

State Street Advises Boards to Focus on Environment and Social Sustainability

February 8, 2017 | Client Update | 3-minute read

[State Street's letter](#) to board members emphasizes the importance of sustainability in long-term corporate strategy. As they have previously focused at length on the importance of independent board leadership, which we discussed [here](#) in 2017 the investor will shift its attention to board oversight of environmental and social sustainability in areas such as climate change, water management, supply chain management, safety issues, workplace diversity and talent development. State Street believes that while each company is different, these areas can pose both risks and opportunities that affect financial returns, citing notable examples from recent scandals related to automotive emissions, food safety and labor issues.

Unlike many other institutional investors, State Street has supported shareholder proposals on climate change initiatives when they found companies' disclosure, practices and board governance structures to be inadequate. Their framework for evaluating sustainability approaches classifies a company according to how it has: (1) identified material environmental and social sustainability issues relevant to its business; (2) assessed and, where necessary, incorporated the implications of relevant environmental and social sustainability issues into the company's long-term strategy; and (3) adequately communicated its approach to sustainability issues and its influence on strategy.

They classify companies into three groups. Tier One companies are those which have satisfied all three criteria, Tier Two companies typically have satisfied one or two and Tier Three companies have not considered sustainability issues at all. Of the 177 companies that they have evaluated in depth in their global portfolio in 2016, 7% qualified as Tier One, 72% were classified as Tier Two, and 21% were in Tier Three. State Street targets Tier Three companies primarily as the most risky, which could impact how they vote proxies. The investor poses the following questions for boards and provides guidance on how some companies have addressed sustainability issues:

- **Has the company identified the sustainability issues material to the business?** State Street indicates that many companies have conducted peer reviews to identify sustainability-related key performance indicators (KPIs), with some companies using analytic tools to prioritize KPIs or further manage those indicators through information systems or life-cycle assessments.
- **Has the company analyzed and incorporated sustainability issues, where relevant, into its long-term strategy?** State Street noted that some boards receive regular updates or have dedicated sessions to discuss sustainability matters and industry trends.
- **Does the company consider long-term sustainability trends in capital allocation decisions?** State Street stated that some companies have incorporated environmental and social factors into strategic planning, such as making early investments in researching products that are eco-friendly and helping differentiate their brands.
- **Is the board equipped to adequately evaluate and oversee the sustainability aspects of the company's long-term strategy?** State Street noted that some companies give their directors explicit oversight responsibility of sustainability practices by incorporating it into committee charters, governance guidelines or through a dedicated committee.
- **Is the board incorporating key sustainability drivers into performance evaluation and compensation programs?** State Street indicated that certain companies establish and measure performance related to material sustainability issues and disclose those to shareholders.

- **Does the company's reporting clearly articulate the influence of sustainability issues on strategy?** State Street expects Tier One companies to communicate their approach to sustainability and its impact on strategy, and provided examples, such as a food and beverage company developing products with less fat and sodium in response to public health concerns, or an international coffee company changing its sourcing guidelines to reward farmers who used sustainable products. Contrasting that with Tier Two companies, such as a services company that identified employee retention as a material social issue but failed to disclose the material KPIs that allowed investors to measure progress, or a grocery chain that positioned itself as a leader in organic products that did not give meaningful data on KPIs that included supply chain and waste management.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

Ning Chiu

+1 212 450 4908

ning.chiu@davispolk.com

This communication, which we believe may be of interest to our clients and friends of the firm, is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. This may be considered attorney advertising in some jurisdictions. Please refer to the firm's privacy notice for further details.