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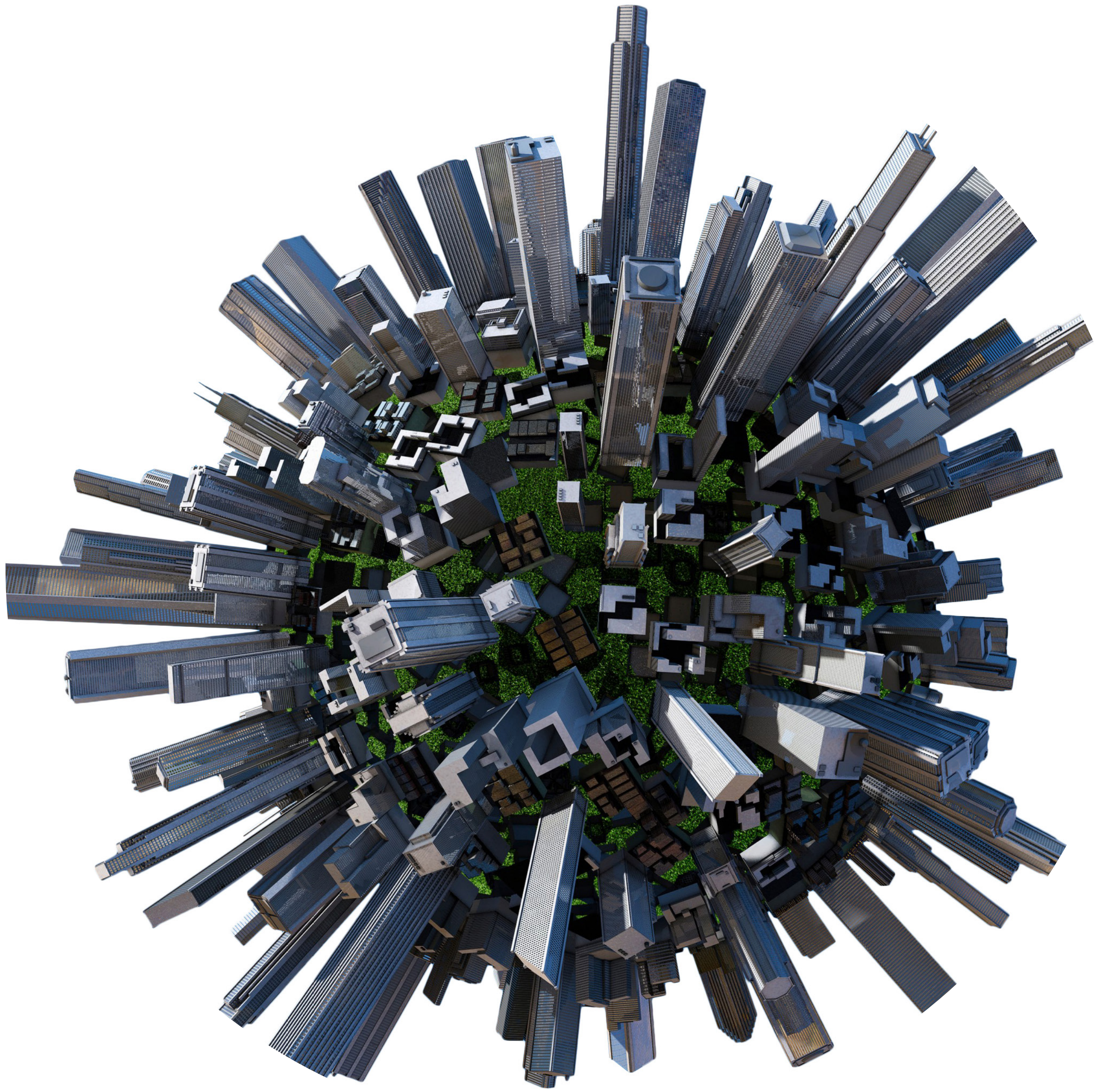

Changing investment stewardship practices in a post COVID-19 world

Perspectives shared by Deloitte and Glass Lewis

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Changing investment stewardship practices in a post COVID-19 world

