LIGHTHOUSE

JANUARY 2019 | GLOBAL EDITION

MORROW SODALI

ESG RATINGS

The importance of engagement: how a tailored and effective engagement strategy can help companies manage the impact of their ESG ratings

Rating Agencies and their Focus

How do investors use ESG ratings?

ESG ratings in Fixed Income

ESG-focused engagement

03

CONTENTS

07

08

ESG ratings

The importance of engagement: how a tailored and effective engagement strategy can help companies manage the impact of their ESG ratings

ESG ratings are becoming more prevalent and are commonly used by institutional investors in assessing the ESG performance of their portfolio companies. Thus, in order to manage the potential risks (e.g. shareholder activism and reputational harm) to which these ratings can contribute, public companies should understand how specific shareholders use the ESG ratings; appreciate the efforts made by key investors to evaluate ESG policies and practices independent of input from ratings firms; develop a long-term strategy to vigilantly manage these risks; and communicate that strategy to shareholders and stakeholders.

There are several factors that can increase or decrease a company's ESG risk exposure, but we believe two strategies core to lowering this risk are (i) **effective disclosure**, and (ii) building and maintaining **relationships** with key shareholders as well as rating agencies/advisory firms.

In this piece, we summarize the methodologies and emerging impact of standard-setters and ratings firms – for contextual purposes – but we encourage companies to develop effective disclosure approach and engagement strategies that are heavily focused on their actual shareholders.

BACKGROUND

The total value of assets managed by institutional investors who integrate ESG into their investment process is growing rapidly. According to the Principles for Responsible Investment's (PRI) 2018 Annual Report, the total AUM of its signatory cohort is US$89.65 tn. As an illustration of this rapid growth, in Australia, AUD$866 billion are now managed as responsible investments, representing 55% of all professionally managed assets in the country – up from AUD$622 billion in 2016, representing annual growth of 39%.

The sheer scale of the portfolios where ESG is integrated means that investors are increasingly having to rely on often external, quantitative assessment of ESG performance.

Assessment of companies from the ESG perspective historically started with governance ratings, followed by an accelerated evolution of sustainability assessments and the combination of environmental, social and governance ratings. Just like the credit ratings, ESG ratings are based on past performance, and are designed to assess the level of investment risk. Some also look at level of companies' "preparedness" (e.g. robustness of relevant policies) as a proxy for risk mitigation effort by management. These approaches allow investors to add a layer of ESG risk assessment to their traditional focus on financial performance, to screen portfolios for certain themes or even to hone their engagement efforts. However, "ESG-worthiness" may not be as straightforward as creditworthiness, and the use of event indicators means that ESG agencies may penalize companies for controversies long after they have addressed and rectified the underlying problem.

Understanding 1) the rating agencies and how they determine their ratings, and 2) how investors use these ratings, is essential when planning a shareholder outreach and engagement, to make the dialogue productive and efficient.

RATING AGENCIES AND THEIR FOCUS

Rating agencies use publicly disclosed information, including corporate social responsibility and sustainability reports, annual reports and company websites. Some also rely on media and social media reports, for example to assess the magnitude of controversies. Information gathered from direct data inquiries and requests is also relied on in some cases. While the companies have no input in the methodology used by the agencies, the rating agencies often offer the companies an opportunity to review the data used in the analysis, typically a few weeks before the report is published. This allows companies to provide further information/data and address potential misunderstanding of the industry and company operations.

Data points analyzed by the rating agencies typically depend on the materiality assessment they conduct on market, industry and/or company level. Environmental variables include data points such as those related to greenhouse gas emissions, climate change impact, product safety, air and water pollution and waste disposal. Social aspects include data points related to employee health & safety, diversity, employee turnover, supply chain management, political contributions, human rights, and community relations. Governance areas cover shareholder rights, board composition, ethics, conflict of interest and various aspects of executive remuneration.

These factors are typically assessed and then adjusted to reflect a relative rank versus an industry-based peer group or the market. In other words, final rating is on a scale reflecting a relative position, however in some cases ratings are given in isolation to the market, particularly for companies with unique circumstances or where there are not enough adequate peers.

