work of any such consultant raised any conflict of interest and, if so, the nature of the conflict and how the conflict was being addressed. In considering whether or not a conflict of interest exists companies are expected to take into account the six independence factors described in Rule 10C-1.
3. NASDAQ listing standards allow smaller reporting companies to adopt either a formal written compensation committee charter or a board resolution that covers only a specified portion of the items that need to be addressed in the charters of larger companies. For examples of compensation and organizational development committee charters and additional commentary on preparation of such charters, see "Board Committee Charters" in the management tools available as

requirements for the content of the charter will vary depending on which of the securities exchanges has oversight responsibilities for the company, the charter should include provisions, either voluntarily or in response to specific listing requirements, relating to the scope of the committee's responsibilities and how it carries out those responsibilities, including structure, processes and membership requirements; compliance with specific exchange requirements regarding the independence of committee members; and prohibitions on the CEO being present during voting or deliberations by the committee on his or her compensation. The charter should also specify that the committee will have sole authority to retain and terminate any compensation advisers to assist in the evaluation of director or senior executive compensation, including sole authority to approve the reasonable compensation and other terms of retention with respect to such advisers, should clearly acknowledge the company's obligations with respect to providing funding for the retention of any such adviser and should describe the committee's responsibilities with respect to considering specific independence factors before selecting advisers other than in-house legal counsel. Finally, the charter should include a requirement that the committee review and reassess the adequacy of the charter on an annual basis.

NYSE-listed companies must have a written charter that addresses: (i) the committee's purpose and responsibilities which, at minimum, must be to have direct responsibility to: (a) review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO's performance in light of those goals and objectives, and, either as a committee or together with the other independent directors (as directed by the board), determine and approve the CEO's compensation level based on this evaluation; and (b) make recommendations to the board with respect to non-CEO executive officer compensation, and incentive-compensation and equity-based plans that are subject to board approval; and (c) produce a compensation committee report on executive officer compensation as required by the SEC to be included in the listed company's annual proxy statement or annual report on Form 10-K filed with the SEC; and (ii) an annual performance evaluation of the compensation committee.⁴ The Commentary to NYSE Listing Manual § 303A.05(b) suggests that the compensation committee charter should also address committee member qualifications; committee member appointment and removal; committee structure and operations (including authority to delegate to subcommittees); and committee reporting to the board.

NASDAQ requirements with respect to compensation committee charters are more general than those imposed by the NYSE; however, NASDAQ listed companies are required to certify that a written compensation committee charter has been adopted and any such charter must specify the scope of compensation committee's responsibilities, and how it carries out those responsibilities, including structure, processes and membership requirements; the compensation committee's responsibility for determining, or recommending to the entire board of directors for determination, CEO and

part of "Governance: A Library of Resources for Sustainable Entrepreneurs" prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

4. NYSE Listing Manual § 303A.05(b).

non-CEO executive compensation; that the CEO may not be present during voting or deliberations on his/her compensation; and the compensation committee's responsibilities and authority required by Exchange Act Rule 10C-1. NASDAQ also requires that the compensation committee or independent directors acting in lieu thereof must possess authority over compensation advisers and that companies must certify that their compensation committee will annually review and reassess adequacy of its charter.

[A] Statement of Purpose

The statement of purpose in the charter of the compensation and organizational development committee typically tracks the more specific duties and responsibilities for the committee included elsewhere in the charter and discussed in detail below. As a general matter, the purpose of the committee is to provide guidance to the entire board of directors, as well as to the members of the senior executive team of the company, with respect to their fiduciary and legal obligations pertaining to the compensation of the CEO and certain other executive officers, as well as such other employees who are members of the company's senior management as the committee shall determine from time to time; the organizational structure of senior management; the succession, retention and training of senior management; the company's overall succession, retention and training programs; supervision of the company's overall compensation and benefits programs, including approval and oversight of grants pursuant to the company's equity compensation plans; the oversight of the company's retirement and employee health and welfare plans; and the oversight of the company's benefits programs and such other matters that directly impact the success and wellbeing of the company's human resources. A Global Compact publication recommended that the purpose statement of the compensation committee include motivating and rewarding sustainability performance in the executive compensation plan.⁵ As a general matter, the compensation and organizational development committee focused on approving material compensation and benefit matters as well as setting high-level policy and strategy, and management remains responsible for the day-to-day administration of the human resources function.

[B] Composition, Meetings and Procedures

"Independence" is the focal point of the requirements for membership on the compensation and organizational development committee. NYSE-listed companies must have a compensation committee composed entirely of independent directors and the entire board of directors is required to make an affirmative determination that each compensation committee member is independent under the general board independence

5. The Essential Role of the Corporate Secretary to Enhance Board Sustainability Oversight: A Best Practices Guide (United Nations Global Compact, September 2016).

standards set forth in the NYSE Listed Company Manual.⁶ When making the affirmative independence determination specifically for compensation committee members the board should consider: (i) all factors that are specifically relevant to determining whether a director has a relationship to the company that is material to that director's ability to be independent from management in connection with the duties of a compensation committee member, including the source of the director's compensation, including any consulting, advisory or other compensatory fee paid by the company to the director; and (ii) whether or not the director is affiliated with the company, a subsidiary of the company or an affiliate of a subsidiary of the company.⁷

The NASDAQ listing rules provide that compensation of the CEO must be determined, or recommended to the board for determination, either by: (a) independent directors constituting a majority of the board's independent directors in a vote in which only independent directors participate; or (b) a compensation committee comprised solely of independent directors. The CEO may not be present during voting or deliberations.⁸ Compensation of all other executive officers (defined as those officers covered in Rule 16a-1(f) under the Exchange Act⁹) must be determined, or recommended to the board for determination, either by: (a) independent directors constituting a majority of the board's independent directors in a vote in which only independent directors participate; or (b) a compensation committee comprised solely of independent directors.¹⁰ A nonindependent director may serve as a member of the compensation committee under exceptional and limited circumstances.¹¹ The board of directors is required to make an affirmative determination that no independent director has a relationship that, in the board's opinion, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director. In addition, when evaluating the independence of compensation committee members the board must consider whether the member is affiliated with the company, a subsidiary of the company or an affiliate of a subsidiary of the company and determine whether any affiliation would impair the member's judgment.¹² An important distinction from the NYSE listing standards is that the NASDAQ standards include a strict prohibition against members of the compensation committee accepting directly or indirectly any

6. NYSE Listing Manual § 303A.05(a).

7. When considering the source of a director's compensation, it is expected that the board of directors will consider whether the source impairs the director's ability to make independent judgments about the company's executive compensation. When considering any affiliate relationship, the board of directors is expected to consider whether the relationship places the director under the direct or indirect control of the company or its senior management, or creates a direct relationship between the director and senior management, in each case of a nature that would impair the director's ability to make independent judgments about the company's executive compensation.

8. NASDAQ Listing Rule 5605(d)(1).

9. NASDAQ Listing Rule 5605(a)(1).

10. NASDAQ Listing Rule 5605(d)(2).

11. NASDAQ Listing Rule 5605(d)(3).

12. While ownership of company stock should be considered, such ownership by itself, or possession of a controlling interest through ownership of company stock by itself, would not necessarily preclude the board of directors from finding that it is appropriate for a director to serve on the compensation committee.

consulting, advisory or other compensatory fee from the company or any of its subsidiaries.

