



ENGAGEMENT

The new rules for engagement in 2020 and beyond.

1. **Who should be involved in engagement campaigns?**

In the past, engagement with a company's investors, if it occurred at all, was generally a responsibility of senior management. Companies focused primarily on financial communications through Investor Relations programs. Board involvement was rare, occurring mainly in cases of crisis, underperformance, activism, or contests for control. The one clear exception was the UK – and to varying degrees in other principles-based governance jurisdictions – where informal but close relations between institutional investors and corporations had long been a common practice.

Engagement is very different today. The Board of Directors is now on the front lines. There are several reasons for promotion of the board to the lead role. First is the significant increase in the concentration of share ownership in asset managers that follow a so-called “passive” investment strategy. These giant and influential institutions, which include index funds, pension funds, sovereign wealth funds and state sector funds, have led the recent movement to focus attention on the business risks and value opportunities related to intangibles and ESG. These large investors want to engage with the Board of Directors who they believe are responsible for

ESG policies and oversight of 'non-financial' risk management. Another factor is the advent of Say-on-Pay voting. The need for companies to explain and justify extraordinary pay practices opened the boardroom door to direct engagement between directors and shareholders. This was particularly true in the United States, where directors had long been shielded from contact with shareholders. Today there is a growing trend to hold directors accountable not only for pay, but for a long list of issues collectively referred to as ESG, sustainability, climate change, culture and purpose, which are all ultimately tied to the company's most precious asset, its reputation. Directors are the guardians of corporate reputation. These ESG responsibilities have become so important that investors are now willing to withhold votes for directors or support dissident slates in cases where boards are deemed not to have met their responsibilities. In addition to a broader range of topics on engagement agendas, active participants now include not only shareholders, but also stakeholders, proxy advisors, ESG research, activist shareholder groups and various standard-setters and NGOs.

Deciding who at the company should be involved in engagement ultimately comes down to the campaign's purpose and goals. The list of potential participants should start at the top with directors. The CEO should be involved where issues involve financial performance or business strategy. Investor Relations executives, General Counsel/Corporate Secretaries and CFOs all play important roles either directly or in preparation for engagement. With the new focus on intangibles and ESG issues, Human Resources and Sustainability or CSR (Corporate Social Responsibility) teams may also be required to provide input. While bringing together all the appropriate players may pose a challenge, particularly for large global companies with complex, departmentalized management structures, the effort to develop an integrated approach can help companies achieve a fully-informed, effective engagement campaign.

2. What are the salient topics of engagements?

ESG issues continue to gather momentum on the engagement agenda, as asset owners, fund managers and the general public increasingly focus on sustainability as a core concern. ESG and sustainability issues are truly global, with differing degrees of urgency locally. In Australia, for example, compulsory superannuation has exposed every working Australian to ownership in listed companies, with the result that individual superannuation fund members, along with their investment managers, want to know their contributions are being responsibly invested for the future. These concerns have achieved a high profile in the face of recent global natural disasters. Climate change and its consequences are now everyday matters in Australia and around the world, and companies are being held accountable to help deal with them.

Corporate culture and corporate purpose are increasingly recognized as drivers of both ESG risks and opportunities. Companies are expected to have a clear understanding of their business enterprise in a broad socioeconomic context. Boards of directors must demonstrate their ability to articulate corporate purpose and explain how their company instils and maintains a healthy corporate culture.

ESG topics can differ in materiality depending on the market sector and investor engagement priorities. While climate change continues to be a key concern for many investors, with specific focus on SASB (Sustainability Accounting Standards Board) and TCFD (Task Force on Climate-related Financial Disclosures) standardization, they are also paying closer attention to other traditional governance issues. Executive pay, which is commonly labelled a “perennial governance issue,” remains high on the engagement agenda for nearly all institutional investors. Seeing pay as a measure of the board’s independence and integrity, investors are particularly attentive to the link between pay and performance, internal pay equity, and even to pay quantum in the context of rapidly rising CEO pay and expanding global wealth inequality.