Most of the large ESG agencies operate internationally, employing their own methodologies to generate their own ESG ratings. While some are taking a more risk-based approach and therefore position themselves as a natural part of the investment decision-making process, others employ methodologies that are more ethically driven. This lends itself better to address clients' expectations and preferences around thematic priorities, but the link to business materiality from a corporate perspective could be less obvious.

In other words, it is important to distinguish between value-driven and values-driven methodology these agencies may apply. While companies are typically aware of factors material to their own business, the visibility over reputational sensitivities of their shareholders and their beneficiaries is limited.

As a result, one of the first steps in the process of understanding the impact of the ESG ratings on a company and its shareholders is to ensure that the difference between the business materiality (value) and reputational risks (values) is acknowledged and addressed.

Dimension	Vigeo-EIRIS	MSCI	Oekom	Sustainalytics	GES International
Rating	-- to ++	AAA to CCC	A+ to D-	0 - 100	n/a
Dimensions	38 sustainability criteria in six domains of analysis: • human resources, human rights at the work place • environment, • business behavior, • corporate governance, • community Involvement.	37 key issues, in ten themes: • climate change, • natural resources, • pollution/waste, • environmental opportunities, • human capital, • product liability, • stakeholder opposition, • social opportunities, • corporate governance, • corporate behavior.	100 sector-specific criteria in two categories: • Social: staff and suppliers, society and product responsibility, corporate governance and business ethics. • Environmental: environmental management, products and services, eco-efficiency.	Min. 70 sector-specific issues per industry in the categories: E – operations, supply chain, products & services; S – employees, supply chain, customers and community & philanthropy; G – business ethics, corporate governance and public policy.	Screening violations against ten dimensions: • community involvement, • corporate governance, • customer/product, • environment, health and safety, • human rights, • labor practices, • social, environmental and ethical risk, • stakeholder engagement, • supply chain responsibility.
Emphasis	80% Qualitative Human/ Labor rights	Quantitative performance measures	50% Quantitative/ 50% Qualitative	50% Quantitative/ 50% Qualitative	Norm-based screening and engagement
Benchmark	Applying a wide variety of public and international standards	Using industry performance benchmarks	Applying a variety of public and international standards	Using industry performance benchmarks and some public standards	Applying a wide variety of public and international standards
Values vs. Value-based	**Value-based**	**Value-based**	**Value-based**	**Hybrid**	**Value-based**

Source: Exploring Social Origins in the Construction of ESG Measures, Working Paper by Eccles and Stroehle

HOW DO INVESTORS USE ESG RATINGS?

Investors use sustainability ratings in their investment decision-making process, as well as investment management process and engagement.

The ratings are considered complementary to traditional investment processes and existing strategies, in that they allow investors to screen for good and poor ESG performers with the aim of reducing their risk exposure, particularly in the long term. We are aware of a growing interest and in some cases use of ESG ratings in investors' custom voting policies. Using a proxy voting platform with proxy research typically allows investors access to ratings that can automatically determine their vote for a specific resolution related to election of directors, remuneration, or a shareholder resolution, or alerts them to a specific, pre-defined material concern. Additionally, the rating can then be used as basis for engagement and targeted call for action to other investors.

Naturally, companies are wishing to optimize the communication with their shareholders and demonstrate responsiveness to consensus expectations, but to do this they need to have clear insight of the shareholder base.

An interesting trend to note is the rise of investors compiling and applying their own, in-house ESG assessment on portfolio companies. For example, the large UK asset manager LGIM recently scored around 2,000 of the largest companies globally according to their management and oversight of ESG, producing a proprietary Global ESG Score[1]. Several other investors, US and European, have developed or are in the process of developing their own in-house ratings.

The rationale behind these initiatives, as we understand it, is that investors are aiming to put forward their own view of the ESG themes and on how it is applied to their portfolio companies. Investor ratings could reflect sector-based materiality, but also reflect the interpretation by the investor of the company's own performance. Furthermore, as investors develop in-house stewardship tools, they can apply a systematic overlay of judgement about engagement quality.

