Scrutiny Hub

Governance Unbound

How more in-depth scrutiny of boards, and for boards, can help corporate governance support sustainability

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Summary

Corporate governance is back in focus, but it risks returning to circular debates on shareholders vs stakeholders. Instead, governance structures need to help find the long-term win-wins. Increasing the capacity for in-depth scrutiny is critical in two ways. First, it would enable a shift from formulaic to company-specific governance assessments, and especially on the backgrounds of directors and pay. Second, a thriving corporate scrutiny ecosystem would provide non-executive directors with valuable support to effectively discuss sustainability on the board.

This report follows The Scrutiny Deficit which argued there needs to be more focus on the lack of capacity for in-depth company analysis versus more disclosure and frameworks. As part of this, it argued that non-executive directors (NEDs) need to be empowered through more connection to investors and scrutiny non-profits. In addition, corporate governance is a prime example of where the lack of capacity for in-depth analysis leads to problematic formulaic assessments.

This research was commissioned by the Laudes Foundation. The views expressed in this document are those of Scrutiny Hub and do not necessarily reflect the views of the Laudes Foundation.

1. Finding the win-wins

The focus of investors is returning to governance. However, most people still believe in short-term shareholder rights and a win-win between profit and people, but this does not stand up to evidence. A minority advocate for a shift in legal duties away from shareholders, which is currently unrealistic and has its own problems. The risk is continued circular debates on shareholders vs stakeholders. Instead, corporate governance structures need to help find and create the win-wins between people and profit to navigate the current backlash against sustainability.

2. Agreement on people and pay

There are wide ranging views on how corporate governance can support sustainability. The research included over 40 interviews covering investors (sustainability and fund managers), data providers, proxy advisors, academics, and industry associations. Amongst the many areas discussed, two stood out as having more agreement. First, more focus on people instead of structures, and so analysis of the backgrounds of directors and support for directors, with the caveat that assessing legal structures is more valuable in emerging markets. Second, beyond crude ESG metrics in executive pay to meaningful alignment with sustainability and strategy. The challenge is both require a step change in analytical capacity to assess.

Board

- **a)** Responsibility for sustainability
- **b)** Non-executive and executive backgrounds
- **c)** Non-executive director role, time and information
- **d)** Stakeholder voice

Executives and organisational structure

- **e)** Exec pay aligned with sustainability
- **f)** Investment frameworks and capital allocation
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Disclosure

- **h)** Sustainability disclosure
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Investors

- **j)** Voting and stewardship
- **k)** ESG shareholder resolutions
- **l)** Universal owner rationale

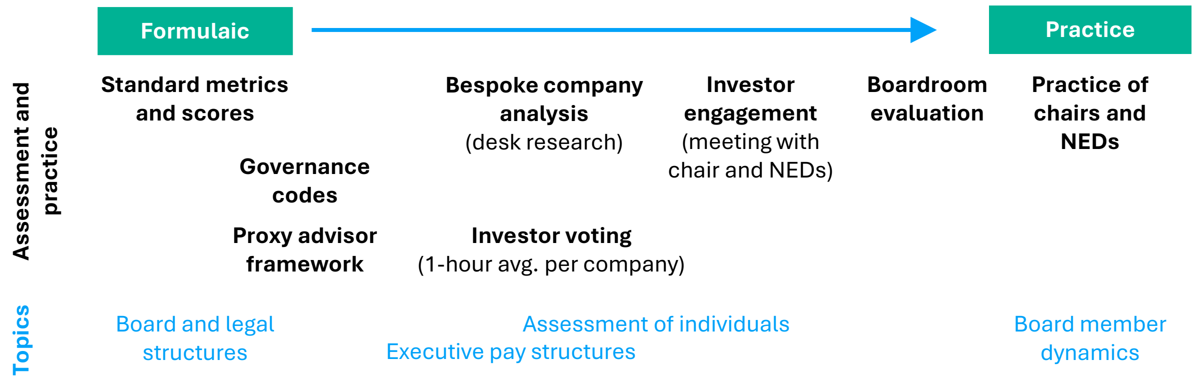
Legal reform

- **m)** Corporate purpose
- **n)** Limited liability
- **o)** Directors' duties
- **p)** Due diligence requirements

3. Beyond box-ticking

Moving to a more in-depth and company-specific assessment of governance is critical for assessing the backgrounds of directors and how pay can support sustainability. This will require going beyond the current formulaic list of requirements in codes, frameworks, scores, proxy advice and investor voting. The current formulaic approach has the below problems.

- **Formulaic assessments vs practice:** The formulaic approach is far removed from how governance is assessed when individuals have more time, and the practice of governance in boardrooms.
- **Weak evidence for governance metrics:** There is surprisingly limited evidence the formulaic approach is associated with improved company outcomes.
- **Variation ignored:** The formulaic approach often defines one version of good governance, when companies succeed with very different structures depending on their size, sector, and country.



4. Capacity for governance scrutiny

The challenge of moving beyond formulaic frameworks is that the ecosystem of governance analysis lacks the capacity for company-specific assessments. This section reviews the sources of governance analysis – investors, data providers, proxy advisors, sell-side, and sustainability non-profits. More analytical capacity is needed to move away from a formulaic approach and to support and encourage different approaches to corporate governance.

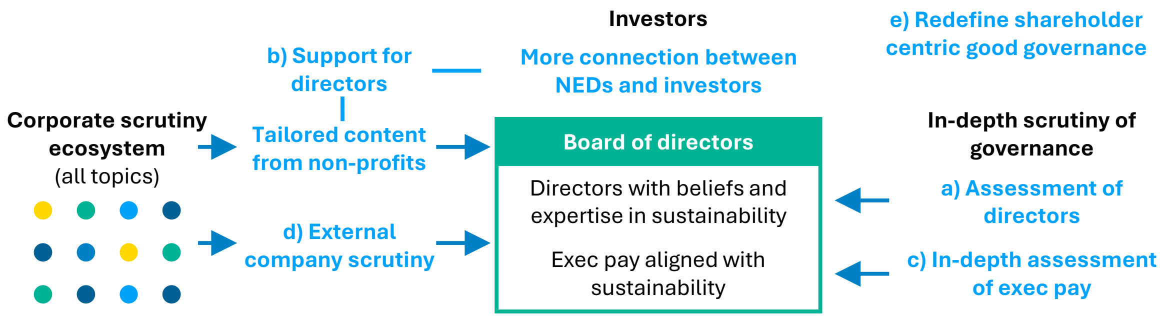
5. Passive tipping point

Any case for change needs to consider the potential tipping points in corporate governance from the steady rise in passive investment. This presents challenges and opportunities for sustainability. There are three important topics to consider.

- **Pass-through voting**: Passive asset managers will increasingly pass the voting decision to a third-party. It is important to have providers of pass-through voting options that support sustainability.
- **Resources for stewardship and scrutiny:** The rise of passive is reducing the budgets for stewardship and corporate scrutiny. This could catalyse a debate on the need to rethink how corporate scrutiny is funded and provided.
- **Legal debates on the definition of shareholders:** The rise of passive and pass-through voting makes it less clear who the shareholder is. Is it the index provider, passive asset manager, voting provider, ultimate beneficiary, or some abstract notion of shareholders? This could reopen debates on the legal duties of directors.

6. Proposed reforms

Drawing on the preceding chapters the report outlines proposals for how corporate governance, and the analysis of it, could better support sustainability. Core to the proposals is the need to move from formulaic frameworks to company-specific assessments of governance structures. This would enable a shift in focus from legal structures to the beliefs and backgrounds of directors, and a more thoughtful assessment of executive pay. Alongside this, a thriving ecosystem of corporate scrutiny across all topics could provide NEDs with valuable support to discuss these topics in the boardroom.



a) Assess directors

Mainstream and sustainability individuals all believe that more focus should be placed on the backgrounds and beliefs of board members, rather than the board structures that form the current list of governance metrics. If a board has individuals who understand and believe in sustainability, then it will give it ample focus irrespective of the governance structures. The challenge is the current data providers place little focus on assessing director CVs and so investors can only assess the backgrounds of directors for a small number of companies.

- **Assess director track records:** The first step is to increase the assessment of director backgrounds. This could include their CV, their track record on financial and sustainability performance, and any certifications and training. This could be done by non-profits or data providers.
- **Call out success and failure:** This analysis could then be used to celebrate success and call out failure. Directors often care deeply about their public profile so it could be more effective to publicly assess their personal performance on sustainability, rather than to influence the board through voting at AGMs.

b) Support directors

There is general agreement that NEDs have too little time and information to be effective, and especially to cover complex sustainability topics. This could be addressed by more connection between directors, investors and sustainability non-profits.

