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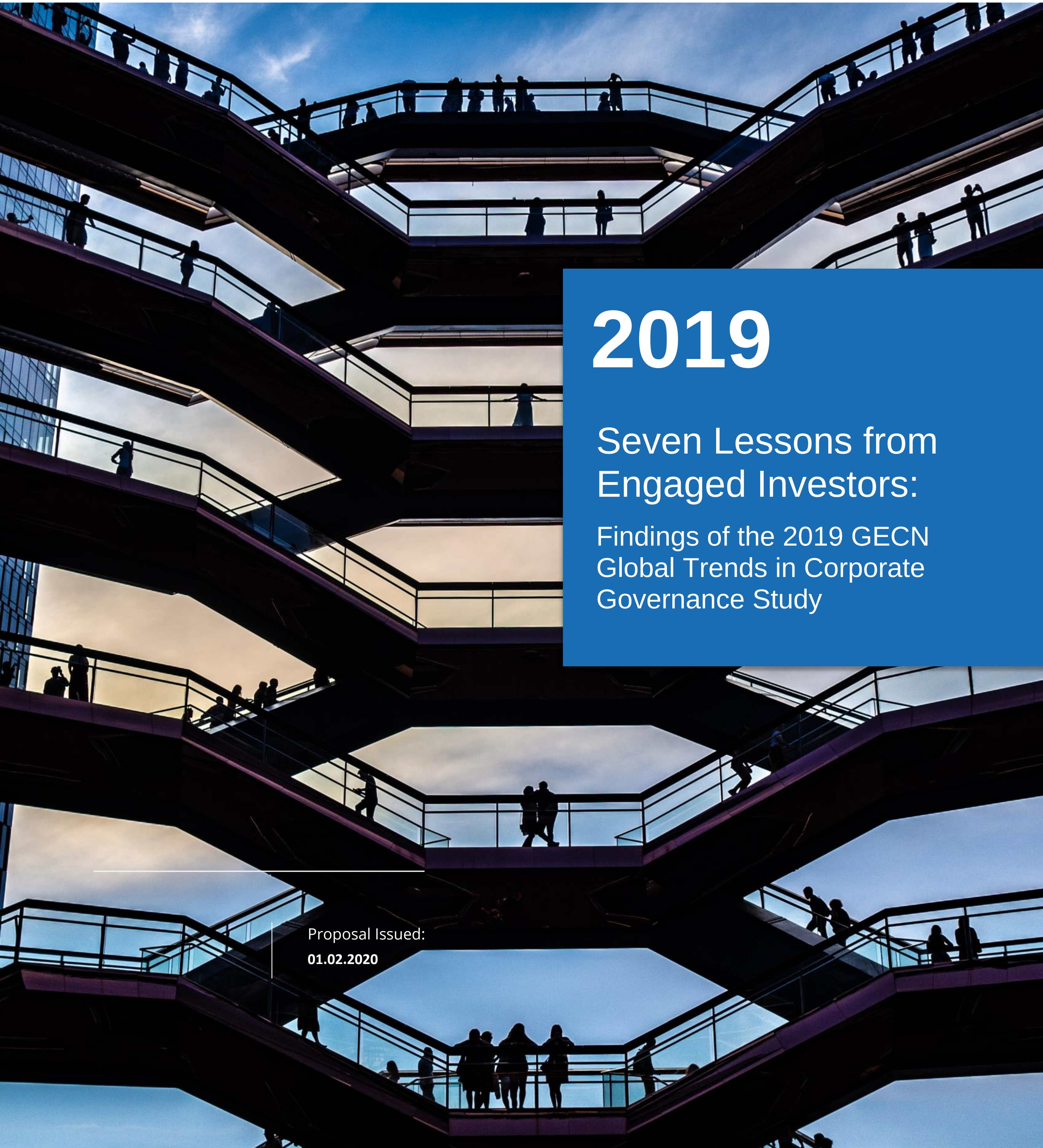

2019

Seven Lessons from Engaged Investors:

Findings of the 2019 GECN Global Trends in Corporate Governance Study

Proposal Issued:

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About This Report

The Global Governance and Executive Compensation Group (GECN Group) is an organization of independent consulting firms jointly serving over 300 clients in more than 30 countries. Each year, the GECN Group publishes its signature research report, *Global Trends in Corporate Governance*. In 2018, the series explored—across 20 countries on six continents—executive remuneration, board structure and composition, and shareholder rights.

This year we examine investors' perspectives on these and other issues of importance to them and discuss how they are raising these concerns with the companies in which they invest.

Over the past year, the GECN Group conducted 25 comprehensive interviews with asset owners and asset managers, including active and index investors. We also analyzed a selection of quantitative data relating to corporate governance practices and the variety of approaches that investors are taking to reach management and the board to better address their concerns.

Based on our research, we identified seven questions that corporations need to ask themselves if they want to engage successfully with their shareholders. Collectively, our research provides a global and regional perspective on the issues of greatest importance to investors and suggests how corporates can anticipate these issues and respond to them in the most effective manner. This report details our findings. An executive summary of this report is also available on demand.

The **GECN Group** is comprised of leading independent firms around the globe specializing in governance, performance, and compensation. Serving more than 300 clients across 30 countries, GECN consultants advise boards, c-suite executives, and other decision-makers on enhancing value through the strategic use of governance and compensation.


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Guerdon Associates Pty Ltd is an independent firm that provides executive and director remuneration and board effectiveness services that contribute to improved and sustainable shareholder value. It brings together behavioral, financial and legal disciplines, comprehensive data and research, a measurement framework, and a global network to achieve this regionally, nationally and globally.

Farient Advisors LLC is an independent executive compensation, performance, and corporate governance advisory. Farient provides a comprehensive array of advisory services, including compensation program design, board of directors' compensation, investor communications, and goal setting and performance metrics. Farient has offices in Los Angeles and New York and serves clients in more than 30 countries through the GECN Group.

HCM International is a leading independent international advisory firm specializing in the strategic and more challenging aspects of governance, compliance, and compensation, with deep experience across various industries and in the advising of boards, board committees, senior management, and control functions. HCM supports companies of all sizes, from large multinationals and public institutions, to mid-sized and smaller companies, including those preparing for an IPO. Our mission is to support companies and other organizations to tackle the ever-important question: "How to measure, steer and allocate value creation?". We also cover governance, risk and compliance as these increasingly affect value creation.

MM&K is a leading independent adviser on executive remuneration and governance; we assist companies to design and implement remuneration strategies, which support their values, culture and business plans. We operate across a wide range of sectors and have strengths in oil & gas, investment management (including private equity, venture capital and hedge funds), retail, media and construction. MM&K provides global remuneration advice as part of its membership of the Global Executive Compensation and Governance Group (GECN Group). MM&K is a member of the UK Remuneration Consultants Group and has signed up to its code of conduct.

Introduction

Asset owners and asset managers are changing the way they view, assess, and value their portfolio companies. At the same time, investors, consumers, and other stakeholders are becoming much more actively engaged in shaping the corporate agenda and pressuring management and the board to concentrate more intently on developing a credible plan for long-term success.

A particular focus of these activities is influencing management to address the environmental, social, and governance (ESG) aspects of their activities, and to disclose their practices in these areas—all while producing competitive returns.

Rather than focusing only on company financials and the next quarterly report, investors are beginning to incorporate non-financial considerations in their decision-making processes and are demanding greater disclosure on these issues. How should portfolio companies prepare themselves for these developments while addressing the competitive pressures and other challenges of a changing global economy? How should they address such challenges as governance, diversity, and increasingly, climate change, all while staying focused on the business? What disclosures should they be prepared to make on these issues? Where is the intersection between doing what's "right" for all stakeholders and creating value for shareholders? If not mutually exclusive, how are these goals best approached and communicated?

This edition of the GECN Group's *Global Trends in Corporate Governance* details investors' changing concerns and expectations, especially regarding ESG, and distills seven questions for corporates to consider before engaging investors.

We start with the growing investor concern that poorly managed non-financial risks may result in a significant loss of shareholder value. This is manifested most dramatically in the growing interest across borders in sustainable investing. In Switzerland, institutional investors' holdings of sustainable investments, which take ESG and ethical issues into account, rose 87% between 2017 and 2018, to CHF630.2 billion.[1] In Australia, the responsible investing market encompassed A$980 billion in assets last year, according to the Australian Bureau of Statistics, representing 44% of total professionally managed assets and a rise of 13% over the previous year. The Responsible Investment Association Australasia reports that responsible investing funds outperformed mainstream fund benchmarks in Australia for almost all periods over the past decade.[2] Other studies analyzing the relationship between ESG and financial performance have also found a positive correlation.[3]

Also fueling investors' ESG concerns are a chain of recent corporate calamities that point to deep management and cultural problems within the organizations themselves.

- ***Vale:*** In January 2019, the Brazilian mining giant suffered the collapse of the Brumadinho dam, which killed hundreds of people and is expected to slash Vale's iron ore production for 2019. It was the second such major disaster for the company in four years. Vale has been accused of colluding to hide dangerous conditions at the mine; if proved, the charge could result in a nearly $7 billion fine.

- ***Equifax:*** In 2017, the credit reporting company experienced a data breach that exposed the personal information of 145 million U.S. consumers. Equifax has agreed to pay as much as $700 million in a global settlement with federal and state authorities,

[1] "Swiss Sustainable Finance: Swiss Sustainable Investment Market Study 2019," University of Zurich, June 2019, p. 22.
[2] "Responsible Investment Benchmark Report Australia 2019," Responsible Investment Association Australasia, p. 3 (source: Australian Bureau of Statistics).
[3] See, for example, G. Friede, T. Busch, A..Bassen, "ESG and financial performance: Aggregated evidence from more than 2000 empirical studies," Journal of Sustainable Finance & Investment, 5(4), 201-233 (2015), and M. Orlitzky, F.L. Schmidt, S.L. Rynes, "Corporate social and financial performance: A meta-analysis," Organization Studies, 24: 403-441 (2015).

