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Corporate Governance Evolves Amid Increasing Sustainability Awareness

FOCUS/THEMES	INDUSTRIES/COMPANIES	COUNTRY/REGION
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Key Takeaways

- Major regulatory initiatives in Europe and in the United States could encourage the consideration of sustainability issues in boards of directors' decision making.
- A focus on stakeholders' interests is currently permitted by certain legislation. While this possibility exists in France and in the United States, only a few medium- and large-sized listed companies have opted for the so-called benefit corporation status.
- Investors' increasing awareness of sustainability issues also contributes to the evolution of issuers' corporate governance structures. Notable investor behavior in this area includes:
 - a. An increase in the number of Principles for Responsible Investment (PRI) signatories;
 - b. A growing proportion of global assets being managed according to sustainable investment strategies;
 - c. An increase in engagement activities focused on environmental and social issues; and
 - d. An increase in support for environmental and social shareholder proposals.
- Regarding evolution in issuers' governance practices, ISS data indicates:
 - a. An increase in the use of board-level sustainability committees;
 - b. A notable percentage of companies with at least one director with ESG skills;
 - c. Growth in the use of ESG metrics in executive compensation; and
 - d. The emergence of management-sponsored say-on-climate proposals.
- Lastly, the report highlights the importance of governance best practices in relation to shareholder rights, such as respecting the one-share, one-vote principle and maintaining a high-quality and accountable board, as these practices may also help companies to address environmental and social risks and seize emerging opportunities.



Introduction – Corporate Governance Models

The International Finance Corporation (IFC) defines corporate governance as "the structures and processes by which companies are directed and controlled."¹ Should companies be governed to maximize shareholder value, though, or should they consider the interests of a broader set of stakeholders? In recent years, boards of directors have been increasingly expected to consider stakeholders' interests in their decision making. This study's introductory section presents two governance models that would allow them to do so: the stakeholder model and the enlightened shareholder value (ESV) approach.

The Stakeholder Model

Professor Alex Edmans from the London Business School has been one of the most vocal advocates recently of the stakeholder governance model. He argues that CEOs should seek to maximize stakeholder welfare and that this should ultimately also benefit shareholders:

"A company may improve working conditions out of genuine concern for its employees, yet these employees become more motivated and productive. A company may develop a new drug to solve a public health crisis, without considering whether those affected are able to pay for it, yet ends up successfully commercializing it. A company may reduce its emissions far beyond the level that would lead to a fine, due to its sense of responsibility to the environment, yet benefit because customers, employees, and investors are attracted to a firm with such values. The pie can grow, to everyone's benefit. Conversely, a company that concentrates exclusively on short-run profit at the expense of stakeholders may end up shrinking the pie."²

Professor Lucian Bebchuk from the Harvard Law School presents a different view in a paper co-authored with Roberto Tallarita. The authors argue that executives have few incentives to protect stakeholders beyond what would serve shareholder value, and thus, acceptance of the stakeholder governance model should not be expected to have any meaningful benefits for stakeholders.

Bebchuk and Tallarita contend that the stakeholder governance model would insulate executives from shareholder oversight, which would hurt performance and reduce the pie available to both shareholders and stakeholders. They further suggest that the acceptance of the stakeholder governance model might delay or impede reforms that could bring more meaningful protection to stakeholders.³

The Enlightened Shareholder Value (ESV) Approach

The ESV approach can be seen as an intermediary solution between the shareholder governance model (focused on shareholder value maximization) and the stakeholder governance model (focused on the maximization of stakeholder welfare). Under this approach, CEOs should consider stakeholders' interests to the extent that doing so contributes to maximizing long-term shareholder

¹ "Corporate Governance: Overview," International Finance Corporation, accessed October 18, 2022,

https://www.ifc.org/wps/wcm/connect/Topics_Ext_Content/IFC_External_Corporate_Site/IFC+CG

² A. Edmans, "Company Purpose and Profit Need Not Be in Conflict If We 'Grow the Pie,'" *Economic Affairs* 40, no. 2 (2020), 287-294, accessed October 18, 2022, <https://onlinelibrary.wiley.com/doi/full/10.1111/ecaf.12395>.

³ L. A. Bebchuk and R. Tallarita, "The Illusory Promise of Stakeholder Governance," *Cornell Law Review* 106 (2020), 91-178, accessed October 18, 2022, <https://cornelllawreview.org/2020/12/01/the-illusory-promise-of-stakeholder-governance-2/>.



value. This principle is part of the 2006 United Kingdom (UK) Companies Act, which includes a non-exhaustive list of factors that directors should consider when making decisions, such as the "interests of the company's employees" and "the impact of the company's operations on the community and the environment."⁴

Professor Bebchuk has also criticized this alternative approach. In a paper co-authored with Kobi Kastiel and Roberto Tallarita, Bebchuk argues that the ESV approach is now broadly supported by corporate leaders and institutional investors. The paper authors contend, however, that the appeal of the ESV approach is grounded in a misperception of how frequent "win-win situations" are. They argue that contrary to this view, companies often face situations that present substantial trade-offs between shareholders' and stakeholders' interests. They conclude that, at best, replacing the shareholder model with the ESV approach would create neither value nor harm. As in their critique of the stakeholder model, they also argue that the acceptance of the ESV approach may delay or impede reforms that would truly protect stakeholders.⁵

Objective of the Review

This review's objective is not to opine on the governance models described above, but rather to provide an overview of the different changes taking place in the corporate governance landscape in light of increasing awareness of sustainability issues. While changes are taking place all over the world, this overview focuses on Europe and the United States. For better comparability, most of the quantitative analyses concentrate on the companies included in the Stoxx Europe 600 and the S&P 500 indices, which capture the largest listed companies in both regions.

Regulatory Initiatives

Part of the changes observed in corporate governance practices around the world can be tied to regulatory initiatives targeting both investors and corporate issuers. In 2021, ISS initiated a report series looking at the expansion of [sustainable finance regulation](#) worldwide. The [second edition](#) was published in October 2022. The report series shows that sustainable finance regulation has developed significantly across the globe, though European countries still have the lead in terms of the depth and breadth of regulatory initiatives. The reports cover topics such as ESG taxonomies, risk management, product standards, disclosures, labelling, stewardship, engagement, and green bond guidelines.