- **More meetings between NEDs and investors:** It is an oddity that NEDs rarely meet with investors, despite most people believing they are on the board to represent shareholders. NEDs could be supported on sustainability by meeting investor sector analysts who have a deep understanding of how sustainability is financially material for the sector.
- **Support NEDs on sustainability:** Initiatives could be created to support NEDs on sustainability such as aggregating and tailoring the insights from sustainability non-profits. This could build on the approach of Chapter Zero that supports NEDs on climate change. This could also take the form of director training and certification, which investors could then use as part of an assessment of director expertise.

c) Executive pay aligned with sustainability and strategy
Most companies have added ESG metrics to executive pay, but the evidence and views of investors is that ESG metrics in pay are too generic and targets too easy. There is an opportunity to push for a more robust alignment of pay, sustainability and strategy.

- **In-depth assessment of executive pay:** This could be supported by developing more detailed best practice examples and a framework for analysis on how executive pay can be better aligned with strategy and sustainability. This would need to cover all aspects of pay, including ESG metrics, but also whether financial metrics strike the right balance between growth and capital discipline. This would need significant analytical capacity to implement, which could come from investor collaboration, non-profits, or data providers.

d) External company scrutiny
The above proposals all require an increase in analytical capacity to 1) go beyond formulaic governance assessments, and 2) provide analysis across all sustainability topics to support NEDs. The scale of analysis required cannot be delivered by investors internally as even the largest asset managers have only a 10-person sustainability research team. The answer is changes to the ecosystem of company scrutiny, such as more support for non-profit research and open-access data. This is covered in the report – The Scrutiny Deficit.

Furthermore, there is a tension between a board's dual roles of advising and monitoring executives. Arguably the expectations on NEDs to monitor executives are too high, and this would be better conducted by external scrutiny. Hence increasing the capacity of external scrutiny could help lead to more balanced expectations on NEDs.

e) Redefine shareholder centric good governance
There is an opportunity to challenge and redefine the definition of 'good governance' without moving away from shareholder primacy. This is because of the lack of evidence for, and frustration with, the current formulaic approach. Plus, the rise of passive investment is leading to unavoidable challenges, such as what we mean by shareholders, the need to incentivise stewardship, and pass-through voting. This provides an opportunity to challenge orthodox thinking and open the possibility of reform.

7. Conclusion

Boardrooms make the final decision on corporate sustainability and so are in a critical position to navigate the current backlash. However, debates risk returning to circular arguments on shareholders vs stakeholders. Instead, there is an opportunity to move beyond these by redefining how governance can support long-term shareholder value, and consequently sustainability.

The report argues for two shifts to support this – moving the focus from structures to people and from formulaic to in-depth company-specific assessments. The opportunity for change comes from the continued frustration and lack of evidence for the formulaic approach and the unavoidable challenges from the rise of passive investment.

Scrutiny Hub will write research to develop these ideas. Please get in touch to discuss.
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1. Finding the win-wins

Governance is back in focus. However, most people still believe in short-term shareholder rights and a win-win between profit and people, but this does not stand up to evidence. A minority advocate for a shift in legal duties away from shareholders, which is unrealistic and has its own problems. The risk is continued circular debates on shareholders vs stakeholders. Instead, corporate governance structures need to help find and create the win-wins between people and profit to help navigate the current backlash against sustainability.

a) Governance back in focus

A consistent view in interviews was that the sustainability backlash is returning the focus to corporate governance. This may be because corporate governance was a focus for investors before sustainability, is an unavoidable part of voting, or is focused on shareholder rights. Either way, this places more importance on whether current corporate governance structures are delivering for shareholders and wider stakeholders.

b) Most people believe the aim is shareholder rights

The research for this report included 40 interviews covering investors (ESG and fund managers), data providers, proxy advisors, academics, and industry associations. There were varied views, but most people interviewed believed the aim of corporate governance should be protecting shareholder rights. Surprisingly this was the view of many sustainability analysts. There were also many who advocated for reform to support sustainability, from small tweaks to rewriting company law.

As with all sustainability and governance debates a key factor differentiating views was what someone believed on the alignment between profit and sustainability. Below are some simplified groupings of the different views. Views on specific reforms are covered later.

- ***Traditionalists:*** *'The focus over the last few years has shifted away from governance towards sustainability topics with low financial materiality. The focus needs to shift back to traditional good governance and the protection of shareholder rights. Where sustainability is financially material it will be considered.'*
- ***Win-win idealists:*** *'Sustainability is financially material and so better governance on the current definition will lead to more action on sustainability. Action on sustainability is stronger if integrated into traditional governance processes rather than creating separate mechanisms to deal with sustainability.'*
- ***Sustainability tweakers:*** *'Governance structures should be changed to support greater action on sustainability. The most important topics are ESG metrics in exec pay and the expertise of board members.'*
- ***Policy reformers:*** *'There are significant trade-offs between profit and sustainability, and this cannot be resolved by governance and so the main lever of change is government policy. Reforming governance could have a small but limited role.'*
- ***Legal radicals:*** *'There is a tension between sustainability and profit, and this can be addressed via legal reform of corporate purpose, directors' duties, or disclosure requirements.'*

c) But there are trade-offs between people and profit

Most investors, and those in the wider industry, are in the traditionalists and win-win idealist groups. They believe that 1) the primary aim of corporate governance is protecting shareholder rights, 2) current structures are doing this well, and 3) this leads to sufficient action on sustainability as there is alignment between people and profit.

But this is not true. First, while there are win-wins between sustainability and profit, for many topics there is a trade-off and especially in the short term. Second, if this view was correct then we would expect to see much higher action on sustainability, but we do not. Third, we'd expect to see a correlation between traditional good governance and action on sustainability, but we do not.

Conversely, the prospect of shifting legal duties from shareholders to stakeholders is unrealistic in the current environment and has a long list of complications. Furthermore, shifting the duty away from shareholders is not necessary. A compelling case can be made to reform the approach to corporate governance to support long-term shareholder value, and with this, sustainability.

d) Governance structures need to help find the win-wins

There is a risk that debates on corporate governance continue to go around in circles on stakeholders vs shareholders as they have done for decades. Instead, any case for reform needs to find the middle ground and work within a shareholder primacy framework.

Corporate governance structures need to help find the long-term win-wins between shareholders and stakeholders. For example, action on sustainability often requires companies to make long-term and risky investments. Or to change the commercial dynamics through new technologies, industry initiatives or policy reform. Boardrooms need the expertise and long-term view to look past short-term trade-offs and find the win-wins.

2. Agreement on people and pay

There are wide ranging views on how corporate governance can help find the win-wins – from those who support the status quo, to small tweaks to radical legal reform. Amongst the many areas discussed in interviews, two stood out as having more agreement. First, more analysis of the backgrounds of directors and support for directors. Second, executive pay aligned with sustainability. The challenge is both require a step change in analytical capacity to assess.

The historical focus of corporate governance has been protecting shareholder rights, but there is a long list of potential reforms for how governance can support wider stakeholders and sustainability. The list of topics covered draws on the interviews and the literature outlined in Appendix A.

Board

a) Responsibility for sustainability
b) Non-executive and executive backgrounds ★
c) Non-executive director role, time and information ★
d) Stakeholder voice

Executives and organisational structure

e) Exec pay aligned with sustainability ★
f) Investment frameworks and capital allocation
g) Employee incentives

Disclosure

h) Sustainability disclosure
i) Assurance of sustainability data

Investors

j) Voting and stewardship
k) ESG shareholder resolutions
l) Universal owner rationale

Legal reform

m) Corporate purpose
n) Limited liability
o) Directors' duties
p) Due diligence requirements

Board

a) Responsibility for sustainability

There is a choice for companies between integrating the responsibility for sustainability within existing structures or having specific responsibility for a committee or individual.

Many boards setup a sustainability sub-committee. In Europe 50% of listed companies by market capitalisation have a sustainability sub-committee to the board and 75% in the US.[1] The recent EU Platform on Sustainable Finance report on assessing transition plans stated *'Typically, boards delegate the development of transition plans to sustainability committees, which present them for approval'*. Some would argue this risks making sustainability a niche topic and not integrated into strategy.[2]

Allocating responsibility for climate change is one area of TCFD, so it naturally receives quite a bit of attention, but it was mentioned less in interviews than expertise and exec pay. Some investors said they did look at which individuals or entities had responsibility for climate change, and what the reporting line was for sustainability.

Conclusion: The general view is that the right approach is up to each company and that companies may move from specific responsibility to a more integrated model. This shows the problems of a framework that turns this into a metric.

b) Non-executive and executive backgrounds
There was high agreement on the need to place more focus on the backgrounds of non-executives and executives.

The rationale behind this is that if the right people are on the board they will make the right decisions irrespective of the governance structures. This view was consistent across traditionalists and sustainability advocates.