The listing standards of both exchanges are essentially the same with respect to compensation advisers and authorize compensation committees, in their sole discretion, to retain or obtain the advice of a compensation consultant, independent legal counsel or other adviser (any person providing such advice is referred to herein as a compensation adviser), and to have sole authority and direct responsibility for the appointment, compensation and oversight of any compensation adviser retained by the committee. However, before selecting a compensation adviser other than in-house legal counsel, the compensation committee must consider all factors relevant to that compensation adviser's independence from management, including the factors described in Rule 10C-1 such as the provision of other services to the company by the employer of the compensation adviser; the amount of fees received from the company by the employer of the compensation adviser as a percentage of its total revenue; the policies and procedures of the employer of the compensation adviser that are designed to prevent conflicts of interest; any business or personal relationship between the compensation adviser and a compensation committee member; any company stock owned by the compensation adviser; and any business or personal relationship between either the compensation adviser or the employer of the compensation adviser and an company's executive officer. If a compensation adviser is retained by the compensation committee, appropriate funding (as determined by the compensation committee) must be provided by the company for payment of reasonable compensation to the adviser.

As is the case with the audit committee, the compensation and organizational development committee maintains a busy schedule with a full agenda that extends throughout the company's fiscal year. As such, provision should be made for four to six regular meetings of the committee annually, generally corresponding with the schedule for meetings of the entire board of directors. Committee members should set aside time for meetings with the CEO to discuss compensation matters for other executive officers and organizational development issues. When appropriate, meetings should be held with administrators of the company's stock and other benefit plans and with compensation advisers that they committee may engage through the processes described above. The executive head of the company's human resources function is typically in attendance for most of the committee's meetings and is often responsible for the preparation of minutes of meetings and drafts of reports that the committee may deliver to the entire board.

[C] Scope of Duties and Responsibilities

A comprehensive list of the duties and responsibilities of a compensation and organizational development committee would likely include obligations and authority to:

- review the company's executive compensation programs to ensure the attraction, retention and appropriate reward of executive officers, to motivate their performance in the achievement of the company's business objectives, and to

align the interest of executive; officers with the long-term interests of the stockholders and other stakeholders of the company;

- review the company's executive compensation programs to ensure that they motivate executives and employees to engage in activities that will improve the company's sustainability performance and reward them for contributing to the success of such activities;
- review and approve corporate goals and objectives relevant to the annual compensation of the CEO, evaluate the CEO's performance in relation to such goals and objectives and, based on such evaluation, recommend to the independent directors for their approval, the CEO's annual compensation, including salary, bonus and equity and nonequity incentive compensation;
- review and approve, for the company's executive officers other than the CEO, annual compensation for such officers, including salary, bonus and equity and nonequity incentive compensation, based on recommendations from the CEO;
- recommend to the independent directors for their approval, the initial compensation for any newly hired or promoted CEO;
- approve, based on recommendations from the CEO, the initial compensation for any newly hired or promoted executive officer;
- review the company's equity and nonequity incentive compensation and other plans and recommend changes in such plans to the entire board of directors as needed, and act as the administrator of such plans on behalf of the board;
- review and approve grants and awards, and the terms and conditions thereof, under the company's equity incentive based plans and the terms of, and review and approve awards under, other incentive compensation plans that the company establishes for, or makes available to, the company's officers and other employees (including recommending to the independent directors for their approval such grants and awards to be made to the CEO) Review and set performance goals, as applicable, under the company's equity and nonequity incentive compensation plans;
- approve any severance agreements, change of control agreements or similar agreements that are entered into between the company and its executive officers other than the CEO;
- review and evaluate the pension, 401(k) and other benefit plans established by the company for officers and other employees and approve recommendations of management regarding such plans;
- serve as a resource to the CEO in matters relating to senior management selection, succession planning, management development, talent utilization, and report to the board or resources on progress on the company's organizational development activities including senior management selection, succession planning and training of all management levels;
- oversee an annual review and make recommendations to the board on director compensation and compensation for the chairperson of the board position;
- review and recommend to the board executive compensation and organizational development policies and processes;

- ensure that a report on executive compensation is prepared for inclusion in the company's annual proxy statement in accordance with applicable SEC rules and regulations and review and discuss with management the Compensation Discussion & Analysis (CD&A) required by the SEC and recommend to the board that the CD&A be included in the company's annual proxy statement;
- oversee and evaluate the company's overall human resources and compensation structure, policies and programs including the implementation and progress of the company's inclusion and diversity initiatives;
- review the risks associated with the company's compensation policies and practices, including an annual review of the company's risk assessment of its compensation policies and practices for its employees;
- conduct an annual evaluation of the committee's performance and report on the committee's activities at each meeting of the entire board of directors.

While a comprehensive, clearly written charter for the compensation committee is essential, companies will also need to develop and follow additional procedures to comply with applicable SEC rules and listing requirements, particularly those that apply to determination of "independence" and engage of compensation advisers. Suggestions in this area include:

- integrating consideration of the need for disclosure of actual or potential conflicts of interests involving compensation advisers in annual proxy statements including establishment of procedures for dealing with any such conflicts;
- implementing procedures for complying with the "independence" criteria for membership on the compensation committee including collection of information on directors' and officers' questionnaires that have been updated to request and collect information about business or personal relationships with compensation advisers;
- implementing procedures for vetting potential compensation advisers before they are retained that take into account the applicable independence factors and incorporating those factors into engagement letters with advisers;
- if applicable, reviewing existing relationship with compensation advisers in light of the independence factors and make appropriate changes including, if necessary, termination of such relationships;
- reviewing and adjusting disclosure controls and procedures to ensure that they collect information that can be used to test for the existence of conflicts of interest involved compensation advisers that might need to be disclosed and resolved; and
- reviewing the activities of other committees (e.g., audit committee) to determine whether they are involved in any aspect of executive compensation oversight such that the requirements imposed specifically on compensation committees might be applicable in some way to such other committees and their members.

[1] *Compensation Philosophy*

The compensation and organizational development committee plays an essential role in setting the overall tone for the company's philosophy with respect to rewards and incentives generally and executive compensation in particular. Among other things, the members of the committee are expected to continuously review and assess the company's executive compensation philosophy and provide counsel and guidance to the CEO and leaders of the human resources function with respect to alternative approaches to rewarding employees for the work they perform on behalf of the company.

When preparing the statement of the company's executive compensation philosophy the committee should begin with a description of the primary purposes of the executive compensation program, such as attracting, retaining and rewarding talented leaders who can achieve sustainable and profitable growth for the company's businesses and maximize the long-term value of the company for its shareholders and other stakeholders. The statement of philosophy is often broken out into several categories, each of which are considered to be important for recruiting and retaining the best people to lead the organization. For example, realizing that qualified and experienced leaders are highly sought after it is essential that companies be prepared to offer compensation packages that are competitive, which means that the statement of philosophy should incorporate the following activities:

- regularly compare the company's total compensation levels against comparable companies in each of the industries from which the company is likely to draw executive talent, with particular emphasis on salary levels and short- and long-term incentives, to ensure the ongoing competitiveness of our compensation program;
- measure the competitiveness of compensation levels in the countries and regions where the company operates, and utilize compensation benchmarks from multiple geographic markets for executives with international responsibilities;
- use median (50th percentile) compensation values reported by the company's comparator group companies as a primary reference for establishing target amounts for each element of compensation, and for maintaining competitive total compensation levels;
- consider factors related to the executive's potential impact on the company's results, scope of responsibility and accountability, and reporting structure in determining appropriate compensation levels.

