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Corporate Climate Governance *and the road to Net Zero: relevance, challenges, and impact in practice*

EXECUTIVE SUMMARY

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A&O SHEARMAN

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Presentation

The study, *'Corporate Climate Governance and the Road to Net Zero: Relevance, Challenges, and Impact in Practice,'* confronts the pressing global challenge of climate change, focusing on the critical role that corporations can play in the energy sector in environmental impact mitigation and progression towards carbon neutrality. Our goal is to make a relevant contribution to the development of robust governance practices that enable progress towards sustainable business strategies that aligns with global environmental goals and standards.

To achieve this goal, the report provides an extensive analysis of corporate climate governance, covering areas such as environmental impact measurement, reporting standards, carbon neutrality goal-setting, and the intricacies of greenwashing. First, it examines climate governance frameworks in different jurisdictions, offering a comprehensive view of how various regions approach climate governance and the implications for global corporate operations.
This analysis is then complemented with an extensive overview of related ESG metrics using well known data providers.

Designed as a strategic guide for corporations, this report aims to assist in incorporating climate considerations into business strategies, corporate governance structures and operations. It serves as a valuable resource for corporate leaders, investors, and stakeholders in evaluating and enhancing corporate governance related to sustainability. Additionally, the report holds academic value, providing insights and data for future research in environmental law, corporate governance, and sustainable business practices.

The report is the result of a collaborative effort between experts in sustainability, law, corporate governance, and sustainable finance to ensure a multifaceted analysis of corporate climate governance. This multidisciplinary team approach, led by Paloma Baena as academic director and Mónica Represa as coordinator, combines legal expertise with practical business knowledge and advanced sustainability research. The diverse expertise of the authors enriches the study, enabling a holistic understanding of the complexities in corporate climate governance.

Reflecting IE Law School's ethos of addressing global challenges through rigorous education and research, and its mission and vision to empower leaders for sustainable impact, as well as A&O Shearman's commitment to excellence and innovation in legal practice, this report serves as a testament to the collaborative effort to address critical environmental challenges through rigorous research and groundbreaking solutions. Contributing to the discourse on corporate responsibility in climate change, the report echoes IE Law School's and A&O Shearman's dedication to shaping legal practice's future, thus making a meaningful difference through the transformative power of law.

It is our hope that **the report, through a detailed exploration of corporate climate governance principles, law and metrics, will contribute to the debate on corporate responsibility in environmental sustainability and to help the development of more effective corporate strategies.**

Climate change and *corporate responsibility*

The challenges

Climate change is one of the most significant challenges facing humanity today,[1] with far-reaching consequences for the environment, society, and the economy. In contrast to other global challenges, such as migration flows or security and defense, businesses are increasingly realizing that they must play a vital role not only in finding innovative solutions to mitigate climate risks and facilitate adaption, but also in leading by example, with a clear ambition to become climate neutral or climate positive actors.

Over the last three years, business has been highlighted as the most trustworthy institution in the Edelman Trust Barometer,[2] ahead of governments, civil society organizations and media. This is a new (and relatively surprising) trend, but it serves to highlight, among other things, the expectations that society has placed in business to help address societal most pressing problems, including climate change.

Other external factors are also driving this shift in company's attitude towards climate change. Financial markets mobilize trillions of dollars globally in climate-related projects and green investments, while the percentage of assets managed according to Environmental, Social and Governance (**ESG**) criteria (with a heavy focus on the E, environment) has increased substantially over the past few years. **Sustainable investing was estimated at $37.8 trillion by the end of 2021, while ESG assets will exceed $53 trillion by 2025.** [3] **Despite recent questioning (particularly in the US) over the aims and principles of ESG investment, this data reflects strong interest from investors in supporting environmentally and socially responsible companies.**

Regulation and government policies aimed at combating climate change (e.g., defining economic activities aligned with environmental goals, carbon pricing, emission reduction targets, and reporting requirements) have also gained momentum, as we will see in the report, pushing companies to take proactive measures in reducing their environmental impact, measures which scope and impact may differ depending on the jurisdiction and the political context.

In addition, companies are increasingly aware that a proactive involvement in addressing climate change could bring important payoffs. First, companies become eligible for ESG-minded investment. Second, there is growing evidence that companies that are more transparent on ESG performance[4] tend to be more resilient, due to improved operational efficiency, reduced risks, and enhanced reputation. Third, companies that take early action also position themselves for a host of economic and impact opportunities, such as accessing green technologies and participating in the transition to a low-carbon economy[5].

On the contrary, companies lagging on climate action, particularly in those economic sectors with a higher expectation to accelerate decarbonization, are exposed to legal and governance challenges. As prominent examples, we can recall some companies that have faced stakeholder mobilization and legal actions related to their climate impact and behavior, including shareholder resolutions, lawsuits, and regulatory investigations concerning a lack of transparency and also ambition regarding their decarbonization targets.

Additionally, some governments and international bodies as well as Courts have considered or implemented sanctions and penalties against companies and industries not taking adequate steps to address their environmental impact. Overall, companies that are perceived as failing to align with global climate goals could face reputational damage, financial repercussions, and exclusion from certain investment portfolios.

Corporate Climate Governance: relevance and key building blocks

To avoid these legal and governance challenges, companies are increasingly recognizing the importance of adopting **robust corporate sustainability strategies, setting science-based emissions reduction targets, and disclosing climate-related risks and opportunities** to investors and stakeholders, but progress remains uneven.

One of the most important drivers for company behavior regarding climate change is internal, and thus, dependent only on a company decision: **corporate climate governance**. As the world grapples with the escalating challenges of climate change, corporations have a pivotal role to play in spearheading environmental stewardship.

The importance of governance is often more talked about than acted upon, as more urgent matters or those with a quicker pay off usually take precedent. Additionally, our analysis evidence that corporate climate governance is a mean, not the end itself, being no guarantee of high climate-related performance. Yet, factors such as the level of commitment with emission cuts, its linkages with directors' remuneration and prioritization of climate-risk management are examples of common practices adopted by energy companies with lower overall ESG risks and better climate performance.

