

Director Responsibility

Over the last decade, as asset owners and asset managers have built their inhouse environmental, social and governance (ESG) stewardship capabilities, they have taken an increasingly active role in the proxy voting process and closely scrutinise the resolutions being put to them. They view proxy voting as being central to their role as good stewards of their members' and clients' capital. Related to this, many asset owner Chief Executive Officers, Chief Investment Officers and superannuation and pension fund Trustees now take a direct interest in their fund's proxy voting activities.

Notwithstanding this heightened focus on proxy voting, until recently, investors were often still reticent to vote against directors on the basis that:

- The Chair, the Nomination Committee and the board collectively all have a strong role to play in the director appointment process (and only in exceptional circumstances should this power be overridden).
- It was believed that as outsiders looking in, it is very difficult for investors to assess how diligent and effective an individual director has been (hence a high level of reluctance to vote against them).
- The board was analysed collectively as a whole, with its decisions not attributable to individual directors

However, in the past few years, Morrow Sodali has observed a trend toward increased efforts to evaluate individual directors, as investors (both asset owners and asset managers) are becoming more comfortable voting against directors on the basis of accountability. This has been driven by:

- Investors' increased focus on ESG issues
- Investors' heightened expectations for board policies and oversight.
- Rising levels of stakeholder (including superannuation fund/pension members, civil society, media) scrutiny regarding issues for which directors are accountable.
- Investors' ability to dissect board actions to determine individual director performance based on the facts before them.

We are also observing that where an individual has moved on from a company (or is on the board but not up for re-election) and potential issues regarding their performance or a lack of accountability come to light, investors will potentially vote against that individual's appointment / reappointment as a director at another unrelated company, thereby holding the individual personally accountable for their actions elsewhere.

OECD Corporate Governance Principles:

Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders.

Investor Stewardship Group's Corporate Governance Principles for US companies:

Principle 1: boards are accountable to shareholders.

Principle 4: boards should have a strong, independent leadership structure.

Principle 5: boards should adopt structures and practices that enhance their effectiveness.

Australian Corporations Act 2001, Section 180: Care and diligence directors and other officers

- (1) A director or other officer of a corporation must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they:
 - (a) were a director or officer of a corporation in the corporation's circumstances; and
 - (b) occupied the office held by, and had the same responsibilities within the corporation as, the director or officer

German Stock Corporation Act§ 93(1):

In conducting business, the members of the management board shall employ the care of a diligent and conscientious manager. They shall not be deemed to have violated the aforementioned duty if, at the time of taking the entrepreneurial decision, they had good reason to assume that they were acting on the basis of adequate information for the benefit of the company.

Consequently, it is critical that boards demonstrate their diligence and accountability by such measures as the following:

- A rigorous and robust board evaluation and assessment framework and process:
- The preparation of a well thought out and detailed board skills matrix;
- Clear governance policies and broader ESG disclosures including narrative that assists in providing insight into how the board is thinking about issues, including its accountability;
- Regular engagement with key investors on a range of issues, including ESG to build mutual respect and trust.

Board evaluation

In the fourth annual Morrow Sodali Institutional Investor Survey, 67% of respondents indicated that both an external third-party assessment and internal self-evaluation are equally important as the most effective form of board evaluation. In the U.S., 93% of Fortune 100 companies included at least some disclosure on board evaluations in their proxy statements.

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Some investors noted that corporate issuers should be mindful that conducting board evaluations without providing meaningful disclosure may become a contentious issue when engaging with investors.

One investor also noted that there is no single best approach, but the evaluation process undertaken by the board should be well articulat-

ed and justified in terms of how it adds value to ensuring the right mix of skills, how director accountability/attentiveness are assessed and how the process ensures an adequate level of board refreshment.

ESG Disclosures

ESG disclosures, if done well, help explain a company's purpose and culture. This is increasingly important, particularly in cases where investors do not have the opportunity or resources to get out "on the ground" and into the operations of a company.

ESG disclosures can bring corporate operations and activities to life and can impart to investors (and other stakeholders) a sense of what issues a company faces and how they are being managed (from the board right down to operations at a site level). Investors want to know:

- What are the material ESG issues facing the company?
- How is the company managing those issues? Who is responsible?
- How is the company performing?
- What has gone well, what could be done better and what the future focus will be?

In assessing corporate reporting, investors look for a balance of narrative, metrics and case studies. Furthermore, reporting should be balanced and should include both good and bad news. Companies can at times be reluctant to report on the

"bad" news, fearing negative perception. However, investors recognise that things can go wrong. What they are keen to understand is how a company responds to problems. Candor, rather than cover-up, can provide positive insight into the integrity and culture of the company.

Engagement

Engagement with board directors is often the only mechanism for investors to get to know individual directors and ascertain their level of commitment, conviction and contribution. Face-to-face engagement also provides insight into the character of individual directors. On meeting and engaging with directors, investors reflect on how the director conversed with them, levels of openness, humility, approachability and, connectedness "to the real world".

Engagement is critical to building a two-way mutually respectful relationship. It builds trust between investors and companies and, crucially, it means that when issues arise, companies have access to their investors and can ensure that they respond appropriately. Companies that respond reactively often find that investors are reluctant to engage ("you are only calling us because you have a problem"). Proactive engagement lays the groundwork so that companies know who to call when issues emerge and can therefore be more effective in garnering the support they need.