The more sustainability minded believe we need more individuals who have the belief and expertise in sustainability. A consistent view in interviews was that action on sustainability comes down to the belief of board members, and especially the CEO and chair. However, most were against having a sustainability 'specialist'.

The traditionalists agreed with the need for more focus on people and thought this should be on the individuals track record and general expertise. This often centred on if individuals had a track record for creating value for shareholders.

All individuals said that when they have the time for more detailed analysis, they look at the backgrounds of board members. It seems that when analysts have freedom to analyse what they want, rather than following a set framework, they place a significant weight on the backgrounds of individuals instead of technical aspects of governance structures. This is especially true of fund managers and sector analysts.

Conclusion: Strong agreement on the need for more analysis of the people on boards. The challenge is an assessment of people cannot easily be turned into a metric and so receives limited focus in formulaic governance assessments. This is expanded in Ch.6 Proposed reforms.

c) Non-executive director role, time and information
Non-executive directors (NEDs) have limited time and information. This makes it harder for them to effectively discuss sustainability in the boardroom.

- **Time:** The time NEDs dedicate to each board has increased over the last 20 years and is now around 35 days a year for large public companies, and less for smaller or private companies. Furthermore, most of this time is in board meetings, committee meetings, and reading the board pack, with relatively little time to meet external experts, stakeholders, shareholders, or go on site visits. Hence, it is fair to conclude that there are still significant time constraints on NEDs (see Appendix B).
- **Information:** The primary source of information for NEDs is the board pack, but there are varying views on the quality of board packs. A survey in 2023 of over 1,000 directors found that the average board pack was 226 pages long, and only 48% of directors say they get value from board papers, and 63% of board members score their board pack as 'weak' or 'poor'.[3] NEDs also receive information from site visits, advisory panels and presentations from internal and external experts. The problem is that this is often organised by management rather than by the NEDs.
- **Dual role of monitors and partners:** On listed company boards NEDs perform a dual role of advising executives and holding them to account. Some have argued there is a tension between these two roles, and it increases the time NEDs need to dedicate to the role.

Conclusion: There was high agreement in interviews that NEDs need more support to effectively discuss sustainability in the boardroom. This is expanded in Ch.6 Proposed reforms.

d) Stakeholder voice
There have been ongoing debates on if and how the voice of stakeholders should be heard in governance structures. This ranges from employees on boards to stakeholder advisory panels.

The degree of stakeholder representation in governance structures varies significantly by country. For example, in Europe 38% of companies by market capitalisation have employee representation on the board versus a negligible amount in North America.[1]

Interviewed investors did not place much focus on stakeholder representation in governance structures. This could be because many had a shareholder centric view or the lack of focus on this in formulaic governance assessments. In contrast, many non-profit and labour activists view stakeholder representation in governance structures as a critical reform that is needed.

Conclusion: The strongly held and opposing views makes progress in this area difficult. Nonetheless, more research could be done on how boards hear the voice of stakeholders, but this would again require more analytical capacity.

Executives and organisational structure

e) Executive pay aligned with sustainability
When talking to sustainability and stewardship analysts the most common governance change to support sustainability was including ESG metrics in executive pay. However, there are widely ranging views, with many individuals strongly against. The focus on including ESG in executive pay is natural given this is part of TCFD and the existing high focus on executive pay.

There is a growing literature on ESG in exec pay with quite few working papers. It generally finds there has been a significant increase in ESG in exec pay but transparency is low, targets are easily met, and it is not closely linked to strategy. (See Appendix C)

The views in interviews were aligned with the literature, and similarly mixed. Everyone believed the initial wave of ESG metrics in exec pay had been implemented poorly as targets are too easy, not aligned with strategy, and transparency too low. There were then differing views on if this was improving. Below are some views from the interviews.

- *'Earnings manipulation went up when EPS was added to pay. The same thing is now happening with ESG in pay'*
- *'ESG metrics have been included in a uniform way and so not aligned with strategy. For example, in France all companies have introduced emissions and diversity metrics'*
- *'Companies feel they need to include ESG in pay to show they care about ESG'*
- *'The initial wave of ESG metrics in exec pay was too general, but investors are now pushing for more robust metrics, but this is reliant on better internal data collection by companies'*
- *'Discussed with a proxy advisor implementing a more detailed assessment of climate metrics in executive pay, but they did not have any interest given the political pushback'*

Conclusion: There were mixed views on if ESG metrics in executive pay is a productive area to focus. Nonetheless, there is appetite for developing what is best practice, and especially how this can align with strategy, and then finding who can implement this assessment. Plus, given companies already have ESG metrics in exec pay, there is an immediate route to impact. This is expanded in Ch.6 Proposed reforms.

f) Investment frameworks and capital allocation
A common criticism of listed company governance structures is that it encourages executives to be too risk averse and short-term focused. This is especially relevant for sustainability which often needs long-term and risky investments to find the win-win between shareholders and stakeholders.

Conclusion: There was limited focus on this in interviews and the literature. However, it is an interesting area for further research. Equally, longer-term exec-pay and higher board expertise should help provide executives with the confidence to invest long-term.

g) Employee incentives
The literature includes whether employees have sufficient incentivise to act on sustainability. For example, this can include use of an internal carbon price.

Conclusion: Interviews placed limited focus on employee incentives or organisational structure as these are hard to assess externally and are not normally the focus of investors on corporate governance.

Disclosure

h) Sustainability disclosure
Disclosure receives a high focus in sustainability debates, which is probably because this has been the main regulatory agenda with tangible impacts on companies and investors.

Interviewees said disclosure obligations can be critical for getting topics into boardroom discussions. One interviewee said it is easy to underestimate how hard it is for a NED to raise a topic not on the agenda. Consequently, one major benefit of TCFD has been as a catalyst for boards to discuss climate change. Nonetheless, while many agreed TCFD had been useful, there was a general sense that disclosure obligations had gone too far in the EU and were now becoming a burden. Some said there is a risk that if a topic gets dealt with under compliance it is handled very differently to topics dealt with under strategy.

There has also been a lack of focus on who has the capacity for analysing increasing sustainability disclosure – as argued in The Scrutiny Deficit.

Conclusion: Improving sustainability through additional disclosure requirements is now politically problematic and risks turning sustainability into a compliance topic and not being matched with sufficient scrutiny.

i) Assurance of sustainability data
Regulations have increased the level of assurance required for sustainability disclosures. This can increase the credibility of sustainability data and help integrate it into governance and risk management processes. Of companies that report sustainability data, 66% by market capitalisation use an external provider for assurance and this is generally the same auditor as for the financial statements.[1]

Some interviewees saw a risk that assurance of sustainability reporting may lead to many auditors saying the quality of sustainability reporting is too low. There are also concerns on the quality and consistency of sustainability assurance.

Conclusion: Assurance of sustainability data is a critical step for how sustainability is incorporated into governance. The next step is to review recent increases in assurance.

Investors

j) Voting and stewardship

There are ongoing debates on the practice, definition and regulation of investor stewardship. A consistent theme of interviews and research is that effective stewardship needs significant resources for background research and then the time to engage companies. This is especially true for sustainability given its complexity. The problem is that the incentives are too low for investors to invest sufficiently in stewardship. Consequently, this means investors can only meaningfully engage with a small number of companies and adopt a shallow approach for the rest.

Furthermore, investors generally vote with management, which limits the prospects of AGM votes being a powerful lever to support sustainability (Appendix D).

Conclusion: There was no consensus on the solution to this conundrum. Many individuals said asset owners need to step up and start paying a premium for good stewardship, rather than being cost focused. One solution not raised was the value of external scrutiny in providing background research needed for in-depth engagements. For example, it is much easier for an investor to conduct an in-depth engagement with a company if a non-profit has already published research that clearly articulates the problem and provides best practice examples for the company to adopt.

k) ESG shareholder resolutions

The general view in interviews was that ESG resolutions have not worked, validated by the falling level of support (Appendix D).

Sustainability advocates thought resolutions had not led to change and so investors now need to focus on voting against directors to shift company behaviour. Those with mainstream views felt that ESG investors and non-profits have proposed resolutions that are not financially aligned with companies, and these subsequently receive very low support. Many in this group felt that ESG resolutions have been detrimental because they have reinforced the view that sustainability is not connected to mainstream financial debates.

Conclusion: To be effective ESG shareholder resolutions need a much stronger grounding in the financial reality companies face.

l) Universal owner rationale

A popular argument in the sustainability community is that because many investors have shares in all major companies, they should act to tackle systemic risks rather than only act in the interest of a specific company.

Conclusion: Too often this argument is used to make the case that a specific sustainability topic is material to a fund manager when it is not relevant to that individual's incentives. However, it is a powerful argument that is relevant to how the rise of passive investment may reshape corporate governance, which is covered later.

