AN FTI CONSULTING REPORT

2022 AGM Season Preview

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Introduction and Review of 2021

Following a 2020 year marked by the Covid-19 pandemic and national lockdowns, extreme weather catastrophes and the rise of social justice movements, the 2021 proxy season was aligned with wider trends as it was part of the shift in perceptions about the intersection between business and society. Companies, globally, were held accountable by their shareholders on a broad scope of topics from climate change, to diversity, equity and inclusion (DEI), to the management of stakeholder relationships when evaluating executive remuneration.

From a social perspective, the unrest and protests over racism and inequity that took place in 2020 led to an increased focus on diversity beyond gender from investors, resulting in eight of the largest US financial institutions facing shareholder proposals seeking racial equity audits to be conducted. In the UK, the Investment Association (IA) announced at the start of 2021 its expectation for FTSE 350 companies to disclose the ethnic diversity of their boards or the commitment to an action plan to address this issue. With 2021 marking the start for many investors' campaigns towards more ethnically diverse boards, we expect 2022 to be the year where these discussions are embedded in engagement practices, before gradually impacting proxy votes.

On the environmental front in 2021, climate concerns dominated the agenda for companies, investors and regulators. The number of climate related proposals continued to increase across the US and Europe, with investors signalling their willingness to support environmental and social (E&S) resolutions at unprecedented levels.[1] Furthermore, as a result of improved reporting and ongoing engagement on these matters, shareholders' expectations have also evolved towards clearer, and more meaningful, climate goals and disclosures based on the latest science. While often the subject of criticism for lack of action, some of the outcomes from COP26 have the potential to reshape the global approach to climate action and will start to impact the way in which companies operate. The role and expectation of banks, and the broader financial services industry, in the transition to net zero was further defined with the creation of the Glasgow Finance Alliance for Net Zero (GFANZ) in May 2021, and during COP26 committed $130 trillion of private capital to transforming the economy by 2050.

1 Between 2020 and 2021, increase in support on environmental and social proposals in Europe and the US increased by 3.79%, as per data collected from company filings

From a strategy and reporting perspective, the formation of the International Sustainability Standards Board (ISSB), which aims to set the framework for a single international standard for sustainability reporting, responded to calls for consistency in the requirements on companies to disclose ESG and sustainability information to the market and wider stakeholders.

As these disclosure frameworks evolve, ensuring and showcasing that strong governance and oversight structures are in place remains a priority. Boards are being called upon to play a more active role of oversight across a broader range of topics outside the traditional focus on financial statements and strategy, with workforce engagement, climate strategy and disclosures, and company culture being included as key issues for board discussions. Nonetheless, despite the ratcheting up of the scrutiny on ESG and sustainability, it remains likely that the most contentious issues during the 2022 AGM season will remain the more "traditional" ones:

- Independent oversight on boards and committees
- Director time commitments
- Quantum of remuneration; and alignment with pay and performance
- Responsiveness to shareholder voting

Ultimately, in the hierarchy of proxy voting and engagement concerns, despite ESG moving up the agenda, investor voting is still likely to focus on the governance themes of oversight, accountability, transparency and alignment of stakeholder interests.

Against the backdrop of a rising focus on E&S matters, as companies prepare for the 2022 AGM season, and finalise reporting and engagement strategies, we look at the most recent guideline updates for the leading proxy advisors, Glass Lewis and ISS. From the investor perspective, we analyse the key topics that were part of BlackRock and State Street's letters to the CEOs of their investee

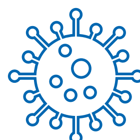
companies, as well as proxy voting guideline updates for the world's three largest asset managers: BlackRock, State Street and Vanguard. The alignment in expectations across these different players this year is unprecedented, reflecting the feeling that significant action is needed from companies, investors, and regulators to address the most pressing E&S issues affecting our society.

Key topics in guideline updates

1. **Remuneration:**
   a. Covid-19 and the stakeholder experience
   b. Remuneration committee performance and accountability
   c. E&S metrics in remuneration
   d. Other temuneration considerations and guideline updates from the Investment Association
   e. Pension alignment
2. **Diversity**
   a. Gender diversity
   b. Ethnic diversity
   c. Board oversight of human capital
   d. Directors' time commitments
3. **Board oversight of E&S issues**
   a. Oversight of environmental considerations
   b. Investor expectations on TCFD reporting
   c. Oversight of human capital
4. **Climate proposals voting guidelines and approach**
   a. 'Say on Climate' proposals and management supported climate proposals
   b. Biodiversity considerations

1. Remuneration

While the proxy voting world clamours to further integrate ESG considerations into engagement and voting strategies, it would be remiss of companies to fail to address what likely remains the most contentious issue annually, that of pay. The Glass Lewis and ISS principles of remuneration are guided by the Principles of Remuneration of the IA. In the revision of its remuneration principles, the IA reminded Remuneration Committee chairs that *"The past year and the continuing response to the Covid-19 pandemic has presented challenges for companies, employees, investors, and wider society"*, and for this reason in its updated principles of remuneration, it maintains a continued focus on the overall stakeholder experience.



a) Covid-19 and the stakeholder experience

The last year was characterised by the importance of restraint, and the wider shareholder and the stakeholder experience. The updated Principles of Remuneration of the IA reflect the increasing expectation on remuneration committees to challenge management around workforce pay and policies, including lower paid workers and driving diversity strategies. In April 2020, the IA provided guidance related to setting and amending executive pay practices during the pandemic, and asked remuneration committees to ***"sensitively balance the need to incentivise executives at a time when they are being asked to show significant leadership and resilience, while being mindful of the effect the pandemic is having on shareholders, employees and other stakeholders"***.