In this context, the section below focuses on regulatory initiatives targeting issuers. Several corporate governance regulatory initiatives point towards further integration of environmental and social factors into the governance structure of the organization in a manner consistent with the ESV approach described in the previous section.

⁴ "Companies Act 2006," UK Public General Acts, accessed October 18, 2022, <https://www.legislation.gov.uk/ukpga/2006/46/section/172>.

⁵ L. A. Bebchuk, K. Kastiel, and R. Tallarita, "Does Enlightened Shareholder Value Add Value?" *The Business Lawyer* 77 (2022), Forthcoming.

Europe

The European Union (EU) Proposal for a Directive on Corporate Sustainability Due Diligence (CSDD)

The aim of the EU's proposed CSDD directive is to regulate companies' sustainability due diligence, including directors' duty of care.⁶ The proposal requires companies to conduct [human rights](#) and environmental due diligence; to take appropriate measures to identify actual and potential [adverse impacts](#) in these areas; to prevent or mitigate potential adverse impacts; and to end actual adverse impacts (Art. 4 and Art. 6-8).

Companies are also required to have a plan to ensure that their business model and strategy are compatible with the objective of limiting global warming to a 1.5 degrees Celsius increase, in line with the Paris Agreement. This plan should be considered when setting variable compensation, if this type of compensation is linked to a director's contribution to the company's strategy and long-term interests (Art. 15).

The proposal also extends directors' duty of care. When fulfilling their duty to act in the best interest of the company, directors would have to consider their decisions' consequences for sustainability in the short, medium, and long term (Art. 25).

Several EU member states having recently implemented similar legislation, one proposal objective is to harmonize requirements for companies across the European Union. Annex 8 of the Impact Assessment accompanying the CSDD directive proposal provides an overview of laws and initiatives in the European Economic Area as of February 2022. Regarding corporate due diligence in the supply or value chain, France, The Netherlands, Germany, and Norway had already adopted laws; Austria, Belgium, Denmark, and The Netherlands were considering laws (or additional laws, in The Netherlands' case); and Finland, Italy, and Luxembourg had committed to introduce legislation.

Regarding directors' duty of care, France, The Netherlands, Ireland, and Portugal had already introduced laws requiring that stakeholders' interests be considered in corporate governance. Similar requirements were also expressed in the corporate governance codes of Belgium, Germany, Italy, and Spain.

Illustration: The French Pacte Law

Enacted in 2019, France's Pacte law requires that a company be managed "in its corporate interest, taking into consideration the social and environmental issues of its activity." In addition, the Pacte law allowed companies to amend their bylaws to specify a *raison d'être* ("a purpose"), "consisting of the principles which the company is endowed with and for the respect of which it intends to allocate resources in the performance of its activity."⁷ The law also introduced the legal status of *société à mission* ("benefit corporation"), which a company can claim if its bylaws include a *raison d'être* and specify one or several social and environmental objectives that the company intends to pursue.⁸

⁶ "Proposal for a Directive on Corporate Sustainability Due Diligence and Annex," European Commission, February 23, 2022, accessed October 18, 2022, https://ec.europa.eu/info/publications/proposal-directive-corporate-sustainable-due-diligence-and-annex_en.

⁷ "Article 1835, Code Civil," Legifrance, May 24, 2019, accessed October 18, 2022, https://www.legifrance.gouv.fr/codes/article_lc/LEGIARTI000038589926/.

⁸ "Article L210-10," Code Civil, Legifrance, May 24, 2019, accessed October 18, 2022, https://www.legifrance.gouv.fr/codes/article_lc/LEGIARTI000038528238/.

Two years after the enactment of the Pacte law, a [WEMEAN study](#) documented the options chosen by the main index (CAC 40) companies:

- 4 had inserted a raison d'être in their bylaws, including 1 which qualified as a société à mission;
- 1 had inserted a raison d'être in the preamble to its bylaws;
- 27 had claimed a raison d'être without amending their bylaws; and
- 8 had not disclosed any raison d'être.⁹

United States (U.S.)

The Securities and Exchange Commission (SEC) Proposed Rules on Climate-Related Disclosure

On the other side of the Atlantic, the SEC has proposed rules to improve and standardize climate-related disclosures. While the proposed EU directive (CSDD) would affect directors' duty of care, the SEC proposal focuses on disclosure and would thus only indirectly affect issuers' awareness of sustainability issues. Among other things, the proposal requires the disclosure of:

- "Any board members or board committees responsible for the oversight of climate-related risks";
- "Whether any member of a registrant's board of directors has expertise in climate-related risks";
- "A description of the processes and frequency by which the board or board committee discusses climate-related risks";
- "Whether and how the board or board committee considers climate-related risks as part of its business strategy, risk management, and financial oversight"; and
- "Whether and how the board sets climate-related targets or goals and how it oversees progress against those targets or goals, including the establishment of any interim targets or goals."

This proposal came a little less than three years after the Business Roundtable – an association of chief executive officers of leading US companies – released its new statement on the [purpose of a corporation](#), highlighting its members' commitment to serve the interests of all corporate stakeholders.

The proposal also shares similarities with the [General Requirements for Disclosure of Sustainability-related Financial Information](#) published by the International Sustainability Standards Board (ISSB). Like the SEC's proposed rules, ISSB's voluntary standards require the disclosure of the body responsible for overseeing sustainability risks and opportunities; how this body considers sustainability risks and opportunities when overseeing business strategy; and how this body ensures it has appropriate skills to perform its duties. These standards also require disclosing how the body oversees the setting of targets and monitors progress towards those targets, and how related performance criteria are included in executive compensation.

These voluntary standards would require a company to disclose "material information about all of the significant sustainability-related risks and opportunities to which it is exposed." The materiality assessment would be made "in the context of the information necessary for users of general-purpose financial reporting to assess enterprise value."

⁹ « Raison d'être et société à mission: Où en est le SBF120? » Étude WEMEAN, October 2021, accessed October 18, 2022, <https://www.wemean.com/livre-blanc-raison-etre-entreprise-sbf120/>.



These standards would thus embrace the concept of financial materiality, as opposed to the concept of double materiality. As discussed in a [perspective review](#) of the Global Reporting Initiative (GRI), double materiality encompasses financial materiality but also considers "information on the reporting company's impact on the economy, environment and people for the benefit of multiple stakeholders, such as investors, employees, customers, suppliers and local communities (impact materiality)." ISSB's approach to materiality appears consistent with a corporate landscape evolving more towards the ESV approach than the stakeholder governance model.