How can companies build a sound climate governance framework? This question is the focus of our report. In general, corporate climate governance refers to the systems, processes, and institutions that are put in place to address climate change and its impacts on a local, national, and global scale. It encompasses a wide range of issues, including international agreements (e.g., Paris Agreement), national climate policies (e.g., national emission reduction targets, national targets of renewable energy production etc.), monitoring and reporting, or public-private partnerships (e.g., UN Global Compact).

In the context of companies, **corporate climate governance refers to the structures, policies, and practices that companies put in place to address and manage their climate-related impacts and risks, but also to seize new business opportunities. It involves the integration of climate change considerations into the decision-making processes, corporate strategy, and overall business operations.**[6] Based on our analysis, we identify a number of critical drivers for a comprehensive climate-governance framework at the company level.

Corporate climate governance refers to the structures, policies, and practices that companies put in place to address and manage their climate-related impacts and risks, but also to seize new business opportunities. It involves the integration of climate change considerations into the decision-making processes, corporate strategy, and overall business operations.

TOWARDS A CORPORATE CLIMATE GOVERNANCE FRAMEWORK

- **Climate-related company goals**: integration of specific and measurable sustainability objectives and targets, related to the energy transition (e.g., science-based emission reduction target, net-zero target date and intermediate targets, alignment with business plans, capex) into corporate strategy.
- **Climate-related considerations in corporate policies and processes**: climate goals, climate risks and related considerations (e.g., stakeholder management) are integrated into decision-making processes (e.g., procurement policies, investment plan) and/or corporate policies (e.g., corporate by-laws, risk management framework, carbon offsetting policies, certifications).
- **Leadership and capacity at the board level**: members of the Board should have a clear understanding of climate change risks and opportunities and seek to integrate them into corporate strategy and long-term planning, exercising clear oversight over it.
- **Climate-linked incentives and remuneration**: climate-related targets (e.g., SDGs, energy transition goals, climate-related investments, emissions targets) are included in executive compensation schemes, linking variable remuneration to the fulfillment of climate goals for the members of the executive and management board.
- **Capacity and responsibility across the organization**: company employees are aware of climate targets and related policies and processes. There is built in capacity to support the organization's alignment towards these targets, including a dedicated management function that reports to the Executive Board or the Management Board.
- **Foresight and anticipation**: the company has the tools to analyze in a forward-looking manner climate-related scenarios with focus on material topics for economic, environmental and social impacts, in order to create, update, adapt and track its climate transition plan. This includes maintaining regular dialogue with peers, investors and other stakeholders and proactive engagement with policy makers (e.g., UN Global Compact, PRI, EU Commission etc.).
- **Climate-related control, transparency, and disclosure**: the company has in place internal control functions/tools that support the fulfillment of its climate goals. In addition, the company reports progress towards its goals in its sustainability plans, non-financial information reports, and carbon footprint reports, using clear, comparable indicators based (when possible) on frequently used standards (e.g., EU Taxonomy and GRI standards).
- **Climate specific verification and auditing**: the company procures external assurance of climate-related reporting as well as external certification on climate governance and performance, such as the SBTi validation or the ISO certifications. The audit results and certifications are easily accessible to stakeholders.

Corporate climate governance in companies is no small endeavor. Building a sound framework requires sustained commitment, capacity and processes development and of course, credible and committed leadership.

Ensuring that enough effort goes into building a sound corporate climate governance framework as a corporate priority even though its payoffs are not immediately apparent remains a challenge.

As evidenced in this report, the importance of early adoption of corporate climate governance measures cexot be overstated since it has proven it pays-off, and the medium-term returns can be significant: **guided by a strong and effective corporate climate governance framework, companies can contribute to global climate action, reduce their environmental footprint, enhance their reputation, and better position themselves to thrive in a low-carbon and climate resilient economy.** This forward-thinking approach has seen early adopting companies emerge as influential change drivers. Their leadership is crucial, setting benchmarks and influencing policy through their practices and commitment to environmental responsibility, as it sends a clear signal to markets and governments alike that the path to long-term prosperity is inextricably linked with the health of our planet.

Setting the scene: global ambition *on climate change*

Public organizations at the national and international level have been active promoters of climate change goals. Their broad ambition in setting global decarbonization goals has had far reaching consequences, including a new wave of climate-related regulation.

The political impulse at an international, European and national level has encouraged companies to adopt a corporate climate governance approach in their actions, and, ultimately, to take proactive measures to reduce their environmental impact, which can potentially result in countless business benefits and for society as a whole.

An essential milestone in the development of a common framework for action on climate change was the approval, on September 25, 2015, of the "**2030 Agenda for Sustainable Development**" by the United Nations. While the primary purpose of the SDGs is to call all countries in the world to action for the achievement of the 2030 Agenda objectives, they also provide a comprehensive framework for countries to monitor and report progress on sustainable development. The 17 SDGs unfold in 169 targets, which have their progress tracked by 248 pre-defined indicators – though some indicators overlap to different targets, and, whereas the 169 targets are preferably oriented towards countries, in some ways, they also influence companies on their progress towards sustainable development[7].

Governments are encouraged to develop national indicators and reporting mechanisms to track their progress towards the goals. Similarly, corporations can also integrate the SDGs into their reporting frameworks and disclose their contributions and impacts. [8] To achieve these ambitious targets, concerted political, social, economic, environmental and financial commitments on the part of both the State and companies, are essential.

Together with the 2030 Agenda, the Paris Agreement of 2015 is a key milestone for the global goals on climate change. After the Kyoto Protocol expectations were not met, the parties to the United Nations Framework Convention on Climate Change reached the Paris Agreement in December 2015. The main commitment is to limit the increase in temperature to well below 2ºC above pre-industrial levels and pursue efforts to limit it to 1.5°C above pre-industrial levels. As of today, 186 states have ratified the Paris Agreement.

To find common ground between more and least developed nations, the Paris Agreement allows the parties to continue increasing their emissions until they reach a maximum point, from where to begin to decrease. Furthermore, it foresees a national "adaptation effort" and does not include a compulsory reporting mechanisms with sanctions attached.

Despite its enforcement weaknesses, the Paris Agreement provides a lasting framework to guide the global effort for decades to come and marks the starting point of a change of course with the goal of a zero-emissions world. Progress to meet its targets is essential to achieve the SDGs, with the combined efforts of public institutions, companies and citizens and consumers.