In its most recent Principles of Remuneration update (November 2021), the IA establishes that these considerations will continue to be a critical investor expectation *"as the effects of the pandemic and its aftermath are felt"*. It specifically calls for issuers who have not yet repaid government support received during Covid-19 to show restraint and not to pay annual bonuses where the situation remains unchanged.

b) Remuneration committee performance and accountability

As scrutiny increases on topics related to executive remuneration, the role of the Remuneration Committee becomes increasingly important. Remuneration Committee Chairs are responsible for ensuring that the remuneration policy appropriately aligns executive directors' interests with the company's long-term growth vision, and ultimately shareholder interests.

Glass Lewis sets out in its updated guidelines that it will recommend a vote against the Chair of the Remuneration Committee in cases where pay is excessive relative to financial performance; particularly if performance goals were inappropriately changed, or when the remuneration policy fails to show alignment with company performance. This update is largely formalising an approach that was already being carried out.

c) ESG metrics in remuneration

As more companies include metrics related to the management of material ESG risks and opportunities into their long-term strategy, Remuneration Committees should be incorporating the management of these material ESG risks as performance conditions in the company's variable remuneration.

'We highlight that if environmental, social, and governance (ESG) criteria are included in executive compensation programs, those metrics should be rigorous, aligned with a company's strategy and business model, and linked to company performance.'

BlackRock's 2022 policy updates

The IA expects issuers to select ESG metrics that are quantifiable, reflect a clear link with company strategy, and that are accompanied by appropriately stretching performance targets. As with any other performance metric, Remuneration Committees are expected to provide rationale for the selection of different ESG metrics or explain how they plan to incorporate ESG metrics into the remuneration structure and the approach in future years. The updated ISS policy is in line with the above guidance, as established in its voting updates that these performance conditions must be *"material to the business and quantifiable"*.

This topic becomes particularly important as there is growing momentum in the adoption of ESG metrics, with approximately 60% of FTSE 100 companies[2] specifically including ESG metrics in their annual bonus plan. In the ISEQ20 companies, all have included non-financial/ ESG metrics in their STIP, and c25% of companies have included these in LTIPs.[3]

d) Other remuneration considerations and guideline updates from the investment association

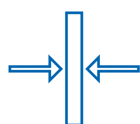
Following a year where many issuers adjusted their approach to remuneration in response to the economic impact of the pandemic, and a year where shareholders increased their scrutiny over issuers' pay structures and alignment with the overall experience of the company's stakeholders, the IA has noted the following amendments to its remuneration principles:

- **Levels of remuneration:** Remuneration committees are expected to provide a clear rationale for an increase to any element of, or to the overall level of, remuneration
- **Grant size:** Following a year of large fluctuations in share prices, given the broader economic environment, the IA principles have

2 Data collected from Deloitte Guide – Directors' remuneration in FTSE 100 companies
3 Data collected by FTI from company filings

been updated to reflect investor preference for companies to reduce awards at grant where share prices have fallen rather than relying on discretion when awards vest.

- **Value Creation Plans (VCPs):** Given the increased adoption of VCPs (incentive plans linked to the creation of value through TSR or market cap) over the last AGM season, a specific section on investor expectation for these plans has been included, outlining investor expectation for rationale on the adoption of a VCP, detail on the monetary cap, and the appropriateness of selected targets and dilution



e) Pension alignment approach in 2022

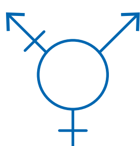
The IA announced in late 2019 that pensions should be aligned with the workforce over time, and not exceed 25% of salary. In late 2020, the threshold was reduced to a maximum of 15% of salary, to be achieved no later than the end of 2022. In line with this expectation, it has established that:

"Any new remuneration policy that does not explicitly state that any appointed executive director will have their pension contribution set in line with the majority of the workforce, will receive a Red Top (used by the IA to signal a serious deviation from expected practice)."

Any remuneration report where executive pension contributions are not aligned to the majority of the workforce, or the company has not disclosed/ implemented a credible action plan to align pension contributions for incumbent directors by the end of 2022 will also receive a "Red Top" label by the IA's governance research arm, IVIS.