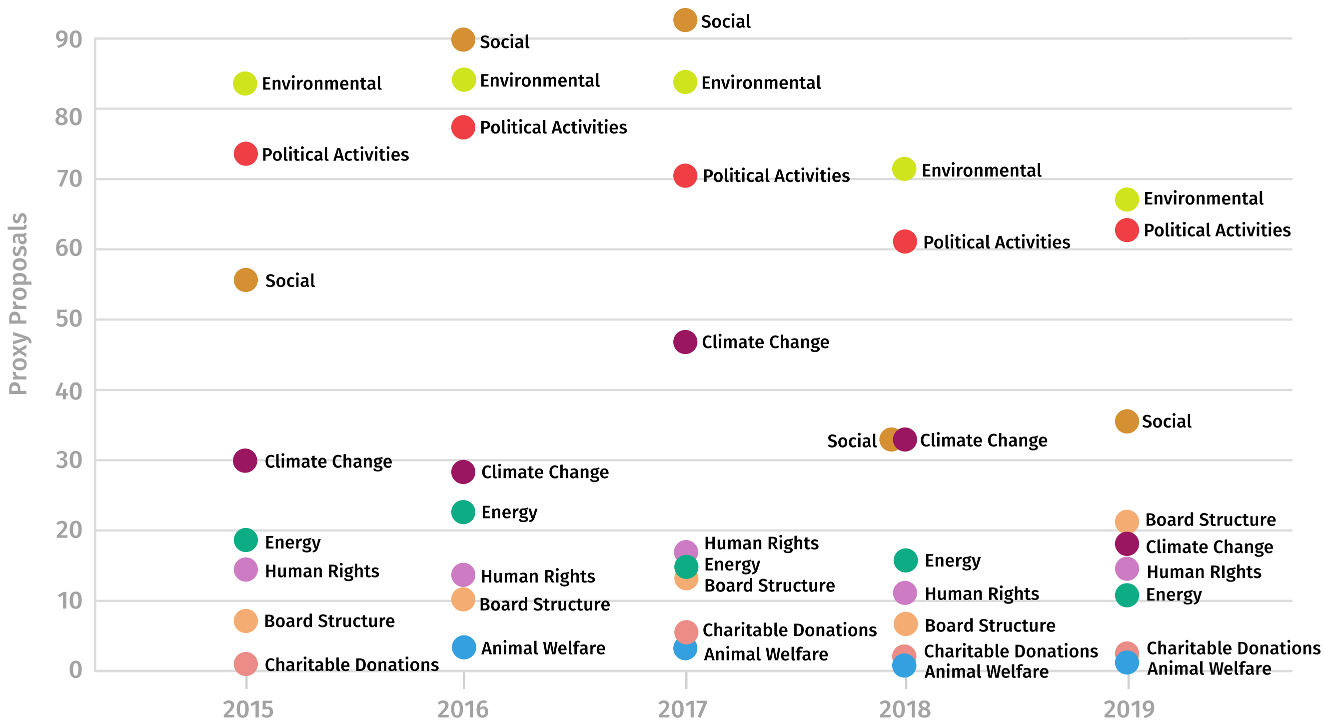
which said it failed to take reasonable compliance measures to secure its network.

- ***Wells Fargo:*** In 2016, badly designed and poorly governed incentives, as well as a failure to provide oversight, were at the root of a scandal in which branch employees were found to have opened millions of phony accounts without customer knowledge. Further violations subsequently emerged in many of the bank's other businesses, costing Wells Fargo over $4 billion in fines and settlements, and dealing a serious blow to its reputation.

Failures such as these are altering investor perspectives on what issues to consider as they make investment decisions. In this context, one item is emerging as basic: that a company must have a real ESG policy. No longer simply a "nice to have," asset owners and managers increasingly are demanding evidence of the communicated ESG commitment. Events such as the 2013 Rana Plaza garment factory collapse in Bangladesh are not only humanitarian disasters but constitute a wake-up call to investors to better understand the full complexity of ESG, including supply chain and other third-party risks that create exposure for shareholders.

Fig. 1: Global ESG Proposals 2015 – 2019

Source: Proxy Insight, 2019

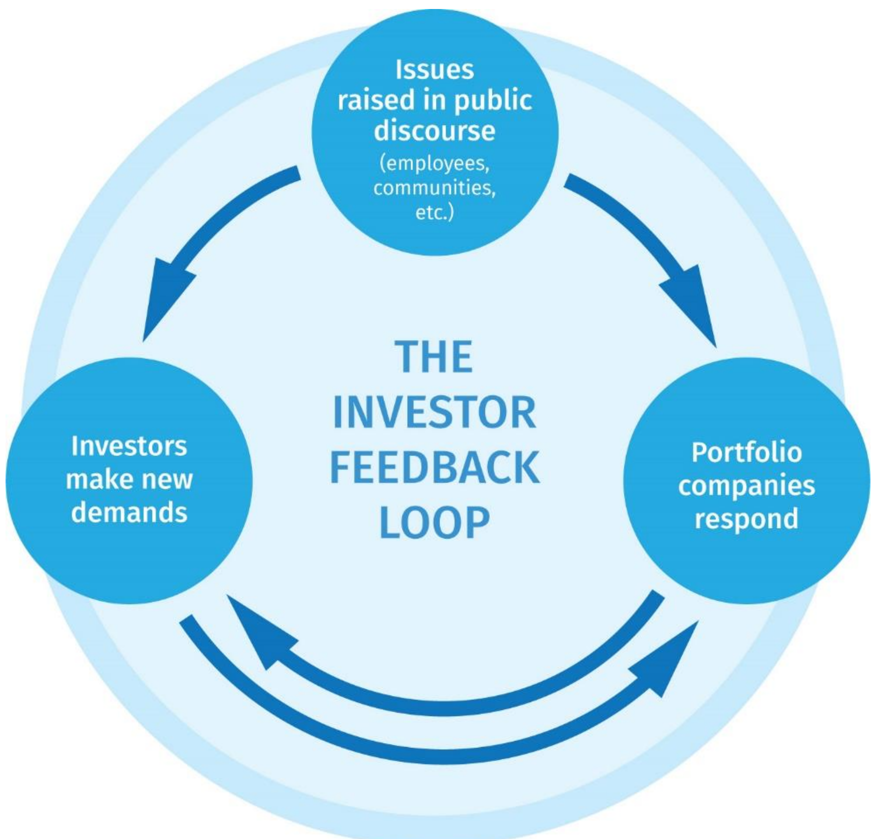


Social and environmental issues, as well as company political activities have been the most frequent topics of ESG-related shareholder proposals over the past five years, but issues related to board structure, energy, and charitable donations have also surfaced regularly.

In other words, investors expect their portfolio companies to recognize and manage the full range of their internal and external risks in pursuit of returns. In a visible sign of this, the past five years have seen shareholders introduce large numbers of shareholder proposals on ESG-related topics (see Fig. 1, above), with environmental risks emerging as the most common. By improving communication between investors and corporates, ESG issues could be handled through shareholder engagement instead of shareholder proposals.

As investors continue to focus on these issues, demand information, and work to strengthen their ability to engage and sometimes challenge portfolio companies, our research suggests that a more robust feedback loop is emerging (see Fig. 2, below). It begins with the appearance of a new issue in the public discourse (social media, traditional media, etc.), moves to large investors engaged globally through to their portfolio companies, and then comes back into the public discourse as corporates attempt to address these concerns. This cycle is intensifying.

Fig. 2. The Investor Feedback Loop



I. A Changing Investor Ecosystem

While concerns about corporate governance and accountability, environmental risks, social and human capital management are all helping to shape investors' posture toward portfolio companies, the investor ecosystem is also being transformed by two powerful outside forces: regulatory pressures and the rise of passive or index investing.

Regulatory influence: Investors are facing pressure from standard-setting bodies and regulators, particularly in Europe, to step up their oversight of portfolio companies. In 2010, the UK Financial Reporting Council responded to the aftershocks of the global financial crisis by introducing a new stewardship code. The council's principal aim was to ensure institutional investors are more active and engaged in corporate governance in the interests of their beneficiaries. The code was revised two years later, and a further revision is now in consultation. Similar stewardship codes are now in place in Japan, Taiwan, Hong Kong, Malaysia, and Thailand. While they differ in the details, they share much of the basic framework of the UK code, which stipulates that institutional investors must:

- *Publicly disclose their policy highlighting how they will discharge their stewardship responsibilities;*
- *Have and disclose a robust policy on managing conflicts of interest in relation to stewardship;*
- *Monitor their portfolio companies;*
- *Establish clear guidelines on when and how they will escalate their stewardship activities;*
- *Be willing to act collectively with other investors, where appropriate;*
- *Have a clear policy on voting and disclosure of voting activity; and*
- *Report periodically on their stewardship and voting activities.*

Investors adopt stewardship codes on a comply-or-explain basis; and in some jurisdictions, such as the UK, they are required to report their stewardship activities annually.