Just as the COVID-19 pandemic has had a significant impact on society, business and public policy, it has also led to significant changes to corporate governance. Companies experienced new ways of organizing annual general meetings ("AGM") of shareholders, in a virtual or hybrid manner (https://www2.deloitte.com/global/en/pages/about-deloitte/articles/covid-19/virtual-shareholder-general-meetings-in-the-age-of-covid-19.html). We have also seen a raft of new voting trends emerge (https://www2.deloitte.com/global/en/pages/about-deloitte/articles/covid-19/board-voting-patterns-point-to-sustainability.html?nc=1). Concurrent to the current lockdowns and restrictions associated with the pandemic, companies are facing pressure from institutional investors who are adjusting their voting policies as part of their evolving stewardship practices which are increasingly focused on material ESG topics. Even though the definition of stewardship can vary depending on language and culture, we see common patterns around the world. For example, the International Corporate Governance Network (ICGN)[1] has revised its Global Stewardship Principles to create an explicit link between fiduciary duty and long-term value creation and to encourage investors to disclose more about their stewardship activities.[2] These changes have occurred in the context of wider public initiatives around what might be called "*sustainable corporate governance*".[3] Many scholars are also encouraging implementation[4] of the Business Roundtable (BRT) statement on corporate purpose,[5] through which CEOs of a number of large companies committed to lead their organisations for the benefit of all stakeholders, not just shareholders. In this publication, we highlight new and innovative investment stewardship practices, both from the perspective of institutional investors and proxy advisory firms. Given the importance of this topic, we have asked the global proxy advisory firm Glass Lewis to share their views on these renewed stewardship practices.

[1] Dan Konigsburg, co-author of this publication, serves as a member of the ICGN's Board of Governors

[2] https://www.icgn.org/sites/default/files/00.08%20Revised%20Global%20Stewardship%20Principles.pdf

[3] See the ongoing sustainable corporate governance initiative of the EU Commission: https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12548-Sustainable-corporate-governance

[4] The Enacting Purpose Initiative (EPI) is a multi-institution partnership mostly sponsored by the University of Oxford and the University of California Berkeley providing directors with guidance on how to enact corporate purpose: https://enactingpurpose.org/#purpose

[5] https://www.businessroundtable.org/

Increasing shareholder engagement from institutional investors

Over the past several years, the strengthening of shareholder rights has become a decisive objective of a number of corporate governance-focused regulations around the world. The EU Shareholder Rights Directive II, which aims to further enhance shareholder rights such as, for example, information rights and voting rights, is a representative example of this regulatory trend. In force since early September 2020, this EU regulation triggers new requirements for issuers, institutional investors and asset managers[6] to ensure the effectiveness of shareholder rights. Proposed reforms that do not seek to enhance shareholder rights can lead to opposition campaigns from institutional investors and asset managers. For example, the final rules issued by the U.S. Securities and Exchange Commission (the "SEC") increasing the Rule 14a-8 thresholds requirements[7] for shareholder proposals and access to proxy materials received criticism from shareholders and institutional investors.[8] Similar strong objections[9] have been observed with respect to the recent US Department of Labor's proposed rule on "*Fiduciary Duties Regarding Proxy Voting and Shareholder Rights*", which states that "*plan fiduciaries [should] refrain from researching and voting on proposals that they prudently determine have no economic impact on the value of the plan's investment*".[10] In this respect, the public comments issued by the ICGN state that "*to propose that fiduciaries must weigh the cost of these engagements against their fiduciary duty (i.e., to ensure that plan assets are spent wisely for their beneficiaries) betrays an apparent misunderstanding by U.S. Department of Labor (DOL)/Employee Benefits Security Administration (EBSA) as to what engagement is and seeks to achieve [and] also suggests some ignorance of an increasing body of research establishing the economic value of environmental, social and governance (ESG) investing and reporting*" [11].