Legal reform

There are long running legal debates on directors' duties, fiduciary duty, and the purpose of companies. These debates have gone back and forth for a few decades, and the view of most people is that directors have sufficient discretion and so the limitation on action is not the legal wording of their duty. However, the rise of passive could change the debate so legal reform should not be ignored.

- **m) Corporate Purpose:** Changing the legal aim of companies to include stakeholders. For example, in Delaware (US) since 2013 for-profit companies can register as a Public Benefit Corporation (PBC). In 2023 there were 332 private PBCs and 14 listed. In France, since 2019 companies can register as a *société à mission*. In 2023 there were 1,276 private companies with this form in France and 8 listed companies.[1] A non-government approach to this has been pushed by B Lab Global that certifies companies as B Corps for meeting certain performance criteria and making a legal commitment. There are now over 6,000 companies with the B Corp certification, including some listed companies.
- **n) Limited liability:** Some legal scholars look back to the historical heated debates on limited liability and argue that the benefit companies enjoy of limited liability should come with more obligations.
- **o) Directors' duties:** There have been long running debates if the duty of directors is to shareholders, the company, or wider stakeholders. For example, The Shareholder Commons bought a lawsuit against Meta arguing that directors should act in the interests of a diversified investor as all shareholders in Meta are diversified.[4] Or, ClientEarth filed a lawsuit against Shell's board of directors that they failed to properly manage climate risk under Section 174 and 172 of the Companies Act.[5]
- **p) Due diligence requirements:** Legal requirement for companies to carry out due diligence on operations and supply chains on sustainability impacts.

Conclusion: These reforms are unrealistic in the current political environment. The best opportunity for reforming legal duties comes from the rise of passive investment as this create unavoidable challenges for corporate governance that will have to be addressed.

Conclusion: Agreement on people and pay

When asked how corporate governance could support sustainability the two most common topics were more focus on the backgrounds of directors and aligning executive pay with sustainability and strategy. One caveat is that some felt that assessing legal structures was more useful as an assessment of governance in emerging markets.

Another recurring theme was that any proposed change in approach was prevented by the lack of analytical capacity to assess governance structures and consequent reliance on formulaic assessments. Hence any shift to boards that better support sustainability will also need to find a way beyond the current formulaic metric-based assessments.

3. Beyond box-ticking

Corporate governance is often reduced to a formulaic list of requirements in codes, frameworks, scores, proxy advice and investor voting. This approach is far removed from how governance is assessed when individuals have more time and the practice of governance in boardrooms. Furthermore, there is limited evidence the formulaic approach is associated with improved company outcomes. Moving to a more in-depth and company-specific assessment of governance is critical for assessing the backgrounds of directors and how pay can support sustainability.

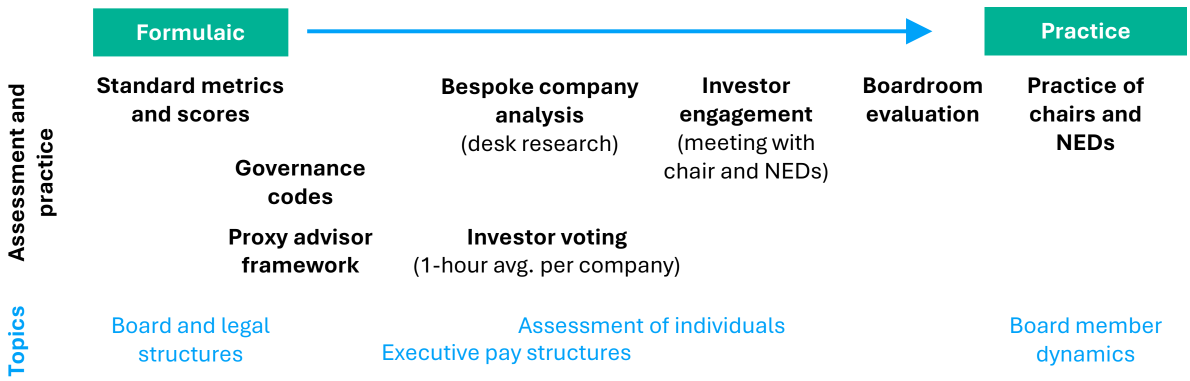
a) Formulaic assessment vs practice of governance

There is a significant gap between how good governance is defined and assessed in a code, score, or proxy advisor framework vs an in-depth engagement by investors, board evaluation or the practice of governance by chairs and NEDs.

It is often assumed that the high-level version of governance has a reasonable correlation with the practice of good governance in the boardroom – but this is not the case.

The formulaic version of governance has three main problems.

- It boils good governance down to a set list of traits and metrics such as CEO-chair separation, board independence and dual-class shares, but this ignores many factors that are hard to capture in metrics, such as the beliefs and backgrounds of directors.
- It creates one definition of good governance, whereas companies benefit from different governance structures depending on their size and sector.
- The formulaic version of governance places a high weight on independence, sometimes at the expense of expertise and financial incentives.



b) Surprisingly weak evidence for 'good governance' metrics

There is surprisingly weak evidence that many of the standard good governance metrics are associated with improved company performance. This is recognised by a large minority, but the majority still (wrongly) believe that the standard good governance metrics are evidence based. A summary of some of the literature is provided in Appendix E and key points highlighted below.

- Empirical studies covering the 1990s found a relationship between corporate governance and improved company outcomes, but the results are mixed for recent time periods.
- CEO-chair separation is one of the core beliefs of good governance, but numerous empirical studies struggle to find a connection to improved company outcomes.
- There is evidence for the benefits of independent directors depending on the level and definition, but the magnitude is quite small.
- Investors strongly object to dual-class shares, but the evidence is less clear.
- Companies with family ownership are normally scored poorly on corporate governance, but, in general, the evidence finds a positive link to company performance.

c) Formulaic approach ignores variation

Implicit in most formulaic approaches to governance is that there is one universal definition of good governance that can be applied to all companies. All evidence suggests this is not true.

Governance does not account for differences in time horizon and risk
Companies have very different investment time horizons and risk profiles depending on their size and sector, but this is not accounted for in formulaic approaches to governance.

For example, high growth companies may benefit from a smaller board that has higher expertise, higher financial incentives, but lower independence. Whereas a large bank arguably needs traditional good governance with high independence and a large board.

Variation between countries
Corporate governance structures differ significantly between countries, as can be seen in the OECD Corporate Governance Factbook 2023.[6] Yet all countries have successful companies. This suggests companies can succeed with very different governance structures. Furthermore, assessments of corporate governance often focus on how aligned companies are to national standards, which ignores the significant variation between countries.

Private equity governance model
Private equity often argue it has a governance advantage over listed companies, and hence they do not see traditional listed company governance as 'good governance'. Many would disagree with this, but it does show there is a diversity of views on what is good governance.

Private equity boards are typically less focused on independence, and more focused on finding individuals with the expertise to advise the CEO and giving them higher financial incentives. This argument was made in a 2018 report from the private equity firm Partners Group, which stated *'We believe that public markets have lost entrepreneurial ground to private markets due to an excessive focus on a corporate governance regime that, in many jurisdictions, has evolved far beyond its original mandate to protect shareholders, a phenomenon we have christened "governance correctness"'*.[7]

Conclusion: Beyond box-ticking

Many individuals think there is an evidence-based definition of good governance that can be assessed with current frameworks and that is embodied in frameworks, scores, proxy advice and investor voting. But this is not true.

- The formulaic version of governance is widely different to what analysts look at when they have time and freedom, or what chairs think makes a good board.
- The evidence is surprisingly weak that the standard governance metrics are associated with improved outcomes.
- The formulaic approach defines one universal definition of good governance, when companies succeed with very different governance structures, and can benefit from having different structures depending on their size and sector.

What does this mean?

There should be more openness to reform and innovation. Plus, even those who believe governance should solely focus on shareholder rights should be open to reform as the current approach is not evidence-based.

4. Capacity for governance scrutiny

The challenge of moving beyond formulaic frameworks is that the current ecosystem of governance analysis lacks the capacity for company-specific assessments. This section reviews the sources of this analysis – investors, data providers, proxy advisors, sell-side, and sustainability non-profits. More analytical capacity is needed to move away from a formulaic approach and to enable an in-depth assessment of people and pay.

a) Investors

Capacity: Stewardship teams are stretched

The capacity to assess governance structures by sustainability and stewardship teams is low versus the number of companies they cover. Investment teams are larger but have a low focus on analysing governance.