1. Legal & General Investment Management: Global ESG Score ranking

> *"At LGIM, our ESG scores set standards that we want all companies to adopt, in full alignment with our voting and engagement policies. The scores are public, so companies know what they are being assessed on and, more importantly, what they need to do to improve. We will invest more in companies that improve, and use our scale to hold to account those that fall short."*
>
> SACHA SADAN,
> Director of Corporate Governance, LGIM

ESG RATINGS IN FIXED INCOME

Fixed income has also been impacted by the push towards more quantitative assessment of ESG risks. Back in 2015, the PRI launched a project to facilitate this move, and the number of investors integrating ESG risks in this asset class has since grown significantly. The credit rating agencies (CRAs) played a significant role in this process. They are steadily expanding their risk assessment approach, and increasingly incorporate ESG factors and risks in their credit risk products.

Figure 1:
Signatories of the ESG in Credit Ratings Statement since its launch in May 2016

	2016	2018
Number of investors	91	133
Investors' AUM (US$)	15.9 tn	26.1 tn
Number of CRAs	6	15

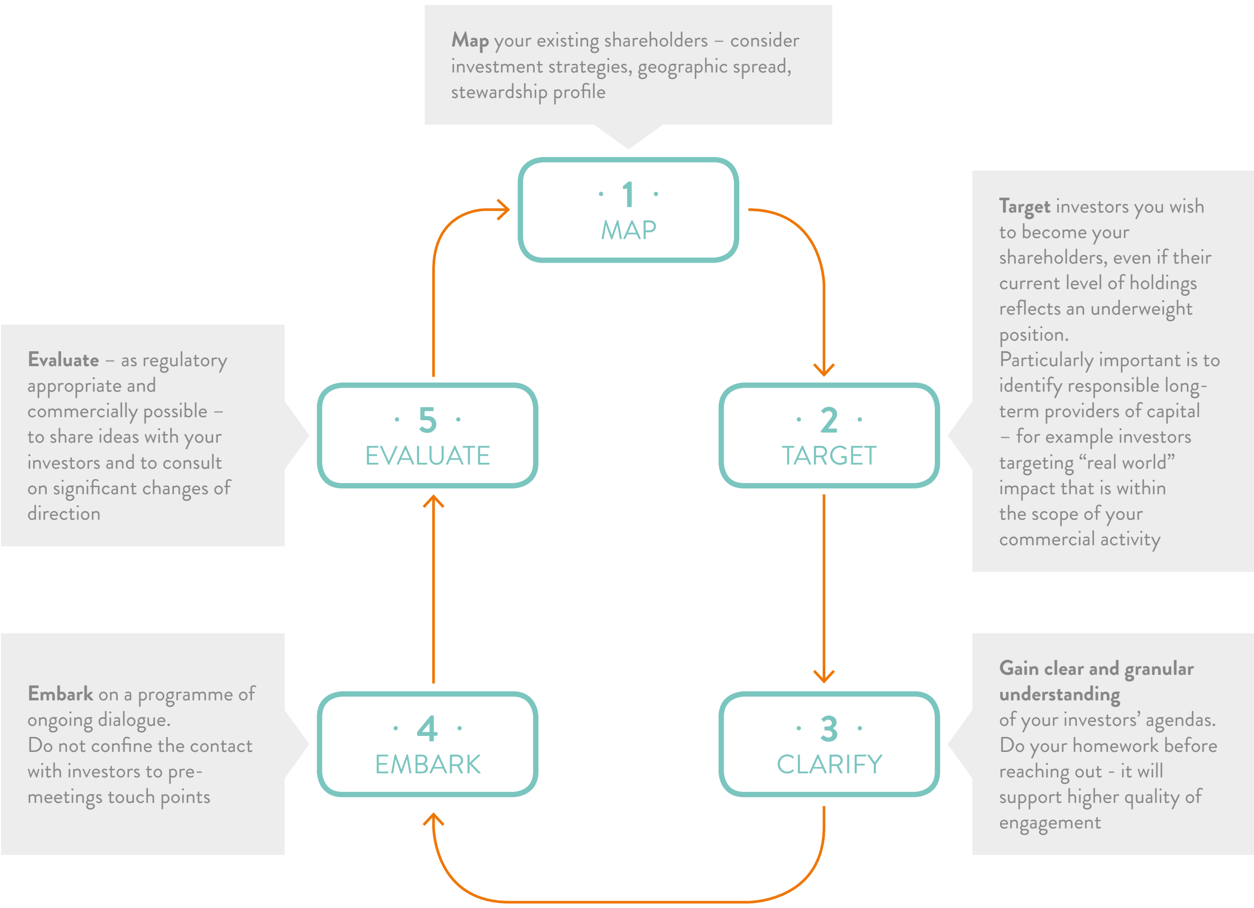
Source: shifting perceptions: ESG, credit risk and ratings. PRI June 2018