In addition, the Paris Agreement unleashed a wave of policy and regulatory changes within the European Union (**EU**) focused on decarbonization, the energy transition and the support from financial markets towards environmentally and socially responsible behavior through a fully-fledged regulatory package on responsible investment. Ultimately, it has led to the EU commitment to become the first carbon neutral continent by 2050. Today, the progress made by and in Europe on addressing climate change and alignment policy, regulation and investment along decarbonization and energy transition goals is undeniable.

Key Issues on *Corporate Climate Governance*

Measuring, Reporting and Setting Long-Term Goals

Introduction

Measuring and reporting represent the cornerstone to put in practice accountability and transparency principles and render any corporate climate change framework truly effective.

A high-quality measuring and reporting process can deliver numerous benefits, such as accountability, transparency, informed decision-making, improved risk management, better response to investor expectations, regulatory compliance, and meaningful stakeholder engagement. And corporations are realizing that. Out of the largest 250 corporations by revenue globally, 96% report on sustainability or ESG matters, and 64% acknowledge climate change as a risk to their business. Overall, the adoption of the Task Force on Climate-related Financial Disclosures (**TCFD**) framework increased from 37% to 61% between 2020 and 2022. [9]

However, **reporting is not done in a uniform manner, limiting the benefits** listed above. Indeed, while at the national level, countries are subject to shared responsibilities under the UNFCCC, corporations in general have a more discretionary approach to climate change measurement and reporting. Regulatory efforts, as well as good practice principles, including from the Organization for Economic Co-operation and Development (**OECD**) and the World Economic Forum, and guidelines: seek to establish a more uniform reporting criteria and methodology. [10] However, **important challenges remain to be addressed, including: 1) data materiality; 2) reporting standards; 3) data quality; and 4) access to data**. These challenges render it more difficult to understand and compare ESG performance by investors, compromising their ability to incorporate ESG criteria into financial modeling.

Scope: the importance of data materiality

Materiality [11] is not only key for reporting purposes, but for the whole corporate strategy, serving as a guide for management priorities and resource allocation.

This view is particularly aligned to traditional disclosure regimes, focused on investors' needs to evaluate financial performance (financial materiality), requiring companies to report on sustainability issues (including climate) that might affect enterprise value. In 2017, the European Commission's Guidelines on Non-Financial Reporting [12] introduced a new element to be taken into account when assessing the materiality of non-financial information. The combination of the financial materiality and the impact materiality resulted in the concept of double materiality.

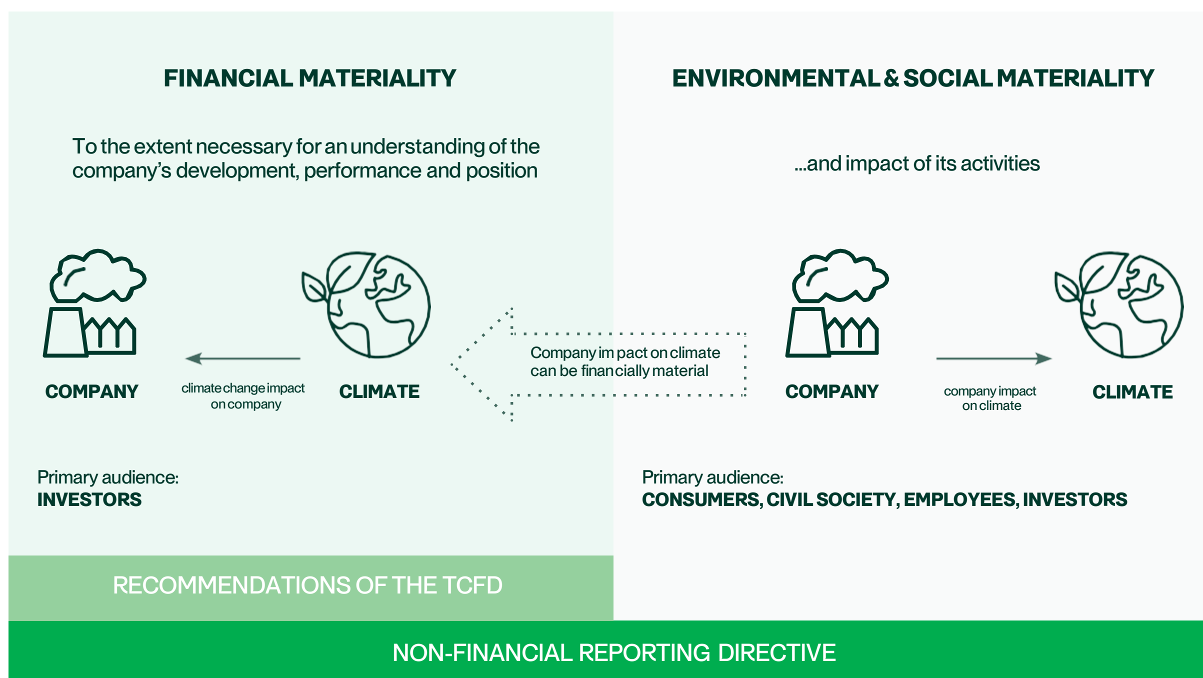
Remaining challenges in measurement and reporting

Despite all progress that has been made in frameworks adoption and data provision by third parties, there are still several remaining challenges to measuring and reporting when it comes to corporate climate governance.

(i) Emissions Data Availability and Quality: Although direct and indirect (those related to products sold) greenhouse gas (**GHG**) emissions can be calculated and therefore report, some corporations, especially those with complex supply chains, struggle to gather data from multiple sources, including suppliers and subcontractors, which may use varying methodologies and reporting standards. Particularly for smaller enterprises, there are additional challenges related to lack the necessary capacity, expertise, and resources to implement robust measurement and reporting systems.

(ii) Lack of Harmonization to Report on Climate Performance and Governance: Numerous methodologies and reporting standards exist, with many of them including sector specific guidelines. Yet, choosing the most suitable methodology and standard for climate performance and reporting can be daunting. Despite some existing consolidation efforts, the absence of a universally accepted framework can lead to confusion and inconsistency in reporting practices.