- **Varied organisational structure:** The organisational responsibility for governance and voting is very varied. Sometimes the sustainability team is quite separate from the governance and stewardship team. Whereas sometimes there is a combined team where everyone takes some responsibility for voting, engagement, themes and sectors. Sometimes there is a distinct research department of sector analysts, while other asset managers have sector specialists within each investment team. The level of integration with the ESG team varies. Some ESG teams are quite siloed, while others maintain strong relationships with investment teams.
- **Sustainability team size:** The largest asset managers have up to a 30-person sustainability team with about 10 doing sustainability research, 5-10 governance/stewardship, and the remainder split between product and data. And most asset managers have far fewer than this.
- **Data sources:** Some investors just use one proxy advisor for recommendations and governance data, while others combine a range of data sources. On top of external data there is a mix of in-house analysis. Some investors mentioned negotiations with proxy advisors on the costs of implementing a more complex custom policy.
- **Voting capacity:** Investors are particularly stretched on voting. One investor said that on average they have one hour per company to read the recommendation from the proxy advisor and decide how to vote, and this was for a large and well-resourced asset manager.
- **Domestic bias:** A consistent theme in interviews was that asset managers engage much more actively with domestic companies even though their holdings are global. There can be an expectation to engage with domestic companies and domestic companies will listen more to domestic asset managers.
- **Varied involvement of sector teams:** Asset managers spend significantly more on investment teams (sector analysts and fund managers) than ESG teams. However, their involvement in governance analysis is generally quite low, and the interaction between stewardship analysts and fund managers is mostly focused on voting decisions.

Approach: Focus on people when there is time and freedom

Surveys of investors normally place governance as the most important ESG topic. However, these surveys do not cover what is meant by governance and how it is considered (Appendix F).

Investors often have a traditional view of governance focused on shareholder rights, but there are those that advocate for reform, and for these individuals the most common topics were the expertise of directors and ESG metrics in executive pay. Capacity for research and stewardship is a major limitation preventing investors going beyond mechanistic assessments from external providers.

A consistent theme in interviews was that when investors have the time and freedom, they place more focus on the backgrounds of individuals rather than compliance with good governance traits. This is especially true for investment analysts.

Fund managers usually place much more focus on the quality of executives and board members. This can come from assessing their track record or from meeting with management. It is often a personal and subjective judgement. One PM said they focused particularly on an individual's M&A track record and if there was a history of deals with adverse share price reactions.

b) Data providers

Capacity: Significant resources
ESG data providers have significant research capacity, and the market is dominated by a few large US companies.

The market for ESG data is around EUR 800m annually.[8] This is dominated by a few large US providers. For example, MSCI reported ESG and climate revenue of USD 288m in its 2023 Annual Report. Similarly, LSEG report they have over 700 research analysts collecting ESG data.

In addition to the large financial data providers there is a long list of smaller ESG and governance data providers. These providers often focus on different topics to differentiate themselves from the large providers such as individuals, audits, or compensation.

Approach: Scores have the similar topics but low correlation

Governance scores typically cover the same areas – board independence, diversity, financial expertise, shareholder rights, executive compensation, and audit (See Appendix G). Hence, it is surprising that the correlation between governance scores is quite low. This was highlighted in the 2022 paper Aggregate Confusion. The paper highlighted the well-known low correlation between ESG scores – it found the average correlation was 0.54. More surprising is that the correlation for the governance pillar was the lowest at 0.30, versus 0.42 for social and 0.53 for environmental.[9]

c) Proxy advisors

Capacity: Significant resources and concentration
The proxy advisor market is dominated ISS and Glass Lewis which have significant research capacity. For example, ISS has 380 full-time research analysts, and the total revenue of proxy advisors is around USD 500m globally (Appendix H).

Approach: Choices offered but still a formulaic framework
Proxy advisors have a benchmark policy and a range of alternative policies, as well as the ability for investors to have the proxy advisor apply a custom policy. Research suggests that around 80% of investors use a custom voting policy rather than one of the standard policies.[10] However, the custom policies may not be that different to the benchmark policies.[11]

There are heated debates about whether investors just follow proxy advisor recommendations and hence if the proxy advisors have too much power. The proxy advisors position themselves as simply the providers of information and recommendations to investors, with investors making the final decision. However, the evidence normally finds they have significant influence over investor voting (Appendix I).

In the interviews conducted for this report, most people felt that proxy advisors were unfairly criticised as they perform a vital function. Asset managers could not vote all the shares they own without proxy advisors. This is mainly due to capacity. The largest asset managers in the world have up to 15 people working on stewardship, or more for the big three passive managers, whereas ISS have 380 research analysts and over 2,000 employees.

d) Sell-side research

Capacity: In-depth sector expertise
Sell-side research is the main provider of primary financial analysis of listed companies. It is dominated by investment banks, but there are some alternative providers. There are around 3,000 sell-side research analysts in the 12 largest investment banks.[12] It is estimated that investors spend around USD 14bn a year annually on sell-side and independent investment research.[13]

The main strength of sell-side research is the in-depth sector expertise. It is unique in having a career path where individuals stay as specialists, often covering the same 10-20 companies for their whole career.

Approach: Limited focus on governance beyond view of management
There is rarely a structured approach to governance on the sell-side as analysts are given a high degree of freedom to approach all their investment analysis as they wish. Below are some of the ways sell-side analysts cover governance.

- Analysts will normally have a strong view on the quality of each management team based on their experience of meeting them and following their decisions. This can be an accurate assessment, but it can also have an element of gut feel and bias to management teams that present well.
- Sell-side analysts will cover specific governance issues when it becomes highly material, such as a battle for control or on-going governance problems or a clear governance valuation discount.
- A small number of sector teams regularly analyse executive pay, but this is not done in a consistent manner across teams.

e) Sustainability frameworks and assessments

Capacity: Potential for analytical scale, but low focus and fragmented
Sustainability frameworks and assessments often include a section on governance, but this is a small part of overall frameworks (See Appendix J). Non-profits have the potential to provide in-depth scrutiny of companies, as outlined in The Scrutiny Deficit, but for governance the analysis is currently quite shallow and fragmented.

Approach: High level assessment of responsibility and expertise
The topics are very different to a traditional assessment of governance. They tend to cover responsibility for sustainability, expertise, and the inclusion of ESG metrics in executive pay. They are generally quite high-level as governance is a small part of the overall sustainability score.

Conclusion: Governance scrutiny ecosystem

Investor stewardship teams are stretched and so can only go into depth on a few companies and then need to rely on shallow analysis from third parties for the rest.

The greatest concentration of analytical capacity is the data providers and proxy advisors, but this is focused on implementing formulaic frameworks.

When investment analysts are given freedom, they often place more focus on a subjective assessment of the individuals on a board, rather than if certain legal structures are present.

There is some governance analysis by sustainability non-profits, but it is at quite a high level.

Overall analysis on the extent to which governance supports sustainability appears limited. The lack of analytical capacity on governance makes it hard to move away from a formulaic metric-based approach.

5. Passive tipping point

The steady and relentless rise in passive investing could lead to tipping points in corporate governance, just as shifts in company ownership have done in the past. This presents challenges, but also opportunities. It could catalyse a need to financially incentivise stewardship, shift influence to pass-through voting providers, and renew debates on the legal duty to shareholders.

a) The relentless shift to passive

Asset management has been steadily shifting from active to passive over the last 20 years. The shift is not slowing and possibly accelerating. This is due to lower fees and studies finding higher performance after fees.

In January 2024 Morningstar reported that at the end of 2023 passive funds surpassed active for US mutual funds and ETFs.[14] Europe is now starting to catch-up with passive at 30% of European funds.[15]

The rise of passive is no surprise given evidence finds it delivers higher returns for investors. For example, the Morningstar Active/Passive Barometer finds that over 10 years to June 2024 only 17.6% of active equity managers in the European fund market have beaten the equivalent passive products.[16]

There were a mix of views on passive investment in interviews – from ideal universal owners to absent owners who underinvest in stewardship to traditionalists resisting sustainability. Below are some of the key implications and possible responses from investors, companies, and regulators.

b) Reduction in research and stewardship capacity

The rise in passive asset management will probably lead to a reduction in research and stewardship capacity for the below reasons.

- Passive fees are much lower and a very small proportion of this is spent on stewardship.
- As long-term investments steadily move to passive the remaining active money may have a shorter-term focus and become more dominated by hedge funds. This could tilt the focus of research to short-term share price movements rather than business fundamentals and long-term topics.
- As passive rises there will be more liquidity impacts on share prices. This could further divert research away from long-term fundamentals towards assessing the liquidity impacts from passive.

This is supported by the empirical literature that finds passive asset managers invest less in stewardship and defer excessively to management (Bebchuk and Hirst 2019).[17] For example, this paper estimated that the big three invest on average 0.2% of their fee income in stewardship. This empirical result has been repeated in many other papers. The academic paper Heath et al 2021 found that passive funds are less likely to vote against management, found no evidence they engage effectively, and promote less board independence and pay alignment.[18] Stewardship teams of the big three have increased recently, but this may now reverse again with the ESG pushback, or certainly the degree of opposition to management resolutions has fallen.