2. Board diversity

The idea of diversity has expanded significantly in recent years, from primarily focusing on gender to encompassing a variety of factors such as 'demographic' diversity, race and ethnicity, gender, age, cognitive strengths, as well as diversity of skill sets and experience, and their relevance to strategy.



a) Gender diversity

Regulation targeting gender diversity at the board level issued in countries such as the UK, Ireland, France, and Germany, has improved the gender balance at a board level, setting the path for improved diversity across other levels of companies, such as the executive level and wider workforce.

The findings from the study published by the Financial Reporting Council (FRC) in July 2021, show that there has been a significant improvement in the number of women on the board of FTSE companies, where women sit in 36% of board seats on FTSE 100 companies and 33% for FTSE 250 companies.

As companies become increasingly aware of the value of diversity, more than half of FTSE 350 companies have now exceeded the 33% target set out by the Hampton Alexander review in 2020. In Ireland, gender diversity at the board level for companies on the ISEQ20 hit 30.7% in 2021, representing a 3.6% increase from the 27.4% female representation on Irish boards in 2020.

Board diversity expectations for 2022

BlackRock.

- **S&P 500 companies:** BlackRock set a gender diversity target of **30%** female representation on the board for the first time
- **FTSE companies:** 33% gender diversity in line with Hampton Alexander review
- **Other markets** should aspire to meaningful diversity in line with regulation and best practice

STATE STREET.

- From 2022, State Street expects **all markets and indices** to have at least one female board member
- From 2023 it will expect Russell 3000, TSX, FTSE 350, STOXX 600 and ASX 300 to have at least **30%** female boards

Vanguard

- European domiciled portfolios will be expected to have at least **30%** gender diversity on the board
- **FTSE 350 companies: 33%** gender diversity/ at least one female director for all other UK domiciled companies

Figure 1.

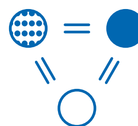
Having played an important role in pressuring companies to enhance diversity at board level, Glass Lewis and ISS will continue to recommend voting against the Chair of the Nomination Committee at companies that are not complying with the targets set out by the Hampton Alexander Review[4] for FTSE companies.

With a growing momentum from investors in the adoption of stricter positions on this topic it is worth noting that board diversity has been part of the investor agenda for a number of years. One example is that of Legal & General Investment Management (LGIM), who in 2015, implemented a diversity policy focused on voting against the largest 100 UK companies with all-male boards.[5] This year, BlackRock, State Street and Vanguard, who have also been engaging with companies on diversity, have tightened their expectations on board gender diversity in 2022 in their proxy voting approach, reflected in Figure 1. on the previous page.

Despite progress at the board level, the same study from the FRC shows that there has been a minimal shift in the percentage of female Executive Directors across company leadership with women being significantly underrepresented in the Executive Director and Chair roles, *"leaving women out of the crucial part of economic power"*. Diversity at the executive level is also part of the diversity ambitions set out by the Hampton Alexander Review, which in its final evaluation, published in February 2021, highlighted that women represented only 14% of the executive directors in the FTSE 100. As these targets have not yet been achieved, the UK government announced in November, that this work will continue to be evaluated by the, FTSE Women Leaders Review, that will succeed the Hampton Alexander Review and continue to build on the improvements brought about by its predecessors. A new report and targets are set to be published at the end of February.

4 Hampton Alexander Review – issued in February 2016 is an independent, business-led initiative supported by Government focused on increasing female representation on FTSE leadership. It has set the target of 33% female representation on FTSE 350 boards and FTSE 350 Executive Committees and their direct reports

5 Its current diversity policy in the UK is aligned with the Hampton Alexander Review with LGIM's policy recommending a vote against "those FTSE 350 companies that do not have a minimum of 30% women on the board. We will also apply voting sanctions to the FTSE 100 companies that do not have 30% women on their executive committee. For smaller companies we expect at least one woman at board level"



b) Ethnic diversity

The number of FTSE 350 companies with a director of colour more than doubled in 2021, but the majority of FTSE 350 boards are still predominantly *"all-white"*, according to Thomson Reuters data. The introduction of an ethnic diversity policy, in line with the Parker Review[6], is deemed by proxy advisors and institutional investors as a natural next step to progress on gender diversity.

Under their policy updates for 2022, both Glass Lewis and ISS expect FTSE 100 companies to have at least one ethnically diverse director on the board in line with the Parker Review. If this is not the case, and if a compelling rationale has not been provided for failure to reach that standard, an adverse recommendation on the re-election of Chair of the Nomination Committee or its equivalent may follow. Furthermore, ISS establishes that for FTSE 250, FTSE Small Cap, and large FTSE AIM companies, their policy will set the expectation for at least one ethnically diverse director on the board by 2024, even though the Parker Review only targets FTSE 100 and FTSE 250 companies. ISS' approach is indicative of how market best practice tends to operate. At first, the expectation is placed on the largest companies and, gradually, those expectations are extended to the wider market.