THE DOUBLE MATERIALITY PERSPECTIVE OF THE NON-FINANCIAL REPORTING DIRECTIVE IN THE CONTEXT OF REPORTING CLIMATE-RELATED INFORMATION



*Financial materiality is used here in the broad sense of affecting the value of the company, not just in the sense of affecting financial measures recognised in the financial statements.

iii) Data Verification and Assurance: While third-party verification and assurance can ensure the accuracy and reliability of reported climate data, companies face challenges in finding qualified verifiers, managing the costs associated with verification processes, and addressing discrepancies or limitations in their reported data. Furthermore, even the verification of historical performance data could have consolidated, meaning the verification of risks and prospective estimations, for which there is no available methodology, is still complex. Limited availability of qualified verifiers and the absence of standardized verification processes further complicate the verification and assurance process.

The challenges above should not downplay the importance of measurement and reporting for corporate climate governance systems. Rather, they reflect an increased relevance of the topics for companies around the world, while practices and solutions are still in a consolidation stage.

Climate change is a topic that goes beyond the traditional duties of corporate boards. This gives measurement and reporting a heavy weight within corporate climate governance systems, not only as a continuous improvement guide, but as tool to minimize the risk of making promises that cannot be delivered or painting a nicer picture than reality. Under pressure of stakeholders, practices often dubbed a greenwashing.

Climate governance related risks: greenwashing and climate litigation

Climate disclosures and greenwashing

Although definitions of "greenwashing" vary across jurisdictions, it is broadly understood to mean **misleading the public into believing that a company or entity is doing more to protect the environmet than it actually is**. In a generic sense, it implies the process of conveying a false impression or providing misleading information about either a company's or a product's "ESG" performance to create an overly positive image.

Greenwashing can take many forms, such as hiding GHG emissions, masking them under a new emerging business line (for example, biofuels or renewables in the case of oil companies), and lacking a real climatic strategy or decoupling goals from the business model. For example, a company may claim to be carbon neutral by offsetting its emissions with dubious projects in developing countries, while continuing to emit large amounts of GHG emissions. Or a company may announce ambitious targets for reducing its environmental impact by 2050 without providing any clear roadmap or interim milestones on how to achieve them. Alternatively, a company may tout its support for renewable energy projects, while lobbying against climate regulations. Or a company may launch a green product line or brand, while neglecting or hiding the environmental costs of its core activities.

Accusations of greenwashing could also relate to statements made by a business in an attempt to revamp its green credentials, or the marketing of any product where environmental credentials are promoted.

Materiality of greenwashing for companies may not only come from climate litigation and regulatory consequences, but also through investors' loss of confidence and market competitiveness. Greenwashing practices end up eroding consumer trust in sustainability initiatives. Some institutional investors have withdrawn from or avoided companies that fail to meet their climate commitments or that operate in high-risk sectors, such as oil & gas, finance, and food and beverage, which account for most of the greenwashing controversies. Moreover, greenwashing can harm companies' future earnings by damaging their reputation, as shown by the recent case of a global fashion retailer that had to remove the "conscious choice" label from its products after facing greenwashing accusations (although the case was later dismissed in court).

Climate litigation or how climate disclosures and greenwashing drive risk for companies

Alongside the rising risk of regulatory enforcement, the threat of **shareholders' activism and civil litigation for companies is also on the rise**. Non-governmental organizations (**NGOs**) and individuals are increasingly suing private entities over their impact on the climate. These cases seek to discourage high-carbon activities, sometimes even presented as sustainable or claiming energy transition focused, target alleged failures to adapt to the net-zero transition and claim compensation for climate damage.

Also, litigation is being used in a bid to hold directors and management accountable for perceived corporate failures to manage climate risks.

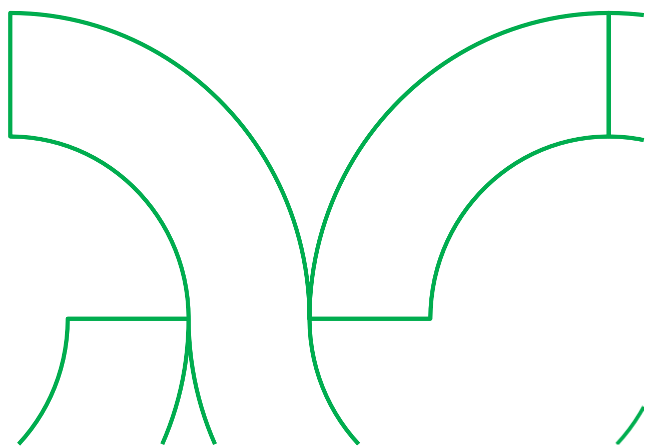
In a landmark decision, in May 2021, the District Court in The Hague ordered a major oil company to cut its global carbon emissions by 45% from their 2019 levels by the end of 2030. The ruling in the case applies not just to the company's own emissions, but also to those created by its products. It is the first example of a court ordering a company to reduce its carbon output. Away from their direct impact on the environment, companies also face growing litigation risk from their climate-related disclosures. These cases seek, among others, to highlight instances of greenwashing. In particular, greenwashing litigation comes in a variety of forms:

GREENWASHING RELATED LITIGATION AND ACTIVISM

- **Investors' litigation activism**. One of the best-known examples involves a major US oil producer, one whose stockholders filed a securities fraud class action against it and three of its directors in a Texas district court in 2016. The complaint alleged the company's public statements were materially false and misleading because they failed to adequately disclose the impact of climate change on the business, and that, as a result, its stock price was artificially inflated. When the company subsequently announced that it might need to write down the value of some of its fossil fuel assets, its share price dropped. Also, in the UK, the Advertising Standards Authority banned a series of advertisements from a number of large oil & gas companies for including misleading information about their environmental credentials.