[6] For a country-by-country overview on the new requirements towards issuers: https://www.glasslewis.com/wp-content/uploads/2020/02/SRDII_Impact_on_Issuers.pdf

[7] See Press Release 2020-220, SEC Adopts Amendments to Modernize Shareholder Proposal Rule (Sept. 23, 2020), available at https://www.sec.gov/news/press-release/2020-220. See also: https://corpgov.law.harvard.edu/2020/10/12/sec-increases-rule-14a-8-thresholds/

[8] See statement from US SIF: The Forum for Sustainable and Responsible Investment: https://www.ussif.org/blog_home.asp?Display=150 and Y. Nili, "It is Not Just Small Investors Who Will Be Silenced Thanks to SEC's New Rules", Promarket - Stigler Center at the University of Chicago Booth School of Business: https://promarket.org/2020/11/04/small-investors-silenced-sec-new-rules-threshold/

[9] See the Council of Institutional Investors (CII)' public comments : "CII believes the Proposed Rule demonstrates an unwarranted prejudice against fiduciaries' exercise of shareholder rights and would impose such burdensome obligations on fiduciaries that ERISA plans would be effectively disenfranchised" (https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AB91/00028.pdf)

[10] https://www.federalregister.gov/documents/2020/09/04/2020-19472/fiduciary-duties-regarding-proxy-voting-and-shareholder-rights#footnote-17- p55221

[11] Under the new Biden administration, part or all of these regulatory changes may still be reversed.

The COVID-19 pandemic has also sharpened institutional investors' willingness to engage with companies across an increasing range of issues. BlackRock's annual stewardship report for the proxy season 2020 shows "*an increase (by) nearly half over the prior year*"[12] in terms of the number of corporate engagements: their investment stewardship team "*had over 3,000 in-depth conversations with corporate leadership [and] in more than 1,000 engagements on corporate strategy and 400 engagements on the impact of COVID-19, [and they] found many companies to be fundamentally re-examining their social and economic contract with their stakeholders*".[13] Some studies show that the number of shareholders resolutions withdrawn before the annual general meeting of shareholders decreased compared to the previous year: "*the number of proposals withdrawn during the 2020 season represents 15.5% of submitted proposals, compared to 26.4% in 2019 [which represents] a notable decrease in negotiated settlements in 2020 as compared to 2019*".[14] Other studies highlight that the opposition rate against executive pay has slightly increased.[15] Therefore, the recent increase in shareholder engagement includes both dialogue with boards of directors and the possibility of votes against management at AGMs.

Many institutional investors also report that their focus on climate change has become more significant over the past 12 months. We see this heightened focus in the increased number of corporate engagements with portfolio companies in climate-intensive industries,[16] requests to further report on climate risk management,[17] stronger support to climate-lobbying proposals[18] and even sometimes initiatives to file climate-change shareholder proposals.[19] The latter point can be illustrated by the success of the shareholder proposal asking Chevron, the US oil giant, for more climate disclosures. This proposal was filed by the institutional investor BNP Paribas Asset Management and won a majority support, including BlackRock Inc, the second main shareholder of Chevron, who backed the proposal.[20] We should therefore expect numerous COVID-19 impacts on proxy statements disclosures and disclosures in annual reports (e.g., around compensation, corporate governance, human capital, to name a few)[21] and a continued focus from investors on ESG issues in general.[22]

[12] https://corpgov.law.harvard.edu/2020/09/30/investment-stewardship-2020-annual-report/ ; BlackRock, Investment Stewardship Annual Report – Sept 2020, p. 5 and 12

[13] Same as above

[14] https://corpgov.law.harvard.edu/2020/10/01/2020-annual-corporate-governance-review/

[15] FTI Consulting/Proxy Insight, UK AGM Season 2020 Review & Highlights: https://fticommunications.com/wp-content/uploads/2020/09/UK-AGM-Season-2020-Review-Highlights_FTIandPI.pdf