"Anti-ESG Investing" Laws

Although "anti-ESG investing" laws run contrary to the general direction of regulatory initiatives worldwide, the picture would be incomplete if such laws weren't mentioned. A [Responsible Investor article](#) from June 10, 2022 mentioned that the US state of West Virginia had implemented a bill allowing the state to deny banking contracts to financial institutions if these institutions were found to be boycotting energy companies. The article also mentioned that similar laws had been passed in Texas and Oklahoma, and that, in Idaho, legislation limiting ESG investments by state funds was set to be implemented on July 1. A [Reuters article](#) prepared by law firm Morgan Lewis and dated August 24, 2022, listed 21 anti-ESG bills in 16 US states as of August 15, 2022. At the other end of the spectrum, 13 state treasurers and New York City's comptroller issued a [statement](#) on September 14, 2022, voicing their discontent with the anti-ESG laws adopted in other states.

Regulatory Initiatives and Governance Models

While the anti-ESG laws enacted in several US states would support the traditional shareholder value model, the EU directive proposal, the French Pacte law, and the rules proposed by the SEC, among other laws and initiatives, could create an environment favorable to the acceptance of the ESV approach. The French Pacte law even goes one step further by enabling the adoption of the stakeholder governance model for companies choosing the quality of société à mission ("benefit corporation"). The number of medium and large listed companies having chosen this option remains limited, however. The benefit corporation status exists in the US as well, under Delaware law. As of February 2022, only 15 listed companies had chosen this status, though.¹⁰

Investors' Awareness of Sustainability Issues

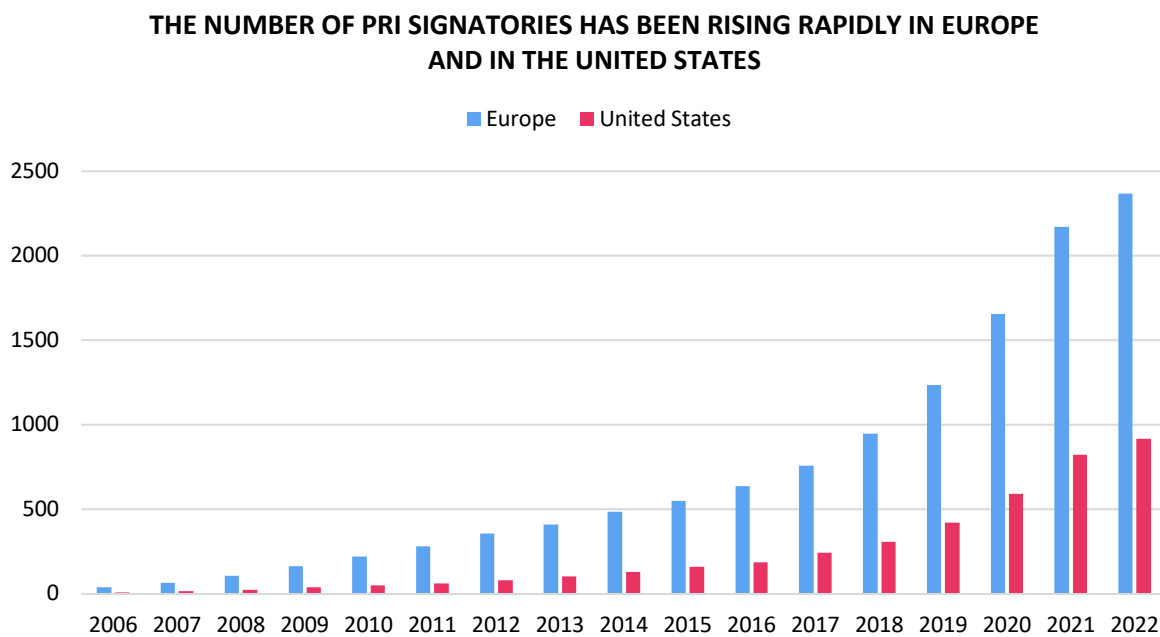
Along with regulatory initiatives targeting issuers, a second factor affecting the transformation of corporate governance structures is many investors' increasing awareness of sustainability issues. Such awareness has been driven by the evolution of investors' own regulatory environment and the investment preferences of their beneficiaries, as well as their own assessment of ESG risks and opportunities (cf. the ISS white paper titled [New Horizons: Navigating ESG in 2022](#)). In recent years, investors have been increasingly committed to integrating ESG factors into their portfolio construction and stewardship strategies.

¹⁰ Amy L. Simmerman, Ryan J. Greecher, and Brian Currie, "Converting to a Delaware Public Benefit Corporation: Lessons from Experience," Harvard Law School Forum on Corporate Governance, February 18, 2022, accessed October 18, 2022, <https://corpgov.law.harvard.edu/2022/02/18/converting-to-a-delaware-public-benefit-corporation-lessons-from-experience/>.

Commitments

The number of investors committing to managing money responsibly is increasing. The number of Principles for Responsible Investment (PRI) signatories has increased significantly in recent years in both Europe and the US. While growth has been steady since 2006, the number of signatories roughly doubled in both regions over the past three years. PRI is the world's leading proponent of responsible investment. PRI signatories acknowledge their duty to act in the best long-term interests of their beneficiaries. Among other things, they commit to incorporate ESG issues into investment analysis, to be active owners, and to consider ESG issues in their ownership practices.

Figure 1: Evolution of the Number of PRI Signatories (Investment Managers and Asset Owners)



Source: www.unpri.org, as of June 30, 2022

Another form of commitment towards managing assets more responsibly is the hiring of additional ESG specialists. A [Financial Times article](#) dated March 8, 2020, showed that the number of stewardship professionals employed at leading asset managers almost doubled between 2017 and 2020, and that the number of people working in other dedicated ESG roles almost quadrupled over the same period.

Sustainable Investment Strategies

The proportion of global assets managed following sustainable investment strategies is growing. According to the latest [Global Sustainable Investment Review](#) published by the Global Sustainable Investment Alliance (GSIA), these assets represented \$35.3 trillion in 2020, which is 15 percent more than in 2018. These assets also represented 36.9 percent of global assets under management in 2020, up from 33.4 percent in 2018.