  Where greenwashing litigation relate to financial products marketed as "green," claims have been brought on the grounds of mis-selling, misleading advertising and unfair business practices. It can be challenging for investors to win these cases, however, as doing so requires them to demonstrate they have suffered a loss. As a result, any uptick in mis-selling claims in relation to green financial products is likely to arise in jurisdictions with claimant-friendly class action regimes, such as the US.
- **Civil society litigation activism**. It is possible that we may see NGOs taking a closer look at corporate offsetting, and whether emissions reduction credits deliver their stated decarbonization benefits. In Europe, we have seen cases brought against energy majors over whether their pledges to be carbon neutral by 2050 are misleading given their fossil fuel investments today, and lawsuits targeting airlines in relation to "responsible flying" campaigns that NGOs claim give consumers "the false impression that ... flights won't worsen the climate emergency." In 2017, a group of NGOs filed a complaint in the Netherlands against an international bank alleging it had failed to disclose the quantity of GHG emissions emitted as a result of its financing activities. The complaint resulted in the bank making a number of commitments to reduce its climate impact, including by steering its lending portfolio in a direction more compatible with the aims of the Paris Agreement.
- **"Advocacy" initiatives**. Here we are seeing private parties engage with authorities to put pressure on companies. As an example, in 2017, an NGO asked a Canadian securities regulator to stop an infrastructure company's initial public offering based on allegations that the prospectus had deficient disclosures around climate-related risks. After the regulator agreed to review the request, the company amended the prospectus.

Greenwashing practices end up eroding consumer trust in sustainability initiatives. Some institutional investors have withdrawn from or avoided companies that fail to meet their climate commitments or that operate in high-risk sectors, such as oil & gas, finance, and food and beverage, which account for most of the greenwashing controversies.



Corporate Climate Governance in practice: *Focus on the energy sector*

The benchmarking analysis

We have conducted a benchmarking analysis of the corporate climate governance systems of 25 listed companies in each of the five jurisdictions under the scope of this study: Spain, Germany, France, the US and the UK. In each country, we have chosen the top five companies in the energy sector listed in the main stock exchange taking into account their market capitalization.

The benchmarking adopts a comprehensive and multidimensional approach to evaluate the corporate climate governance systems of the companies, using a set of KPIs that reflect different aspects of their corporate strategy, internal regulations, remuneration, supervision, risk management, reporting and auditing related to the climate goals, following those identified in this study. These KPIs are based on traditional good corporate governance indicators across the board in the world and are also referred and considered in the ESRS 2 among the standards for sustainability disclosures .

The benchmarking analysis relies on two main sources of data: (i) the information provided by selected ESG data providers, which offer detailed information on the performance of the companies; and (ii) public available information reported as by the companies, which offer more detailed and specific data on their corporate climate governance systems. The benchmarking compares the data from these two sources, as well as the data across the jurisdictions and the companies, to identify the level of alignment, consistency, and transparency of the corporate climate governance systems, in order to identify opportunities and best practices for improvement.

The specific issues analyzed as part of this benchmarking mimic the earlier qualitative analysis and allows to conclude with a discussion on the impact of corporate climate governance on risk metrics and ESG performance, which is set in this executive summary.

THE IMPORTANCE OF PIONEERSHIP

Although it could not be presented as a KPI and, therefore, it is not included among the selected indicators for the benchmarking, the early adoption of corporate climate governance measures is a relevant factor to weigh. The maturity of a company's corporate climate governance system is indicative of its commitment to long-term sustainability goals and its capacity to integrate climate considerations into strategic decision-making.

Mature systems are characterized by comprehensive policies, clear accountability mechanisms, and regular reporting on climate-related performance. Companies with mature climate governance are more likely to have robust data collection and analysis capabilities, enabling them to track progress and make informed decisions. By proactively integrating climate-related objectives and KPIs into their corporate governance frameworks, companies are better positioned to anticipate and manage risks associated with climate change.

Generally, investors recognize the value of such maturity, which should also be reflected in higher ESG ratings.

Impact of Corporate Climate Governance on risk metrics and ESG performance

Considering that corporate climate governance is gaining traction, prompted by several regulations and voluntary standards as shown in the previous chapters, this chapter explores the extent to which it is embedded into different assessments, ratings and rankings used by investors to incorporate ESG in their decision-making processes. The insights shared below are not intended to be exhaustive, but rather to be a starting point for a discussion on how these assessments do or do not represent an incentive for companies to improve their climate governance systems.

#1 Very few initiatives or data providers assess corporate climate governance as a key aspect of ESG risk and performance, despite the relevance of the topic for energy companies

While several disclosure standards and frameworks offer recommendations on how companies may address different aspects of corporate climate governance, very few initiatives offer a comparative assessment of such elements.

As part of its work to support climate-related investor engagement, Climate 100+ publishes The Net Zero Company Benchmark, a comprehensive assessment of focus corporations covering governance, emission reduction across the value chain and transition plans. These performance indicators, which draw on public and self-disclosed data, are grouped into disclosure framework indicators and alignment assessments, the first focused on the adequacy of corporate disclosure and the latter on company actions towards the Paris Agreement goals. Corporate climate governance is part of the disclosure framework indicators group, and it is directly linked to one of the three engagement goals of the initiative: "*implement a strong governance framework which clearly articulates the board's accountability and oversight of climate change risk*". Metrics are assessed on a binary Yes/No basis.[13]

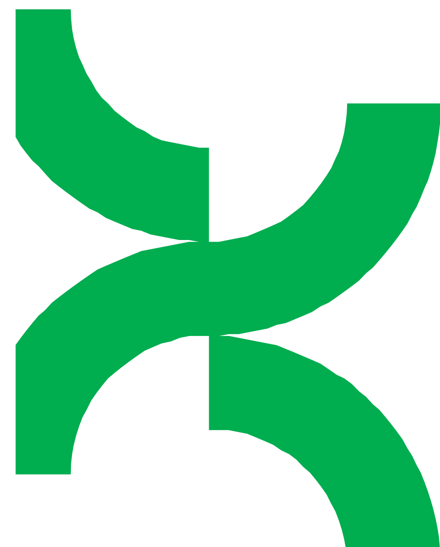
The CDP Climate Change Score is also a key initiative looking at specific elements of corporate climate governance, although those elements are not scored individually. Rather, the consolidated final score is the result of an overall analysis conducted by an internal scoring team based on companies' responses to CDP questionnaires, complemented by data quality checks to ensure that scoring standards are accurate and consistent. Out of its 15 modules, at least ten can be considered directly linked to climate governance: governance (including board oversight, management responsibilities and employee incentives), risks and opportunities, business strategy, targets and performance, emissions methodology, emissions data, energy, verification, carbon pricing and engagement.

#2 In the case of ESG ratings and rankings, corporate climate governance is often diluted among several indicators, having a low weight in final ratings and scores

While ESG ratings and scoring methodologies often use materiality screenings to assign weight to varied factors depending on the industry and, sometimes, on the company's particularities, corporate climate governance is overlooked even for activities as carbon intensive as energy production based on fossil fuels.