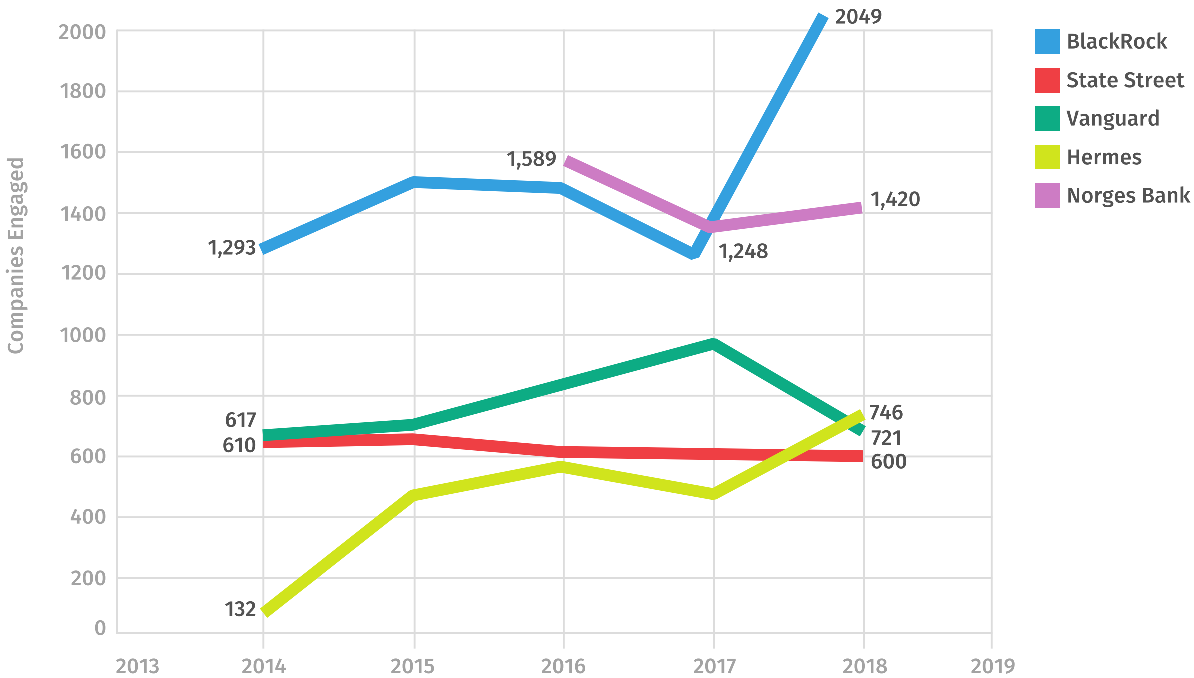
The rise of index investing: Another key factor in the shift of investor attention to non-financial risks and ESG has been the global rise of index investing, a strategy in which the fund tracks a market-wired index or portfolio. Index investors, by definition, take a long-term perspective on their holdings because their strategy is to replicate a particular index. That means selling certain equities when they have an ESG concern is generally not an option, thus leaving engagement with companies as the only course.

"Our public equity investments are index-like and systematic, so we have to pay attention to corporate governance and compensation through proxy voting and corporate engagements," says **Simiso Nzima, investment director and head of corporate governance at the California Public Employees Retirement System (CalPERS).** "We rely on active engagement to influence our portfolio companies to be managed and governed in such a way as to generate long-term sustainable investment returns."

This approach is likely to persist as Vanguard, BlackRock, and State Street Global Advisors, which together control three-quarters of all passive-fund assets, have augmented their shareholder engagement teams and intensified their efforts in this direction (see Fig. 3, below). State Street defines its approach this way:

- *Our stewardship role in global capital markets extends beyond proxy voting and engagement with issuer companies.*
- *Our approach to stewardship is designed to have an impact through thought leadership, engagement, proxy voting, and client disclosure.*
- *Companies embracing ESG best practice have strong, effective independent boards and incorporate sustainability into their long-term strategy across these two issues.*

Fig. 3: Company Engagements by Selected Global Investors 2014 – 2018



Source: Farient Advisors LLC 2019, based on engagement and governance reports published by investors

The world's largest passive-fund managers—BlackRock, State Street, and Vanguard—have all sharply intensified their engagement with portfolio companies over the past six years.

Pursuing such an approach requires having the means to assess which companies are truly embracing ESG best practice and developing consistent standards for doing so. In this regard, investors have made considerable progress in recent years. The Global Reporting Initiative (GRI) launched its sustainability reporting framework in 2000; covering such areas as climate change, human rights, and corruption, 63% of the 100 largest global companies now report that they apply it. The Sustainability Accounting Standards Board (SASB) has been formulating industry specific ESG disclosure standards since 2011. And the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD) has been developing voluntary, climate-related financial reporting standards since 2016.

These initiatives are helping companies and investors to develop a common language for assessing progress on ESG-related issues. Recently, State Street delved deeper with R-Factor, a new scoring system designed to provide companies with a roadmap for improving ESG practices and disclosure. R-Factor leverages multiple data sources and aligns them to widely accepted, transparent materiality frameworks to generate a unique score for listed companies. It also measures the performance of a company's governance and business operations in addressing financially material, industry-wide ESG challenges.[4]

If intensifying regulatory attention and the shift to index investing supply the motivation, the move to common industry standards and measurement

[4] For more information, see Rakhi Kumar, "R-Factor: Reinventing ESG Investing Through a Transparent Scoring System," State Street Global Advisors, Insights ESG, July 2019.

tools provide investors with more of the quantitative understanding they need to address ESG with their portfolio companies. As a result, an increasing number is shifting their focus toward active ownership —i.e., from passive proxy voting to personal engagement with management and the board. These dialogs make it easier for investors to express their ESG expectations, which include strong, independent boards, meaningful compliance functions and mechanisms, and in general, good integration of sustainability in the company’s long-term strategy.

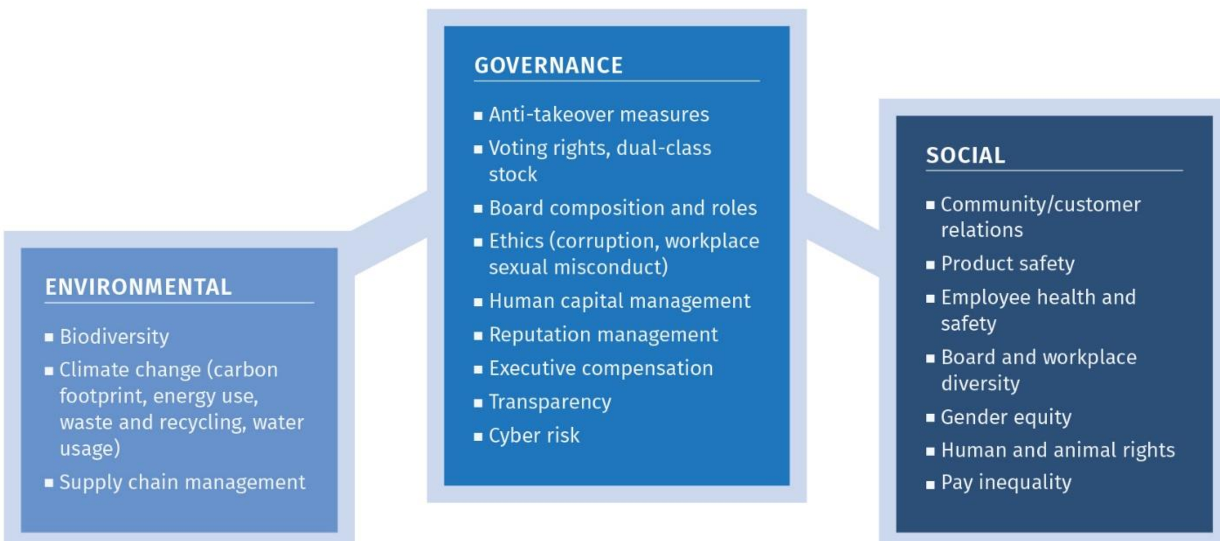
When engagement does not yield the desired result, investors may decide to vote against the re-election of directors or other management proposals and may elevate the issue through groups like the Council of Institutional Investors (CII), through shareholder proposals, or the media.

II. Governance and the Role of the Board

Investors emphasize that good governance is the foundation of ESG. Without sound management and careful oversight by an independent, and independently minded board, as well as appropriate company control functions, companies cannot build and execute a sustainable vision for long-term success, including the non-financial components of that vision.

Good governance begins with the board and embraces three other issues of importance to investors: diversity and human capital management, executive remuneration, as well as engagement and responsiveness. Good governance also improves the company's ability to address climate change and other environmental and social issues that make up the other two sides of the ESG triad (see Fig. 4, below).

Fig. 4. The ESG Triad



Aeisha Mastagni, portfolio manager for sustainable investments and stewardship strategies at the California State Teachers' Retirement System (CalSTRS), explains: "Without a good governance structure where executive management teams, the board, and shareholders are all accountable for their roles, it's very difficult to manage the E and the S."

Several investors emphasized that what counts as acceptable corporate governance in one market may not be the same in another. "What this is essentially about is, can you trust management? Can we entrust our clients' money with the people in charge of this company?" says **Freddie Woolfe, head of responsible investment and stewardship at Merian Global Investors in the UK.**

Most investors interviewed believe that an independent board with a deep understanding of the business and a diversity of skills ensures sound decision-making and is essential to any company's long-term success. The board must not be captive to management and must have the skills and aptitude to provide appropriate oversight of the CEO and the entire C-suite. Board members also must have the time necessary for their duties. Investors advocate no hard-and-fast rules for board attendance, but many cite being present at 75% of meetings as a rough benchmark. Most consider attendance an important factor to monitor as it is indicative of commitment to the role.

Some investors consider unexpected or rapid changes in the board itself to be a red flag. "A high degree of board turnover is always interesting to have a look at. Sudden departures with not-great explanations are interesting red flags, too," says **Iris Davila, director at BlackRock Australia.**

"Overboarding"—when a board member has too many board or management mandates—is another warning sign. How many is too many? "Usually it's five, but we'll start looking at it and asking questions at four other boards," says **Timothy Youmans, director at Hermes EOS in North America.** Service on outside boards is to be avoided or limited for the CEO as well, whose role as such is 24/7.

To assure themselves that the board is truly independent and that the directors have the time to fulfill their role on behalf of shareholders, several investors said they request detailed profiles of directors that clearly articulate their relationship to management and their other external commitments. Such information should be publicly available to all stakeholders.

Investors are also paying more attention to the effectiveness of the board's committee structure and the membership of key committees, such as audit and remuneration. Some research respondents expressed concern that when a risk, such as cybersecurity, needs a home, it is often quickly assigned to the audit committee. This overloads a committee that already has a full agenda and deprives these important areas of the close attention they need. Investors also expressed a strong preference that board members rotate out of their committee postings often enough to guarantee independent thinking in these roles.

