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2022 GOVERNANCE OUTLOOK

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The *2022 Governance Outlook* is designed to give corporate directors and senior executives a comprehensive overview of major business and governance issues that are likely to demand board focus over the coming year. The report begins with an introduction from NACD that highlights survey findings about leading board priorities for 2022 and follows with four partner contributions that provide distinct insights and projections on the following themes: proxy priorities, ESG oversight, M&A oversight and purpose, ransomware risk, assessing DE&I practices, and D&O threat landscape.

Each partner contribution provides (1) an overview of key trends in a particular area of governance, (2) an outlook for how those trends will play out in 2022, and (3) relevant implications and questions for boards to consider. The *2022 Governance Outlook* is designed as a collection of observations to help corporate boards to prioritize their focus in 2022 and increase their awareness of emerging issues through both detailed topical analysis and coverage of broader governance implications.

National Association of Corporate Directors

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Embracing Greater Investor Interest in ESG Practices

By Dorothy J. Flynn and Chuck Callan, Broadridge

The 2021 proxy season was an ESG inflection point for US corporate boards, and many more directors are now preparing for heightened shareholder interest in corporate social responsibility.

Environmental activists this year won a series of victories against several of the world's biggest companies, passing shareholder resolutions to force companies to adopt more sustainable business practices and winning board seats. As climate-related proxy contests made headlines, activist shareholders also achieved success with initiatives aimed at companies' diversity, equity, and inclusion (DE&I) policies and the demographic makeup of corporate boards.

None of this should come as a surprise. In fact, many boards have been working proactively for years to integrate environmental, social, and governance criteria into their businesses and annual financial reports. Many companies are embracing greater investor interest in ESG policies and practices.

But for others, pressure for greater disclosure and change is coming from many sources. Internally, companies are hearing from employees demanding greater pay equity and more meaningful commitments to improving their communities. Externally, investors are demanding better reporting on climate risks and human capital management.

Investors' embrace of ESG reporting is on the rise. For example, institutional investors representing more than $100 trillion in assets have signed on to the United Nations-supported *Principles for Responsible Investment*. These asset owners are incorporating ESG criteria into their investment decisions and capital allocation. Research from consulting firm Coalition Greenwich shows that 72 percent of institutional investors now include some form of "sustainability" in their investment processes. The firm projects that share to grow to 80 percent by 2026.[1]

Environmental activists were able to win proxy votes in 2021 with backing from mainstream global index-fund giants. Over the past two years, some of the largest asset managers have vowed to champion ESG causes. They voted in favor of many environmental and social shareholder resolutions, and they are holding board members accountable for progress in reporting ESG risks.

Many of the successful 2021 resolutions also had the support of proxy advisors, who are in the process of adopting much-more-detailed ESG policies. As one example, Institutional Shareholder Services (ISS) recently updated its list of "material failures of governance, stewardship or risk oversight" that would warrant negative recommendations against directors when there is "demonstrably poor risk oversight of environmental and social issues, including climate change."[2]

The activist trends described so far pertain mostly to institutional investors such as pension funds and hedge funds, which together with mutual funds as a group hold approximately 70 percent of the outstanding shares of US listed firms. While individual (aka retail) investors have generally voted more in line with board recommendations on shareholder proposals, it remains to be seen whether their interest is changing. In the same way that Reddit galvanized retail interest in GameStop and other meme stocks, there were instances where the social media platform became a forum for environmentally conscious individuals voting their proxies.

Over the past two years, some of the largest asset managers have vowed to champion ESG causes.

According to Forbes, the 2021 proxy season set new records, with at least 467 shareholder resolutions on ESG issues.[3] Some of these proposals received "eye-popping" levels of support, according to the "2021 Proxy Season Review" on the *Harvard Law School Forum on Corporate Governance*, which cites more than a dozen proposals on diversity, climate change, and political spending that scored over 80 percent, and 34 that received majority support—up from last year's record 21.[4]

Engine No. 1, the climate-change activist, continued to agitate for change and was successful in winning board seats where it launched a proxy challenge. Activists also scored with resolutions to force Chevron to lower emissions, and garnered high levels of support for proposals requiring oil producers to disclose the impacts of climate change and the move to a net-zero economy on their businesses. Meanwhile, the number of proposal submissions related to DE&I reporting and effectiveness tripled from 2020 to 2021, with three proposals receiving majority support.[5]

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1 See Coalition Greenwich's press release, "Institutional Investors Directing Assets to Thematic Strategies Focused on Climate and Other Sustainability Goals," August 10, 2021.

2 See Brian V. Breheny, Marc S. Gerber, Richard J. Grossman, Regina Olshan, Stephanie Birndorf, and Blake M. Grady, "ISS and Glass Lewis Release Updated Proxy Voting Guidelines," December 7, 2020, on skadden.com.

