



# SUSTAINABILITY

2020 arrived with what *Global Proxy Watch* headlined an “Epic Escalation” in institutional investors’ focus on climate change, ESG and sustainability. This escalation, notably highlighted by BlackRock’s annual letter to CEOs and by statements from prominent business organizations and institutional investors around the world, did not come as a surprise. For most of the last decade there has been a growing conviction, particularly among institutional investors, academics and governance professionals, that the issues collectively embraced by the term “sustainability” have a material impact on companies’ financial performance and on the long-term returns of investment portfolios. Part of what makes this escalation “epic” is that it alters the behavior not only of executives managing corporations, but also of the asset managers and asset owners who are the providers of capital.

In this issue we take a brief look at some of the implications for institutional investors, companies, boards and corporate executives in the U.S., Europe/Latin America and Australia/Asia-Pacific.

# What is new in the way institutional investors in key markets are focusing on ESG and sustainability?

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## U.S. PERSPECTIVE

Despite different views on sustainability issues, there is a clear consensus among investors that ESG ISSUES MATTER in terms of risk, opportunities and financial performance. Individual companies are asking which issues are material to them, how should they be measured and how should their policies and oversight be reported.

One of the main differences for the U.S. market compared to the other markets is that the approach to ESG issues has been more of a bottom-up approach, rather than the top-down regulatory-driven approach seen in other markets. This is not expected to change in the near term. Some U.S. asset managers take a more prescriptive approach to ESG issues, such as gender diversity and climate change, asserting their views through shareholder proposals, proxy voting policies, engagement or public messaging like BlackRock's 2020 letter to CEOs.

Leading U.S. asset managers have also made clear their intention to integrate ESG and sustainability into their investment decisions.

Companies will see the impact of these ESG integration efforts in their engagement campaigns and proxy voting results in 2020. BlackRock and State Street Global Investors have taken the lead role in articulating their expectations for both companies and institutional investors in 2020 and beyond.

## EUROPE

In Europe, unlike the U.S., there is a growing political push to include ESG issues in the regulatory agenda. Companies are already taking note of the EU non-financial reporting directive. There are also stewardship codes and formal stewardship duties governing investors' oversight of portfolio companies.

In Europe shareholder proposals play a relatively minor role. Nevertheless, sustainability issues play a prominent role at shareholder meetings. For example, in France there is a recently passed legislation to introduce corporate purpose as an agenda item at companies when it is enshrined in the articles of incorporation. In Spain there is now a mandatory vote on non-financial information.

Another trend has been an increasing willingness by investors to vote against directors' discharge resolutions. In Germany, the Netherlands and Switzerland, there

have been high-profile cases of votes against director discharge and more such initiatives are expected.

Engagement continues to be the preferred tool for European institutional investors to address sustainability. They have taken a leadership role in several major collaborative engagement initiatives such as Climate Action 100+.

European institutional investors are taking a systematic approach to ESG integration. In Dec 2019, The Global Sustainable Investment Alliance released its Global Sustainable Investment Review. When asked whether they are going to incorporate TCFD disclosures into their investment analysis, over 20% of European investors (UK 50%) replied positively, with an additional 40% confirming they will be doing so by the end of 2020.

## AUSTRALIA/ASIA-PACIFIC

2019 has been a watershed year for ESG and sustainability. This was partly driven by recent highly-publicized corporate culture and conduct failings at Australia's four largest banks (culminating in a Royal Commission). In addition, unseasonal wild-fires of epic magnitude, known as "mega-fires" have made climate change a reality for the Australian public.

The prominence of climate change issues in public life increased pressure on institutional investors and asset owners to focus both on companies' sustainability and on the potential impact on investment portfolios.

The Australian compulsory system of superannuation and retirement saving (whereby 9.5% of every worker's salary is withheld and invested) means that every working Australian has personal exposure to the investment markets, creating a self-reinforcing cycle focused on ESG and sustainability.