III. Human Capital Management and Diversity

"Board independence is very important. Next comes diversity. Those are the two areas that we typically look at in terms of corporate governance on the board," says **Seiji Kawazoe, Chief Officer of Stewardship Development at Sumitomo Mitsui Trust Asset Management Co. Ltd.**—and our other research respondents tend to agree. But there are different aspects to diversity. One way to view it is as a facet of human capital management; diversity aims to bring a richer mix of talent, experience, and expertise to the company and its decision-making processes.

Human capital management: Evidence is building that focusing on human capital management also enables companies to perform better. The non-profit Just Capital developed a rating system that assesses companies based on corporate behavior criteria ranging from training and career development to health care to work-life balance. Companies that scored in the top 50% based on work-life balance metrics have enjoyed an average annual return on equity of 19.4% over the past five years, it found, while the rest reported a ROE 2 points lower.[5]

Most important, investors want to understand how companies intend to create the right value proposition for talent in coming years.[6] "Investors are taking a careful look at the way that companies are managing their employee base and their ability to attract and retain staff," says **Andrew Ninian, director of stewardship and corporate governance at the UK Investment Association.** "That has meant that all employee pay is rising up the board agenda, so that for pay ratio disclosures, one of the most interesting aspects is going to be the denominator."

In its 2017 Productivity Action Plan for promoting greater productivity in the UK economy, the Investment Association noted that 54% of its members said they had engaged with UK companies about their reporting on "culture, human capital, and intangibles" in the prior year, and that 69% said they would do so on the future.[7] To better understand how each company is managing risk connected to its human capital base, Ninian says the association's members ask for four specific KPIs:

- Total headcount, broken down by division between full-time and part-time employees, gender, and diversity;
- Annual turnover, including both planned and regrettable turnover;
- Investment in training, skills, and professional development, including the rate of progression and promotion within the business; and
- Employee engagement score.

"The next step is that we get the companies to discuss what are the material risks and opportunities for that employee base, and how do they manage that," Ninian says.

Response from companies themselves varies considerably. Investors globally tell us they obtain this information from a variety of sources, including investor relations contacts, news media, proxy advisors, and other third parties. However, this does not mean, that not all necessarily demand specific human capital KPIs.

Gender diversity: While the definition of diversity continues to expand, gender diversity remains by far the most commonly raised concern related to board composition and structure, as it is considered to be insufficiently addressed in many places. In Japan, for example, "the number of women who are potential candidates for director is very, very, very limited, in effect because there are few women in management," says **Atsushi Matsunaga, director at IR Japan, Inc.,** a financial consultant, "and Japanese investors understand that. They know that if they push Japanese companies to introduce more women

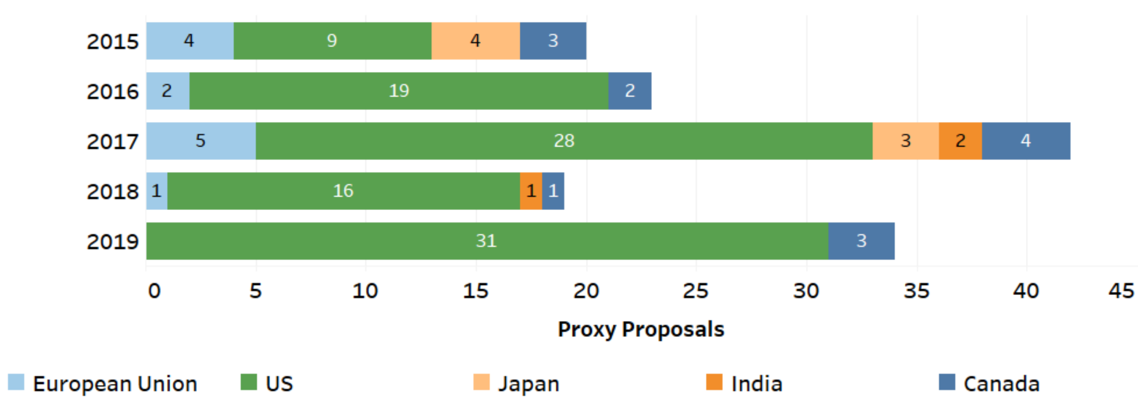
[5] Ryan Derousseau, "Why Investors Win When Companies Treat Workers Well," *Fortune*, December 21, 2018.
[6] In this connection, how companies and their boards propose to make themselves attractive to new generations of creative talent is also a current human capital management challenge. See, e.g., G.S. Varges, "The New Generations Within Boardrooms,"
[7] "Supporting UK Productivity with Long-Term Investment," *The Investment Association*, August 2017, p. 13.

directors, it's unrealistic for the companies to do it."

In some European, and particularly Nordic, countries, a combination of investor engagement and regulatory action has accelerated change. Norway, France, and Germany have introduced targets ranging from 30% to 40% for female membership of the board. Last year, California became the first state in the U.S. to require all publicly-held domestic or foreign corporations whose principal executive offices are located in California to have at least one woman on their board by the end of 2019, and at least three for those with larger boards by the end of 2021.

While countries including the U.S. (on the federal level), Sweden, Australia, and the UK have not introduced such requirements, investors have been raising the issue of board gender diversity for many years (see Figs. 5, 6, below). The average percentage of women on boards of Standard & Poor's 500 companies increased from less than 15% in 2005 to almost 30% in 2015, according to S&P Capital IQ.[8] That contrasts dramatically with companies based in Asia. The degree of gender diversity on corporate boards in Japan, South Korea, and Hong Kong is well behind Europe and the U.S., at levels of 6.4%, 2.3%, and 11%, respectively, according to a 2018 MSCI study.[9] The U.S. lands in between; last year, 23.4% of board seats at the Russell 3000 companies were occupied by women, according to MSCI.

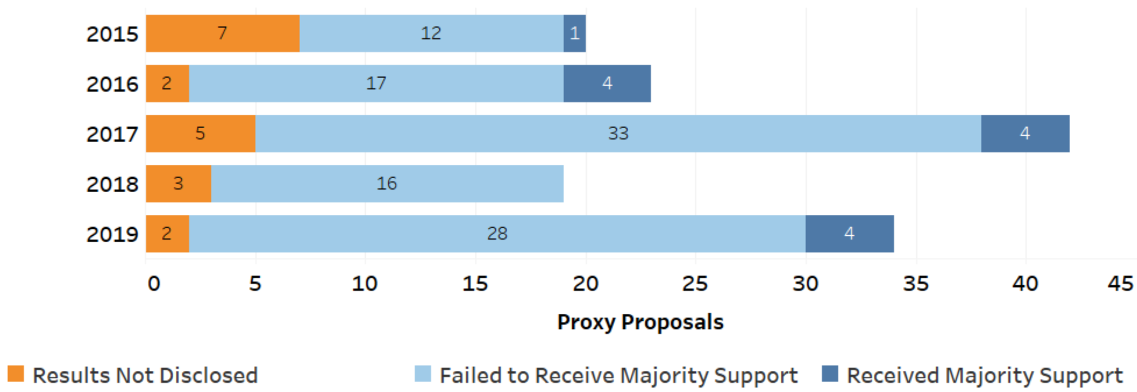
Fig. 5: Frequency of Shareholder Proposals Related to Diversity 2015-2019



Source: Proxy Insight, 2019

[8]Jena McGregor, "These are the 12 major companies that still don't have women on their boards," *Washington Post*, August 12, 2015.
[9]Morgan Ellis, Meggin Thwing Eastman, "Women on Boards: Progress Report 2018," MSCI ESG Research LLC, December 1, 2018.

Fig. 6: Results of Shareholder Proposals Related to Diversity 2015-2019



Source: Proxy Insight, 2019

The number of shareholder proposals related to diversity is rising around the world, and particularly in the U.S., although they are still unlikely to receive majority support.

Geographic and ethnic diversity: Gender is not the sole element of diversity that concerns investors, however. Given the rising profile of Asian markets, for example, several investors expressed concern that boards of companies that have operations or do a rising volume of business in the region do not include enough directors with roots or work experience there.

"Lots of Australian companies are looking to Asia for growth, but hardly any of them have a director who has Asian background or Asian experience," says **Akaash Sachdeva, senior responsible investment adviser at Australia's HESTA Superannuation.**

Historically, obtaining detailed information about board members has tended to be difficult. As a result, investors are demanding more. Some respondents tell us they ask companies to provide biographies and CVs in their proxy materials, and even photographs of directors, to get a clearer idea of the board's composition.

Appropriate succession planning and limits on tenure are also necessary to assure the board benefits from fresh thinking and cognitive diversity, without sacrificing corporate memory. Investors ask companies if they have a succession plan and look for clues such as one-time retention bonuses and sudden revisions in the CEO's pay plan to assess how well the company is adhering to such plans. "Many times, when companies make blatantly bad governance decisions, like one-time retention bonuses or out-of-the-blue increases in the CEO's pay plan, it suggests to us, for example, that there really is no succession plan," says Youmans at Hermes EOS.

Cognitive diversity: One of our most dramatic findings is the degree of concern investors express about boards not always having the intellectual and strategic capabilities and imagination to address the complicated challenges of the 21st century. They question whether boards without sufficient independence or experience and cognitive diversity can develop and help drive a long-term strategy for success.

"Not just gender, but all types [of diversity] are important. A diverse board will be less subject to groupthink and more likely to make better decisions," says **Diandra Soobiah, head of responsible investment at the UK's National Employment Savings Trust (NEST).**

IV. Executive Remuneration

In some locations, such as the U.S., executive remuneration, or compensation, continues to rise. In 2018, median compensation for the CEOs of S&P 500 companies rose 6.6%, to $12.4 million, according to a *Wall Street Journal* analysis. Yet, median return per shareholder was -5.8%.[10]

None of this is encouraging to investors. “There is a significant frustration within our membership that some companies just aren’t getting it, particularly on executive pay,” says Ninian from the UK Investment Association’s with regards to Britain. “The investors feel that they have been clear about their expectations of companies, clearly signaling on pensions, quantum, and pay-for-performance. Instead, companies are saying, ‘we’re exceptional’ or ‘we’re different.’”