Companies must now assess engagement topics at multiple levels: (1) company-specific ESG business, financial and operational issues; (2) local market-related regulatory, social and even political impact; (3) global and macro-economic implications. *For engagement to be effective, corporate reporting must meet the growing expectations of investors for a comprehensive narrative that addresses both non-financial and financial topics as well as the interests of both stakeholders and shareholders.*

3. How should engagement campaigns be conducted to achieve maximum effect?

Preparation and planning are essential for the conduct of a successful engagement campaign. The following steps are suggested for companies planning to engage with shareholders for a particular ESG issue or in the context of a general meeting proxy solicitation:

- Develop a slide deck of specific issues that can serve as a guide for the engagement campaign. Topics will include, for example, matters of strategic importance to the company, issues of concern to investors and shareholders, problems highlighted in the media, issues raised by proxy advisory firms and issues that have surfaced at previous shareholder meetings, or during IR and governance roadshows.
- Conduct a thorough analysis of the ownership base and develop a profile of owners' policies and expectations.
- Monitor stock trading to detect ownership and stock price movements that signal changing investor sentiment, potential activism or change of control threats.
- Rather than being reactive to external factors, take the initiative to set the agenda and control the messaging during the engagement campaign.
- Engage with investors 'out-of-sync' from your reporting periods and annual meeting schedule in order to highlight new developments at the company and to provide sustained engagement throughout the year.
- Determine who from the company will be most effective to convey your message and strengthen credibility with shareholders, generally including appropriate board members as well as key management team members.
- Be sure to follow up on commitments made during the engagement.
- Remember that engagement is not limited to organized road shows and face-to-face meetings but should be part of a continuous program of communication.
- Be careful to avoid inadvertent selective disclosure of material, non-public information.

The quality of companies' disclosure around ESG and extent to which it assists investors in their decision-making process will shape engagement in 2020. Investors want to understand how companies are integrating and reporting ESG issues relating to their businesses. For example, with climate change at the top of the list of ESG priorities, there is an expectation from large funds that companies should report under the SASB and TCFD frameworks. Deeper levels of disclosure are expected around board skills, culture and other non-financial topics.

4. Why engage – What are the benefits?

Engagement has evolved over the last few years, with large investors taking the lead in voluntarily intensifying their stewardship activities around ESG issues. Investors' engagement strategies are also evolving. In the international arena collective engagement initiatives are increasingly common. Initiatives are not limited to traditional one-on-one meetings but now include writing collective letters to companies, active public media campaigns, collaboration on sustainable initiatives and formal coalitions (increasing their AUM clout) to help achieve defined objectives at specific targeted companies. There has been some movement on the regulatory front as well. In Europe, the Shareholder Rights Directive II that took effect in June 2019 requires investors to increase disclosure and transparency about interactions with companies during shareholder engagements. In the UK, the Investor Forum, a community interest company set up by institutional investors in UK equities, is becoming more vocal and involved in seeking change at UK listed companies with poor ESG disclosure and practices. Some investors are also undertaking targeted engagement at their clients' request, based on clients' ESG expectations about specific ESG issues. Impact investing is increasing. We expect these trends to continue in 2020 and beyond.

In the face of all these pressures, the benefits to companies of taking a proactive approach to engagement are clear:

- Establishing credibility and a relationship of trust with key investors
- Telling the company's story holistically
- Pre-empting activism and dissident shareholder activity
- Educating the market as to company fundamentals
- Attracting long-term investors rather than short-term opportunistic investors

- Reducing risk
- Discovering opportunities for value creation
- Avoiding undervaluation in the marketplace
- Improving internal collaboration and teamwork
- Building an enterprise culture which strengthens the allegiance of employees and other stakeholders
- Reducing the cost of capital
- Achieving sustainability for the business enterprise

Both companies and investors now understand that engagement is worth doing for its own sake. Investors want portfolio companies to engage. Companies in turn increasingly understand that engagement is an essential responsibility of running the business.

Kiran Vasantham
Morrow Sodali
 London

Ben Walsh
Morrow Sodali
 Sydney

Andrea Di Segni
Morrow Sodali
 Rome

John Wilcox
Morrow Sodali
 New York

ABOUT MORROW SODALI

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

From headquarters in New York and London, and offices and partners in major capital markets, Morrow Sodali serves more than 700 corporate clients in 40 countries, including many of the world's largest multinational corporations. In addition to listed and private companies, its clients include mutual funds, ETFs, stock exchanges and membership associations.

CONTACTS

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

US
 +1 212 300 2470

EMEA and LATAM
 +44 20 71006451

APAC
 +61 2 8022 7940