Australian institutional investors are pursuing several approaches to ESG integration:

- Pricing and factoring it into investment models (quantitative)
- Analyzing it as an indicator of 'quality' (qualitative)
- Targeting specific ESG topics (e.g. clean water, clean energy, green property)
- Selecting the better sustainability performers (e.g. best in class companies)
- Excluding poor sustainability performers (e.g. negative screening)
- Impact investing (i.e. selecting investments that target a measurable environmental or social impact)

The Responsible Investment Association of Australasia (RIAA) in its annual RIAA Benchmark Report (released in 2019) stated that the Australian responsible investment market continued to grow in 2018, with \$980 billion in assets under management, a rise of 13% over 2017. As such, the amount of assets being managed in accordance with responsible investment principles in 2018 represented 44% of Australia's total \$2.25 trillion in professionally managed assets.

## **How do ESG and sustainability affect the roles of corporate boards and management?**

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### **U.S.**

The general view in the U.S. market has long been that boards make policy - including the purpose of the corporation and its mission. While working with the CEO to determine strategy, exercising oversight of and seeking verification that risks are being managed and strategy is working.

Given that ESG issues are now central to how every company operates, the board should focus carefully on the specifics of its responsibilities. It should determine which ESG issues are material to the business, what policies are required, how policies and strategies are implemented by the CEO and management, how effectively the company's culture is aligned with ESG and how to communicate all this information to stakeholders.

Shareholders are increasingly interested in understanding how the board and management work together collaboratively to oversee and manage ESG issues. The board should explain what it does, including how it communicates. Management should bring the board into internal communications relating to ESG, including the CEO, CFO, General Counsel, Corporate Secretary, Investor Relations, Human Resources, and CSR executives between other ESG managers and the board.

### **EUROPE**

In 2019, investors were already demanding more information about corporate purpose and specifically we are noticing growing investor expectations around climate change disclosure. The board's responsibility in 2020 will be to authenticate corporate purpose, take the lead on culture and work with the CEO in setting strategy to achieve sustainability. This board responsibility is made explicit in several corporate governance codes across Europe, including Italy, the Netherlands and the UK.

## AUSTRALIA/ASIA-PACIFIC

The Australian legal framework makes clear that directors are responsible for ESG. Australia's Corporations Law defines the general duties of directors broadly including risk oversight. The most recent (2019) iteration of the ASX Corporate Governance Principles and Recommendations is explicit regarding sustainability and ESG Recommendation 7.4 states: "A listed entity should disclose whether it has any material exposure to environmental or social risks, and if it does, how it manages or intends to manage those risks". Responsibility for this disclosure lies with the Board Risk Committee.

Climate risk is now a concern of the Australian public, investors and, importantly, regulators. There is consensus among organizations such as the Australian Prudential Regulatory Authority, the Australian Securities and Investments Commission and the Reserve Bank of Australia that the Board is responsible for addressing climate risk. Former high court judges have also weighed in on the issue.

At the Business Roundtable on Climate and Sustainability (in late November 2019) Kenneth Hayne QC stated: ". . . in Australia, a director acting in the best interests of the company must take account of, and the board must report publicly on, climate-related risks and issues relevant to the entity".

## Should ESG and sustainability metrics be included as KPIs in executive compensation plans?

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### U.S.

It is still uncommon to find ESG metrics in U.S. companies' executive compensation plans. However, the answer to this question may depend on the sector in which a company operates. For example, public utility companies have certain ESG-related data points they are legally obligated to report to regulators. These data points are often included in their executive compensation plans. For extraction companies (e.g., mining, oil & gas, forestry), environmental impact and safety are key operational metrics directly related to 'License to Operate ("LTO").' As a result, ESG metrics are often already embedded in executive compensation plans for these sectors.

In our view, investor pressure will increase for ESG factors to be included in KPIs and disclosures in executive compensation plans generally. Pressure will be focused on boards to ensure that ESG metrics are included in their overall executive compensation planning.