Below are some the possible responses and solutions to this problem.

Will asset owners pay? A key question is if asset owners are willing to pay for stewardship or if they will always choose the lowest cost passive products. One negative signal is that European asset owners still predominantly chose the big three passive managers despite the US ESG pushback making it harder for them to focus on sustainability. It is odd that we are not seeing more flows towards the European passive managers.

Will regulators incentivise stewardship? A common theme from interviews and the literature is that at some point regulators may need to create financial incentives for investors to dedicate resources to stewardship. This could come in a variety of forms, for example, regulations could require asset managers to have a minimum investment level in stewardship, or regulators could impose fees to fund stewardship. This could be mandated by regulators or enacted on a voluntary basis by companies joining different listing regimes.

Will more stewardship need to be done externally? Good company research and stewardship needs scale, and this is hard to achieve if it is fragmented across hundreds of small teams. It may become clearer that company scrutiny needs scale and so more of the research that supports stewardship is done by external parties such as commercial research providers, non-profits, or investor collaborations. This argument was made in The Scrutiny Deficit.

c) Power concentration and pass-through voting

The rise of passive asset management will likely lead to a significant concentration of power. Passive asset management is dominated by the big three – Blackrock, Vanguard, and State Street. For example, the big three collectively had a median stake of 22% in S&P 500 companies in 2021.[19] The total assets under management of the big three is now USD 25tn. In addition, if pass-through voting gains traction, then voting decisions may be determined by proxy advisors which is dominated by two companies.

The concentration of power leads to heavy criticism when the big three use this influence in any direction. When ESG was booming the big three were under pressure to increase support for ESG, which they did. But now ESG is in retreat, so is the support from the big three.[20]

Will pass-through voting gain traction? Consequently, there have been increasing calls to restrict the voting power of passive asset managers. For example, in 2022 a group of Senators proposed the Index Act that would require passive asset managers to pass-through the vote to the underlying investors.

The act did not pass, but Blackrock voluntarily launched pass-through voting in 2022. Clients can ask Blackrock to implement their custom voting policy, contract with a proxy advisor to implement a policy, or choose from a range of options including external providers. In Q2 2024 50% of indexed equity were eligible for voting choice, and of this 23% have chosen to use voting choice, hence 12% of the total.[21] The proportion exercising voting choice appears to be only rising slowly. Though Blackrock only started to provide voting choice to retail customers in 2024.

It's unclear what proportion of passive funds will opt for pass-through voting either voluntarily or mandated by regulators. And then more importantly who will decide the votes. The underlying investors in passive funds do not have the resources to engage and vote all the shares so it will have to be done by entities with the scale to cover thousands of companies. This is most likely to be the proxy advisors or new entities could be created.

d) Renewed debates on directors' duties and universal ownership

Passive investing is also leading to renewed debates on directors' duties and if the fiduciary duty of investors should have a universal owner rationale.

There have been recuring debates on if the duty of company directors is purely to shareholders or also the company and stakeholders. If passive ownership rises it becomes less clear who the shareholders are, is it the passive asset manager (e,g, Blackrock), is it the index provider (e,g, MSCI), is it the entity that decides the vote (e,g, ISS), or is it the ultimate beneficiaries, or is it an abstract notion of shareholder value. It could become harder to simply argue the duty is to 'the shareholders' as that will increasingly become an unclear concept.

Connected to this is the universal owner argument. The idea is that because passive investors own all companies, they should act in the interest of all companies rather than an individual company and hence have more incentive to consider systemic risks. There could be renewed arguments that passive asset managers must consider systemic risks to meet their fiduciary duty.

This question was seen in the recent court case by Shareholder Commons against Meta. It argued that Meta's directors needed to act in the interests of a diversified shareholder rather than someone only invested in Meta. The judge said prior cases showed directors needed to act in the interests of 'the shares' rather than the interests of the ultimate beneficiaries.[22] This shows the definition of shareholders is in flux.

Is there an opportunity on legal duties? Debates on legal duties tend to go around in circles, but the rise of passive changes this. The debate stops being about shareholders vs stakeholders and shifts to how we define shareholders. Hence, there could be an opportunity to make the consideration of systemic risks part of the legal duty of directors and investors. On the other hand, it could just lead to more confusion and hence more discretion for directors, which again comes back to their background and beliefs.

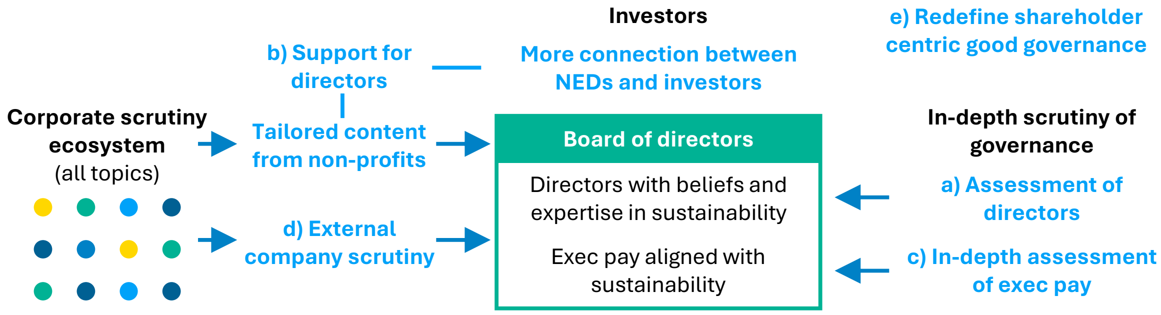
Conclusion: Passive tipping point

Passive investing has been rising for decades, so many people have stopped questioning its impact, but it could reach a tipping point with significant implications for governance.

- There is likely to be more acknowledgement that stewardship and scrutiny of companies needs to be financial incentivised, and that the research behind this is best done externally to shareholders.
- There will be heated debates on passive voting and the outcome of pass-through voting is uncertain.
- Alongside this will be renewed legal debates on the duty of directors and investors, which could support a universal owner rationale or just give directors more discretion.

6. Proposed reforms

This chapter outlines proposals for how corporate governance, and the analysis of it, could better support sustainability. Core to the proposals is the need to move from formulaic frameworks to company specific assessments of governance structures. This would enable a shift in focus from legal structures to the beliefs and backgrounds of directors, and a more thoughtful assessment of executive pay. Alongside this, directors could be provided with more support from the corporate scrutiny ecosystem across all topics.



a) Assessment of directors

The area of strongest agreement was there needs to be more focus on the people on boards rather than the legal structures. The rationale behind this is that if the right people are on the board they will make the right decisions irrespective of the governance structures. This view was consistent across traditionalists and sustainability advocates.

The more sustainability minded believe we need more individuals who have the belief and expertise in sustainability, though most were against having a sustainability 'specialist'. A consistent view in interviews was that action on sustainability all comes down to the belief of board members, and especially the CEO and chair.

The traditionalists agreed with the need for more focus on people and thought this should be on the individuals track record and general expertise. This often centred on if individuals had a track record for creating value for shareholders.

All individuals said that when they have the time for more detailed analysis, they look at the backgrounds of board members. It seems that when analysts have freedom to analyse what they want, rather than following a set framework, they place a significant weight on the backgrounds of individuals instead of technical aspects of governance structures. This is especially true of fund managers and sector analysts.

Action: Create assessment of individuals

It is currently very time consuming for investors to assess the backgrounds of board members. Data providers only offer a very high-level assessment of board expertise. This is generally a binary assessment on if a director has financial or industry knowledge (For example, the MSCI governance score assesses director expertise on financial, industry, and risk management). To go beyond this assessment requires reading CVs and searching backgrounds which is time consuming and so can only be done for a small number of companies.

There are some niche data providers assessing individuals, for example, Boardroom Alpha assesses the quality of the executives and the board, and Boardex covers the connections of directors. Overall use of these new offers appeared to be limited.

Adding to the challenge is that the board skills matrix published by companies is not very useful as they tend to say a high number of individuals have sustainability expertise, which investors do not believe is accurate.

All interviewees agreed that it should be possible to form an objective assessment on board member expertise and track records, especially using AI. However, there does not appear to be interest from the large data providers and proxy advisors to expand their assessment of individuals given its potentially controversial nature.

An assessment of director background and expertise could cover the CV of directors, sustainability and financial performance of the companies they worked for, and any director training and certifications covering sustainability.

Below are some potential actions to increase the focus on individuals.