ESG-FOCUSED ENGAGEMENT

With the rising use of ESG ratings by investors, it is important for companies to continue and treat engagement as central to the interaction between companies and their providers of capital. Engagement provides an invaluable opportunity for companies to gain more in-depth understanding of the thinking of their investors and the expectations. More importantly, it enables companies to test significant changes and obtain the views of their long-term investors, ensuring smooth ongoing progress of practices.

> ***"We believe in the value of direct engagement with the companies that we invest in on behalf of our clients, and we are continuing to invest to build our capabilities in this area. We are also leveraging new technology and tools within BlackRock in an effort to continually improve our investment stewardship efforts."***
>
> THE INVESTMENT STEWARDSHIP ECOSYSTEM
> published by BlackRock in July 2018

ROADMAP TO UNDERSTANDING THE ESG VIEWS AND EXPECTATIONS OF YOUR SHAREHOLDERS



Looking ahead: a focus on Corporate Culture

In a number of markets, we observe that corporate culture – specifically board connectivity and oversight of the issue – is rising in importance to regulators, investors and other stakeholders. This is the logical progression of the ever-expanding expectations for corporate directors fueled by high-profile corporate governance failures that were tied to toxic widespread conduct. Indeed, the focus on culture touches all industries but carries echoes of the financial crisis and the impact it had on financial regulation.

In some markets such as Australia, the process is well underway to form a possible regulatory outcome. In other markets such as the Netherlands and the UK, codes already are in place but the practical implications to companies still are unfolding. And in the US, many shareholder proponents have targeted corporate issuers with proposals focused on gender pay equity, workforce diversity, and other topics that touch on corporate culture.

Additionally, the voting policies of many institutional investors and proxy advisory firms have been updated to cover these and related topics.

While the progression of these issues is unclear, in our view greater investor scrutiny of corporate culture is inevitable. Stay tuned for more in our next edition.

Regulator, investor and proxy advisor policy changes in the pipeline: Europe, Australia

Two major proxy advisory firms, Institutional Shareholder Services (ISS) and Glass Lewis, recently released their 2019 policy updates. **ISS' 2019 policy updates**[2] and **Glass Lewis' 2019 policy guidelines**[3], which are generally consistent with the 2018 versions, also provide guidance on how ISS and Glass Lewis will make recommendations on companies' "say-on-pay" vote. Morrow Sodali published separate updates[4] summarising the key points.

Expect a spring of reviews in the **UK**! The UK Financial Reporting Council is set to publish a revised Stewardship Code in 2019. The Code was last updated in September 2012. A consultation on a new Code will be published on January 30, 2019, with a final version published in summer 2019. Another area currently subject to several reviews in the UK is the auditor market. On December 18, 2018, the UK competition watchdog published a widely expected interim report that looked into whether the so-called "Big Four" auditors have an anti-competitive hold on the audit of major companies. Several recommendations contained in this report were hailed in the press as "radical", including a duty for companies to be audited by two firms and a stricter regime of regulation on the audit firms. This comes in addition to a previously launched independent committee set up by the business secretary and headed by Sir John Kingman to review the FRC's governance, impact and powers, which published its findings on the same day and which has also contained far reaching conclusions. That report recommends to disban the FRC and establish a much more powerful and independent regulator body that will have authority over all company directors, not just those qualified as accountants.