It is necessary, but not sufficient, for companies to offer competitive compensation arrangements to their executives. Compensation plans must also motivate executives to consistently deliver superior performance and this means ensuring that executives have a significant proportion of total annual compensation contingent upon achieving objective measures of financial and operating performance; establishing an appropriate "mix" of compensation elements to ensure an appropriate and balanced

focus on short- and long-term results; and preserving a strong and direct relationship between business and individual performance, and the short and long term compensation earned by executives. Committees should strive to create incentive arrangements that provide executives with opportunities to achieve compensation levels comparable with the highest earners among their peers at other companies; however, incentives should be tailored so that they are aligned with the company's long-term strategic objectives and not just winning compensation battles with competitors.

Finally, the compensation package should be built in a way that ensure that executives are properly engaged with the pursuit and achievement of the company's long-term strategic goals and meeting the expectations of the company's stakeholders. Engagement provides a foundation for building a deep and committed relationship between the executive and the company and makes the executive a stronger ambassador of the company to both internal and external stakeholders. In order to achieve engagement, the company's executive compensation philosophy must include linking a material portion of executive compensation to measures of business performance for which the executive has direct line of sight and accountability; ensuring that the company's compensation programs and practices encourage appropriate risk taking and discourage inappropriate risk taking; and ensuring that senior executives meaningfully share the risks and rewards of ownership with the company's shareholders by basing a portion of their total compensation on share price performance. While compensation arrangements have traditionally emphasized achievement of financial goals, mounting pressure from institutional investors and other stakeholders has driven companies include sustainability issues in their executive compensation philosophies and explicitly provide that sustainability performance and innovation will be tracked and that a significant element of executive rewards will be based on demonstrable success in those areas.

[2] *Executive Compensation*

While the compensation and organizational development committee oversees compensation arrangements for everyone inside the company the committee has special duties and responsibilities with respect to the compensation of the CEO and other members of the executive team. One important task of the committee is ensuring that the company has access to the C-suite level talent necessary for it to be successful and this means that committee members must regularly review, no less frequently than annually, competitive market data, including executive compensation surveys and reports compiled by third-party consultants, to assess the adequacy and competitiveness of the company's executive compensation plans vis-à-vis the company's peers in the industry with which they may be competing for talent. When considering the compensation of executive officers other than the CEO the committee should take into account the recommendations of the CEO and the head of the company's human resources function. The committee should also advise and consult with the CEO and the head of the company's human resources function on the terms and conditions of any incentive plans for executive officers other than the CEO, mid-year compensation

changes for such executives, the terms of employment for all new executives and the termination of employment of any executives. The entire process used by the committee in determining what it considers to be the appropriate level and type of executive compensation should be disclosed in the company's public filings or reports to shareholders and other stakeholders including a report that meets the specifications of the SEC with respect to the required CD&A report.

While the compensation and organizational development committee is responsible for compensation review and assessment for all of the company's executives, CEO performance and compensation is obviously a central issues and concern for the committee.¹³ Prior to the start of each fiscal year, the committee and the CEO should discuss the metrics and performance goals for the CEO during the upcoming fiscal year, with metrics and goals being measurable and based on financial results, strategic imperatives, and other matters deemed appropriate by the committee and the entire board of directors. The results of these discussions should be ratified by all of the independent directors on the board, not just those members who are assigned to the compensation and organizational development committee. The committee should also oversee the development of a performance evaluation process for the CEO that typically includes a self-evaluation by the CEO, input from the CEO's direct reports, and input from all directors. Efforts should be made to provide the CEO was continuous feedback throughout the year and a formal performance evaluation should be provided to the CEO annually following the fiscal year end and after the performance of the CEO has been reviewed by the committee. The information from the performance evaluation will be used to measure how well the CEO has performed against the previously agreed metrics and performance goals and make decisions on performance actions with respect to the CEO. The compensation and organizational development committee is responsible for consulting with the entire board on CEO compensation actions and communicating to the CEO all compensation actions relating to him or her. In no event shall the CEO be present during discussions and/or voting by the entire board of directors on his/her own compensation actions.

The rules and regulations relating to compensation committees have been supplemented by mandates for increased shareholder involvement in consideration and approval of executive compensation. For example, the NYSE requires that NYSE-listed companies provide their shareholders with the opportunity to vote on all equity-compensation plans and material revisions thereto, with limited exemptions, in order to provide checks and balances on the potential dilution resulting from the process of earmarking shares to be used for equity-based awards.¹⁴ The byproduct of regulatory activity with respect to executive compensation has been increased pressure on the board of directors is to develop performance measures and incentive strategies that allow the company to continue to attract experienced senior managers while at the same time ensuring that those managers are accountable to the shareholders of the

13. For detailed discussion of the duties and responsibilities of the CEO, see "Chief Executive Officer" in "Governance: A Library of Resources for Sustainable Entrepreneurs" prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

14. See generally NYSE Rules Section 303A.08 of the Listed Company Manual.

company. While there is no single form of compensation plan that makes sense for all companies, directors must certainly consider the relationship between base salary and incentive compensation and creating clear and direct links between incentives and enhancement of shareholder value. The Commentary to NYSE Listing Manual § 303A.05(b) recommends that in determining the long-term incentive component of CEO compensation, the committee should consider the listed company's performance and relative shareholder return, the value of similar incentive awards to CEOs at comparable companies, and the awards given to the listed company's CEO in past years.

[3] *Incentive Compensation Plans*

The compensation and organizational development committee should oversee the company's incentive compensation plans. With respect to bonus plans, the committee should approve and have oversight over all such plans and specific authority to designate employees eligible to participate in such plan(s); approve the financial metrics and performance goals under such plan(s); approve the total bonus pool/plan payout; approve individual payouts for executive officers; and delegate authority to management for the day-to-day nonmaterial administration of the plan(s). The committee should also approve and oversee all of the company's stock-based compensation plans and have the authority to make recommendations to the board regarding the adoption, amendment, design parameters, and termination of such plans; approve grant guidelines, grant provisions, and ongoing share utilization; approve individual grants to executive officers; delegate authority to management to make grants to nonexecutive officers (including new hires, promotions, annual awards, and for retention purposes); interpret plan provisions when appropriate; designate employees eligible to participate in the plans; and delegate authority to management with respect to the day-to-day nonmaterial administration of the plan(s). Finally, the committee should establish and periodically review and recommend stock ownership guidelines for directors and executives.

[4] *Employee Retirement and Health and Welfare Benefit Plans*

The compensation and organizational development committee is charged with taking the lead on behalf of the entire board of directors in helping the board discharge its fiduciary responsibilities for pension and welfare benefit plans sponsored by the Company and all majority owned domestic subsidiaries. Among other things, committee members should annually review fiduciary responsibility reports from the plan administrators or administrative committees of the company's retirement and health and welfare benefits plans and provide appropriate reports to the entire board of directors, including recommendations for the establishment of new plans or the material alteration of existing plans. In carrying out their responsibilities in this area, committee members should be prepared to review the financial aspects of the company's retirement programs, including actuarial assumptions, and receive reports

from any internal committees formed to perform day-to-day administration of the programs.