- **Non-profit to assess individuals:** Form a non-profit to publish positive and negative reviews of individuals. This would be controversial so it should be separated from building a data product that could be sold to investors. Ultimately the decisions board members make are personal, so the most effective route to impact is making it personal. This could announce annual awards for executives and non-executives showing bold leadership on sustainability. It could start with a report on the backgrounds of individuals at the most important companies to sustainability.
- **Database on track records:** Build an open-source database of individual track records. It may be possible to co-fund this with companies that would use the data.
- **Engage data providers:** Further research on data providers already assessing individuals, and the potential for this to place more focus on sustainability.
- **Investors assess NED involvement in Chapter Zero:** Investors could start to assess non-executive director involvement in initiatives such as Chapter Zero as part of their assessment of companies.

Action: Develop the next generation of sustainability NEDs

A few interviewees said it is hard to find individuals who are credible board members and have sustainability expertise, and those with both are in high demand. Work could be done to support the development of individuals who in the future would be credible board members and have sustainability expertise. The most successful route would be to provide more sustainability expertise to successful business leaders.

Action: Further research

- Views are split on if boards are a closed shop or if there are genuinely only a small group of individuals who can be effective board members. More research could be done on board member labour markets. This could challenge the belief that only a small group of people are credible board members.
- Research on the role of board evaluations can have in assessing if boards have the right balance of individuals and focus on sustainability.
- Some argue that expectations on NEDs are too high given they only spend 30 days on each company per year. Research could be done on the possibility of paying a few NEDs more so they can dedicate more time to the role and so they can build a deeper understanding of the company, which is necessary for advocating sustainability.

b) Support directors

Non-executive directors only spend about 30 days a year on a company and have limited access to information. More could be done to provide them with the support and information they need to effectively discuss sustainability.

Below are fours ways to increase support and information for NEDs on sustainability.

- **Non-profit support for NEDs on sustainability:** Scrutiny non-profits have insights that could be useful for NEDs to discuss sustainability in the boardroom. The problem is there are a large array of non-profits and they do not speak in the language of NEDs. A platform could be setup to aggregate and tailor the content from sustainability non-profits so it is relevant to NEDs. Ideally this platform would have salespeople who could engage NEDs on the relevant sector and topics. This could build on the approach of Chapter Zero that supports NEDs on climate change.
- **Training and certifications for NEDs:** The offerings of sustainability training and certifications for directors could be improved. This has the added benefit that investors could include this in their assessment of director expertise.
- **Meetings between NEDs and sector analysts:** It is currently odd that NEDs rarely meet investors. However, some sector analysts have valuable knowledge that could be useful to NEDs. These analysts have deep sector knowledge and an understanding of how sustainability can be financially material to companies in the sector. Sustainability analysts could help identify which sector analysts meet these criteria and then support meetings between them and NEDs. Or this could be coordinated by the initiatives proposed above to support NEDs.
- **Research on information sources for NEDs:** More research could be conducted on the best practice for providing information to NEDs and specifically for sustainability topics. Below are some of the sources of sustainability information for NEDs.
    - Information dashboard for the board including operational sustainability metrics.
    - Updates from internal sustainability team.
    - Updates from external experts. NEDs often don't seek external input, so this could be supported and encouraged.
    - Ability of NEDs to commission their own research, though this is very rare.

c) Executive pay aligned with sustainability and strategy

When talking to ESG and stewardship analysts the most common governance change to support sustainability was including ESG metrics in executive pay. However, there are wide ranging views, with many individuals strongly against.

There is a growing literature on ESG in exec pay with quite few working papers. It generally finds there has been a significant increase in ESG in exec pay but transparency is low, targets are easily met, and it is not closely linked to strategy. (See Appendix C)

The views in interviews were aligned with the literature, and similarly mixed. Everyone believed the initial wave of ESG metrics in exec pay had been implemented poorly as targets are too easy, not aligned with strategy, and transparency too low. There were then differing views on if this was improving.

Some people are resistant to more focus on executive pay as it has dominated governance debates for so long. Nonetheless, it is a powerful lever for influencing executives and there is appetite to move beyond basic ESG metrics to how executive pay is aligned with sustainability and strategy.

Any work on executive pay should focus on alignment with strategy, financial metrics and time horizons, in addition to ESG metrics. For example, the time horizon of executive pay is often much shorter than the investment horizon for a company. Financial metrics can encourage capital discipline or long-term investment, using FCF as a metric could reduce the incentive to invest long-term.

One example of this is that in 2022 European autos company executive pay had a high focus on operating profit and FCF, and hence on maximising cash returns from the legacy ICE business and controlling investment (including in EVs). This was not aligned with long-term value which was determined by if the company had a successful approach to the EV transition. This shows how aligning executive pay with sustainability can be about the choice of financial metrics as well as including ESG metrics.

Action: More in-depth assessments of executive pay

- **Review of pay literature:** A report providing a full review of the literature, guidance and practice on ESG in exec pay.
- **Test assessment of pay for 20-40 companies:** Publish a report assessing the executive pay of a small number of companies. This would include an assessment of current pay plans and a proposal for how pay could better align with strategy and sustainability.
- **Best practice:** Use this initial work to build an alliance to develop guidance on the best practice alignment of executive pay with sustainability.
- **Build into climate assessments:** Work with TPI and WBA to improve the executive pay assessment within their climate governance assessment.
- **Encourage use by data providers:** Encourage data providers to improve their assessment of ESG in executive pay. This could involve helping coordinate investors to have a coordinated request for different analysis.

d) External company scrutiny

A consistent theme in interviews and research is that there is a lack of resources for in-depth research on governance and sustainability. Consequently, investors resort to simplistic data driven assessments either internally or from external providers (data or proxy providers).

More in-depth research is critical for many topics discussed in this report. On governance, it can enable an assessment of the individuals on the board rather than just legal structures, or how executive pay aligns with strategy rather than just if it includes ESG metrics. On sustainability, it can enable analysis of the financial implications for each company, rather than just a generic proposal. In short, enabling more in-depth analysis is necessary to address many of the issues identified in this report and for further progress on sustainability.

This is covered at length in The Scrutiny Deficit which proposes a range of actions to increase the capacity for in-depth corporate scrutiny.

e) Redefine shareholder centric good governance

Most people, and especially investors, have a strong belief in the status quo approach to corporate governance. However, as covered earlier, the evidence for this approach is far weaker than most people realise. Acknowledging the weak evidence can lead to a more open debate on the possibility for reform.

Furthermore, there is an opportunity to challenge views on what governance structures support long-term shareholder value without getting stuck in debates on shareholders vs stakeholders.

Action: Evidence to challenge status quo views on governance

The first step is to challenge strongly held beliefs in the current approach to governance.

- **New empirical governance studies and literature reviews:** New comprehensive empirical studies of corporate governance, and literature reviews of empirical studies, as there have recently been less of these in the academic literature.
- **Academia-practice feedback loop:** The feedback loop from academic research into practice appears quite weak. This could be helped by funding more literature reviews of academic research written for a non-academic audience. This could turn into live summaries of the literature that are updated each year and are peer reviewed. This could include a survey of governance academics on which topics have clear evidence, and which do not.
- **Open case studies:** Most governance case studies are scandals. The debate could be shifted by creating an open-source resource of governance case studies that focus on examples where governance had a positive or negative impact on strategy and the long-term success of the company.
- **Open-source governance database:** An open-source database could enable more in-depth research and harness the work of all researchers to improve the quality of the data. This can be built in two directions – a detailed dataset for a small number of companies, and wide coverage for a handful of metrics. The benefits are building an ecosystem of governance research where everyone helps improve the data and everyone has access to the data.

Action: Pass-through voting

Critical to the future of stewardship is how pass-through voting evolves for passive funds. How many end-investors will choose this option? Who will they delegate their vote to? Will this be proxy advisors or new entities? Will the entities deciding pass-through votes support sustainability?

A critical area of research is to assess how pass-through voting is evolving and how this could support sustainability.

- **Research on pass-through voting:** Research and advocacy on which choices are provided to end-investors and how these are presented, and then scrutiny on how these are implemented.
- **Non-profit proxy advisor:** Form new organisations to provide alternative voting options. For example, a proxy advisor drawing on all the work of sustainability non-profits and sustainable investors.

Appendices

Appendix A: Literature on how governance can support sustainability

Academic literature

There is an extensive academic literature on corporate governance and sustainability. The main areas of the literature are empirical studies on the relationship between sustainability performance and traditional governance (e,g, board independence), ownership (e,g, institutional investors), and sustainability tilts in governance (e,g, diversity and ESG in exec pay). And separately there is a wide literature on potential legal reforms.

A useful summary of the range of topics covered is provided in *'Sustainable Corporate Governance. An Overview and an Assessment'* (June 2023).[23] This covers the following topics – company law reform, corporate purpose, long-term ownership, universal owners, ESG investment, active ownership, sustainability committees, board expertise, board diversity, sustainability incentives, climate and sustainability plans, sustainability risk management, sustainability reporting, internal carbon pricing, and corporate cooperation.