The GSIA review covers five regions (Europe, the US, Canada, Australasia, and Japan) and seven sustainable investment strategies. Investors may implement several of these strategies simultaneously. Ranked in ascending order of assets managed in 2020, these strategies are:

- Impact/community investing (\$352 billion),



- Positive/best-in-class screening (\$1,384 billion),
- Sustainability-themed investing (\$1,948 billion),
- Norms-based screening (\$4,140 billion),
- Corporate engagement and shareholder action (\$10,504 billion),
- Negative/exclusionary screening (\$15,030 billion), and
- ESG integration (\$25,195 billion).

In 2020, the US represented the largest share of global sustainable investments (48 percent) followed by Europe (34 percent). In the US, the proportion of assets managed following sustainable investment strategies increased from 25.7 percent in 2018 to 33.2 percent in 2020. In Europe, this proportion decreased from 48.8 percent in 2018 to 41.6 percent in 2020. The review's authors noted, however, that Europe enacted significant changes in the way sustainable investment is defined, which makes historical comparisons difficult for this market.

As sustainable investment strategies grow in popularity, regulators perceive [an increasing risk of greenwashing](#) (that is, intentionally or unintentionally marketing investment products as more green or sustainable than they are). Tackling this issue is part of the European Securities and Markets Authority (ESMA)'s roadmap for 2024. The SEC has also issued proposals to tackle greenwashing. More information about these regulatory initiatives can be found in the ISS publication [The Depth & Breadth of Sustainable Finance Regulatory Initiatives: Global Developments in 2022](#). It is worth noting that greenwashing by corporate issuers is also on regulators' radar.

Stewardship Practices

Many leading asset managers have been improving their reporting related to engagement efforts, demonstrating increasing engagement activity, notably with regards to environmental and social (E&S) issues.

Stewardship practices were covered by the [EU revised Shareholder Rights Directive \(SRD II\)](#), which took effect in June 2017 and had to be transposed into local laws by June 2019. Article 3g of this directive required that investors disclose how they monitored investees on different matters, including non-financial performance and risk, social and environmental impact, and corporate governance. Investors would also have to disclose how they conduct dialogues with investee companies and how they exercise their voting rights. They would also need to disclose on an annual basis how they implemented their engagement policy, including a description of their voting behavior. All these provisions should be applied on a comply-or-explain basis.

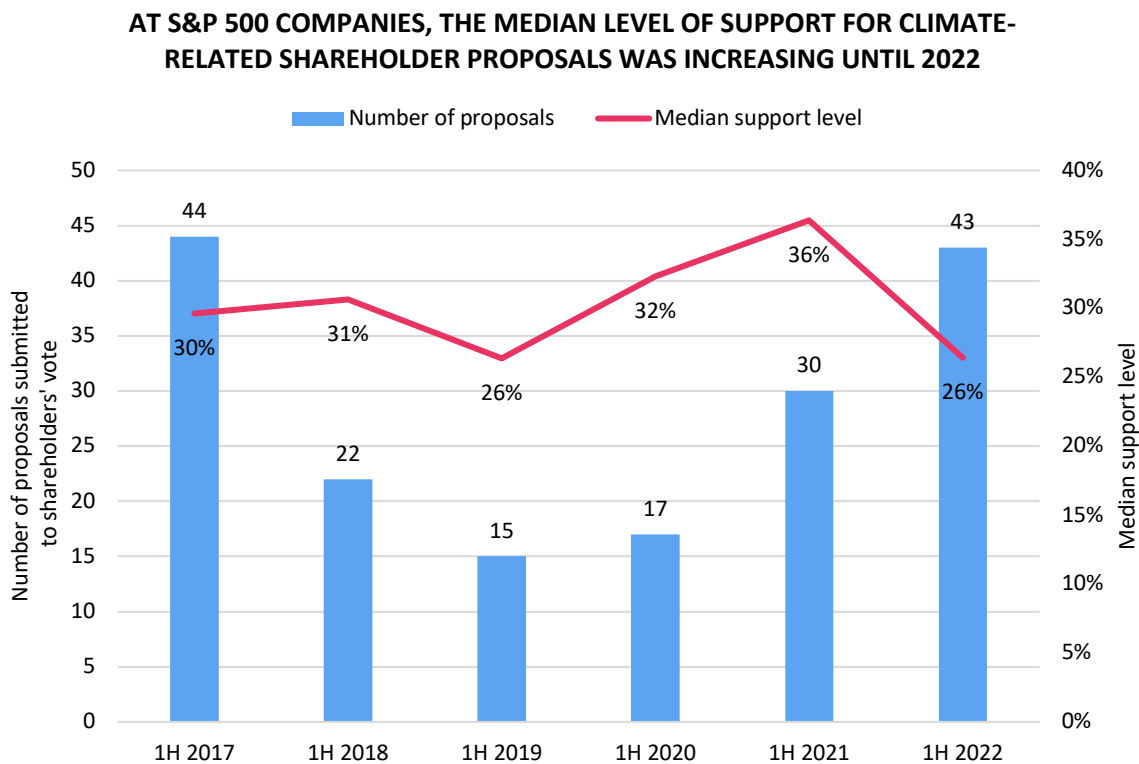
Beyond individual investors' stewardship reports, increasing engagement efforts related to climate change can also be observed from the Progress Update reports of the investor-led [Climate Action 100+](#) initiative. Investors participating in this initiative commit to engage with the world's largest greenhouse gas emitters to improve climate change governance, cut emissions, and strengthen climate-related financial disclosures. In 2021, this initiative comprised 615 signatories managing \$65 trillion, up from 373 signatories managing \$35 trillion in 2019.

Investors' increasing awareness of sustainability issues is also reflected in their voting practices, which represent a significant part of their engagement and stewardship efforts. [ISS Research](#) shows that the median rate of support on US E&S shareholder proposals increased from 22-23% between 2013 and 2017 to 25-28% between 2018 and 2021. High levels of support were observed on shareholder proposals covering a range of topics from human capital management to climate issues.

The median level of support for climate-related shareholder proposals submitted at large US companies (S&P 500) reached a five-year high of 36 percent in 2021, before decreasing to 26 percent in 2022. In the US shareholder proposal process, issuers have the option to ask the SEC to omit certain shareholder proposals from the annual general meeting ballot. After the change in the US administration in January 2021, however, the SEC decided to allow for significantly fewer climate-related proposals to be omitted from ballots. This might explain the 2021 increase in climate-related shareholder proposals.