Large **French** institutional investors have not yet formally announced their policy changes for 2019. Nonetheless there is a clear move towards reinforced integration of ESG issues into investors' voting and engagement process, and closer collaboration between governance/proxy teams and ESG research teams. Moreover, investors seem to pay closer attention to corporate directors' actual expertise on these issues. Directors' and executives' accountability on CSR issues is increasingly in the spotlight. For instance, the head of Corporate Governance at BNP Paribas AM, one of the biggest French asset managers, stated a few months ago that BNP will require environmental performance to be included in pay schemes, more specifically in long-term incentives.[5]

In an attempt to provide some guidance to corporates and regulators alike, **Germany**'s major institutional investors, including DWS, Allianz Global Investors, DEKA and Union Invest, regularly provide discussion papers on corporate governance related topics in the framework of the DVFA (German Association of Investment Professionals). Most recently, the DVFA joined forces with scientists to develop standards for "sustainable" executive remuneration[6] and board independence[7] which were published in September 2018. One of the intentions of this publication was to influence the decision-making of the German Codex Commission who published the draft of their revision of the corpo-

2. ISS Policy Gateway: 2019 Policy Updates
3. Glass Lewis Policy Guidelines: 2019 Updates
4. Morrow Sodali Proxy Updates: ISS Voting Guidelines (US), Glass Lewis Voting Guidelines (US), ISS & Glass Lewis Voting Guidelines (EMEA)
5. Board Agenda: interview with Michael Herskovich, BNP Paribas AM
6. Press release: "Guidelines for sustainable management board remuneration systems"
7. Press release: "DVFA Kommission Corporate Governance definiert Position zur Unabhängigkeit von Aufsichtsratsmitgliedern"

rate governance code shortly afterwards. The extent of the effect of the initiative as yet remains unknown.

Since the Minder legislation came into force in 2014, **Swiss** investors are required to vote by law at domestic company meetings. Excluding the larger institutions, this has led to a strong dependence on proxy advisor services of smaller pension funds. This trend seems to cement further. In its latest survey of institutional investors, SWIPRA Services AG, who promotes a constructive dialogue on corporate governance between investors and companies listed in Switzerland, found that Swiss and international investors alike use proxy advisors frequently[8]. However, while over 70% of international respondents read proxy advisor reports to align their research with Swiss market practice, conversely over 70% of Swiss institutions purchase them mostly for their recommendations.

Greek institutional investors tend to be less active than their international peers in terms of proxy voting guidelines and policies. That said, all eyes will be on remuneration this year given the new 2019 EU requirement (SRD II) to adopt a remuneration policy for the board and a non-binding annual remuneration report, which has already been transposed into Greek Law (4548/2018) and will be effective for all publicly listed Greek companies from January 1, 2019.

In **Italy**, the implementation of the shareholder rights directive was under consultation until December 18, 2018. Transparency of institutional investors are among the elements under evaluation by the legislator. It is very likely that asset owners and asset managers will develop and publicly disclose an engagement policy that describes how they integrate shareholder engagement in their investment strategy. Furthermore, institutional investors will be required to disclose a general description of their voting behavior, how they have cast votes in the general meetings of companies in which they hold shares, an explanation of the most significant votes and the use of the services of proxy advisors.

As a result of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Royal Commission), assessment of directors' accountability in **Australia** is reaching its peak, with a growing number of negative recommendations from proxy advisors and higher levels of votes against from investors. The country's largest superannuation fund, AustralianSuper, is however waiting for the final report of the Royal Commission and will abstain from voting for or against the re-election of board members at any of the big four banks. In addition, the 4th edition of the Australian Corporate Governance Principles and Recommendations will come into effect on July 1, 2019, with entities reporting against it for their first full financial year ending on or after June 30, 2020.

8. SWIPRA survey on the development of corporate governance in Switzerland

Events and conferences Key takeaways

The Thomson Reuters Company Secretaries Forum was held in **London** at the end of November 2018. The topics covered the skill set of a company secretary required to succeed in the 21st century, the key challenges for company secretaries, board reviews, the impact of technology and associated risks, the future of corporate reporting and the impact of Brexit.

Significant ESG-related events were held in **Paris** in November 2018 - Climate Finance Day (26-28) and Paris Sustainable & positive Impact Finance 2018 Conference (14), organized by the French bank Société Générale.