[5] *Organizational Development*

While most of the stated duties and responsibilities of the compensation and organizational development committee relating to executive compensation, not surprisingly given the intense interest in that topic among regulators, investors and other stakeholders, the committee is usually the primary group within the entire board of directors that is tasked with providing support on the following important issues and topics relating to the structure of the company's management team and the ensuring that the structure adapts to address changes in the company's operating environment:

- *Management Team Structure:* The committee should regularly consult with the CEO regarding the establishment of senior management positions and provide direction for management in the recruitment for such positions; however, the actual hiring and termination of senior managers should generally be left to the discretion of the CEO with appropriate consultation from the committee.
- *CEO:* The committee should provide input to the entire board of directors from time to time relating to the employment and disengagement of the CEO, and also should, as appropriate, assist the board in recruiting candidates for the CEO position.
- *Management Succession and Development Planning:* The committee plays an important role in the critical areas of management succession (including CEO succession), management development at all levels, and management retention at all levels. The committee should be responsible for ensuring that there are current and viable back-up and succession plans for the CEO and each of the key members of the executive team and that there are specific development programs in place to minimize any loss of time or effectiveness in transitions from a current officer to a successor. The committee should review these plans no less than annually and provide guidance to management, and the entire board of directors, regarding any weaknesses in the plans identified by the committee.
- *Leadership Development:* The compensation and organizational development committee should be responsible for providing guidance to the CEO and the executive leader of the company's human resources function relating to leading development including global talent and organization reviews, leadership assessments, performance reviews, recruiting, leadership training programs, development of the company's talent pipeline and development of alumni networks.

Beyond the specific matters above, the compensation and organizational committee should meet periodically to review and discuss all of the company's organizational and human resources practices and policies to ensure that they are effective tools for strengthening the organization and aligned with the company's overall strategy.

[6] Sustainability Performance

It is no secret that incentive elements of executive compensation arrangements have long been tied to financial performance and increasing shareholder value as demonstrated by improvements in share prices. Certainly financial success is important to the long-term viability of the business and provides the CEO and other senior executives with access to the capital necessary to remain competitive and pursue and commercialize innovative products, services and technologies; however, there is growing interest among stakeholders, including many institutional investors still very interested in financial returns, to create links between executive compensation and sustainability measures (i.e., metrics based on ESG targets).¹⁵ A Global Compact publication recommended that the duties and responsibilities of the compensation committee include:¹⁶

- ensuring that sustainability issues are included in the compensation philosophy (e.g., the intent to reward sustainability performance and innovation, pay a living wage, ensure equitable pay, ensure appropriate CEO to worker pay ratios and limit excessive compensation, etc.);
- drafting a CEO position profile/description that includes reference to sustainability experience, values and leadership, fostering a sustainability culture, incorporating sustainability into corporate strategies and ERM, ensuring effective internal controls and management systems for sustainability and maintaining quality stakeholder relationships;
- mandating that the CEO's annual performance plan and evaluation/review include sustainability objectives, leadership and competencies;
- implementing succession planning and management/leadership development programs that include sustainability competencies, leadership and values alignment; incorporate sustainability as a factor in position profiles, development plans and career planning for executive leadership and potential successors; and integrate sustainability into talent management strategies and discussions.

While a strong business case can be made for including sustainability in the overall strategic goals and objectives for a company and, in turn, integrating sustainability into the elements of executive compensation, it is still far from settled practice. In fact, surveys conducted by executive compensation consultants among S&P 500 companies have found that only 2% of the companies tied voluntary environmental targets (e.g., reduction of greenhouse gas emissions) to executive compensation and

15. For discussion of the unique and important role that the CEO plays in sustainability initiatives, see "Chief Executive Officer" in "Governance: A Library of Resources for Sustainable Entrepreneurs" prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

16. The Essential Role of the Corporate Secretary to Enhance Board Sustainability Oversight: A Best Practices Guide (United Nations Global Compact, September 2016).

that just 2.6% of the companies had a performance metric tied to diversity.¹⁷ Several practical issues need to be overcome in order for sustainability performance to take a more central role in executive compensation. For example, compensation arrangements become unworkable if they attempt to address too many metrics. According to Burchman and Sullivan, compensation consultants have traditionally recommended that compensation plans focus on no more than five metrics—one or two financial metrics, such as sales growth or earnings per share, and two or three nonfinancial metrics, in areas such as quality or innovation—and cautioned that including additional metrics, such as sustainability, will likely dilute executive focus.¹⁸ Another problem, at least in the U.S., is that regulators have been slow to prioritize sustainability and environmental risks in their pronouncements regarding reporting;¹⁹ however, regulators outside the U.S., notably in Europe, have moved aggressively to formerly include sustainability into corporate governance frameworks, voluntary reporting on sustainability has become increasingly prevalent and companies are becoming more sophisticated with respect to integrating sustainability and financial performance in the disclosures they make to their stakeholders. Advances in sustainability reporting provide a foundation for constructing sustainability metrics that can be added to the financial results and measures of quality and innovation.

While the compensation and organizational development committee is the body of the entire board of directors that focuses its efforts on executive compensation, significant actions in that area must still be reviewed and endorsed by all of the directors. Directors have long considered financial performance and long-term shareholder value to be the bedrock of their fiduciary responsibilities; however, in recent years boards have shown a willingness to "explicitly embrace the proposition that sustainability is a core indicator of the CEO's and internal company's responsibilities and performance."²⁰ The key, according to Burchman and Sullivan, is to focus on those ESG factors that are "relevant to a company's business" rather than attempting to address all 17 of the SDGs identified by the United Nations.²¹ Any ESG factor

17. S. Burchman and B. Sullivan "It's Time to Tie Executive Compensation to Sustainability", Harvard Business Review (August 17, 2017), <https://hbr.org/2017/08/its-time-to-tie-executive-compensation-to-sustainability> Larsen cited a report published in 2015 by the sustainability non-profit Ceres along with Sustanalytics that found that 24% percent of the 613 largest publicly traded companies tied some aspect of sustainability to executive compensation; however, a majority of the sustainability initiatives in the report were related to compliance matters as to which the company was already required to disclose and that only 3% of the companies linked executive compensation to voluntary sustainability performance targets. K. Larsen, "Why Tying CEO Pay to Sustainability Still Isn't a Slam Dunk", GreenBiz (May 26, 2015), <https://www.greenbiz.com/article/why-tying-ceo-pay-sustainability-still-isnt-slam-dunk>.

18. *Id.*

19. K. Larsen, "Why Tying CEO Pay to Sustainability Still Isn't A Slam Dunk", GreenBiz (May 26, 2015), <https://www.greenbiz.com/article/why-tying-ceo-pay-sustainability-still-isnt-slam-dunk>.

20. *Id.* (quoting Bennett Freeman, former senior vice president for social research and policy of the Calvert Group, who actually argued that director acceptance of sustainability as a core indicator of performance would proceed quite slowly).