[16] Vanguard, Investment Stewardship 2020 Annual Report, p. 6

[17] BlackRock, Investment Stewardship Annual Report, Sept. 2020, p.11

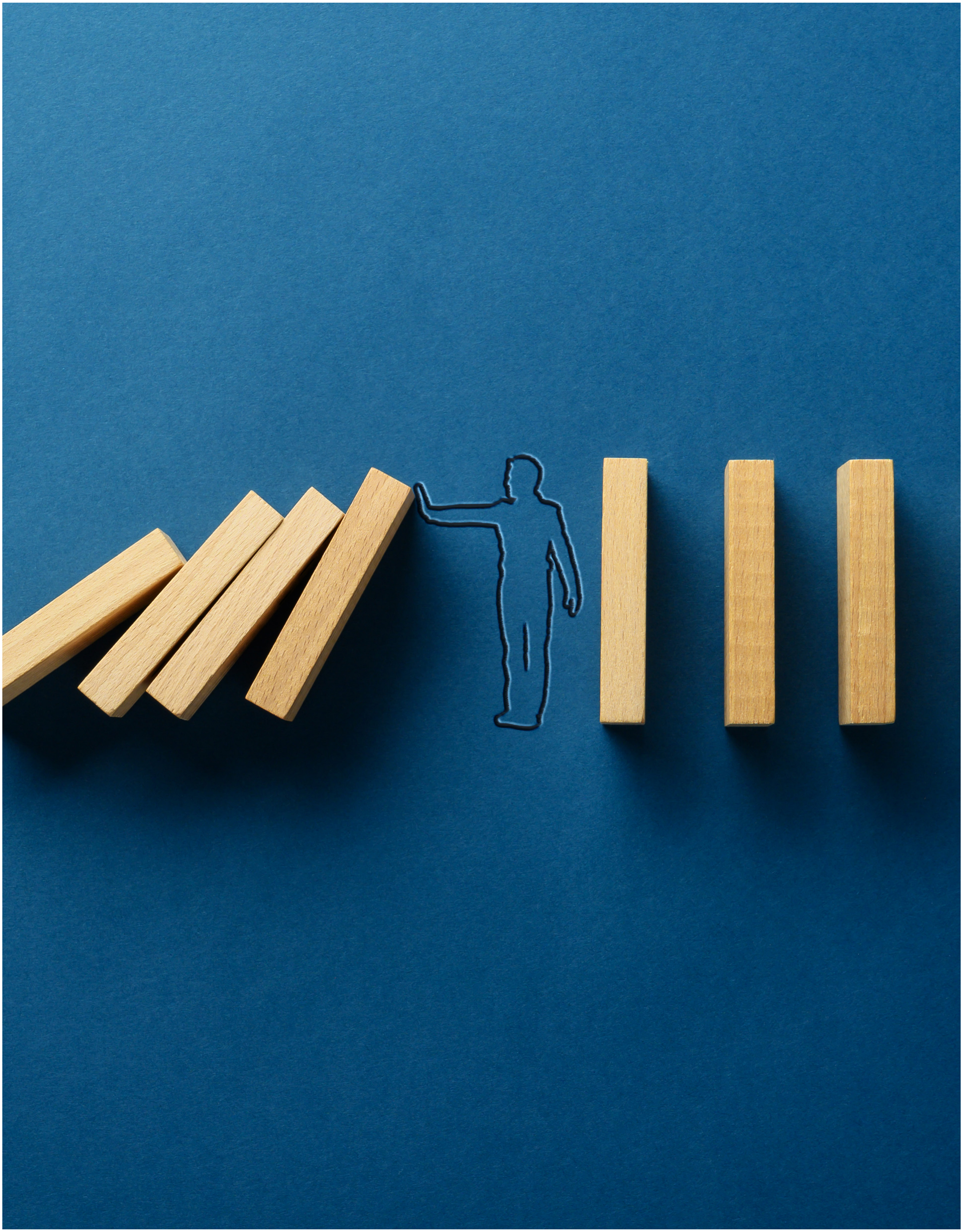
[18] State Street Global Advisors, Q2 2020 Asset Stewardship Activity Report, figure 2

[19] Climate Action 100+, Proxy Season 2020: https://climateaction100.wpcomstaging.com/proxy-season-2020/

[20] https://www.bloomberg.com/news/articles/2020-05-27/chevron-investors-back-proposal-for-climate-lobbying-report