Based on this paper's definition, we assessed how some of the key ESG rating providers incorporate corporate climate governance in their methodologies. As an example, within the energy sector, MSCI ESG Ratings for the Integrated Oil & Gas subindustry, the carbon emissions key issue contributes with 14.1% of companies' overall risk. Under the governance pillar, which contributes with 33.0% of total ESG risk, the key climate governance topics considered are pay linked to sustainability key metric and, indirectly, risk management expertise key metric. Together, these two metrics may represent less than 5% of the potential impact of governance issues. Therefore, elements of corporate climate governance considered in the study may account in total for less than 10% of this subindustry's ESG risk.

Similarly, the Sustainalytics ESG Ratings do not consider corporate climate governance as a separate topic, but rather as part of broader issues under environmental and governance issues.



Within the corporate governance issue, which is deemed as material for all companies regardless the industry, the pillar defined as stakeholder management comprises different indicators related to corporate climate governance, such as ESG governance, ESG performance targets, verification of ESG reporting, environmental policy and GHG reduction program, the latter being the only one with a climate-related focus. As corporate governance's contribution to the overall ESG rating ranges from 7.5% to 35.7% for the selected companies, the stakeholder management pillar's total weight varies from less than 1% to around 3.5%.

#3: Corporate climate governance enhances management of climate issues, but it is no guarantee of good climate performance and/or low climate risk as perceived by ESG ratings

While good corporate climate governance intends to deliver excellence in climate performance, performance is also influenced by other key drivers, such as transition costs and shareholder pressure.

The ISS 2023 report on corporate climate governance [14] concluded that climate governance measures are positively associated with GHG emissions disclosure and progress towards Net Zero. An analysis of the performance of the companies under scope in the ESG ratings compared to their corporate climate governance shows the paramount importance of the operating sector in the risk rating. A strong corporate climate governance system helps risk-rate assessment when the measures included within the governance system are specific and have a financial or business impact in the company. On the other hand, a poor corporate climate governance structure does have a negative impact. The benchmarking reveals that the companies perform well overall in all regions, except for the US, where oil & gas producers are more prevalent and where there are also jurisdictional specificities (as explained below).

Among the oil & gas entities under study, one French and one Spanish company are the best performers, while two US companies have the lowest ratings. Among the utilities in the sample, two Spanish companies are the best performers, [15] while again, two US companies have the lowest valuations. The main factors that distinguish the performance of these companies are:

- The degree of **specificity and commitment of their emission reduction targets**, especially for Scope 3 emissions, and the **effective integration** of these climate goals into their business strategy and investment plans.

All the highest rated companies have committed to achieving net-zero emissions by 2050, covering all three scopes, and have science-based validated targets. They also present a clear roadmap for reaching these goals, including interim targets, and align them with their business plans, capex (e.g., 20% capex allocated to low carbon electricity by the French company) or corporate investments (e.g., 35% investment in low carbon business by the Spanish oil & gas company). In contrast, US companies have committed to achieving net-zero by 2050, but only for Scope 1 and 2 emissions, or with a limited consideration of Scope 3. They also do not provide detailed information on their investment strategies and plans for reaching their targets.

- The linkage of the remuneration of directors to specific and clear targets, which usually is a key indicator of corporate governance, and most importantly, the objective measurement of the achievement. In general, all the companies consider corporate climate goals to determine the remuneration of their directors and most of them set up objective performance indicators (e.g., achieving a specific GHG reduction target, concrete improvement of an ESG rating, etc.). However, the best rated companies disclose the assessment of the achievement of the relevant goals. For example, one company has this assessment audited by an independent expert; another provides the details of the quantification method in its corporate regulatory disclosures. US companies, on the other hand, present a more discretionary assessment methodology that may also change in each award cycle.

- The use of **well-known equivalent standards for measurement and reporting** (rather than their own internal metrics) and the use of specific comparable data and frameworks in their disclosures, **covering Scope 3 reporting**. The best performing companies adopt EU Taxonomy, TCFD or GRI as reference standards and they also use a comparable report framework (e.g., non-financial information reports). In companies with a lower rating, the alignment of their disclosure to the relevant standard (e.g., TCFD) is incomplete and partial, and their reporting on Scope 3 is limited to certain categories only. Note, however, that simply measuring and reporting ESG metrics without an accompanying, robust sustainability strategy is not likely to be a powerful performance driver.
- The prioritization of climate risks in **risk management**, as critical factors, assessing their materiality with recognized methods and against a clearly defined timeframe. The best rated companies use, for example, IPCC or the IEA to evaluate the impacts and opportunities of climate change for their businesses. They also address risk management with specific measures that affect the financials of the company (e.g., investments, R&D, etc.,) and corporate operations (e.g., procurement). US companies, on the contrary, rely on limited materiality assessments without specialized climate risk criteria, and may use more generic risk management frameworks.

The auditing of the disclosed information is a de minimis must-have, so even when companies go beyond what is required in the regulations or the market practice, it does not have a relevant weight in the risk assessment. In this sense, some US companies use internationally recognized certification bodies or sustainability services providers as auditors, while one of the best-rated Spanish companies just uses its statutory auditor.

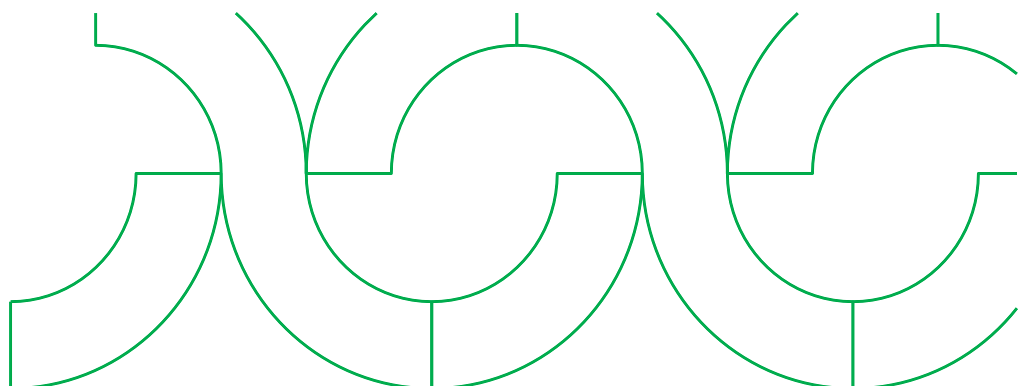
Finally, it is interesting to note how the relevance of other corporate governance metrics, which would be considered evidence of a strong commitment to climate goals from a traditional perspective, prove to have limited relevance for the ESG risk assessments. In this sense, the integration of climate goals in a company's by-laws or within its corporate purpose could be considered as one of the most binding measures for companies from a legal perspective. However, it does not improve the rating of some of the French companies when all of them have adopted this measure. Likewise, the existence of internal committees, their composition and their members' different skills and qualifications on sustainability matters do not tip the balance in favor of US companies, which have strong internal organic governance structures.