Investors view executive remuneration as their “window into the boardroom,” says CalSTRS’s Mastagni. What people are paid is seen as a fundamental indicator of a company’s strategic direction, management, and potential for long-term success. As BlackRock expressed it in a January 2019 paper, “The key purpose of executive compensation is to attract, reward, and retain competent directors, executives and other staff who are fundamental to the long-term sustainable growth of the company, with rewards contingent on controllable outcomes that add value.”

One question investors frequently raise is: How does their remuneration incentivize executives to focus on the issues and opportunities that are most likely to affect long-term value creation and the alignment of executive and shareholder interests?

When evaluating executive compensation, there are seven areas that investors often consider:

- **Complexity:** Most investors find compensation schemes too complex and not sufficiently reflective of the company's strategy. “Some companies go out of their way to obfuscate, use decimals, or don’t use plain terminology. It’s obnoxious,” says the corporate governance analyst at a large asset manager.

  Beyond that, investors complain that the story behind the numbers too often remains unclear. “What’s lacking in remuneration reports is the ‘why’: the ‘why’ being the strategy, which is, how remuneration is linked to long-term value creation,” says **Andrew Gray, director of ESG and stewardship at AustralianSuper.**

- **Pay-for-performance:** Most investors emphasize the need to strengthen the pay-for-performance link, which is often derailed by poorly designed targets or the use of discretion to pay out even when targets have not been met. “If you have a large non-equity segment of the compensation system, and performance is not being tied to the performance of the company, then probably it’s not a very good remuneration system,” says Sumitomo’s Kawazoe. “So, in those cases, we may vote against [the directors].”

- **“Skin in the game”:** Management often has too small an ownership stake in the company, some investors complain, reducing alignment with company interests. “I would like to see a 10-year holding requirement on the equity side and at least two years holding requirement post-retirement or post-separation to mitigate short-termism,” suggests CalPERS’s Nzima.

- **Quantum:** In part because of difficulties getting companies to address complexity in their remuneration structure and weak ties to performance, excessive pay is top-of-mind among investors. For some, it is a matter of having a remuneration level that can be justified economically. For others, it is an equity concern about pay packages being too rich. “The quantum issue has really come to the forefront,” says Ninian. “For the

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[10] Theo Francis, “Many S&P 500 CEOs Got a Raise in 2018 That Lifted Their Pay to $1 Million a Month, *Wall Street Journal*, updated March 17, 2019.

first time, investors are saying there is an absolute level of pay which is too much, irrespective of performance." There's no agreement, however, on how much pay is "too much."[11]

- **Share buybacks:** A related red flag is share buybacks. Several respondents feel that buybacks are often intended primarily to bring about a boost to earnings per share that can trigger a rise in management remuneration when per-share metrics are used. "A number of our socially-oriented clients feel it's manipulating management compensation or that companies underinvest in the business to favor the buy-back," says one corporate governance analyst.

- **Wrong goals:** The targets or metrics companies apply to top executives are also coming under scrutiny, especially from public pension plans whose participants include low- and moderate-wage earners such as union members and teachers. Some investors ascribe excessive "top hat" plans to companies' failure to adjust their pay metrics to drive the right targets as they grow and mature; for example, retaining an incentive program that is appropriate during a rapid growth phase may not be appropriate when the company finds itself in a different stage of development.

  "We see a lot of companies that used to be growth companies and now should really be focused on returns that don't get it yet and still have their incentive plan pointing toward just buying growth," says one corporate governance analyst. "We look out for those kinds of mismatches between how the company sees itself and what's reflected in the comp plan versus how the rest of us see them."

  Some investors have specific ideas, too, as to how they would like to see problems related to remuneration resolved. "A growing body of investors are willing to look at different structures," says Ninian. "Some focus on the annual bonus with a very long holding period and others have moved to restricted shares."

- **Means of recouping pay not earned:** Still other investors are pushing for companies to implement and enforce clawback rules—i.e., policies to recover paid out incentive-based compensation that turned out not to have been justified, such as when the company later requires a financial restatement or a material non-compliance event is discovered.

While the U.S. Securities and Exchange Commission has been considering rules on the matter since 2015 without implementing them, companies in other developed markets, sometimes under regulatory pressure, have taken action, especially in the financial sector. In the UK and in Switzerland, financial services and other types of companies have implemented clawbacks. In Australia, a rule requiring clawbacks is under consideration. All UK-listed companies must include malus and clawback provisions within performance-related plans. At the same time, large investors including BlackRock and CalPERS want U.S. companies to apply voluntarily clawback clauses, including for management misconduct that results in reputational harm or adverse publicity.[12]

However, investors also stress that remuneration schemes are best devised by the company itself and that practices such as the use of discretion by the remuneration committee when justified, can have a place if properly explained ("that's the point of having a remuneration committee," says **Donna Anderson, Vice President and Global Corporate Governance Analyst at T. Rowe Price**. The disconnect comes when discretion

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[11]An annual survey, 2019, of the Swiss public conducted by HCM finds a wide disparity of answers among those favoring an upper limit (76%) whereby 28% favor an upper limit yet did not specify what this upper limit should be). Some opt for less than CHF 500'000 (18%), others cite figures between CHF 500'000 and CHF 1 million (13%), and others go as high as a maximum of CHF 10 million (8%).

[12]Jonathan M. Ocker, Justin Krawitz, Benjamin T. Gibbs, "The State of Play on Clawbacks and Forfeitures Based on Misconduct," Pillsbury Winthrop Shaw Pittman LLP, October 11, 2019.

moves in only one direction", says HESTA Superannuation's Sachdeva), particularly when earnings deteriorate Remuneration committees appear shy in using discretion to reduce CEO or other C-suite pay.

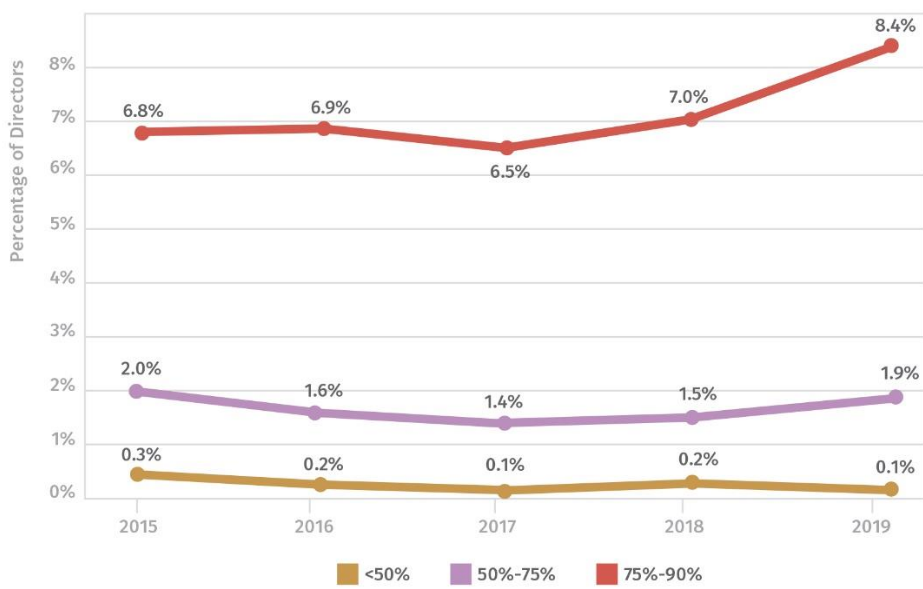
Most investors interviewed say they assess the remuneration committee's performance over a period of years. If the committee fails to provide oversight year over year, investors will review their voting record and vote against the chair, other members, or the entire committee.

Investors also want discretion to be transparent, along with the reasons why it is used, and attached to an identifiable goal. If an exceptional award continues to be made from year to year while performance changes, it indicates that proper discretion is no longer being applied. "Discretion should be structured, it should be logical, and it should be transparent," says Sachdeva.

"If the quantum is a little on the high side, but we think the plan is otherwise well structured, there are clear metrics, and it aligns with shareholder interests, then we may vote in favor," says **Linda Giuliano, Senior Vice President and Head of Responsible Investment at Alliance Bernstein**. "But if the other factors are poorly structured, then we would be more likely to vote against the pay program."

This in turn can impact shareholder votes on directors. Proxy Insight examined voting patterns at 11,000 companies around the world and found that the percentage of directors receiving less than 90% support from shareholders has been steadily increasing over the past 5 years (see Fig. 7, below).

Fig. 7: Percentage of Management-Proposed Directors Receiving Less than 90% Support 2015 - 2019



Source: Proxy Insight 2019

The last five years have seen an increase in the percentage of directors who fail to achieve strong shareholder support.

V. Engagement and Responsiveness

In most cases, investors prefer to address issues with corporates by building relationships at the board and C-suite levels and engaging with them behind the scenes.

This practice has come into its own over the past few years. At least superficially, boards, management, and investor relations officers have become more responsive, making themselves more available to meet with their investors for more substantive exchanges. This is happening as investors become more systematic about engagement.

Recently, Alliance Bernstein built an "engagement database" that tracks discussions it has with companies in its portfolio and how it voted on specific issues historically. "It's an easy indicator of where our portfolio companies are this year and how they responded to our concerns, and it helps inform how we want to move forward," says Giuliano.

However, engagement and response also demand that the company get to know its shareholders better and vice versa. Institutional investors are a large and disparate community whose perspectives and priorities vary depending on their constituency. Many acknowledge that with large, diverse participant populations, they cannot prioritize every issue and must focus resources, money, and time where engagement is likely to have the most impact.