Non-financial metrics (as well as non-GAAP metrics) in executive compensation programs often face more scrutiny from both the regulators and investors. If a company decides to add an ESG-related metric, robust disclosure has to follow as to why it is material to the company's business and how executives' accountability is being measured.

For investors, instead of insisting on an ESG-related metrics in executive compensation programs, there is always a broader goal of understanding companies' unique operational, legal requirements and challenges as context for evaluating comprehensive metrics.

## EUROPE

ESG metrics in compensation are increasingly found in investor remuneration guidelines. The UK's influential Investment Association, in the update to its guidelines in November 2019, stated:

**“Remuneration committees should consider including strategic or non-financial performance criteria in variable remuneration, for example relating to environmental, social and governance (ESG) objectives, or to particular operational or strategic objectives. ESG measures should be material to the business and quantifiable. In each case, the link to strategy and method of performance measurement should be clearly explained.”**

Elsewhere in Europe, we are aware of at least one notable collective engagement initiative by investors where this is an explicit requirement. More such collective activities are sure to follow in 2020.

From the perspective of companies however, there is still little guidance on what measures might they use to meet investors' expectations for robustness and transparency.

## AUSTRALIA/ASIA-PACIFIC

Australian investors recognize that executive remuneration drives long-term value creation. The inclusion of sustainability metrics in the executive remuneration plan is directly aligned with that goal.

Companies are responding by including a range of ESG / sustainability factors in their executive remuneration plans, e.g. safety, culture, diversity, and customer satisfaction. Some companies are also starting to explain climate risk management (e.g. emissions reduction) measures in their executive remuneration plans. In 2020, investors will push for more detail from companies on these issues.

## **What steps should issuers take to deal effectively with shareholder expectations about sustainability?**

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In all global markets, investors are challenging companies to provide comprehensive, robust and transparent disclosure of their strategy and sustainability goals. They want to understand the purpose of a company's long-term strategy, environmental and social responsibility for all stakeholders, its program for and the board to achieve sustainability.

Once a company has made these disclosures, active engagement with investors should follow. Transparency and communication should always be the main focus of both investors and issuers. Proxy voting is important, but engagement should not be limited to proxy-related issues.

With respect to ESG-related disclosure, companies can in turn ask investors not only what data they want to see, but also how the data is utilized in their investment and voting decisions. Mutual understanding makes engagement more meaningful and effective. ESG is not a destination but rather a journey. Collaboration between issuers and investors is always the goal.

While issuers are influenced by local requirements, here are some key steps issuers can take to meet shareholder expectations:

- Identify what sustainably issues are material to individual companies
- Explain how these issues are being managed and mitigated
- Articulate how the Board is maintaining oversight of these matters

At a practical level, this means that companies should:

1. Make clear and comprehensive disclosures regarding the material sustainability issues
2. Be balanced in their reporting (what went well, what could have gone better and what the areas for future focus are)
3. Be very explicit regarding climate risk, noting that there is a clear preference for reporting in accordance with the Taskforce on Climate-related Financial Disclosures reporting framework
4. Engage with investors on ESG in a pro-active manner (even where "there are no issues")

**Daniel Oh**  
*Morrow Sodali*  
New York

**David Shammai**  
*Morrow Sodali*  
London

**Emily Lay**  
*Morrow Sodali*  
Sydney

**Maria Davis-Poynter**  
*Morrow Sodali*  
Sydney

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## ABOUT MORROW SODALI

Morrow Sodali is a leading provider of strategic advice and shareholder services to corporate clients around the world. The firm provides corporate boards and executives with strategic advice and services relating to corporate governance, shareholder and bondholder communication and engagement, capital markets intelligence, proxy solicitation, shareholder activism and mergers and acquisitions.

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, ETFs, stock exchanges and membership associations.

## CONTACTS

If you would like assistance refining your existing ESG disclosures, please get in touch with one of our experts.

**US**  
+1 212 300 2470

**EMEA and LATAM**  
+44 20 71006451

**APAC**  
+61 2 8022 7940