[21] https://corpgov.law.harvard.edu/2020/10/15/2021-proxy-and-annual-report-season/

[22] https://corpgov.law.harvard.edu/2020/08/23/2020-proxy-season-a-look-back-and-a-look-forward/



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Evolution of Investor Stewardship

A recent proliferation of comply-or-explain stewardship codes in markets as diverse as Brazil, Japan and the Netherlands, along with the 2020 revision of the ground-breaking UK Stewardship Code,[23] make it clear that exercising stewardship responsibilities requires a thoughtful, holistic approach to risk management. High-profile audit failures, unjustifiable executive bonanzas, and social and environmental disasters continue to turn the spotlight on institutional investors, who must produce evidence to show that they are fulfilling their oversight roles responsibly.

Yet, stewardship cannot be reduced to a simple numbers game of which investors voted for or against the most proposals or engaged with the most companies. Best-in-class stewardship increasingly requires an investor to demonstrate a cohesive, principles-based approach to monitoring and acting on firm-specific and systemic risk across asset classes. It is also increasingly important that investors are prepared to show how the outcomes of key engagement and voting decisions improve sustainable financial or ESG performance. This requires a well-informed and nuanced approach that accounts for the individual characteristics of each company and issue. Aiming for the best outcomes also often requires some level of collaboration with other investors and relevant stakeholders in order to maximise impact.

While U.S. regulators push for a stewardship focus purely on fund-specific returns, European regulators are pushing the opposite direction, requiring increasing reporting and action from investors on ESG issues while accounting for a multi-stakeholder perspective. Regardless of very different global regulatory approaches to ESG risk management, it is clear that the COVID-19 pandemic has only accelerated investors' willingness to tackle ESG risk on both sides of the Atlantic.

All sides are in agreement that unmitigated ESG risk poses a threat to financial performance and shareholder value. This is nothing new; however, the crisis has—perhaps predictably—exposed the weakness of companies that have failed to prioritise critical issues such as human capital management or climate change mitigation. Future-proofing investment portfolios requires some level of assurance that investees are contributing to, rather than detracting from, the sustainability of market performance.

[23] https://www.frc.org.uk/investors/uk-stewardship-code

Renewed role for proxy advisors serving institutional investors

In the overall context of higher shareholder engagement, shareholders' use of proxy advisory firms has also increased markedly. Regulators have anticipated this trend through a number of legal and regulatory reforms which, depending on jurisdiction, have had a number of different effects. Under EU law, the Shareholders Rights Directive II (SRD II) requests more transparency from proxy advisors, notably through an annual report on the key elements of their methodologies, their sources of information and their policies on conflicts of interests[24] In the US, proposals have triggered both debate and opposition. On July 22, 2020, the SEC amended its rules governing proxy solicitations and proxy voting advice, requiring (i) the inclusion of proxy voting advice in the definition of proxy solicitation – with associated consequences in terms of possibly increased liability for proxy advisers and (ii) requiring procedures to make voting recommendations available to issuers in a timely manner.[25] In response, Institutional Shareholder Services("ISS"), another global proxy adviser, subsequently announced a lawsuit against the SEC.[26] Some representatives of leading institutional investors also publicly raised their concerns about the reform which "*could result in delays in distribution of proxy advice [...] and caus(e) uncertainty for institutional investors*".[27] It is worth noting here that ISS announced to all S&P 500 companies that they will no longer provide issuers with draft copies of ISS research reports prior to their publication for the upcoming 2021 proxy season, pointing to lobbying initiatives from some issuers.[28] The new SEC rule will require the same process to be applied after the transition period ending December 1, 2021 but, in this changing regulatory framework, S&P 500 companies will not benefit from the prior ISS practice next year.