21. S. Burchman and B. Sullivan "It's Time to Tie Executive Compensation to Sustainability", Harvard Business Review (August 17, 2017), <https://hbr.org/2017/08/its-time-to-tie-executive-compensation-to-sustainability>.

matters. Specific areas of focus for this committee included the environment, health and safety and technology. The functions of a compliance committee might overlap with the risk, public policy and sustainability committees. Sectors most likely to have a compliance committee included health care, energy and financial.²

With respect to risk management committees, the preparers of the EY report found that these committees generally were responsible for making recommendations for the articulation and establishment of the company's overall risk tolerance and risk appetite; overseeing enterprise-wide risk management to identify, assess and address major risks facing the company, which may include credit, operational, compliance/regulatory, interest, liquidity, investment, funding, market, strategic, reputational, emerging and other risks; and reviewing and discussing management's assessment of the company's enterprise-wide risk profile. The functions of a risk management committee might overlap with the finance and compliance committees. Sectors most likely to have a risk committee included financial services (almost 75% of the companies in that sector had a risk committee), industrials, utilities, consumer discretionary, information technology and consumer staples.³

§11.02 COMPLIANCE AND COMPLIANCE PROGRAMS

In today's business world, all companies, regardless of their size, business model and scope of activities, are required to understand and comply with a plethora of laws and regulations, including:

- common law legal relationships with employees, creditors, and landlords;
- various licensing requirements imposed by federal, state, and local governments;
- intellectual property rights;
- employment laws (e.g., harassment, discrimination and immigration laws) and applicable human resources policies;
- federal and state tax laws and regulations, including the reporting obligations imposed under such laws;
- domestic and foreign laws regulating technology transfers and the form and content of many common commercial relationships;
- federal and state statutes relating to antitrust and unfair competition;
- federal and state laws regulating commercial and consumer transactions;
- federal and state environmental laws and regulations;
- federal and state health and safety laws;
- federal and state laws relating to privacy and data security;
- federal and state securities laws and governance rules and regulations and requirements of national securities exchanges in the case of public companies;

2. [http://www.ey.com/Publication/vwLUAssets/EY-board-committees-evolve-to-address-new-challenges/\\$FILE/EY-board-committees-evolve-to-address-new-challenges.pdf](http://www.ey.com/Publication/vwLUAssets/EY-board-committees-evolve-to-address-new-challenges/$FILE/EY-board-committees-evolve-to-address-new-challenges.pdf).

3. *Id.*

- domestic and foreign laws relating to cross-border business activities (e.g., laws and regulations pertaining to exports, imports, bribery and compliance with foreign boycotts);
- laws and regulations relating to conducting business with the federal government and acting as a "government contractor;"
- federal and state laws relating to conflicts of interest, working with government officials, lobbying and political activities (e.g., contributions);
- internal accounting and financial controls to reduce theft and facilities accurate disclosures and financial reporting; and
- federal and state statutes relating to consumer protection and other matters.

These requirements apply regardless of whether the business is operated as a proprietorship, a partnership, a limited liability company (LLC), or a corporation and also apply to nonprofit organizations. Moreover, each form of legal entity available for use by an organization has its own set of rules regarding formation and internal operations that must be followed in order to gain the legal benefits from the use of the entity. For example, in order for the shareholders of a corporation to take advantage of the limited liability offered through the use of the corporate form, they must observe certain governance procedures and operational formalities.⁴

The penalties for failing to comply with laws and regulations can be significant and often can ruin a company and the careers of the persons involved in the misconduct. For example, criminal sanctions may include fines, probation, and remedial action, including restitution, community service, and notice to victims. Civil penalties can also be substantial and may include treble damages and the additional costs of litigation. Added to all of this is the damage to the company's reputation and employee morale, and additional scrutiny from government investigators. Finally, companies that have been found to have violated laws in government investigations may be exposed to shareholder lawsuits, loss of business partners, and debarment from government contracting.

In order to fulfill their obligations and avoid the costs associated with violations, all companies should be admonished to adopt and aggressively implement compliance programs in a wide range of areas. Compliance programs are important even for companies that honestly believe they are acting in a lawful fashion, since these programs are probably the best way to establish formal policies and procedures that can guide the actions of employees and institutionalize regular assessment of actual practices. Moreover, the existence of a formal compliance program that is actually followed can be an important factor in reducing the liability of the company in the event that a problem arises in spite of the controls that have been put in place.

Compliance programs are generally discussed, and adopted, in the context of the fiduciary duties in the corporate context which flow from the directors and officers to the shareholders. Thus, it is not surprising that commentators and courts have turned

4. For further discussion of the legal and regulatory basis for compliance programs, see "Compliance and Risk Management: A Library of Resources for Sustainable Entrepreneurs" prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

to principles of duty and care in analyzing legal compliance programs. Courts have also begun to recognize the importance of guidance from governmental agencies, such as the U.S. Federal Sentencing Guidelines for Organizational Defendants established by the U.S. Sentencing Commission (Sentencing Guidelines) and the opportunity that compliance with such guidelines offers with respect to reducing potential liability for companies and their managers. Therefore, one can expect to see courts examining whether compliance procedures, programs and other techniques have been implemented to determine if those serving in fiduciary capacities have acted diligently. When evaluating the compliance procedures for a particular company courts can now also refer to very specific guidelines that have been announced by regulatory agencies as well as to commentaries prepared and disseminated by professional organizations. Finally, information that may be relevant to establishing a compliance program can be gleaned from statutes such as the U.S. Sarbanes-Oxley Act of 2002 (SOX) and the listing requirements of the major securities exchanges.

[A] Directors' Role in Developing and Overseeing Compliance Programs

When companies run afoul of laws and regulations the publicity can be intense and the adverse reputational and financial consequences to the company are generally quite significant. The post-mortem brings the board of directors to "center stage" and judges, regulators, investors and pundits in the financial press will all be asking whether the directors were paying attention, asking the right questions, adopting and enforcing appropriate policies and procedures, and making it clear that "compliance matters" when setting goals and allocating rewards. Simply put, while directors are not expected to fend off every act of misconduct by executives, employees and agents of their companies, they are responsible for effectively discharging their own duties and responsibilities relating to compliance and ethics programs.

While attention to compliance problems is generally most intense for larger publicly owned companies, directors of firms of all sizes, including privately owned companies, should consider "compliance" to be a significant part of their jobs. All directors have a fiduciary duty to their corporations and to the stockholders who are actual owners of the corporation and that duty will almost certainly be breached if directors fail to act with care in developing and implementing compliance and ethics programs and as a result the corporation and/or its agents are found to be culpable of misconduct and/or unlawful activity. In order to be sure that the board and its members understand their role in developing and overseeing an effective compliance and ethics program the following questions should be carefully considered:

- Is each prospective member of the board advised prior to appointment that he or she will be expected to achieve and maintain an adequate level of knowledge and skills relating to their duties with respect to overseeing the company's compliance and ethics program and is prior compliance experience a factor in vetting new board members?
- Has each new member of the board completed an orientation program that includes information on the sources of a director's duties and obligations with

respect to oversight of the company's compliance and ethics program and illustrative case studies of how courts and regulators have interpreted and enforced such duties and obligations?

- Are the members of the board sufficiently knowledgeable about the operations and structure of the company to understand internal reporting procedures and lines of authority and identify the activities that present the highest level of compliance risk?
- Are the members of the board sufficiently knowledgeable about the legal environment for the company's specific business activities so that they can readily understand the statutes and regulatory guidelines that are most relevant to decisions about how to design the compliance and ethics program?
- Has the board ensured the compliance and ethics program is appropriate for the specific activities of the company by undertaking a detailed risk assessment that identifies and ranks risk areas and issues that have raised compliance problems in the past and must be specifically addressed in the program?
- Has the board conducted a "cost-benefit" analysis regarding the scope of the company's compliance and ethics program to ensure that the company's limited resources for compliance infrastructure have been efficiently allocated to the areas that present the most significant potential risks and liabilities for the company?
- Has the board fulfilled its overriding obligation to be knowledgeable about the content and operation of the company's compliance and ethics program by overseeing the development of the program and formally reviewing and approving the overall program and specific policies and procedures within the program (e.g., code of conduct, policies regarding conflicts of interest, "hot line" or other policies for reporting misconduct and policies that address the company's highest risk areas such as employment laws, antitrust laws and/or products liability laws) before implementation?
- Has the board formally approved the creation of an independent team with compliance expertise within the company's organizational structure that includes: (1) a CCO who reports directly to the board (or audit or compliance committee of the board); (2) a compliance department overseen by the CCO; (3) a CCC with members from all the company's functional departments charged with implementing compliance policies and procedures; and (4) an internal controls/security department charged with implementing internal controls and detecting and reporting actual misconduct and suspicious activities?
- Has the board formally given the CCO and the compliance department the authority to audit the activities of the company's legal department and provide direct guidance and assistance to members of the board regarding fulfillment of their oversight responsibilities relating to compliance activities?
- Has the board formally reviewed and approved the charter of the CCC to ensure that it addresses key activities such as the development and implementation of codes of conduct and other compliance policies and procedures, development and administration of compliance and ethics training programs,