The more recent decrease could be at least partly explained by the prescriptive or constraining nature of some of the shareholder proposals submitted in 2022. As discussed in a recent study from ISS Corporate Solutions titled [The Rise of Say on Climate Proposals](#), the lower level of support observed in 2022 may also result from growing engagement between issuers and investors.

Figure 2: Evolution of the Number of Climate-Related Shareholder Proposals and Median Level of Support in the US



Source: ISS Research and ISS Voting Analytics. Data from the first half of the calendar year.

The dynamics are different in Europe. Historically, fewer climate-related shareholder proposals have been filed in Europe compared to the US. The minimum shareholding requirement for placing items on the agenda is lower in the US than in most European countries.¹¹ In Europe, management-sponsored climate-related proposals have emerged in recent years, to some extent replacing shareholder climate-related proposals. Further details about this emerging corporate governance practice are included in the following section of this report. ISS also published a detailed review of [climate-related voting trends](#) earlier this year.

¹¹ "OECD Corporate Governance Factbook 2021," OECD, June 30, 2021, accessed October 18, 2022, <https://www.oecd.org/corporate/corporate-governance-factbook.htm>, p. 75.

Figure 3: Evolution of the Number of Climate-Related Proposals in Europe



Source: ISS Research and ISS Voting Analytics. Data from the first half of the calendar year.

Investors are also voicing their concerns on E&S issues by means other than E&S proposals. Some investors will (when E&S proposals are not on the ballot, for example) also vote against director elections and/or other items.

Recent Developments in Issuers' Practices

With regulatory initiatives and evolving investor stewardship practices in the background, many issuers' awareness of sustainability challenges has been on the rise, leading to evolutions in governance practices, such as the establishment of board-level sustainability committees, the inclusion of ESG metrics in executive compensation, and the emergence of management-sponsored say-on-climate proposals.

Board-Level Sustainability Committees

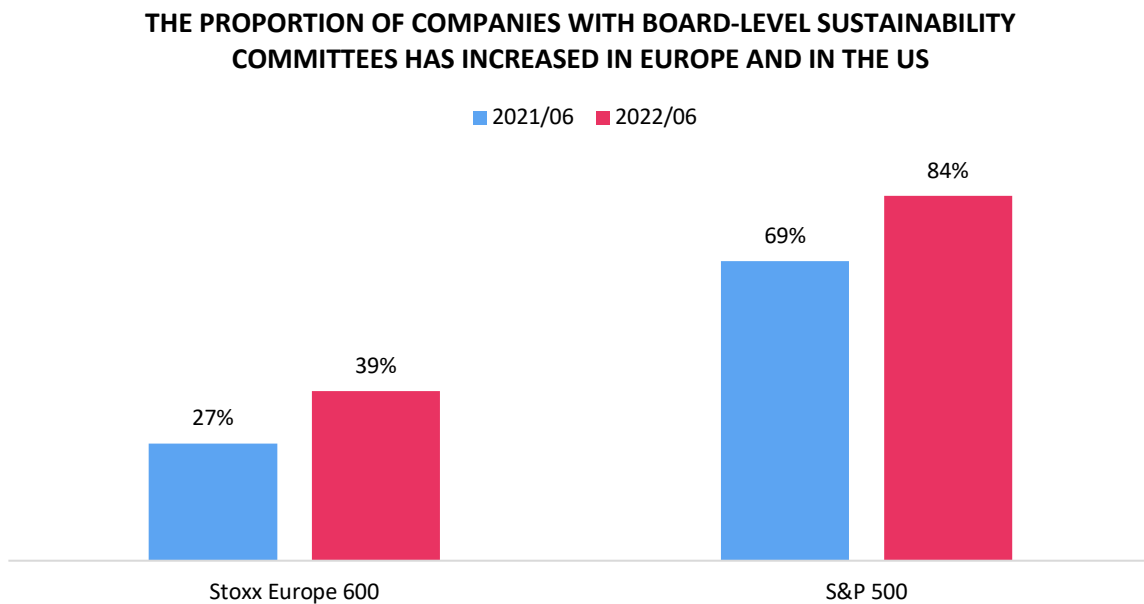
An increasing number of companies are disclosing that their boards of directors delegate ESG oversight to specific board-level committees.

In 2021, the International Finance Corporation (IFC) published a [guidance paper](#) to help boards oversee E&S issues using board-level sustainability committees. Importantly, the IFC notes that governance is the legal duty of the board, which is accountable for the company's actions, including in relation to sustainability. While the board may delegate the oversight of sustainability issues to a committee, it remains accountable for the company's actions. Sustainability committees may be set up at the management and/or board level. A company may either establish a standalone sustainability committee or give additional responsibilities to one or more existing committees.



ISS data suggest that 39 percent of Stoxx Europe 600 companies and 84 percent of S&P 500 companies had established a sustainability committee by the end of June 2022, and that these proportions were higher than in the previous year. These numbers include companies that have set up a standalone sustainability committee and companies that have tasked other committees with sustainability oversight. The latter scenario may sometimes be more difficult to assess, and the actual proportion of companies having tasked a committee with ESG oversight might be even greater than the percentages captured in the figure below.

Figure 4: Evolution of the Proportion of Companies with Board-Level Sustainability Committees



Source: ISS Governance QualityScore, Q396. Data as of June 30 of each year.

In the US, tasking a board committee with ESG oversight increasingly represents standard market practice. An EY review of the [2021 proxy season reports](#) that 85 percent of Fortune 100 companies disclosed that a board committee oversaw sustainability matters in 2021, up from 78 percent in 2020. This study also shows that only 11 percent of Fortune 100 companies have a standalone sustainability committee. In most cases (53 percent of the universe), sustainability oversight is attributed to the nominating/governance committee. In the remaining cases, the role is attributed to other existing committees.