While ISS recognises that the UK has a generally more diverse demographic than Ireland, it has also identified that, in the Irish market, three of the top six ISEQ20 companies (based on market cap), have already identified a director of an ethnically diverse background. The following institutional investors, in particular, have stated that they will take the below guidelines when voting on the election of directors. (See Figure 2.)

The latest study in McKinsey's diversity series published in 2020, shows that the business case for diversity remains robust but also *"that the relationship between diversity on executive teams and the likelihood of financial outperformance has strengthened over time"*.

6 Parker Review – was launched in November 2016 and has set out objectives and timescales to encourage greater diversity of UK boards. It has proposed that each FTSE 100 board to have at least one director from an ethnic minority background by 2021 and for each of the FTSE 250 boards to achieve the same by 2024

BlackRock

- FTSE 100 (Parker Review) and S&P 500 company boards: at least 1 board member of an underrepresented group
- Other markets should aspire to meaningful diversity in line with regulation and best practice

STATE STREET

- S&P 500 and FTSE 100 companies: at least one person of colour on their boards
- S&P 500 and FTSE 100 companies: disclose the racial and ethnic diversity of their boards
- S&P 500 companies: expected to disclose their EEO-1 reports

Vanguard

- FTSE 100 are expected to have at least one director of a diverse ethnical background

Figure 2.

Its data suggests that companies in the top quartile of ethnic diversity perform better by 36% than those in the fourth quartile, a trend it has evidenced since 2014.

More recently, at the start of February this year, the Principles of Responsible Investment (PRI), published guidance to investors around diversity, equity and inclusion highlighting the important role it plays in company performance but with particular consideration to its importance from a human rights perspective. It notes the pivotal role that investors play in reducing the diversity gap and identifies three focus areas for action:

i) the definition of inclusive corporate cultures, that ensures a diverse workforce;

ii) the inclusive business models that contemplate DEI in the products and services in companies' offerings; and

iii) by building inclusive societies, that supports individuals the tools and development opportunities they need.

The paper further explores the links between financial performance and DEI, and explains that *"Strong DEI within a company can positively affect decision-making, levels of employee engagement, reputation amongst stakeholders, innovation and access to untapped markets"*.

With improved visibility of the topic, the report sets the expectation for investors to continue their efforts towards a level that matches the public commitment.

While social justice movements typically unravel the importance of issues such as diversity and inclusion, this topic has been increasingly identified *"as a source of competitive advantage and specifically as a key enabler of growth"*[7]. As the topic increasingly becomes part of investors stewardship responsibilities and incorporated in proxy voting guidelines and investor engagement, the aforementioned PRI highlights that mentions of DEI in signatories' policies have increased substantially from 6% in 2017 to 21% in 2020. Further, other investors have taken a more holistic approach to this topic, identifying diversity and inclusion as a value enhancing factor in business but also an important social consideration, as noted in BMO's call to action below:

> *"We recognise the importance of ethnic diversity and inclusion as a critical issue of social justice, and we recognise its real value to our business and the businesses we invest in. We expect our investee companies to address systemic racism and the lack of inclusion in the workforce of under-represented groups. Companies should seek to collect and disclose, where permissible, relevant data on the composition of the workforce, report on associated pay gaps and set and disclose targets and timelines for improvement where issues are identified. We may not support the re-election of nomination committee chairs or other relevant directors or management resolutions at companies that are failing to keep pace with their industry in this area."*
>
> *ESG Viewpoint - Radical justice: the imperative for investor action*

Finally, there is a recognition among market participants that there have been difficulties in collecting data on race and ethnic as a means of enhancing their DEI policies. Nonetheless, given the spotlight placed on this topic by investors and proxy advisors, racial and ethnic diversity will be an agenda priority for the Nomination Committees in reviewing board refreshment plans and related policies during 2022; and, corporate disclosure should point to the specific steps being taken to address the issue.

c) Directors' time commitments

The impacts of the Covid-19 pandemic, along with increased efforts on shareholder engagement and broadened expectations of directors' role of oversight, have increased the time commitment required to serve as a director on a public company board. Proxy advisors and institutional investors have sharpened their focus and their voting policies on directors who serve on an excessive number of boards.

In BlackRock's last investment stewardship report, it reported that during the period between 1 July 2020 and 30 June 2021, it voted against 758 directors at 639 companies, globally, of which 497 directors served on the boards of companies across the EMEA region.

In 2022, Vanguard formalised a policy on directors' overcommitments for the European and UK market in the following manner:

Non-Executive Directors: Vanguard will generally vote against directors who serve on five or more public company boards, at each company except the one where they serve as board Chair or lead independent director.

Directors who also hold Executive positions:

Vanguard will generally vote against a director who is a current Executive at a public company and sits on more than two public company boards, and will typically vote against the nominee at each company where they serve as a non-executive director.