- risk assessments, annual audits of compliance and internal controls programs and remedial actions and employee discipline in the case of compliance issues or other misconduct?
- Does the board (or the audit or compliance committee of the board) receive regular reports from the CCO regarding the involvement of managerial leaders from other departments (e.g., human resources, legal, finance, business development, etc.) in the activities of the CCC and the actions they have taken to implement relevant aspects of the compliance and ethics program within their departments?
 - Has the board required that the CCO develop objective performance metrics for the compliance and ethics program that have been formally approved by the board and set aside time at each meeting of the board (or audit or compliance committee of the board) to receive reports on the operations of the compliance department and progress toward satisfying the program's goals and objectives and ask compliance-related questions of the CCO and members of the senior management team?
 - Has the board allocated sufficient human, financial and technological resources to the compliance and ethics program (including funding for the CCC and retention of outside advisors (e.g., lawyers, accountants and consultants)) and invested the board's own time in continuously considering compliance-related issues?
 - Has the board provided for the "express authority" and "direct reporting obligation" for those persons with day-to-day responsibility for compliance activities (e.g., the CCO) to have direct access to members of the board and/or the committee of the board to which compliance matters have been delegated (i.e., audit or compliance committee) without having to report to the CEO, other members of the senior management team or the legal department?
 - Has the board acted in a manner that sets the appropriate "tone at the top" with respect to promotion of an organizational culture of ethical conduct throughout the company and encouraging compliance through the use of appropriate incentives and disciplinary measures and proactive involvement in the development and approval of the compliance and ethics program in the manner described above?
 - Has the board properly aligned the incentives for members of the management team and employees by ensuring that the company's performance evaluation and incentive compensation processes take into account not only traditional financial metrics but also compliance and ethics-related objectives such as product/services quality, safety and customer satisfaction?
 - Have all of the members of the board, as well as officers and employees of the company, completed adequate training to ensure that they are aware of the content and purposes of the company's compliance and ethics program and how issues are identified and remediated?
 - Has the board provided for continuous training of board members and senior management on the impact of changes in the legal and regulatory environment of the company that will impact the company's compliance requirements?

- Have all of the members of the board been provided with suggestions on how they can educate themselves about how to carry out their compliance oversight activities such as by accessing information, guidelines and educational programs available through government websites (e.g., Office of Inspector General)?
- Does the board oversee regular reviews of the compliance and ethics program, no less than annually, to determine if changes are necessary in light of objective metrics of the efficacy of the procedures included in the program and changes in applicable laws and regulatory enforcement initiatives?
- Does the board oversee regular reviews of the company's internal controls and risk management policies and procedures, no less than annually?
- Does the board ensure that reports or findings of compliance problems or other acts of misconduct are promptly reviewed and that responses are made in a timely fashion?

[B] Elements of Effective Compliance Programs

In general, a compliance program can be understood to be an internal management system that educates the officers and employees of a company about laws and regulations relevant to the business activities of the company, and establishes processes and procedures to guide and monitor the behavior of those persons. There are no legally mandated standards for compliance programs; however, numerous attempts have been made to identify and define the essential elements of an effective corporate compliance program. In the accounting world, for example, the American Institute of Certified Public Accountants has issued an SAS No. 99, also known as AU 316) "Consideration of Fraud in a Financial Statement Audit," which contains an appendix with examples of measures that companies can use to prevent, deter, and detect fraud. The influential Sentencing Guidelines also identify several areas that should be assessed to determine the effectiveness of a company's efforts to manage its ethical and compliance risks.⁵ Specific types of programs, such as those necessary for compliance with export and import laws and regulations, will be influenced by guidelines developed by the agencies chiefly responsible for administration and enforcement in those areas. Finally, there is a rapidly growing body of U.S. case law, notably the *Caremark* case, which is helping to define certain legal principles regarding compliance programs.⁶

Each compliance program should be tailored to the unique circumstances of the company, including the size of the company, the level of regulation applicable to the company's business activities, and its past compliance history. In any case, however, the program should be broad in its scope of application; and extend beyond all officers

5. USSG §§ 8A1.1 et seq. For discussion, see "Legal and Regulatory Basis for Compliance Programs" in "Compliance: A Library of Resources for Sustainable Entrepreneurs" prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

6. For discussion of the *Caremark* case, see "Legal and Regulatory Basis for Compliance Programs" in "Compliance: A Library of Resources for Sustainable Entrepreneurs" prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

and employees of the company and its subsidiaries and branches to include outside consultants, advisors, independent contractors, and business partners such as distributors, agents, sales representatives, licensees, and joint venture partners. While there is no one standard, the following elements are generally recognized as important to creating and maintaining an acceptable compliance program:⁷

- The company should prepare a set of clear and realistic goals and objectives that are documented and monitored in an enterprise-wide annual compliance plan. The plan should identify the major legal and regulatory risks confronting the company, describe the scope and company of the compliance system, and allocate responsibility for each aspect.
- The compliance program must be formally adopted at the highest levels of the company, preferably by the board of directors and the members of the senior management team. In addition to formal endorsement of the program, however, the directors and senior executives must continuously emphasize the need to establish and maintain a culture of legal compliance throughout the company.
- The compliance plan should include a clearly defined structure and unambiguous reporting lines that preserve independence and demonstrate senior-level commitment. A single person should be identified as the CCO with authority to direct the program, disseminate information, and launch investigations of suspected violations. The CCO should be a member of the senior management team and report independently to the audit committee of the board of directors and to the chief executive officer.
- The company must allocate funds for sufficient staff, tools, and other resources to create an effective compliance program. The compliance department should have its own separate budget, and compliance personnel assigned to business units should not be exposed to conflicts with those units with respect to availability of resources and personnel policies.
- The board of directors should adopt a formal code of business conduct for the company and its officers, employees, and agents; and other elements of the compliance program should be set forth in written documents, such as policies and procedures setting forth guidelines to be followed by company employees.
- A formal education and training program should be established for all employees throughout the company, including personnel in foreign countries. Written materials prepared in simple and straightforward language should be made available as training tools for employees to explain applicable laws and regulations and the company's procedures in order to ensure compliance. In addition, the company should provide training classes, training videos, discussion groups, testing, and other forms of training interaction.