Outcomes of engagement: Large shareholders—from BlackRock, State Street, and Vanguard in the asset management sector to CalSTRS, CalPERS, HESTA, NEST, and AustralianSuper in the pension world, to name a few—report having achieved significant successes through engagement. Examples include changes to the structure of executive remuneration, increased board diversity, and adherence to guidelines like SASB's industry standards and the TCFD disclosure standards. BlackRock, on its own, has engaged with more than 200 companies on climate change risk, board oversight, diversity, and human capital management since doubling the size of its stewardship team.

CalSTRS has achieved success on several of these fronts. An early investor in Facebook, it was instrumental in the placement in 2012 of two women on the social media company's board. In 2017, CalSTRS engaged four oil and gas companies and 15 utility companies regarding questionable management of methane leaks, then filed four shareholder proposals asking for improved leak detection and repair disclosure. The four companies, including Cimarex and Gulfport, eventually agreed to improve their efforts.

Actions taken in the face of non-responsiveness: When engagement does not yield desired results, respondents say they are prepared to take a more aggressive approach. This may include collective action with other investors, voting against the re-election of directors who were considered accountable for the failure to respond, exposing their issues in the media, or introducing shareholder proposals.

Investors can also work through investor representative groups such as the CII, the Australian Council of Superannuation Investors, and the UK Investment Association. Additionally, several leading institutions joined forces in 2017 to create a global alliance, Climate Action 100+, which now includes 320 investors with more than $32 trillion in assets under management collectively. The following year, responding to pressure from the group, Royal Dutch Shell agreed to set short-term targets as an initial step in reducing the net carbon footprint of its energy products. Last December, after pressure from Robeco and the Church of England's Pension Board, Royal Dutch Shell agreed to link carbon-emission targets to long-term executive pay, subject to a shareholder vote next year.[13]

Prospects for effecting change differ from region to region, although in most countries, large

[13]"Royal Dutch Shell ties executive pay to carbon reduction," *BBC News*, December 3, 2018, https://www.bbc.com/news/business-46424830.

investors tend to focus on the same issues, led by greater transparency and disclosure. Large investors tailor their approach to engagement depending on their investment stake, the size of the company, the potential for the issue to impact shareholder value, and how they communicate portfolio activity to plan participants, unions, public-employer sponsors, institutional clients, and other stakeholders.

CalSTRS, one of the largest pension funds in the U.S and the world with $236.9 billion under management as of June 30, 2019, engages both independently and through CII. Given its presence in the market, CalSTRS can engage successfully with portfolio companies on its own, but it also networks with other institutions to increase its leverage. When this level of engagement doesn't achieve results, CalSTRS turns to shareholder proposals, which often pass.

Some industries, too, are more open to private or more public engagement. High-tech and new media, for example, which are dominated by very large companies with enormous market valuations, have been especially slow to engage with shareholders, as have some energy companies, whose business model is often challenged by environmentalists.

ExxonMobil has been a frequent target of shareholder proposals in recent years—a total of 44 between 2014 and 2019—but only two of them received majority shareholder support. And this year, the oil giant persuaded the U.S. Securities and Exchange Commission to block voting on a shareholder proposal that would have required it to set and disclose targets for reducing greenhouse gas emissions. However, the SEC rejected ExxonMobil's request to block further shareholder proposals to create a board-level climate committee and force disclosure of the company's political contributions.

The size of the market, coupled with the portfolio holdings and reputation of the investor, also increase the likelihood that private engagement will yield results. A large fund like AustralianSuper, for example, can influence issuers in its home country but must work collaboratively with other shareholders and groups like CII in other markets where its profile may not be as high.

As the foregoing suggests, not every region or industry is yet open to investor engagement. Moreover, larger investors tend to wield more influence without having to create alliances than smaller ones. However, investors agree that their efforts to engage management and the board will only intensify going forward.

Measuring responsiveness: Responsiveness to requests for engagement is paramount for investors and appears to be improving in most regions. Investors largely agree that boards and management are becoming more transparent and receptive to shareholder input. Examples are the general reduction in the use of classified boards (except in Australia), dual-class stock structures, and poison pills.

Nordic companies, for example, are well regarded in the investment community for their disclosures and responsiveness. In all four countries—Denmark, Finland, Norway, and Sweden—an external nomination committee, normally composed of representatives of large shareholders along with some minority investors, is elected at the annual general meeting (AGM). The nominating committee evaluates the board and nominates new members. The board chair is often a member of the nomination committee. This structure is designed to keep the current board from becoming self-perpetuating, either in background or strategic bias.[14]

Asian companies and those located in other emerging markets, however, continue to demonstrate shortcomings in responsiveness to shareholders. This may be the case when they are majority state-owned entities or closely held by a single family.

Some progress is seen in Japanese companies as they work to move from an introverted, closely held management style—especially at the board level—to more independent boards and more openness to scrutiny from investors. The

[14] Steen Thomsen, "Nordic Corporate Governance Revisited," *Nordic Journal of Business*, Vol. 65, No. 1, 2016, pp. 7-8.

transformation received a push with the introduction of a Japan Stewardship Code in 2014, followed in 2015 by the first Corporate Governance Code. Since then, public companies and institutional investors are required to engage in constructive dialog to enhance shareholder value. The Japan Stewardship Code now urges disclosure of detailed proxy voting decisions by institutional investors as well.

"Communication between the board and the investors is still relatively low. We still need much more robust engagement going forward," says Sumitomo's Kawazoe. **Satoshi Iwanaka, director at IR Japan, Inc.,** says this is changing, however: "Part of our business is we arrange meetings of particular Japanese companies with domestic investors to talk about corporate governance. In the past, the person who visited the investor was just the team manager. Today, the directors are present, even the CEO. So Japanese companies are more responsive to investors' concerns, to some extent."

"We have seen an increasing adoption of stewardship codes" in Japan, notes Freddie Woolfe at UK's Merian Global Investors, "and those naturally push companies down the route of needing to be more responsive. With certain kinds of governance topics, like diversity, it is now possible to have a reasonably meaningful conversation in Japan, whereas a number of years ago it was much harder."

In Australia, too, the recommendations this year of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, which was set up in response to a series of corporate scandals, are having a noticeable impact not just on publicly owned banks but on companies more generally,[15] according to AustralianSuper's Gray.

"The Royal Commission, he says, "made comments around how companies should better manage their culture, how companies should better manage their governance in particular, information flows to boards and how boards should manage non-financial risks, and also remuneration. In particular, culture and management of non-financial risks are really important. We're encouraging companies in Australia to reflect on the Royal Commission, even if they're not in the banking sector, as to how its recommendations are applicable to their company."

In major markets like the U.S. and Europe, many large investors say they are more often approached today by corporates that want to explain their position on issues that may impact their say-on-pay vote or bring challenges from the investor community, such as any major shift in strategy, remuneration, or diversity. But some investors question companies' motivation in doing so. One concern is whether companies are more interested in gauging the investor's intentions during proxy season than in genuinely listening to and addressing investor concerns. Large investors, therefore, are becoming more selective as to which portfolio companies they will meet with and with which representatives.

"If we have an opportunity to talk to any executive officers or independent directors, we will generally take those meetings and involve our investment professionals," says **Tom Elliott, governance and proxy specialist at Capital Group**. "When there are specific concerns with governance, compensation, or ESG, we will also meet with governance staff to discuss."

Engagement, in other words, needs to be in good faith and year-round, not just during proxy season. Furthermore, investors prefer when the person speaking for the company is a responsible official such as an independent board member or the CEO or CFO. While investors strongly encourage this, it creates an additional challenge for companies.

"One of the results of the whole movement toward more engagement with your shareholders is that a lot of companies have also been pushed to get their directors involved, and that's created more visibility for us into who's representing them," says an executive at a large asset manager. "We have definitely walked out of what the company thought

[15]While the consideration of clawbacks by non-financial service companies in Australia began earlier, the Royal Commission report may create further impetus. See, e.g., "Qantas toughens share clawbacks as Alan Joyce's bonus drops 41pc," Financial Review, August 30, 2019.

was a routine meeting and gone straight to the trading desk and sold the stock."

Investors also pay close attention to the company's governance structure and chain of escalation when they raise issues with the board. How are investor concerns addressed once the board agrees to follow up?

Most investors are confident that greater openness and accessibility are trends that will only grow stronger in more regions of the world. "It's taken 15 years or more for companies to really listen to what shareholders are saying," says **Sarah Wilson, CEO of Minerva Analytics in the UK.** "I think it's a mixture of the genuine with lip service and window dressing. But what we see is that, as boards become more diverse, as new talent is brought in with new ideas, new approaches, and newer understanding, real listening is certainly improving."

Perhaps recognizing that improvement is a process, most investors remain willing to take a flexible approach, even on governance matters to which they attach great importance, such as board composition, diversity, and remuneration. For example, if a company is performing well and has a credible plan for long-term success, many investors are less apt to be critical of a board with longer average tenure and fewer truly independent directors. "I think the question is: how is the company performing?" says Alliance Bernstein's Giuliano. "What have their refreshment practices been? Is this whole board just on the older end and do you really need to start moving to make some change?"

VI. E and S: The Two Other Sides of ESG

While asset owners and managers make the case for continuing focus on governance, the other two sides of the ESG triad (see Fig. 4)—environmental and social risk—are assuming a more prominent place in their agenda as well. Lawmakers, regulators, the public, and sometimes pension plan beneficiaries or institutional clients are pushing investors to focus on the E and the S.

By various measures, climate change is now a fast-rising concern for investors. Seeing it as a potential threat to the long-term success of their investments, many investors are insisting that companies take action and keep shareholders abreast of their progress on the issue.