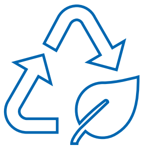
Global investor viewpoints around the maximum number of public company boards have converged toward a maximum of one outside board directorship for the CEO, participation on two boards in total for other Executives, and a limit of four boards for other non-executive directors. Vanguard's updates to it's UK and Ireland proxy voting policy, are in broader broader alignment with the limits established in the proxy' advisors' policies, with a maximum of five non-executive director positions, and two non-executive director positions held by an executive, director, as summarized in the table below:

The table below shows the number of public non-executive director positions that can be held before a non-executive director is considered 'overboarded':

Proxy Advisor/ Institutional Investor	Director is a Public Company CEO/ Executive	Director is a Public Company Non-Executive Chair	Director does not hold any Executive Director positions
Glass Lewis	2 total	3 additional	5 total
ISS	2 additional	3 additional	5 total
BlackRock	1 additional	2 additional	4 total
State Street	2 total	2 additional	4 total
Vanguard	2 additional	n/a	5 total

Figure 3

3. Board oversight of environmental and social issues



a) Oversight of environmental considerations

On the heels of COP26, and a year where climate related concerns took the spotlight, Glass Lewis and ISS have both updated their climate voting guidelines. As companies are beginning to incorporate ESG considerations into their strategy, the oversight process of these efforts is equally important. While this can be achieved in different ways, either through the creation of an ESG Committee on the board, or by defining ESG risk as a financially material risk that is to be overseen by the Audit Committee, proxy advisors and investors expect clear disclosure around companies processes in implementing ESG into strategy and managing ESG risks and opportunities. Increased reporting around ESG initiatives, as well as efforts towards a more quantitative and scientific approach to companies' commitments and targets, and the clear identification of its most material ESG issues, are important examples of companies' commitments to these topics.

From Glass Lewis' perspective, how all of these efforts are overseen by the board is the most important aspect which it addresses in its 2022 Voting Guideline updates for the UK and Ireland **markets**.

"As previously announced, from 2022, we will generally recommend that shareholders vote against the re-election of the governance committee chair (or equivalent) of FTSE 100 companies that fail to provide explicit disclosure concerning the board's role in overseeing material environmental and social issues."

Glass Lewis UK Proxy Voting Guidelines 2022

As Glass Lewis aims to review environmental and social issues through the lens of long-term shareholder value, a new section on the overall approach to ESG has been included in its policy (and additional ESG analysis added to its proxy reports – more on which is detailed shortly). It highlights the important role of the board of directors in the mitigation and oversight of environmental risks and opportunities, as a mechanism to protect shareholders and promote director accountability. It will also take a similar approach when reviewing shareholder proposals and support those that promote board accountability, shareholder rights and transparency, within each company's unique risk profile and operations.

ISS has further set out expectations for the board of directors and management and their role in setting the climate strategy, as well as in the mitigation of climate related risks. It has also incorporated new policy provisions for both shareholder and management proposals related to '**Say on Climate**' votes.

"For companies that are significant greenhouse gas (GHG) emitters, through their operations or value chain, generally vote against the board chair in cases where ISS determines that the company is not taking the minimum steps needed to understand, assess, and mitigate risks related to climate change to the company and the larger economy."

ISS UK and Ireland Proxy Voting Guidelines 2022

While the above policy largely sets minimum standards, ISS has integrated a new climate-related board accountability policy based on widely held investor expectations of the steps that should be taken by these companies to assess, mitigate, and report on their climate change risks and targets. ISS is proposing to introduce recommendations to vote against the re-election of relevant directors or any other appropriate items at companies that have not made appropriate climate-related disclosures, such as according to the TCFD framework, or that have not set quantitative GHG reduction targets. This is where the bar rises, to expectations that specific disclosure is provided, and targets are set.

Following ISS' engagement with investors, it was determined that targets for Scope 3 emissions will not be required for 2022 and ISS will focus on Scopes 1 and 2 and provide additional climate-related data in its reports. This policy is expected to evolve over time, in line with expectations that Scope 3 emissions are part of the reduction target-setting for all companies.

b) Investors' expectations on TCFD reporting

Outside of the two major proxy advisors, BlackRock, State Street and Vanguard have all specified their preference for reporting in line with the TCFD framework, further underpinning it as the most useful – and stringent – reporting framework for large investors.

"We focus on sustainability not because we're environmentalists, but because we are capitalists and fiduciaries to our clients."

Larry Fink, 2022 Annual Letter to CEOs

In his address to CEOs this year, BlackRock's Larry Fink, notes that the way by which each company navigates the global energy transition will become the most important factor affecting capital allocation decisions. BlackRock views reporting in line with the TCFD as a way to gain a better understanding of companies' approach and monitoring of climate-related issues. Since 2020, BlackRock has set the expectation that all companies adopt a combination of SASB and TCFD to provide insight into sustainability risks and opportunities. Furthermore, and as specified in its guideline updates, BlackRock expect companies to disclose their short-, medium- and long-term GHG targets. The targets and the quality of plans to meet them, BlackRock states, are key to shareholders' long-term interests.