7. For detailed discussion of establishing an effective compliance program, see "Elements of an Effective Compliance Program" in "Compliance: A Library of Resources for Sustainable Entrepreneurs" prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

- The compliance plan should include clear procedures and restrictions regarding delegation of authority for activities and decisions that might impact the legal obligations of the company. For example, the authority of officers and managers to execute certain types of contracts should be spelled out in detail.
- The compliance plan should include procedures for monitoring changes in the legal and regulatory environment and the overall risks confronting the company in the course of its day-to-day business operations. As changes occur, appropriate modifications and updates should be made to the compliance program and the company's policies and procedures.
- Regular audits of the program should be conducted by the compliance group and, as necessary, independent consultants to verify that personnel are complying with the program and that appropriate records are being maintained. The audit process should also assess the effectiveness of the compliance program and identify areas in need of improvement. The results of each audit should be reported to the board of directors or its audit committee with recommendations for changes to the program.
- The program must include mechanisms for enforcement through investigation and discipline, as well as procedures to encourage employees to report possible violations to the compliance officer without fear of retaliation. A program that is merely announced and not enforced will not be considered effective, and will not create any advantage for the company.
- The program should include guidelines and procedures for ensuring that the company complies with the wide array of recordkeeping requirements imposed on United States businesses. Plans should be developed and implemented for collecting the necessary documents and other records, organizing them for easy access, and retaining them for periods required under applicable laws and regulations.

If a company does not have a legal compliance program in place, or has decided to make significant changes to its existing policies and procedures, the first step is coming up with a set of guiding rules and principles for structuring an effective program. There is no shortage of resources in this area, and the right plan for a particular company generally incorporates ideas developed by commentators, other companies in the specific industry, and regulatory agencies. In general, companies have based the structure and design of their compliance programs on the recommendations made in the Sentencing Guidelines, SOX and guidelines and pronouncements issued by governmental agencies that regulate the activities of the particular business (and, thus, are more likely to be involved in an investigation of wrongdoing by the company). In addition, the growing interest in development of compliance programs and creation of codes of conduct has led to creation of several websites dedicated to various aspects of business ethics, including the materials made available by organizations such as the Center for Business Ethics, the Corporate Executive Board, the Ethics Resource Center and the Institute for Global Ethics.

establish communication channels to be sure that activities do not overlap or that important risks “fall between the cracks.”

[A] Risk Assessments

Effective risk management begins with identification and assessment of the risks confronting the enterprise, both current and in the foreseeable future.¹¹ The risks that are the greatest concerns for corporate executives include corporate governance issues, which not only expose companies to the costs of actual liability for violation of corporate governance laws and regulations but also force them to invest substantial amounts in compliance programs; natural disasters (e.g., hurricanes, flooding and earthquakes) in countries where companies have substantial assets and/or are engaged in a high volume of business activities; higher levels of litigation that can result not only in liability for claims made against a company but also in substantial additional expenses to defend against the lawsuits even if the company is ultimately found not to be liable; physical infrastructure and facilities risks, including the rising costs of maintaining aging facilities and the potential damage to products, property and humans that may occur as the company operates over public roads and railways; governmental regulation that carries higher costs of compliance which will ultimately cause companies to raise the prices of their products and services and risk loss of market share to competitors; terrorist attacks, unforeseen changes in customer requirements and the entry of new competitors or introduction of new technologies; and cyber-attacks that disable a company’s communications infrastructure and expose companies to potential liability for theft of personal information that has been entrusted to them for safekeeping.

Management should be prepared to increase the company’s control mechanisms whenever there are changes in the organization’s regulatory or operating environment, changes in personnel; new or revamped information systems; rapid growth of the organization; changes in technology affecting production processes or information systems; new business models, products or activities; corporate restructurings; expansion or acquisition of foreign operations; and/or adoption of new accounting principles or changing accounting principles.

Risk assessment is primarily concerned with what are generally referred to as operational risks (also sometimes called transaction risks), which are risks of loss or injury to the company from inadequacies or failures relating to processes, systems or people (e.g., fraud or error). Operational risks can arise from internal and external factors and can be found in every major business activity of the company. Operational risks may be broken down into various categories such as credit and market risks, reputation risks, strategic risks and compliance risks. Credit and market risks include an unforeseen adverse decline in the liquidity of a key customer that must be addressed by changes in underwriting policies and collection systems to avoid significant losses

11. For further discussion of conducting a risk assessment, see “Risk Assessments” in “Compliance and Risk Management: A Library of Resources for Sustainable Entrepreneurs” prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

and higher costs of servicing that customer. Reputation risks include the possibility of security breaches that result in the loss of confidential information and the loss of confidence of customers and other business partners. Strategic risk increases when the company fails to invest in the resources necessary for collection and analysis of all of the information needed to make proper and informed decision about major new investments. Compliance risks include failure to comply with legal and regulatory requirements applicable to the company’s products and services which leave to civil and/or criminal penalties.

The activities associated with an effective risk assessment process include identifying the risks that are most relevant to the company and developing a short description of the key characteristics of each risk so that it can be analyzed and strategies created for mitigating or eliminating them; defining the company’s “risk appetite” to determine which types of identified risks are most problematic for the company and thus are appropriate targets for mitigation activities; risk mitigation, which involves developing compliance programs and internal controls designed to reduce risks to levels consistent with the company’s risk appetite; and establishing benchmarks for measuring the effectiveness of the company’s risk mitigation efforts and procedures for continuous risk assessment to identify and manage new risks that may arise as the activities of the company and its external environment changes. The scope of the process, and required investment, depend on the size of the company and its stage of development and available resources, and companies must decide on the level of sophistication of risk management procedures, how much of the process should be outsourced and the appropriate internal management structure for the risk management activities.

Recognized general guidelines for conducting effective risk assessments include covering all major areas of potential misconduct; examining risk in the context of the company’s resources; using industry information and company history; including managers and employees from all organizational levels; analyzing both the impact and likelihood of the occurrence of a risk; quantifying each risk area; documenting the outcome of the risk assessment process; conducting the risk assessment in a defensibly objective manner and on a regular basis; and benchmarking the company’s compliance programs.

[B] ERM and Sustainability-Related Risks

A joint report published as a preliminary draft in February 2018 by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and the WBCSD included a telling comparison of the results of surveys conducted by the World Economic Forum (WEF) that showed that the prevalence of risks related to ESG steadily increased from 2008 to 2018 while the more traditional economic, geopolitical

and technological risks became less dominant.¹² For example, in 2008 only one societal-related risk (pandemics) was reported to be among the top five risks in terms of impact in that year's "Global Risks Report;" however, by 2018 four of the top five risks in the report were either environmental- or social-related: extreme weather events, water crises, natural disasters and failure of climate change mitigation and adaptation.¹³ Apart from the WEF survey, news reports have made it clear that companies all around the world have been suffering severe, and sometimes enterprise-ending, adverse financial and/or reputational impacts from events commonly placed under the umbrella of environmental and social responsibility including product safety recalls, worker fatalities, the discovery of illegal child labor in their supply chains, polluting and delays in the delivery of materials due to climate-related disasters suffered by suppliers.

For COSO and the WBCSD all of this was clear evidence that companies needed to make fundamental changes in their ERM strategies and systems to ensure that they were effectively expanded to include ESG-related risks. From their perspective this means companies must identify and prioritize a new set of risks and build them into their ERM strategies, processes and practice and also realize that there are new opportunities associated with dealing with these risks that can create real value for their investors and other stakeholders. COSO has defined ERM broadly as "the culture, capabilities and practices integrated into strategy and execution that organizations rely on to manage risk and in creating, preserving and realizing value." COSO and the WBCSD illustrated their point as follows:¹⁴

- Environmental issues include energy use and efficiency, climate change impacts and use of ecosystem services. Associated risks include higher-than-average energy costs that cause companies to miss profit targets and greater frequency of extreme weather events that adversely impact operations; however, companies can take advantage of opportunities such as an internal carbon pricing scheme to reduce greenhouse gas emissions and energy costs and using byproducts in waste processes to create new income streams in adjacent industries.
- Social issues include employee engagement, labor conditions in the supply chain and poverty and community impacts. Associated risks include increased costs and missed profit targets due to low engagement and high turnover and challenges with local governments to maintain operating permits due to lack of

12. Enterprise Risk Management: Applying enterprise risk management to environmental, social and governance-related risks (Committee of Sponsoring Organizations of the Treadway Commission and the World Business Council for Sustainable Development, Preliminary Draft published February 2018). COSO has been a recognized leader in the development of enterprise risk management frameworks that companies can use to implement effective ERM systems.