#4 Yet, there is a correlation between jurisdictional regulations, corporate climate governance and ESG risk rating

The analysis indicates a correlation between jurisdictional regulations, corporate climate governance and ESG risk rating. Companies operating in jurisdictions with stricter and more proactive climate regulations tend to adopt better climate governance practices and have lower ESG risk ratings than those in jurisdictions with weaker or less consistent regulations. This suggests that regulation can significantly influence corporate action and disclosure on climate issues, as well as the environmental performance and risk exposure of companies as perceived by investors and stakeholders.

France and Spain have the best rated companies for climate governance. France has been a leader in climate regulation, enacting laws before and beyond the EU requirements. Spain, as an EU member state, has transposed the EU legislation into its national laws. However, the better performance of Spanish companies compared to, for example, German companies, cannot be explained solely by the jurisdictional regulations, which are quite similar, but also by a stronger private sector interest in Spain. In this sense, being an early adopter of corporate climate governance practices could enhance performance, reputation, and resilience of companies, so they can gain a competitive edge by anticipating the expectations of their stakeholders. Anticipation in corporate climate governance leads to a consistent development of mitigation and adaptation strategies towards net zero, avoiding stranded assets and liabilities. This is the case for Spanish Company 3 and French Company 1, both of which started building up best climate governance practices more than a decade ago in some cases.

In contrast, the US has the worst rated companies for climate governance. The US has lagged in integrating climate issues into its regulations, despite its historically strong and more sophisticated corporate governance standards. Consequently, US companies have not yet incorporated climate issues into their core business decisions and not yet fully reported their climate impacts and performance either.



Towards a real commitment: *Strengthening Corporate Climate Governance as a driver for climate action*

Throughout this study, we have examined the effectiveness and consistency of corporate climate governance in practice as a driver for climate action, digging into the structures, policies, and practices that companies put in place to address and manage their climate-related impacts and risks, but also to seize new business opportunities.

Corporate climate governance is a good compass of climate-related performance in companies, as well as a key factor for reducing ESG risk and enhancing ESG ratings. Companies with robust corporate climate governance systems tend to have more ambitious and specific emission reduction targets, more comprehensive and transparent reporting, more effective risk management and stakeholder engagement, and more alignment with the goals of the Paris Agreement and the SDGs.

However, corporate climate governance is strongly influenced by the legal and regulatory frameworks in which companies operate, as well as by the expectations and demands of investors and other stakeholders. Companies operating in jurisdictions with stricter and more proactive climate regulations tend to adopt better climate governance practices and have lower ESG risk ratings than those in jurisdictions with weaker or less consistent regulations. Likewise, companies that face more pressure and scrutiny from their shareholders, customers, employees, or civil society tend to be more responsive and accountable on climate issues. Enhancing the coherence and effectiveness of the legal and regulatory frameworks, as well as fostering dialogue and collaboration between companies and their stakeholders, is essential for creating an enabling environment for corporate climate governance.

Furthermore, it is imperative for corporations to assess and understand the importance of their corporate governance systems and internal measures in the design and execution of their net-zero goals. A genuine dedication to sustainability should be manifested not only in the strategic planning but also in the financial architecture of the organization. This commitment necessitates a substantial allocation of corporate resources, which encompasses capital expenditures and financial outlays. The integration of sustainability into corporate governance is essential for ensuring that environmental objectives are not merely peripheral concerns but are central to the company's operational and financial decision-making processes. By doing so, companies can demonstrate to stakeholders that their pursuit of sustainability is both strategic and economically grounded, thereby reinforcing the credibility of their environmental initiatives.

In any case, corporate climate governance cannot be reduced to a one-size-fits-all approach, but is rather a context-specific and dynamic process that requires continuous improvement and adaptation. Companies have various levels of exposure and vulnerability to climate risks and opportunities, depending on their sector, size, location, and business model. While also following some common principles and standards that ensure comparability and credibility, corporate climate governance compliance and measurement, in particular by ESG data providers, should consider the specific nuances that affect each company to deliver a real and accurate picture of the progress of any company's genuine commitment to climate action.

Based on these conclusions, the report makes the following recommendations that include proposals (i) at the level of public policies and regulations for governments and supervisors and (ii) at the company level.

Furthermore, it is imperative for corporations to assess and understand the importance of their corporate governance systems and internal measures in the design and execution of their net-zero goals. A genuine dedication to sustainability should be manifested not only in the strategic planning but also in the financial architecture of the organization.

At the level of public policy

(a) **Promote cooperation and the creation of multi-stakeholder partnerships for harmonizing and coordinating policies on climate action and governance**. Multi-stakeholder forums would allow different governments, intergovernmental organizations, civil society and companies to design, implement and evaluate governance initiatives and policies, and should be encouraged to share efforts and experiences, and harmonize and coordinate policies, regulations and incentives to raise standards. These partnerships, with close alignment to the SDGs, will be drivers to boost climate action, with proposed solutions across all sectors of the economy.

(b) **Focus on regulation effectiveness and purpose to achieve desired results**. Companies operating in jurisdictions with stronger and more proactive climate regulations tend to adopt better climate governance practices and have lower ESG risk ratings than those in jurisdictions with weaker or less consistent regulations. This suggests that regulation can significantly influence corporate action and disclosure on climate issues, as well as the environmental performance and risk exposure of companies as perceived by investors and stakeholders. Indeed, the most successful countries in climate action are those in which governments have approved clear policies known to all of society and reflected in the corresponding national planning, and have implemented regulations that include actual obligations and incentives.