In his annual addresses to the CEOs of investee companies[8], State Street CEO, Cyrus Taraporevala, establishes its role, and that of other asset managers, in supporting companies to effectively plan their transition to net zero, whether by helping them develop new climate-positive business models, accelerate a push into renewables, or assist those making their traditional operations cleaner and more efficient. It has also set the expectation for companies in the major indices, the US, Canada, the UK, Europe, and Australia to align reporting with the TCFD reporting framework. As part of its engagement efforts and noting that approximately one third of S&P companies do not yet report in line with the TCFD, State Street will launch an engagement campaign in 2022 on climate transition plan disclosures at its investee companies and will start to hold directors accountable and vote against their re-election, from 2023.

Vanguard has also updated its guidelines to reflect the instances in which the funds will vote against the relevant committee Chair, or the Chair/ lead independent director in cases where the board has failed to identify relevant material ESG risks.

8 CEO's letter on Our 2022 Proxy Voting Agenda

Key considerations for BlackRock, State Street and Vanguard in their assessment of climate risk oversight failures

BlackRock.

- BlackRock expects all companies to report in line with the recommendations of the TCFD framework
- In certain cases companies may reporting using frameworks other than TCFD or SASB, and in those instances, expects companies to highlight the metrics that are industry and company specific and provide clear rationale for their approach

STATE STREET.

Alignment with TCFD reporting for companies in the major indices, the US, Canada, the UK, Europe and Australia and to disclose their approach to:

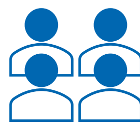
- The role of the board in the oversight of climate-related risks and opportunities.
- The total direct and indirect GHG emissions ("Scope 1" and "Scope 2" emissions); and to Set targets for reducing GHG emissions

Vanguard®

To assess climate risk oversight failures, the funds will consider:

- The materiality of the risk identified
- Effectiveness of disclosures, that are meaningful and insightful
- Clear and detailed disclosure of company strategies and risk mitigation procedures in the context of the regulatory requirements and changes in market activity in line with the latest climate science
- Details on any company-specific or market regulation requirements for specific reporting frameworks regarding environmental topics

Figure 4



c) Oversight of human capital

Effective board oversight of human capital goes beyond disclosure on management and workforce diversity and inclusion measures. Increasingly, investors and proxy advisors believe boards should be considered accountable for direct oversight of workplace issues at large, including labour practices, employee health and safety, and employee wellbeing. These considerations have been heightened by the Covid-19 pandemic with the board's responsibility to ensure that management appropriately addresses, and responds, to human capital risks and opportunities.

In his letter, Larry Fink, explained BlackRock's views on human capital management as an investment issue, and believes companies should be able to attract, retain, and develop workers with the skills and expertise necessary to execute their long-term strategy and to deliver value creation.

> *"With human capital management now widely seen as both a risk and opportunity for employers in the wake of the pandemic, we have also published guidance for effective disclosures and practices."*
>
> Cyrus Taraporevala,
> 2022 Annual Letter to CEOs

This topic was also part of State Street's priorities addressed in the CEO's annual address and through a separate guidance document. It outlines five key topics it expects companies to address as part of their Human Capital Management disclosures:

1. board oversight;
2. strategy (specifically, how a company's approach to HCM advances its overall long-term business strategy);
3. compensation, and how it helps to attract and retain employees and incentivise contributions to an effective HCM strategy;
4. "voice" (how companies solicit and act on employee feedback, and how the workforce is engaged in the organisation); and
5. how the company advances diversity, equity and inclusion.

It will focus its approach on engagement with companies and industries with high human capital management risks and opportunities and will use its vote to express concerns if companies do not make sufficient progress after their engagement.

As per BlackRock's approach to engagement on human capital management[9], the world's largest asset manager states that it aims to get a better understanding of topics such as:

1 Board oversight of human capital risks and opportunities, understanding who holds oversight responsibility, the type of information and frequency at which information is reviewed, and how performance on human capital metrics may be linked to executive compensation as a means to encourage accountability

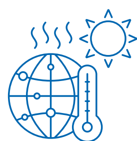
2 Workforce engagement, used to address and understand workforce expectations and how senior leadership assess the efficacy of its efforts. This also includes Health & Safety policy considerations

3 Workforce compensation, to ensure alignment of the company's remuneration philosophy with its purpose and culture, and to ensure that executive management are not isolated from the remaining workforce in this regard

The UK Corporate Governance Code (2018) establishes that *"In order for the company to meet its responsibilities to shareholders and stakeholders, the board should ensure effective engagement with, and encourage participation from, these parties"*. To do so, the Financial Reporting Council (FRC) has pointed to the following methods to be used for companies, workforce engagement strategies: i) a director appointed from the workforce; ii) a formal workforce advisory panel; iii) a designated non-executive director.