13. The two main technological risks in terms of likelihood were cyberattacks and data fraud or theft, each of which comes with substantial reputational and financial risk to companies particularly when the incident involves compromise of consumer information.

14. Enterprise Risk Management: Applying enterprise risk management to environmental, social and governance-related risks (Committee of Sponsoring Organizations of the Treadway Commission and the World Business Council for Sustainable Development, Preliminary Draft published February 2018), 4.

support for local communities; however, companies that can successfully engage with employees and create a diverse workforce will enjoy greater loyalty among their workers and be able to attract top talent and companies that can provide education to members of the local community can improve their standard of living, build stronger bonds with the community and strengthen opportunities to sell goods within the community and recruit local workers.

- Governance issues include codes of conduct, accountability and transparency and disclosures. Associated risks include negative company performance due to poor board oversight and reduced access to financing due to limited transparency; however, proactive embrace of ESG issues and risks as a focal point of the board's oversight responsibilities will satisfy the new expectations of institutional investors who are demanding that their companies consider ESG-related risks and opportunities as core to their business.

COSO and the WBCSD expressed concern that while companies appear to understand the importance of ESG-related risks, they have been slow to integrate them with traditional risks. For example, they pointed to evidence of significant misalignment between risks deemed material in sustainability reports prepared by companies and the risks that the companies disclosed in their traditional financial and legal reports. Among the possible reasons for this misalignment were the following:¹⁵

- The challenges of quantifying ESG-related risks in monetary terms due to the fact that they were often long-term risks with uncertain impacts over an unknown time period. The inability to place a "cash value" on these risks makes it difficult for companies to prioritize them and determine the amount of resources that need to be addressed in order to manage and mitigate those risks.
- A lack of knowledge of ESG-related risks and poor communication and collaboration between risk and sustainability professionals, a situation that has often led to ESG-related risks being viewed as separate and less important than traditional strategic, operational and financial risks.
- The lack of a mainstream practice for integrating reporting of ESG-related risks into traditional financial reports and the difficulties of determining which of those risks is sufficiently material to require reporting.

The problems mentioned above are being addressed in a number of ways including organizational structures that embed sustainability throughout the organization, rather than in a separate unit, and continuous improvements to reporting regimes that make it easier for companies to align strategic, operational, financial and ESG-related risks in their disclosures to regulators and other stakeholders. In 2017 COSO released an initial draft of an updated framework for ERM that reflected the evolution of ERM and the need to integrate ERM with strategy and performance and

15. *Id.* at 7.

incorporate ESG-related risks and opportunities. The framework consisted of the following five components and associated principles that included establishing governance for effective risk management, understanding the business context and strategy, identifying, assessing and prioritizing ESG-related risks, responding to ESG-related risks, reviewing and revising ESG-related risks and, finally, communicating and reporting on ESG-related risks. COSO and WBCSD argued that integrating ESG-related risks into their ERM would allow companies to enhance their resilience, develop a common language for articulating risk, improve resource deployment, enhance pursuit of opportunity, realize efficiencies of scale and improve transparency and disclosure to address the expectations of investors.¹⁶

§11.04 CHARTER AND ACTIVITIES OF COMPLIANCE AND RISK MANAGEMENT COMMITTEE

The compliance and risk management committee should have a charter that begins with a statement of purposes and goes on to specify the direct responsibilities of the committee with respect to compliance, risk management and corporate governance in general. The charter should specify the specific duties and powers of the committee and describe the organizational structure of the committee including any criteria that may be established with respect to the skills and experience of the individual members of the committee. As with other board committees, the compliance and risk management committee should have the right to appoint independent counsel and should also be obligated to make regular reports to the full board of directors.¹⁷

[A] Statement of Purpose

The charter should include a statement of purpose that addresses both compliance and risk management, recognizing that the two areas overlap substantially. From a compliance perspective, the purpose of the committee can be stated to include oversight of the company's implementation of compliance programs, policies and procedures, including the company's code of conduct, that are designed to respond to the various compliance and regulatory risks facing the company; and assisting the board of directors and the other committees of the board, notably the audit and governance committees, in fulfilling their oversight responsibilities for the company's compliance and ethics programs, policies and procedures. When defining compliance, the focus should not only be on relevant laws and regulations but also any voluntary standards that the board has agreed should be adhered to with respect to the day-to-day conduct of the company's operations and other activities. A Global Compact publication recommended that the purpose statement of a risk management committee should

16. *Id.* at 12–13.

17. For examples of compliance and risk management committee charters and additional commentary on preparation of such charters, see "Board Committee Charters" in the management tools available as part of "Governance: A Library of Resources for Sustainable Entrepreneurs" prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

include ensuring that the risks and opportunities arising from current and emerging corporate sustainability trends are included and addressed in the company's ERM program and that the board is informed of material issues relating to current and emerging economic, social and environmental trends.¹⁸

While the name of the committee may imply that compliance and risk management should be considered side-by-side, many companies view the primary focus of the committee to be risk management and that compliance risks are just one of many risks that identified and evaluated along with other operational and business risks. Given the potential scope of any company's operational, business and compliance risks, it is important for the board to thoughtfully allocate primary responsibilities for certain types of risks among the board's various committees to ensure that the appropriate focus and expertise is applied to those risks. For example, in the charter of its risk and compliance committee the board of directors of Target made it clear that the entire board would retain oversight responsibility over the company's key strategic risks, as well as the company's reputation and CSR efforts (which could also have been assigned to a separate board-level committee formed to oversee CSR), and oversight responsibility for certain other risk areas were assigned to other committees of the board (i.e., the audit and finance committee would handle financial reporting, internal controls and financial risks; the infrastructure and investment committee would handle risks related to the company's capital expenditures, major expense commitments and infrastructure needs; the human resources and compensation committee would handle compensation incentive-related risks, organizational talent and culture, and management succession risks; and the nominating and governance committee would handle governance structuring, board succession and public policy engagement risks).

[B] Composition, Meetings and Procedures

The compliance and risk management committee charter should address composition, frequency of meetings, powers and authority of the committee and other procedures. In general, the same "independence" requirements that apply to audit, governance and compensation committees are also imposed on the members of this committee and it is important that the members of the committee be generally familiar with compliance and ERM issues applicable to the company's specific line of business and operational activities. It is recommended that at least one of the members of the committee have deep experience and technical skills with respect to risk assessment and management, comparable to the qualifications of a financial expert on the audit committee. Given the scope of the mandate of the committee, including the need to regularly receive and review reports from both the CCO and the CRO, members should expect that meetings will occur frequently and that additional time will need to be invested in interviews and site visits as part of the general oversight of compliance and risk matters.

18. The Essential Role of the Corporate Secretary to Enhance Board Sustainability Oversight: A Best Practices Guide (United Nations Global Compact, September 2016).