"We really want to see companies and boards talking about climate risk management, human rights and labor standards, risk management, privacy and data security, which are emerging as very critical ESG risks," says **Talieh Williams, manager, governance and sustainable investment at UniSuper Management Pty, Ltd** in Australia. "We want to know that the boards are maintaining oversight of those issues." Since these topics are often complex and touch on long-term strategic thinking, boards are typically the right place to discuss ESG initiatives.[16]

While the increase in index investing makes divestitures an unrealistic mechanism for influencing corporate behavior, many investors, notably large public pension funds, are building lists of corporates that they will exclude from their portfolios.

One example is Sweden's AP Funds, which supports the national pension system. Over the past six years, AP Funds have excluded:

- Freeport-McMoRan, citing human rights violations and adverse environmental impacts in its Indonesian mining activities;
- China's Zijin Mining Group, for discharging mining wastes into rivers;
- South Korean defense contractor Poongsan Corporation, noting that it manufactures and markets cluster munitions; and
- Vale, citing the Brumadinho dam collapse.

Norges Bank, which manages the Norwegian oil fund, also excludes Freeport-McMoRan and Zijin along with others including Russia's MMC Norilsk Nickel PJSC and South Korean steelmaker POSCO, both for severe environmental damage.

Some investors exclude whole categories of companies. In the case of Australia's Local Government Super, the list includes any company that derives at least 10% of its revenue from gambling, armaments, old-growth logging, or uranium mining or at least one third from high carbon-sensitive activities such as coal mining. In some cases, however, exclusions relate directly to the company's reluctance or inability to engage with investors over the issues at hand.

New Zealand Superannuation, for example, excludes contractor KBR due to compliance issues (breaches of anti-bribery and corruption standards), but also because "engagement with the company is unlikely to be effective due to ongoing litigation and the company's limited responsiveness in the past." Neither will it invest in Freeport McMoRan, because "breaches of standards by government security forces [protecting the company's facilities] are beyond the company's control. This limits the effectiveness of further engagement with the company."

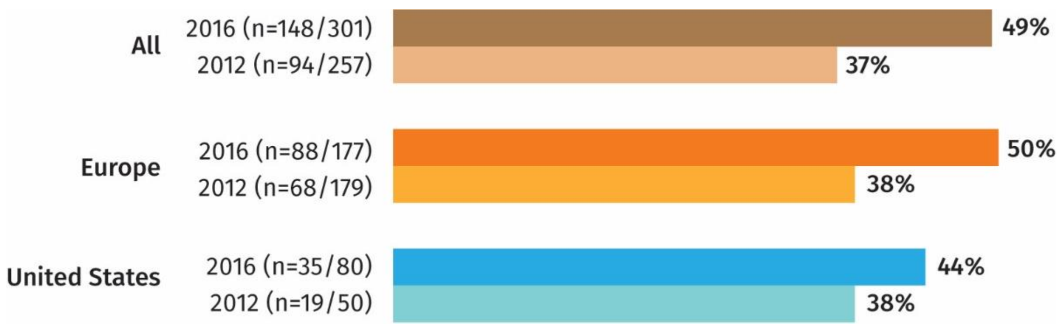
Next to exclusion, other sustainable investment strategies include norms-based screening that considers the extent of the company's ESG integration or engagement and whether the company meets best-in-class investment criteria. While most investors prefer engagement to exclusion, the issue becomes what measures are most effective at getting companies to change their behavior.

[16] Claudia Wuerstle and Samuel Leder, "ESG beyond ticking the box: 4 action points for Board of Directors," HCM International Ltd.

The connection to compensation. Some investors suggest that metrics based on sustainability performance will not by themselves yield sufficient or rapid progress unless they are incorporated into pay structures (see Fig. 8, below). When sustainability performance is poor, pay outcomes should be reduced.

"When we know that oil and gas companies generally face big challenges around carbon emission reduction, should climate indicators be in executive pay packages? We absolutely think they should be," says NEST's Soobiah.

Fig. 8: Companies Disclosing a Link Between ESG Factors and Executive Pay



Source: HCM International Ltd. Includes only global companies with market capitalization of CHF7.55 billion or more as of December 31, 2016.

More global companies are disclosing specific ESG criteria for how they pay executives, but there remains considerable variation by size.

Introducing ESG-based metrics in executive remuneration in some way is a growing market trend, while remaining one of the trickiest challenges ahead for companies since they require very careful design to work well within the rest of the compensation framework. Nonetheless, companies are using and disclosing targets such as health and safety, workforce diversity, and talent management (see Fig. 9, below). In some industries, broader societal topics and environmental targets for remuneration continue to be experimented with as well.[17]

[17] Stephan Hostettler, Raphaël Lambin, and Claudia Wuerstle, "Pay-for-Sustainability: How to reflect ESG in modern compensation systems," HCM International.

Fig. 9: Examples of ESG-related KPIs frequently applied for remuneration purposes

	Environmental	Social			Governance
		Employment Practices	Customers	Society	
Examples of KPIs	▪ Volume of operational spills ▪ Environmental responsibility ▪ Carbon emissions ▪ Green product development	▪ Workforce diversity ▪ Process safety ▪ Talent management ▪ Employee satisfaction	▪ Customer satisfaction ▪ Customer focus/ centricity ▪ Safety performance	▪ Human rights topics ▪ Social value creation ▪ Involvement in social projects ▪ Community involvement	▪ Compliance ▪ Risk culture ▪ Fulfilment of risk/ compliance polices

General Sustainability Performance	
▪ Overall sustainability ambitions ▪ Corporate responsibility	▪ Sustainability index ratings ▪ Sustainable product launch

Source: HCM International Ltd, adapted from standards of the Global Reporting Initiative (GRI)

Not all criteria fit together easily; companies may need to balance KPIs related to customer satisfaction, for example, against those related to human rights topics or social value creation.

Feeling pressure now also from consumers and public advocacy groups, not just investors, companies are becoming more willing to discuss climate change, pollution, employee safety, and other environmental and social issues. At the same time, investors are going further by connecting these issues to their investment decisions. The overarching idea is that companies that negatively impact stakeholders should, in effect, lose their "social license to operate" if they continue causing social or environmental damage.

"Safety [for example] will continue to be very, very important for mining companies in the next two years," says Minerva's Wilson, citing disasters like the Brumadinho dam collapse. This raises the issue whether companies have appropriate compliance procedures in place to foster the right culture and prevent such risks. "We're also looking at bribery and corruption," says Wilson, "to see whether or not the risk measures are actually taking bribery and corruption into account as a risk. This is about scandals that might actually see a company excluded from operating in a country, or even threatening its entire existence." The interest by investors in these topics illustrate a link between the "E" and "S" of ESG back to the "G" or governance.

Climate as a priority: Among environmental concerns, management of climate change risk leads the list for most of the investors we interviewed, due in part to regulatory action and activism by some of their constituents.

Since 2017, large German public companies have had to publish sustainability reports.[18] This year, the Australian Securities and Investments Commission updated its guidance on corporate disclosure of climate-related risks and opportunities, announcing that it will conduct "surveillances" of climate change-related

[18] A. Bergmann, P. Posch," Mandatory Sustainability Reporting in Germany: Does Size Matter?" Sustainability, 10(11), 3904 (2018).

disclosure practices by selected listed companies. The guidance pointedly highlights that “climate change is a systemic risk that could impact an entity’s financial prospects for future years,” hence the need for disclosure to investors.[19]

Meanwhile, climate campaigners are demanding, for instance, that the £22.5 billion Greater Manchester Pension Fund, which is already a major investor in renewable energy, completely divest its holdings in fossil-fuel companies.

The recent proxy season in the U.S. anticipated 75 climate-related shareholder proposals introduced, up from just 17 in 2013, according to ISS Analytics.[20] Powerful managers like BlackRock and Vanguard are backing voluntary climate reporting standards for public companies using the TCFD framework. The UK and Australia have seen an uptick in climate-related proposals as well. According to Ceres, an advocacy group that tracks climate-related proposals, 39% of 145 shareholder proposals filed in 2017 led to agreements and were withdrawn, up from 21% in 2015. Ceres’ universe covers mainly companies headquartered in North America, along with a few proposals filed with companies elsewhere that touch directly on North American investors' efforts to address climate-related risk.[21]

ExxonMobil has received numerous shareholder proposals requesting more transparency around its management of climate risk. In 2017, a proposal for reporting on the company’s efforts to restrict the discharge of methane gas received support from 62.1% of shareholders[22] despite intense lobbying by ExxonMobil against the action.

Large institutions and asset managers including CalSTRS, CalPERS, AustralianSuper, Hermes, Ircantec, Manulife, Cathay Financial Holdings, and China Asset Management support Climate Action 100+. On their own, State Street engages as many as 300 companies a year on climate risk, Vanguard more than 200, AustralianSuper 152, and Hermes 156.

CalPERS has been especially active. The $370 billion-plus fund has worked with like-minded investors to require implementation of climate risk reporting at oil companies including Occidental Petroleum, PPL, and ExxonMobil. The average level of support for shareholder proposals on climate risk reporting has been climbing, CalPERS says, to 45% in 2017, up from 34% the previous year and 22% in 2015. In 2017, CalPERS’s proxy solicitation efforts helped drive the majority-support resolutions at ExxonMobil and Occidental that required both companies to improve the transparency of their climate change risk reporting.

Even investors who express skepticism about ESG as a matter of public or corporate priority acknowledge that the pressure to address these issues will not go away. “Companies will have to be ESG-compliant, even though it is probably politically motivated,” says **Marc Possa, CEO and partner at Switzerland’s VV Vermögensverwaltung AG**. “We need incentives for management to comply before the system forces them to. It should be on every director’s agenda.”

Three offshoot areas of growing concern for investors relate to the spread of plastics in the oceans; obesity, a growing problem in most regions; and data privacy/cybersecurity. Tying these concerns together is often “materiality,” the threshold at which financial or non-financial information becomes relevant to the investor’s decision-making. In Australia, each ASX-listed company is now required to “disclose whether it has any material exposure to economic, environmental, and social sustainability risks and, if it does, how it manages or intends to manage those risks,” notes HESTA Superannuation’s Sachdeva.