In the Morrow Sodali Investor Survey, a total of 67% of respondents indicated that when engaging with listed companies and their directors, they look to understand the company's business strategy and capital allocation and to understand how the boards oversee corporate culture and tone at the top. Additionally, 85% of survey respondents indicated that climate change is the most prioritised sustainability topic of their corporate engagements.

Board Skills Matrix

The Board Skills Matrix (BSM) is a tool that is becoming increasingly important to investors as well as policy makers.

In Australia, both the ASX Corporate Governance Principles and Recommendations and the Australian Council of Superannuation Investors Governance Guidelines emphasise the importance of having and disclosing a BSM.

The New Zealand Stock Exchange provides guidance that "an issuer may choose to use a skills matrix to help ensure the correct mix of skills is achieved when considering appropriate appointments to the board."

The London Stock Exchange recommends that "[t]he board must have an appropriate balance of functional and sector skills and experience in order to make the key decisions expected of it and to plan for the future."

The South African King IV Code on Corporate Governance recommends that there should be a "...balance of knowledge, skills, experience, diversity and independence to objectively and effectively discharge its governance roles and responsibilities."

Neither The New York Stock Exchange nor the U.S. Securities and Exchange Commission provide specific guidance for a BSM, however many companies provide disclosure of directors' skills in a matrix as a matter of good corporate governance.

For the reasons outlined above, the disclosure of a detailed board skills matrix has become of greater interest to investors, and companies are increasingly being scrutinised in this regard. A high quality BSM provides investors and other stakeholders with the opportunity to make a more informed (and hopefully independent) judgment of the skills and experience on the board. Investors often rely on BSM disclosures when determining whether directors are in fact contributing relevant background and experience to drive the company's strategy.

Often, BSM disclosure is in the form of a table, with a list of skills and experience and an accompanying description. However, companies are now constructing quantified and even director-specific matrices. This greater level of transparency indicates that the company 'has nothing to hide' and is confident of their board appointees' qualifications.

We believe it is in companies' and investors' best interests to provide a detailed BSM, particularly, owing to the fact that:

- There is increased scrutiny by investors of board qualifications, diligence, accountability and oversight practices;
- There is increased willingness to hold individual directors accountable;
- BSMs improve board transparency, strengthening credibility and trust;
- BSMs assist companies in identifying gaps in board skills and expertise and can play a critical role in ensuring a rigorous and robust approach regarding succession planning.

EXAMPLE 1: QUANTIFIED

SKILLS AND EXPERIENCE	Number of Directors (out of 4)
TECHNOLOGY • Strong understanding of information technology processes, cyber risk, digital disruption • Experience at a senior executive level managing technological risks	3
FINANCIAL EXPERTISE • Strong financial background involving corporate finance, deep understanding of taxation principles and accounting • Previously held a CFO role	2
GOVERNANCE AND RISK Strong understanding and application of good governance practices and disclosures Expert in public policy, regulation and risk management	2
FMCG EXPERIENCE • Senior executive experience in the fast-moving consumer goods (FMCG) industry • In-depth experience of merchandising, customer service and supply chains	3

EXAMPLE 2: DIRECTOR SPECIFIC

SKILLS AND EXPERIENCE	JANE DOE	JOE BLOGGS	RICHARD ROE	JOHN SMITH
TECHNOLOGY Strong understanding of information technology processes, cyber risk, digital disruption Experience at a senior executive level managing technological risks	✓		✓	✓
FINANCIAL EXPERTISE Strong financial background involving corporate finance, deep understanding of taxation principles and accounting Previously held a CFO role	✓	✓		
GOVERNANCE AND RISK Strong understanding and application of good governance practices and disclosures Expert in public policy, regulation and risk management		✓		✓
Senior executive experience in the fast-moving consumer goods (FMCG) industry In-depth experience of merchandising, customer service and supply chains		✓	✓	√

Director Appointments

New appointments to the board can occur when there is vacancy or where additional skills are required to address strategic issues facing the company. Such appointments often need to comply with the relevant jurisdiction's Listing Rules. Therefore, it is important to provide investors a clear explanation of why a director's appointment is warranted.

- APPROACH 1 -

Director A has been elected on the board, however the company has not outlined the rationale to their appointment and there may be a possible related-party relationship between the Chair and the new director.



Investors raise governance concerns and with limited disclosure regarding their appointment, may vote against their election.

- APPROACH 2 -

Company X has expressed their need to enhance the skills represented on the board, particularly in the area of sustainability. The board has clearly disclosed within the company's governance disclosures and ongoing communications that there is a need for sustainability expertise on the board to mitigate and better understand ESG factors affecting the business.

The appointee's background includes Chief Sustainability Officer at a listed company, a member of the G20 Environment Sustainability Working Group and a PhD in Ecosystem Biology and Sustainability from the Queen's University Belfast.



Investors are more willing to support the nominee where the disclosures around their skills align with the board's strategy. To further support this disclosure, some companies provide in-depth disclosure of the nominee background and indicate how and why their appointment is highly relevant to filling a gap in skills.

Recommendations

- Review the company's business strategy, life cycle, and key risks and opportunities, to determine the relevant pool of boardroom skills and criteria
- Develop and disclose a detailed BSM that addresses skills and links succession planning and future appointments to achieving the company's strategy.
- Ensure director biographies are up to date, with detailed descriptions of their professional career linked to the BSM.
- If there may be a contentious appointment to the board or a situation that may pose risk, consider undertaking engagement with investors to mitigate concerns and address any governance issues prior to the AGM. Use this time to properly brief directors on their talking points with investors and the wider public.

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ABOUT MORROW SODALL

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

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