3 Bhakti Mirchandani, "What You Need To Know About The 2021 Proxy Season," June 28, 2021, on forbes.com.

4 Shirley Westcott, "2021 Proxy Season Review," the *Harvard Law School Forum on Corporate Governance* (blog), August 5, 2021.

5 Ibid.

Proxy advisors have announced plans to further increase their scrutiny of corporate ESG policies.

The number of ESG-related resolutions would have been even larger this year if companies hadn't altered policies in response to investor engagement apart from shareholder meetings. For example, numerous resolutions related to board diversity and "Rooney Rule" requirements for director candidate searches were withdrawn after companies adopted new business practices. Also in play were new proxy rules making it harder for smaller shareholders to get resolutions onto proxy ballots, as well as some successful exclusions granted under Rule 14a-8 "no action" rule. Had these resolutions not been abandoned, prevented, or excluded, they could have been put to a vote by public pension plans and asset managers through letter-writing campaigns and other engagements. November 2021 guidance from the SEC removed certain limits on the kinds of "social policy" proposals that management was required to put to a vote. Under the new guidance, shareholder proposals with a broad social policy interest not strictly connected to day-to-day operations may not per se be excludable by management from company proxies.

There is no reason to think that the trends toward greater ESG activism has abated. New requirements for human capital disclosure and a recent request for comments on climate disclosure may bring to light information that will inspire new resolutions in companies that fall short of investor ideals. As a result of these trends, the increasing interest in ESG among investors is putting pressure on corporate boards, both in annual general meetings and behind closed doors. For example, the "2021 Proxy Season Review" notes that several of the world's largest asset managers have announced that, starting next year, they will vote against compensation committee chairs at S&P 500 firms that don't disclose a breakdown of workforce demographics. Their "against" votes would extend to nominating committee chairs of boards that fail to disclose, or that lack, racial and ethnic diversity—a protest that new board diversity disclosure rules will facilitate for investors in Nasdaq-listed companies by making it easier to identify such companies. As for climate, one prominent activist submitted proposals this year that would require companies to hold an annual shareholder advisory vote on their climate action plans. According to the "2021 Proxy Season Review," the fund plans to roll that initiative out to 100 S&P 500 firms by the end of 2022.

Meanwhile, proxy advisors have announced plans to further increase their scrutiny of corporate ESG policies. Starting in 2022, ISS may oppose nominating committee chairs at companies with all-male boards and at companies without at least one racially or ethnically diverse director. Glass Lewis may start recommending against nominating committee chairs of boards that fall short on certain board diversity measures, and against governance committee chairs that fail to provide clear disclosure on board-level oversight of environmental and social issues.

Many factors point to a continuance of the ESG momentum in the 2022 proxy season in terms of proxy resolutions, direct engagement with investors, and the overall involvement of corporate boards. According to the "2021 Proxy Season Review," through June of 2021, 95 nominating/governance committee chairs had received negative votes of over 30 percent of the voted shares—up from just 55 chairs in the first half of 2020.[6] Those results suggest that investors will continue holding boards and individual directors accountable for real or perceived ESG shortcomings.

Companies viewed as lagging peers in progress on ESG should prepare for heightened scrutiny and, in some cases, activism. In general, board members should ask the following questions:

1. **Should the board add ESG expertise and establish a dedicated ESG committee?**
   Nominating directors with specific ESG expertise can increase the board's effectiveness in setting policies across a range of issues and can demonstrate a critical level of competence to both internal and external audiences. Creating an ESG committee (apart from required committees on audit, compensation, and nominating and governance) could be an important step in establishing effective board oversight for some firms. A dedicated ESG committee elevates the importance of ESG, works with management on investment priorities, and considers (with the compensation committee) how targets can be reinforced with appropriate incentives.
2. **To what extent should executive compensation be aligned with ESG performance?**
   Tying executive compensation to ESG metrics can be an effective way for corporate boards to communicate their commitment to elevating ESG standards and to achieving real improvements in corporate ESG performance. As NACD's Friso van der Oord has remarked in his op-ed on tying more CEO pay to climate progress, what gets measured gets managed.
3. **Does the board share a vision on the degree to which ESG drives company performance?**
   It's imperative that boards understand the importance of ESG to their businesses together with the risks to long-term value creation.

We expect many corporate boards will step up efforts with their management teams to address investors' expectations for greater information on ESG risks and progress on measurable ESG goals.

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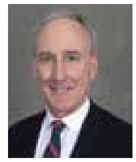
[6] Shirley Westcott, "2021 Proxy Season Review," the *Harvard Law School Forum on Corporate Governance* (blog), August 5, 2021.


Dorothy J. Flynn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