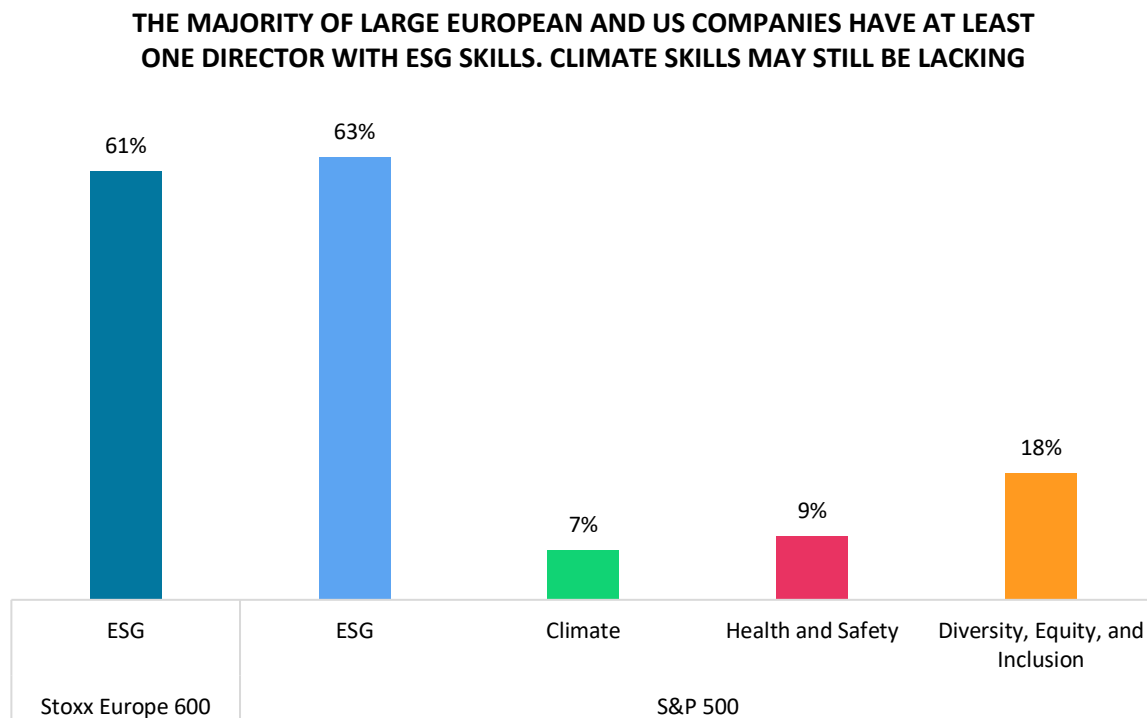
The practice has also gained in popularity in Europe. An [article](#) by Mattison Public Relations from September 5, 2022 reports that 54 percent of large UK companies (FTSE 100 index constituents) had an ESG committee at board level in 2022. According to IFA and Ethics & Boards' [latest review](#) of French boards of directors, 64 percent of medium and large French companies (SBF 120 index constituents) had a board committee tasked with ESG oversight in 2021, up from 47 percent in 2019, and 32 percent in 2017. In 2021, 26 percent of the SBF 120 companies had a standalone sustainability committee and 38 percent tasked an existing committee with ESG oversight. A related development in France has been the designation by a few companies of a lead climate director in charge of climate and environmental issues.

Directors' ESG Skills

With a growing number of boards willing to consider stakeholders' interests in their decision making, directors with ESG skills are becoming increasingly sought after.

ISS data show that roughly 60 percent of large European and US companies had at least one director with ESG skills (as per their own disclosure) in August and September 2022. More granular data, available for only the S&P 500 at the time of this study, show that just 7 percent of these companies had at least one director with climate-related skills.

Figure 5: Proportion of Companies with at Least One Director Having Specific ESG Skills



Source: ISS Director Data. Stoxx Europe 600 data as of August 2022. S&P 500 data as of September 2022.

The IFC guidance paper mentions that sustainability committee members should have skills extending across a diverse range of matters; that they should have a broad understanding of how sustainability issues affect the company's strategy, risk, and opportunities; and that they should be able to challenge the information that they receive. The IFC also notes that due to the challenges of finding members with such a diverse skill set, access to outside partners can be important to supplement internal expertise.

A Responsible Investor [article](#) from May 3, 2022 highlighted the need for climate-related skills on boards to deliver on Net Zero commitments. This article argued that boards would need a significant scaling up in director skills and/or need to be open to hiring candidates from different talent pools. In this context, the Climate Governance Initiative and its local networks (Chapter Zeros) have been seeking to build communities of non-executive directors and equip them with the proper tools to lead discussions on the impact of climate change.

ESG-Linked Compensation

Sustainability committees and directors with ESG skills may also help compensation committees to integrate E&S considerations into executive remuneration. Such integration is part of the requirements included in the new EU directive proposal (CSDD). It is also considered in the voting policies of certain asset managers.

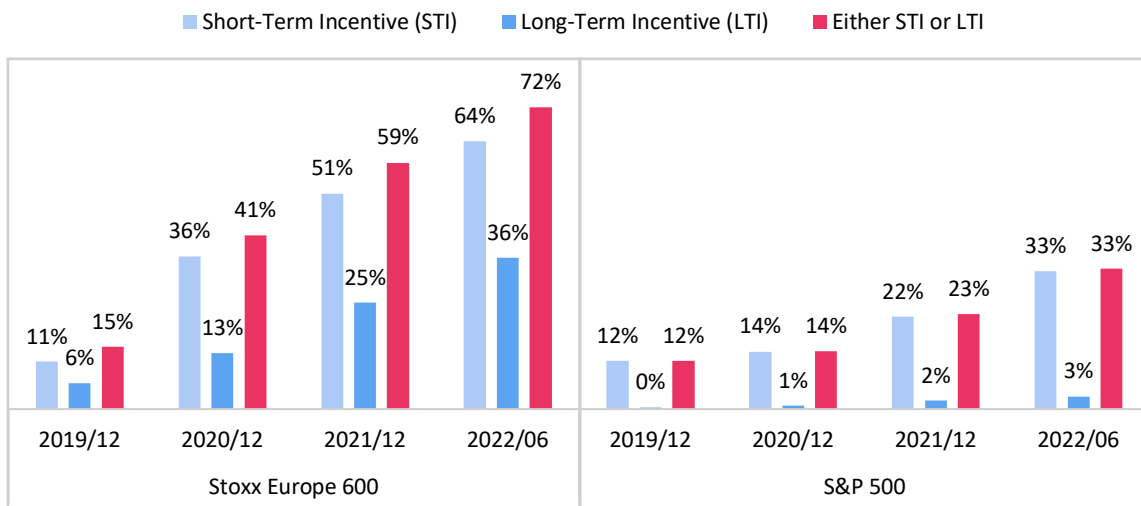
The use of ESG metrics in executive compensation is growing rapidly among large European firms and their US counterparts. In Europe, this has become standard market practice. As of June 2022, the proportion of Stoxx Europe 600 companies that include ESG metrics in executive compensation was 72 percent, more than double the corresponding proportion at S&P 500 companies.