9 BlackRock Investment Stewardship Approach to Engagement on Human Capital Management

4. Climate proposals voting guidelines and approach



a) 'Say on Climate' Proposals and Management Supported Climate Proposals

There were 23 management 'Say on Climate' proposals globally in 2021[10], of which 10 were proposed by UK listed companies. After Barclays broke ground in the UK by addressing shareholder demands with its very own proposal, several UK companies followed and proposed their own 'Say on Climate' Votes in 2021.

To assess the rigour and completeness of these plans, ISS has defined a set of key information points to assist in its analysis. ISS will review issuers' disclosure regarding its Scope 1, 2 and 3 GHG emissions, and assess whether these disclosures are in line with the TCFD. Further, ISS will review issuers' commitments to setting and receiving third party approval of its science-based targets, the disclosure and robustness of its short, medium and long-term targets, as well as any net zero commitments.

BlackRock guidelines 2022 updates

BlackRock.

"For 2022, we encourage companies to demonstrate that their plans are resilient under likely decarbonisation pathways, and the global aspiration to limit warming to 1.5°C. We also encourage companies to disclose how considerations related to having a reliable energy supply and just transition affect their plans."

- *BlackRock will be looking at whether companies have set short-, medium- and long-term targets, and the chance to review its progress in line with the global aspiration of limiting warming by 1.5*
- *Further, in its Global Policy it calls out that investors increasingly recognise a broader range of risks and opportunities can materially impact financial performance. It sets the expectation for increased scrutiny of "the assumptions underlying financial reports, particularly those that pertain to the impact of the transition to a low carbon economy on a company's business model and asset mix"*

10 Data based on proxy voting information available on the Diligent Intel database

On the other hand, when reviewing management-sponsored proposals on environmental and social topics, Glass Lewis will generally consider: *"(i) the request of the resolution and whether it would materially impact shareholders; (ii) whether there is a competing or corresponding shareholder proposal on the topic; (iii) the company's general responsiveness to shareholders and to emerging environmental and social issues; (iv) whether the proposal is binding or advisory; and (v) management's recommendation on how shareholders should vote on the proposal."* In the second half of 2022, Glass Lewis opposed a management Say on Climate proposal on the basis that the company's plan lacked an approved science-based target.

While, initially, proposing a Say on Climate proposal may have seemed to offer little downside, the expectation on the rigour of companies' plans has certainly increased. Furthermore, and particularly focused on companies operating in carbon- or energy- intensive industries, the need for managing and mitigating carbon emissions is key to ensuring long-term financial and environmental sustainability. As such, Glass Lewis and ISS in their review of climate related proposals and GHG reduction targets, will pay special attention to the industry events, the existence of robust risk management of environmental issues (evidenced by material fines, reputational damage), and whether the proposed GHG reduction targets are in line with its peers, and with the latest climate science.

To further support its analysis on these issues, Glass Lewis announced in the beginning of February the launch of its in-house ESG-score and data that will be featured in the ESG profile page that will be included in the research proxy paper for approximately 1,900 companies. The information around each company's environmental and social strategy and performance, and emissions reductions targets will be collected close to each company's AGM date, to provide institutional investors with the additional context to vote a proxy. In its methodology, it will consider "a Board Accountability Score, an ESG Transparency Score, an ESG Targets and Alignments Score, and, for certain companies, a Climate Risk Mitigation Score". This initiative further reflects the increased evidence of the importance of ESG ratings and data in the minds of investors and, specifically, the relevance of data in the context of corporate reputation and risk.

b) Biodiversity priorities

Investors are increasingly being called upon to act on biodiversity loss with the same urgency as climate change, particularly in light of the inextricable link between biodiversity and climate change. The World Economic Forum has recognised it as one of the top three most severe risks on "*a global scale over the next ten years*" in its Global Risks Report 2022. As highlighted by the Taskforce on Nature Related Financial Disclosures (TNFD), more than half of the world's GDP comes from industries that are highly ($13 trillion) or moderately ($31 trillion) dependent on nature, such as the provision of food, fibre and fuel.

As the financial sector increasingly recognises the systemic risk that biodiversity loss poses to the global economy, many investors and financial institutions have started to make significant efforts to develop an approach to this topic. In its guidance to investors, the PRI noted that an understanding of this topic will be very important and that investors should tailor their investment approach to manage biodiversity loss, particularly considering that *"exposure to some sectors may lead to those assets becoming stranded, if not properly managed"*.

Although investors have been struggling to set targets around biodiversity, given the significant lack of comprehensive guidance, as the momentum around the topic grows, so does the number of communities, networks and initiatives dedicated to it. In its biodiversity policy, Aviva notes the important catalyst role played by these collaborative platforms towards the development of a robust approach to this issue. It further explains that while it has not yet set any specific targets on biodiversity loss, its participation in these various market initiatives on this topic, particularly its membership of Finance for Biodiversity Impact Assessment Working Group, will equip Aviva with the tools needed to assess its current approach, and evaluate the dependencies and impact of its portfolio on biodiversity.