But agreeing whether something is “material” is complicated (see Fig. 10, below). This is one

[19] Paul Osborne, “Australia’s biggest companies to face climate risk exposure checks under new ASIC guidelines,” The West Australian, August 12, 2019.
[20] Gabriel T. Rubin, “Show Us Your Climate Risks, Investors Tell Companies,” Wall Street Journal, February 28, 2019.
[21] Ceres Climate and Sustainability Shareholder Resolutions Database.
[22] “2017 Year-End Update for the Oil & Gas Industry,” Gibson, Dunn & Crutcher, January 22, 2018.

reason many investors say they would welcome more commonly accepted industry-wide standards around environmental and social issues, since these would enable shareholders to link them to elements of governance and to remuneration.

Fig. 10: What ESG issues do investors consider “material”?

	Examples of KPIs	Health Care	Financials	Infrastructure	Technology & Communications	Consumer Goods
Governance		▪ Business ethics ▪ Competitive behavior	▪ Systemic risk management ▪ Legal and risk management ▪ Data security	▪ Critical incident risk management ▪ Systemic risk management	▪ Competitive behavior ▪ Systemic risk management	▪ Business ethics ▪ Legal and risk management
Social		▪ Product quality ▪ Access and affordability ▪ Data security	▪ Selling practices ▪ Employee engagement and diversity ▪ Project finance	▪ Access and affordability ▪ Service safety ▪ Labor practices	▪ Data security ▪ Consumer privacy	▪ Data security ▪ Product quality ▪ Product safety
Environmental		▪ Energy management ▪ Waste management ▪ Circle economy	▪ Sustainable investment management ▪ Circle economy ▪ Project finance	▪ Gas emissions ▪ Air quality ▪ Overall ecological impact ▪ Circle economy	▪ Energy management ▪ Waste management ▪ Circle economy	▪ Water and waste management ▪ Energy management ▪ Circle economy

Source: HCM International Ltd., based on Sustainability Accounting Standards Board (SASB) criteria.

While material issues vary by industry, in each case they should be informed by feedback from key internal and external stakeholder groups.

VII. Disclosure: Why Your Story Matters to Investors

Investors want more engagement with boards on a variety of issues that could, if not managed properly, impact shareholder value. Transparency, clarity, and better disclosure are critical components of this dialog. Corporates must have the right skills to supply these. Done the wrong way, even efforts with the best intentions can have unintended consequences, such as when disclosures are unduly rosy or raise expectations too high.

Disclosure can cover a broad swath of information, data, and strategic determination. The relative importance of any of these depends on factors like industry and geography. “When you invest in a biotech company, it’s not really the remuneration; the know-how of the people is much more important,” while in banking, “remuneration is key,” says **Hans-Pieter Diener, managing partner at HAPAG Partners AG in Switzerland**.

Our investors are consistent on one point: It’s not the volume but the quality of disclosure that’s paramount. Accurate, timely, and detailed disclosure is particularly valued when it provides investors with insights on how the company assesses and manages non-financial risk. On what topics are management and the board focusing? How does the company assess materiality relating to non-financial risk and how is it providing oversight and accountability around managing these risks? Perfunctory or boilerplate disclosures reflect poorly on the company, suggesting that the board does not understand or has failed to address non-financial performance and its potential impact on shareholder value, both positive and negative, or that it is neglecting certain topics.

Investors view management of ESG risks as a strategic issue, not merely a matter of checking the box. In particular, they want to see anything that is material and relevant to the company’s performance disclosed in a timely manner, including anything related to its exposure to environmental and social risks and its management of those risks.

“Information must reflect clearly stated metrics and targets that tie back to value creation and protection,” NEST’s Soobiah emphasizes, “and disclosures must show clearly how remuneration is linked to business strategy.”

How do investors know when they are *not* getting what they need? Respondents highlight five criteria:

- ***Automatism:*** Proxies rely on boilerplate language that does not describe what a corporate has done, is doing now, and what it will do;
- ***Insufficient clarity on the link to pay:*** The company has performance metrics related to remuneration outcomes but does not reveal why they were chosen, how they relate to company performance, and how they are weighted to determine performance outcomes; *Insufficient indication of future sustained performance:* Performance metrics are only backward-, not forward-looking, and do not provide enough information for investors to gauge how the company will do in the future;
- ***Opacity/complexity:*** The company provides data that is either too detailed or too complex and obscure to understand; and
- ***Myopia:*** The focus is only on corporate charitable giving or a single flagship issue, as opposed to the more general impact of ESG risks on the company’s sustainability and opportunities.

What concerns many investors perhaps most is disclosure that fails to clearly tell the story behind the company’s long-term strategy for success and how its work on governance and other sustainability factors relating to that strategy. “We don’t necessarily need an additional 100 pages on what you’re doing on your remuneration practice,” says Davila at BlackRock in Australia. “What we are looking for is to better understand the narrative behind the remuneration structures. Companies are good at explaining ‘how’ remuneration structures work but forget the ‘why’ around selection of performance metrics, performance periods, goals, and the link to longer term strategy."

Most investors agree, however, that the quality of disclosure is improving, although this varies by size, industry, and geographic region. "In the emerging markets, you can say these companies are not cutting it. In the U.S., it's more difficult because sometimes there are a lot of words and not a lot of content," says Giuliano at Alliance Bernstein.

Conclusion: Seven Opportunities to Improve Shareholder Engagement

Corporate governance, compliance, environmental and social protections, executive remuneration, ongoing human capital challenges, and the demand for better disclosure by corporates are not new concerns for investors. New is the higher positioning of these topics and the expectation by investors for more frequent and higher-level engagement—public and private—with management and the board. This marks a new phase in their relationship with portfolio companies, bringing investors' priorities closer to those of other stakeholders. An important element in this shift is the rise of index investing, which has created a new breed of passive investors and active owners focused on the long-term success of their portfolio companies.

"These issues aren't going away, whether it's governance or whether it's environmental stewardship," says **Michael McCauley, senior officer, investment programs and governance at the Florida State Board of Administration**. "You have a generational shift with millennials (and even younger folks) for whom the environment is a much more significant issue than it has been ever before. That's not going to change any time soon. It's only going to get more important, more significant."

Indications are that many of the largest companies now accept that the landscape for engagement with investors has changed permanently. Recently, the Business Roundtable in the U.S. issued a statement signed by 181 Chief Executive Officers asserting that the purpose of the corporation can't be only to advance the interests of shareholders. Instead, it must share "a fundamental commitment to all of our stakeholders," including "our communities and our country"—although there was no mention of the role of executive remuneration.[23]

That being the case, managing relationships with investors, which at one time was typically delegated to an investor relations department, has become the responsibility of the C-suite and board. To this end, management and the board should continue to devote more care and diligence to engaging with investors.

We have distilled the seven lessons learned from engaged investors into seven questions that boards can use to gauge their ability to improve shareholder engagement.

- ***Is your governance house in order?*** Investors want to know that the right people are in board seats, that they have the requisite skills to effectively oversee all aspects of the company on behalf of shareholders, are accountable, and employ appropriate internal checks and balances. Further, they want to know that the board is independent, informed, diverse, and committed to providing active oversight of management.

- ***Is your board sufficiently proactive?*** Approach your largest investors before they approach you. Failing this, respond promptly, listen, and take steps to address their concerns.

- ***Does your board know its audiences?*** Large public pension sponsors such as AustraliaSuper, HESTA, NEST, CalPERS, CalSTRS, and the unions that comprise several large pension funds in the U.S. answer to different constituencies than mutual fund houses or asset managers like BlackRock, Hermes, and T. Rowe Price. You will have more success in your engagement if you recognize the drivers of each investors' concerns.

- ***Does your board understand its investors' engagement strategy?*** Interaction with portfolio companies is conducted differently depending on the investor. Some large asset managers and pension funds assign this responsibility to

[23]David Gelles and David Yaffe-Bellany, "Shareholders Rule No More, E.E.O.s Pledge," New York Times, August 19, 2019.

specific offices or individuals; others rely heavily on the appropriate portfolio manager. Knowing with whom you are in dialog will better prepare you for engagement.

- ***Is your board prepared to act?*** When you engage privately with investors, they will expect their questions to be answered by an appropriate discussion partner from management and the board, who will reliably take their input under advisement. This requires being informed, open to input, and prepared to act.
- ***Does your board focus on quality (vs. quantity)?*** Disclosure is a big concern to investors, but more is not always better. Disclosures need to be substantive, clear, and supported by evidence. They need to offer the "why" of the decisions and not just the "what." "There are four levels of disclosure," says Youmans: "one is no disclosure, two is boilerplate, three is backward-looking metrics, four is forward-looking metrics. Number four is the best. The first one is the worst."
- ***Is your board able to put it all together in a compelling narrative?*** When investors ask for more and better disclosure, they are also asking you to provide a clear, well-founded strategy for long-term success that considers material issues related to ESG and other areas that impact your company, your industry, and your communities. In other words, they are asking that disclosures paint a holistic picture, linking company results with each leg of the ESG triad. If the proxy doesn't cover all of these areas, then links in the proxy to the relevant documents will go a long way toward demonstrating sensitivity to all stakeholders, not just shareholders.

In today's ever-changing markets, systematically responding to these seven questions can help the board and management determine whether they have a plan to create value and do so sustainably. Investors urge that the time to start, ramp up, or improve the engagement process is now. While this is most obvious in developed economies, the sentiment we gathered from responding investors is that the demand for better, more attentive engagement will only intensify in emerging markets as well.

The message from investors to corporates is clear: Investors value proactive leadership on issues that influence a company's long-term ability to create value in a responsible way. Is your company prepared to confront the new reality and embrace this challenge?

We wish to thank the individuals who contributed their knowledge, experience, insights and time and in so doing, helped us compile this report:

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