Differences in hard and soft law may provide some explanation for this finding. As discussed in previous sections of this report, the consideration of stakeholders' interests in board decision making is foreseen in the law and/or the local corporate governance code in several European countries, including the UK, the Netherlands, France, Germany, Spain, and Italy.

Another notable geographic difference is that European companies include ESG metrics in short-term incentives and long-term incentives while US ones currently prefer to focus on short-term incentives. Long-term incentives in the US are typically a much larger proportion of total compensation than they are in Europe, while the inclusion of ESG criteria in executive compensation is still a developing practice in the US.

Figure 6: Percentages of Companies Including ESG Metrics in Executive Compensation

THE USE OF ESG METRICS IN EXECUTIVE COMPENSATION IS GROWING IN EUROPE AND IN THE US



Source: ISS Governance QualityScore, Q394 and Q395. Data as of June 30 or December 31 of each year.

A [study](#) by ISS Corporate Solutions focusing on European companies further showed that in 2018 ESG metrics included in executive compensation were mainly related to social matters, but that the share of environmental metrics had been increasing over the following three years.

As can be seen from the chart above, the use of ESG-linked compensation by a broad number of companies is still a relatively new practice. An amendment to the French Corporate Governance Code (Afep-Medef) from June 2018 recommended that companies include one or more ESG criteria



in the variable compensation of their executives. Following this amendment to the local corporate governance code, many companies started implementing changes in their remuneration programs, often using poorly defined ESG metrics. Over the years, the practice has become more mature, however, and ESG criteria now tend to be better aligned with corporate strategy.

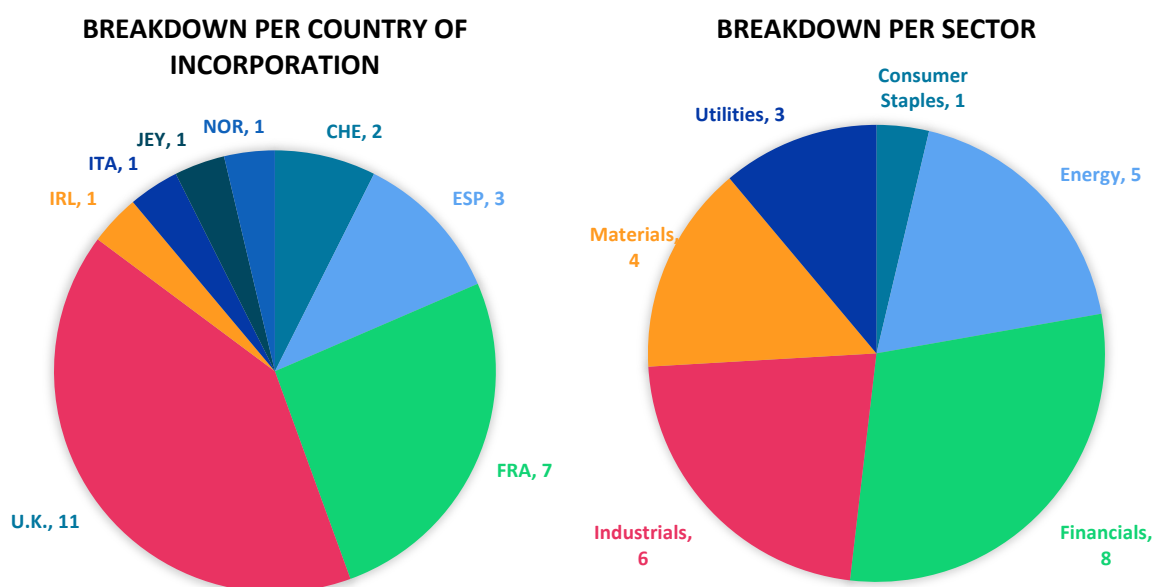
The SEC adopted pay versus performance disclosure rules on August 25, 2022. Issuers will be required to disclose information about their total shareholder returns, their net income, and the financial measure that they would consider to be the most important to link executive remuneration to company performance. Issuers would also need to provide a list of three to seven indicators that they consider to be most important in linking remuneration and corporate performance. Issuers are allowed to include non-financial performance measures in this list. These rules will apply as soon as 2023.

Management-Sponsored Say-On-Climate

Another recent development in issuers' corporate governance practices is the emergence of management-sponsored say-on-climate proposals, mainly in Europe. In the last two years, Stoxx Europe 600 companies submitted 40 proposals of this type to shareholders' vote (13 in 2021 and 27 in 2022). While until 2021, say-on-climate shareholder resolutions were brought up by activist funds and generally opposed by management, there is now a trend of companies proposing advisory votes on their companies' own climate strategies.

The 27 proposals presented in 2022 came from 27 different companies. The majority of proposals were submitted in the UK and in France. Most of them were presented by companies operating in carbon-intensive sectors or in the financial sector.

Figure 7: Number of Stoxx Europe 600 Companies Having Presented a Say-on-Climate in 2022



Source: ISS Research and ISS Voting Analytics. Data from the first half of the calendar year.

While all these proposals were approved by comfortable margins, six of them were supported by less than 80 percent of the votes cast in 2022, signaling some level of discontent on the part of investors.



The Role of Traditional Corporate Governance Elements

While new corporate governance tools such as board-level sustainability committees and ESG-linked compensation may help companies to better address E&S risks and opportunities, traditional corporate governance elements remain equally important and warrant continued attention.

Shareholder Rights

Stronger shareholder rights (e.g., respecting the one-share, one-vote principle, avoiding voting caps, or easing the submission of shareholder resolutions and the dismissal of directors) may foster better E&S performance by giving greater voice to minority shareholders and improving director accountability. A Responsible Investor [article](#) from June 1, 2022 discusses how dual-class shares may have helped large US technology firms to fend off shareholder proposals related to the social issues facing the industry.

While investors overwhelmingly prefer the one-share, one-vote capital structure, one needs to acknowledge the counterargument often put forward by proponents of the dual-class share structure (and of other multiple-class share structures): control is necessary to protect the company from short-term market pressures and to allow management to focus on its long-term strategy. Following this line of thought, short-term market pressures could also be detrimental to the execution of a firm's sustainability strategy.