However, regulatory overload may hamper progress. Market flexibility is essential, and striking the balance between robust market safeguards and allowing innovation is going to be critical. Such fragmentation undermines the credibility and effectiveness of the sustainability agenda, creating as it does confusion in the market and arbitrage and regulatory gaps.

(c) **Promote uniform legal standards to best comparative practice**. As this report evidences, one of the main challenges is the lack of global consensus and coordination on the criteria, indicators and thresholds for defining and measuring sustainability. Better international alignment around key concepts, principles and definitions would be of great benefit, and greater consistency between frameworks in relation to sustainability reporting standards must be expected.

(d) **Provide guidance and support for companies to implement and report on their corporate climate governance systems, as well as to comply with the relevant standards and frameworks**. The creation of specific corporate climate governance codes or guidelines, either as a standalone document or as part of existing good governance codes, would help boards and senior management to address with a higher level of certainty the climate-related aspects of their internal organization, aligned with stakeholder engagement and expectations. Such a code or guidance would also enhance the comparability and credibility of corporate climate governance practices and facilitate the monitoring and evaluation of corporate performance and progress towards climate goals.

(e) **Strengthen corporate climate governance indicators within ESG ratings**.[15] Together with efforts to introduce a higher degree of transparency and comparability and reliability of ESG ratings and data providers, we call for a more detailed inclusion of corporate climate governance KPIs. As this report shows, good climate governance should be reflected in lower climate risk. However, there are nuances in the definitions and in the practices that result in companies with solid climate governance systems not achieving an equivalent good climate rating. Despite its relevance for corporate action on climate change, corporate climate governance is often diluted among several indicators, having a low weight in final ratings and scores.

In addition, the energy sector deserves specific attention in the methodologies, and clearer and more exigent KPIs should be streamed out, reflecting also a more positive impact for those companies operating in this sector that are ahead in and have more mature, and hence stronger, climate corporate governance systems.

At the company level

(a) **Be clear on the transition strategy and ensure they give sufficient resource and oversight to its implementation**. There is a positive relationship between ESG performance and financial performance[16].

Stakeholders are demanding that businesses review their commercial strategies (such as through the development of transition plans) and look at regulatory change and implementation in a way never seen before in relation to environmental and climate matters. The need to better integrate sustainability into day-to-day decision-making is clear and will require governance models to adapt.

(a) **Be specific on climate-related goals and the related plans for their achievement**. All the highest rated companies have committed to achieving net-zero emissions by 2050, covering all three scopes, and have science-based validated targets. Furthermore, companies with the best ratings have adopted a robust commitment towards those goals through a clear and ambitious roadmap for reaching these goals (i.e., including interim targets, and aligning them with their business plans, capex (e.g., 20% capex allocated to low carbon electricity by one of the French companies) or corporate investments (e.g., 35% investment in low carbon business by one of the Spanish oil & gas companies)).

(c) **Design a solid, transparent and detailed climate governance framework**. Companies will need to review and update their governance frameworks to reflect sustainability strategies and priorities and build these into their internal structures. A corporate climate governance system helps with risk-rate assessment when the measures included within the governance system are specific and have a financial or business impact on the company.

(d) **Prioritize climate risks, as critical factors, assessing their materiality with recognized methods and against a clearly defined timeframe**. The best rated companies use specific scenarios, for example, IPCC or the IEA to evaluate the impacts and opportunities of climate change for their businesses. They also address risk management with specific measures that affect the financials of the company (e.g., investments, R&D, etc.) and the corporate operations (e.g., procurement). However, it is important to recognize the absence of proven methodologies to assess the financial impact of long-term climate scenarios, which can lead to unrealistic estimations of financial impact or, in some cases, to companies opting for less ambitious targets.

(e) **Disclose the assessment of the accrual of directors' remuneration related to the achievement of climate goals**. The best rated companies disclose the methodology to calculate and validate the performance of their directors for remuneration purposes, providing details of the quantification method and following up on the effective achievement.

(f) **Be transparent in every aspect of climate governance disclosure**, providing investors, regulators and other stakeholders with **detailed information on existing structures, responsibilities, stakeholders' relation, processes, methodologies and practices** in place to deliver on good climate performance and low climate risk. Our research indicates that companies with a consistent climate strategy are transparent about their goals and real impact, which also results in less exposure to the risk of greenwashing claims.

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5. As an illustrative example, the US auto sector, which regulatory framework for electric vehicles is fragmented, is taking the initiative in a bid to reduce political risk. Several leading automakers have agreed bilateral framework deals with the Californian government that incentivize faster emissions reductions than current laws require.
6. Source: authors' own elaboration.
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12. Material topics are topics that represent an organization's most significant impact on the economy, environment, and people, including impacts on human rights. The process to identify these topics is often called materiality assessment, and usually involves a survey with key company stakeholders on what the sustainability themes that they deem to be relevant in their relationship with the business in question.
13. Guidelines 2019/C 209/01. The guidelines were prepared in accordance with art. 2 of the Directive 2014/95/EU of the European Parliament and of the Council as regards disclosure of non-financial and diversity information by certain large undertakings and groups (**NFRD**), in order to assist companies concerned to disclose non-financial information in a relevant, useful, consistent and more comparable manner.
14. ISS Insights "*Corporate Climate Governance: A Subject of Growing Investor Scrutiny*", September 26, 2023, at https://insights.issgovernance.com/posts/corporate-climate-governance-a-subject-of-growing-investor-scrutiny/
15. This resembles the case of proxy advisors, who became very influential in the analysis of the governance systems of listed companies. At first, issues such as their methodology and the possible conflicts of interest they faced were tackled by various self-regulation proposals. However, in the end, legislation was enacted that establishes their operating and transparency obligations.
16. A 2021 Paper – ESG and Financial Performance by Tensie Whelan, Ulrich Atz, Tracy Van Holt and Casey Clark – reviewed more than 1,000 studies published between 2015 and 2020 and found that there was a positive relationship between ESG and financial performance in 58% of the corporate studies and 43% of investor-focused studies, which tend to look at a direct relationship between ESG and performance based on benchmarks and a portfolio-level view of themes such as materiality or governance structure.

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