In a regulatory environment where transparency seems to be valued more and more, the two largest proxy advisors both recently issued annual updates to their global proxy voting guidelines for 2021. For both Glass Lewis and ISS, doing so reinforces their standard processes whereby they request market participants to share their feedback on draft policies. However, whether we look at Europe or the US, common themes emerge: there remains a strong focus on board diversity (with new director withhold vote policies for lack of diversity), oversight of ESG-related risks, and say-on-pay proposals.[29] It is also important to note that market participants expect continuing COVID-19 specific guidance from proxy advisors in the upcoming AGMs season.[30] A recent PRI study also shows that 64% of investors surveyed found that COVID-19 brought new social issues to their attention (https://www.unpri.org/pri-blogs/covid-19-accelerates-esg-trends-global-investors-confirm/6372.article). This illustrates, once again, that the COVID-19 pandemic has acted as a catalyst for change, accelerating many underlying trends such as the digitization of the voting process and the inclusion of ESG factors in corporate governance decisions.

[24] Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement, art. 3j

[25] For the press release: https://www.sec.gov/corpfin/exemptions-proxy-rules-proxy-advice-secg. And for the rule: https://www.sec.gov/rules/final/2020/34-89372.pdf

[26] https://insights.issgovernance.com/posts/august-12-2020-statement-from-iss-president-ceo-gary-retelny/

[27] Council of Institutional Investors, Press release July 22, 2020: https://www.cii.org/july22_sec_proxy_advice_rules

[28] https://corpgov.law.harvard.edu/2020/11/25/sp-500-companies-no-longer-receive-drafts-of-proxy-advisory-reports-during-2021-proxy-season/

[29] https://corpgov.law.harvard.edu/2020/12/07/glass-lewis-and-iss-issue-final-2021-u-s-voting-policies/

[30] https://www.briefinggovernance.com/2020/09/iss-releases-2020-benchmark-policy-survey-results/

The Role of Proxy Advisors

Glass Lewis has been working with other leading proxy advisors to increase transparency of how the industry supports institutional investors in exercising their stewardship duties since the foundation of the Best Practice Principles Group for Shareholder Voting Research in 2013.[31] The comply-and-explain Best Practice Principles (BPP) were updated in 2019 to account for Shareholder Rights Directive II (SRD II) regulatory requirements and a public consultation; all signatories will soon provide expanded reporting on important topics such as research methodologies, conflict of interest management, and engagement according to the revised code.[32] The BPP emphasise that investors cannot outsource their fiduciary duties or stewardship responsibilities to a signatory. Ultimately, investors retain responsibility for monitoring investments, including making voting decisions.

Proxy advisors may support investor stewardship in different ways based on their diverse business models. It is important that any investor understands the different ways that firms can support their own stewardship efforts given the diversity of business practices. For example, one of the primary ways Glass Lewis supports investor stewardship is through customised voting policy implementation and reporting,[33] which is used by a supermajority of our clients in order to reflect their own views in voting decisions.

On the issuer side, Glass Lewis' research analysts engage directly with thousands of companies globally each year to understand the context of their unique ESG practices and to advocate for better public disclosure on material issues that are of importance to our investor clients. Uniquely among proxy advisors, Glass Lewis offers companies the opportunity to preview the company's data driving our recommendations and client policy implementation for free,[34] while also offering companies the opportunity to include their unedited opinions on our analysis directly in our Proxy Papers.[35]

Proxy advisors may also provide thematic research reports with or without voting recommendations, ESG data and ratings, engagement services, workflow tools and other stewardship support mechanisms for institutional investors. Given the constant evolution of the stewardship landscape, expect to see more innovation from the proxy advisory industry to meet investors' growing ESG needs.

[31] https://bppgrp.info/

[32] https://www.glasslewis.com/best-practices-principles/

[33] https://www.glasslewis.com/proxy-voting-policy-options/

[34] https://www.glasslewis.com/issuer-data-report/

[35] https://www.glasslewis.com/report-feedback-statement/

The post COVID-19 corporate governance arena is therefore very likely to present the following features, all of which bear watching:

- Regulatory frameworks all around the world requiring further transparency from companies and proxy advisors and further engagement from institutional investors
- Institutional investors incorporating more and more ESG considerations in their stewardship activities
- Proxy advisors diversifying their services to further address the ESG advisory needs of institutional investors
- Corporate governance regulations being revised to embed sustainability practices and monitor ESG reporting and advisory services in a consistent manner

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