Morrow Sodali took part in the annual Italian conference on corporate governance held in **Milan** on December 10 and 11 last year. The event included four round tables where the following topics were discussed:

- Development of engagement policies and practices: the dialogue between the board and investors
- Controlling shareholders, growth and access to capital markets: the role of loyalty and multiple voting shares
- Is shareholder activism good for shareholders and companies?
- Blockchain and Corporate Governance: challenges and opportunities

In late November 2018, the Australasian Investor Relations Association (AIRA) hosted its Annual Conference & Gala Dinner in **Sydney**. Prior to the conference, Morrow Sodali, AIRA's Professional Development Partner hosted a workshop focusing on how to "Maximise Shareholder Voting Support Through Effective Engagement," addressing investor engagement and ESG trends.

The Morrow Sodali governance team also attended the Responsible Investment Association Australasia (RIAA) held in **Melbourne** on October 31 and November 1, 2018. The panels discussed ESG and corporate financial performance, held a masterclass into modern slavery and supply chain risk management, dived into the sustainable development goals and explored the topic of inequality.

RI America event was held in **NYC** on December 5 and 6, 2018. There was a strong message from the largest institutional investors internationally, that ESG is now part of the investment outlook, even for some of the mainstream investors. One illustration of this is how the UN Sustainable Development Goals have matured into what several speakers described as the "strategy plan for the world", with investors seeking to demonstrate how their investments create desirable impact and companies will be required to evolve that aspect of their disclosure.

M O R R O W
S O D A L I

ABOUT MORROW SODALI

Morrow Sodali is the leading global consultancy specializing in shareholder and bondholder services, corporate governance, proxy solicitation and capital markets transactions.

The firm provides corporate boards and executives with strategic advice and services relating to a broad range of activities, including: mergers and acquisitions, annual and special meetings, shareholder activist initiatives, multinational cross-border equity transactions and debt restructuring services.

From headquarters in New York and London, and offices and partners in major capital markets, Morrow Sodali serves more than 700 corporate clients in 40 countries, including many of the world's largest multinational corporations. In addition to listed and private companies, its clients include mutual funds, stock exchanges, membership associations and activist investors.

DAVID SHAMMAI
Cross-Border Director, Corporate Governance

d.shammai@morrowsodali.com
T. +44 207 3550 618
M. +44 7825 880 886

JANA JEVCAKOVA
Governance Manager

j.jevcakova@morrowsodali.com
T. +61 2 8022 7952
M. +61 452 061 779

KIRAN VASANTHAM
Director, Investor Engagement

k.vasantham@morrowsodali.com
T. +44 207 3550 603
M. +44 7887 955 816

WILLIAM ULTAN
Managing Director, Corporate Governance

w.ultan@morrowsodali.com
T. +1 203 658 9449
M. +1 917 232 2018

Offices

NEW YORK
509 Madison Avenue
Suite 1206
New York, NY 10022
P. +1 212 825 1600

LONDON
103 Wigmore St
Marylebone, W1U 1QS
London, United Kingdom
P. +44 207 355 0921

SYDNEY
135 King Street
Suite 25.02, Level 25
Sydney NSW 2000
P. +61 2 80 22 79 35

FRANKFURT
Mainzer Landstrasse 50
60325
Frankfurt am Main, Germany
M. +49 176 6366 7485

MADRID
Calle de Almagro 3
28010
Madrid, Spain
P. +34 9142 91 412

PARIS
20 Rue Quentin-Bauchart
75008
Paris, France
P. +33 1 441 78007

ROME
Via XXIV Maggio, 43
00184
Rome, Italy
P. +39 06 45212800

SAO PAULO
Rua Prof. Atílio Innocenti 165, 4º Andar
Vila Nova Conceição
São Paulo - SP, 04538-000, Brazil
M. +55 11 972 783 858

STAMFORD
470 West Avenue
Suite 3000
Stamford, CT 06902
P. +1 203 658 9400

Local Partnerships:
MEXICO CITY • BEIJING • JOHANNESBURG

morrowsodali.com