Aviva's biodiversity principles

1. Protect and restore biodiversity - not just minimise loss
2. Identify and manage biodiversity impacts, dependence on ecosystem services and risks
3. Collaborate with others to improve measurement, disclosure and action on biodiversity;
4. Engage companies in the first instance and exercise our rights and responsibilities as stewards to support them to tackle biodiversity loss
5. Act for progress now, whilst recognising the challenges and evolving our approach in line with emerging best practice
6. Champion biodiversity through our own people and operations, through the businesses we invest in and underwrite, and through what we ask of governments
7. Prioritise areas where we can make the greatest impact

Figure 4.

Furthermore, it has identified seven biodiversity principles on which it will base its strategy, summarised in the box above (See Figure 4.). As an investor, it will look carry out an assessment of its investments to identify key areas of impact by 2023. After this initial assessment, as an active manager, it will use engagement as a tool to encourage and support investees to address biodiversity impacts and manage associated risks, as a means to support transition vs divesting, an approach similar to that taken on GHG emissions reductions. It will continue to work across various collaborative platforms on biodiversity as well as with governments and policymakers to support and incentivise system-level changes to support the protection of biodiversity and natural capital.

Other investors such as BMO have also highlighted that biodiversity will remain a key priority for 2022, particularly through its engagement strategy with companies that have a significant biodiversity impact as noted in its disclosures, *"with increased engagement with companies in the most critical sectors including food and beverage, extractives, materials, transportation and finance to set out strategies, governance, targets and metrics to mitigate biodiversity risks."*

Furthermore, and to support investors in setting a biodiversity strategy and identifying suitable KPIs, the Climate Disclosures Standard Board (CDSB) released its most recent sustainability disclosure guidance on the topic of biodiversity. The CDSB guidance provides specific methods for applying governance to support a biodiversity strategy. It also outlines how to create biodiversity policies, strategies and targets; and how to quantify financial risks and opportunities associated with biodiversity. The guidance also provides a detailed table on its alignment to other disclosure guidelines, providing one of the most comprehensive frameworks yet published. It will likely form the foundation of the upcoming recommendations from the TNFD, although many upcoming frameworks have indicated that they will take a double materiality approach to biodiversity, measuring both the impact of biodiversity to the company and the impact of the company on biodiversity.

Despite the fact that reporting frameworks on the topic of biodiversity remain less sophisticated than reporting on other environmental topics, and with the increased focus on the topic as interest increases around the upcoming COP15, the bi-annual UN Biodiversity Conference, which is set to take place in April 2022, biodiversity appears to be the next environmental 'hot topic' for investors globally.

Conclusion

The alignment of expectations in the proxy voting guideline updates and expectations for 2022 for proxy advisors and BlackRock, Vanguard and State Street on a number of themes, including sustainability reporting, board level considerations around diversity, as well as effective human capital management, represents a clear direction of travel for future proxy voting trends, starting for the 2022 AGM season. While these issues will not yet supplant the established battle lines around remuneration and board elections, it is clear that Covid-19 has hastened the altered expectations of investors. Topics such as talent retention, employee health and safety, culture, stakeholder engagement need increased oversight from the board, with associated changes in reporting needed. In order to effectively oversee those issues, diversity, beyond gender, is needed. Whereas in many areas investors are cautious about mandating targets, board diversity is not one, which has immediate ramifications for board Chairs and Chairs of Nomination Committees.

Concerns about the lack of action and oversight on the implementation of companies' ESG strategies have been addressed in both Glass Lewis' and ISS' proxy voting guideline updates, as well as by investors. As sustainability considerations shift from being an investor preference to a regulatory requirement and societal demand, its integration into companies existing risk management frameworks and structures requires significant board involvement, on a par with material financial risk. Investors have asked companies to report in line with the TCFD framework, as it provides them with insight into an investee company's climate-related governance, strategy, risk management, metrics, and targets. Furthermore, the upcoming regulatory updates on environmental issues will further improve transparency and provide an additional framework to support companies in the integration of these objectives into their strategies. On the back of COP26, other investors' focus on environmental issues, such as BMO and Aviva's prioritisation of biodiversity reflect a widening of the proxy voting lens, increasing the challenges around effective reporting.

Finally, concerns regarding the misalignment in pay between management and the wider workforce at certain companies during the Covid-19 pandemic has resulted in investors more actively holding Remuneration Committee Chairs to account for their decisions and policy applications. The shift in perceptions on how executive directors should be rewarded has been driven by the impacts of the pandemic across all stakeholders of the company, and Chairs have been called to play the important role of ensuring that executives are not isolated from the macro impacts to the business in a manner that is inconsistent with the approach taken to the general workforce. These concerns made headlines with many companies receiving high levels of dissent on their remuneration related proposals in 2021, but given the outcomes at recent AGMs, further evidence that this expectation is here to stay. While the impact of Covid-19 may subside in time, evidence of a disconnect between the treatment of management and stakeholders – which arguably started with the IA's expectations that both salary increases and pensions payments were aligned with the workforce – is likely to drive significant dissent at AGMs.

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