ISS data, however, support the concerns raised in the Responsible Investor article previously cited. Based on data extracted on September 19, 2022, 40 US companies in the Interactive Media & Online Consumer Services industry (applying the ISS ESG Corporate Rating industry classification) are covered by both ISS' [Governance QualityScore](#) and ISS' [ESG Corporate Rating](#). The former solution allows us to identify which companies have classes of shares with different voting rights. The latter provides a Social Rating, which ranges from 1 to 4, where 1 is poor, 4 is excellent, and 2.5 represents the threshold for good performance. There are 16 companies that maintain classes of shares with differential voting rights. The median Social Rating for these companies is 1.58, compared to 1.66 for the other US companies in the same industry. Thus, while the social performance of US companies in this industry is generally poor, it is even worse for companies that maintain classes of shares with differential voting rights.

Table 1: Capital Structures and Social Ratings in the US Interactive Media & Online Consumer Services Industry

CAPITAL STRUCTURE	NUMBER OF COMPANIES	MEDIAN SOCIAL RATING
One class of shares (1 share = 1 vote)	24	1.66
Multiple classes of shares	16	1.58

Source: ISS Governance QualityScore Data and ISS ESG Corporate Rating. Data as of September 2022

Board Quality and ESG Performance

Several board attributes may also impact a company's ESG performance. For instance, some academic research has found a positive relationship between environmental performance and board

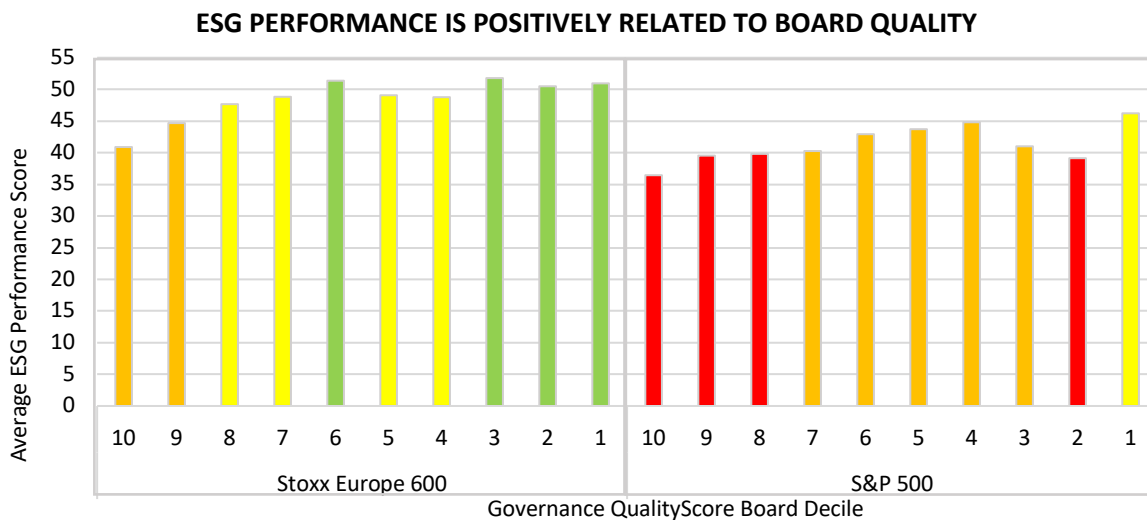


independence.¹² ISS data shows a positive relationship between ESG performance and board quality for companies included in the Stoxx Europe 600 index and the S&P 500 index.

ESG performance is measured using ISS' ESG Performance Score, which is a normalized version of the ISS ESG Corporate Rating that considers the company's exposure to ESG risks. This metric ranges from 0 to 100. A score equal to or above 50 means that the company fulfills ambitious performance requirements regarding the most material ESG issues, considering its individual risk exposure.

Board quality is measured using ISS' Governance QualityScore board decile, which considers dimensions such as board composition, policies, practices, and controversies. These decile scores provide an indication of risk relative to regional peers. A score of 1 corresponds to the lowest level of risk. While ISS' ESG Corporate Rating also considers board composition, the weight of this element in the overall ESG performance assessment is not large enough to explain the differences observed in the charts below.

Figure 8: Average ESG Performance Score per GQS Board Decile



Source: ISS Governance QualityScore and ISS ESG Corporate Rating. Data as of Aug. 17, 2022

The charts do not show a perfect correlation between ESG performance and board quality, but this is not unexpected given that the samples include companies with different business models. The European sample also includes companies from different countries. Lastly, even within groups of similar companies, there may still be heterogeneity in boards' perceptions of the optimal level of ESG performance.

ESG performance is generally higher at large European firms than at their US counterparts. Only the poorest-performing European companies, as measured in terms of board quality, are significantly below the 50-threshold in terms of ESG performance. The relatively greater depth and breadth of sustainable finance regulation in Europe may provide a partial explanation for this finding (see related [ISS Research](#) on this matter). The [EY CEO Survey 2022](#) also notes that, while globally some investors may have reservations, Eurozone investors are generally more supportive of CEOs investing in environmental sustainability.

¹² C. de Villiers, V. Naiker, and C. van Staden, "The Effect of Board Characteristics on Firm Environmental Performance," *Journal of Management* 37, no. 6 (2011), 1636-1663, accessed October 18, 2022, <https://journals.sagepub.com/doi/abs/10.1177/0149206311411506>.

Conclusion

This review has documented some of the major changes taking place in the corporate governance landscape pursuant to the growing awareness of sustainability challenges among corporate issuers, investors, legislators, and society at large. The review has also stressed the importance of traditional corporate governance dimensions such as shareholder rights and board attributes to address E&S issues.

Important regulatory initiatives are still at the proposal stage, and their evolution will warrant attention. Directors' ESG skills, the use of ESG criteria in executive compensation, and votes on companies' climate strategies will also remain important topics in coming months and years.

Investors can leverage the data used in this study to analyze how issuers incorporate sustainability matters into their corporate governance structures. ISS [Governance QualityScore](#), [Director Data](#), and [Executive Compensation Data](#) can help investors identify companies that have a board-level sustainability committee, have directors with specific ESG skills, and/or include ESG metrics in executive remuneration. The ISS [ESG Corporate Rating](#) can also be used to take a direct look at companies' ESG performance. The same data can be useful for corporate issuers seeking to benchmark their practices.

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