Industry literature

There is a similarly extensive and varied literature from industry. It is generally quite high level, but a recurring question is to what extent should sustainability be integrated into normal structures and processes vs having separate governance structures just for sustainability.

- **OCED Principles of Corporate Governance:** In 2023 a new chapter on 'Sustainability and resilience' was added to the G20/OECD Principles of Corporate Governance. The chapter covers the following areas – disclosure, alignment of disclosure and goals, assurance requirements, balance of shareholder and stakeholder voice, lobbying, capital structure, and engaging stakeholders.
- **Centre for Climate Engagement:** A briefing from the Centre for Climate Engagement argued that organisations either integrate sustainability into strategy and normal governance processes or treat the governance of sustainability as standalone function.[24]
- **Deloitte:** A report from Deloitte identified four governance and culture challenges related to the net-zero transition. These are 1) deciding who has responsibility between sustainability, strategy and operations, and board, committee and executives, 2) aligning priorities across the organisation, 3) engaging all employees, 4) tensions between group and subsidiary.[25]
- **INSEAD:** A report from the INSEAD Corporate Governance Centre outlines six possible models for governance to incorporate sustainability from not formally embedded to a board champion to fully integrated.[26]
- **Climate Governance Initiative:** The Climate Governance Initiative carried out a survey of 440 chairs and board members. On asking 'what are the key barriers to progress', 50% said climate is not seen as a priority and 40% said a lack of knowledge.[27]
- **ICGN:** An investor viewpoint from the ICGN in 2022 covered the following topics for how board effectiveness could be improved on sustainability – board diversity, board evaluations, board skills, strong chair and LID, board committee involvement, commitment to disclosure, board training, and evaluation of the CEO.[28]
- **OECD:** A report by the OECD reviewed corporate governance sustainability practices. It covers disclosure, assurance, targets, board committees, lobbying, stakeholder engagement, and sustainable bonds.[29]

- **WEF:** The World Economic Forum published a guide for climate governance. It has eight principles – accountability, knowledge, structure (ie committees), risk and opportunity assessment, strategic decision making, incentives, disclosure, and dialogue with peers.[30]
- **EU Platform on Sustainable Finance:** The EU Platform on Sustainable Finance published a report on assessing transition plans. There was only one page out of 60 on governance. It covered the normal topics of responsibility and incentives, but not expertise. It also covered the role of audit committees overseeing sustainability disclosure. Policy lobbying was also placed under governance, but it is not normally considered as part of governance.[31]

Case studies

There appears to be a lack of case studies on how governance can support sustainability. The Climate Governance Institute published a series of case studies on the role of boards in driving climate action (Case studies: The role of boards in driving climate action). A few are summarised below.

- **British Land:** The ESG committee has senior people from the board and executives, including three NEDs, CEO, CFO, COO, General Counsel and HR Director. The sustainability team reports directly to the COO. All executives have sustainability objectives in remuneration. There is an internal carbon price of GBP 60.
- **Natura:** In 2014 Natura became the first listed company to receive a B Corp certification. Since then, Natura has developed an Integrated P&L financial tool that calculates a monetary value for the impact on natural, human and social capital. This tool is managed by the finance team which helps integrate sustainability into financial planning. Sustainability indicators are also included in the pay of employees and executives.
- **Smurfit Kappa:** The company has integrated sustainability into its funding strategy with a sustainability-linked loan and green bonds. It also has an engaged board with four NEDs on its sustainability committee.

The company most mentioned in interviews was **DSM** that has shown bold leadership on sustainability as it transformed itself from coal mining to chemicals to biotech with a strong focus on sustainability. It is now one of the most owned companies by sustainable funds. It's also interesting to note that DSM had sustainability metrics in executive pay already in 2010 and these metrics were aligned with its strategy, such as the energy used per unit of product. DSM also benefited from a long tenured CEO from 2007 to 2020.

On the other hand, there are many examples where governance and sustainability are not aligned. The prime example of this is **Tesla**. Tesla has pioneered EVs but is always assessed as having poor governance. Indeed, the correlation between governance and sustainability solutions appears to be lower than for governance and operational sustainability. We can see this in the low correlation between governance scores and the ownership of clean energy funds. Or using Climate Arc, the companies that are rated highest on capital allocation are generally rated the worst on governance. This is just anecdotal, but it could be that traditional good governance does not sufficiently support the long-term and risky investment needed to develop sustainability solutions.

There are also cases where governance shifts towards sustainability have not led to an improvement in sustainability. In 2021 **Engine No.1** won a proxy fight and secured three board seats on **ExxonMobil**, but the company has continued to expand oil and gas production.

Appendix B: Non-executive director time commitment

Non-executive directors (NEDs) have limited time per company. Surveys suggest NEDs for large-listed companies dedicate about 35 days per year to each company.

- A survey of 743 directors in 2023 found that directors on average dedicate 321 hours per year to boards of public companies and 150 hours for private companies. This includes time to prepare, travel and attend meetings. On a 9-hour day this is 36 days and 17 days.[32]
- A survey of 586 directors for financial services in 2018 found the average days dedicated to each entity by a director was 22 days and 42 days for the chair. There was a wide range with directors for large entities dedicating significantly more time. For example, directors of entities with over EUR 100bn in assets dedicated 37 days on average.[33]

Appendix C: ESG metrics in executive pay literature

There is a growing literature on ESG in exec pay with quite few working papers. It generally finds there has been a significant increase in ESG in exec pay but transparency is low, targets are easily met, and it is not closely linked to strategy. A few examples are provided below.

- The inclusion of ESG metrics in executive pay has risen sharply over the last few years. In Europe 80% of companies by market capitalisation have some link to sustainability in executive compensation and 60% in the US.[1]
- The split of opinion was shown in the survey in 'Sustainable Investing: Evidence from the Field' – 44% of respondents viewed ES metrics in exec pay as a cause of overinvestment in ES, and similarly 46% viewed them as a cause of underinvestment.[68]
- An academic working paper reviewing S&P500 companies in 2023 found that 63% include an ESG component in exec pay and this was mostly in the annual bonus. It found companies miss ESG targets far less often than financial targets. It also found that ESG in exec pay is associated with more opposition in say-on-pay votes and no increase in ESG score leading the authors to conclude it relates to weak governance.[34]
- Bebchuk provides a critique in a 2022 paper 'The Perils and Questionable Promise of ESG-Based Compensation'. It argues there are two main problems with ESG in exec pay 1) ESG metrics only capture a small number of stakeholders so do not serve aggregate stakeholder welfare, 2) it exacerbates the agency problem as outside scrutiny of ESG in exec pay is very hard.[35]
- A review of ESG in exec pay for European companies found the most common metrics were related to employees such as diversity and safety.[36]
- Three reports on ESG in exec pay for PwC by Tom Gosling echo other findings and emphasise that ESG metrics should be aligned with strategy.[37] The most common targets are employee engagement and health and safety. One argument made is that ESG goals may be best achieved by longer-term pay horizons rather than ESG metrics. This is supported by prior studies, for example, a paper from 2017 found that shifts in pay to longer time horizons was associated with increases in firm value and investment.[38]
- Carter, Pawliczek, and Zhong 2023 found that adopting ESG metrics in executive pay led to an improvement in ESG performance (scores).[39]

Appendix D: Shareholder voting and engagement

Investors rarely vote against the election of non-executive directors and very rarely meet non-executive directors. Investors are more likely to vote against management on other topics, but it is still relatively low. Support for ESG shareholder resolutions is low and falling.

US: The Conference Board published a review of the 2024 proxy season in the US, which is summarised in a Harvard Law School Forum on Corporate Governance article. Some of the key points are highlighted below.[40]

Shareholder proposals

- For H1 2024 shareholder proposals for the Russell 3000 increased to 918, with 58% being E&S, 29% corporate governance, and 8% compensation. 65% of these went to a vote.
- The average support for shareholder proposals was 22% (vs 23% 2023). Support in all areas fell, other than governance where support increased to 39% vs 29% in 2023. Out of 529 E&S proposals filed, 344 were voted on, and 3 passed. One cause of the fall in support for E&S proposals was Blackrock reduced its support for E&S proposals to 4% vs 47% in 2021.

Directors

- The average support for directors remained high at 95%, with only 2% receiving less than 70% support and 0.4% less than 50% support. Most directors with low support are on the boards of small companies.
- Average support for audit committee chairs was 95%, 90% for nominating committee chairs, and 93% for compensation committee chairs.
- Where a company in the S&P500 received less than 50% support for the say on pay vote the vote for the compensation committee chair only fell from 94% to 83%. This shows many investors are very reluctant to vote against directors.

Compensation

- Average support for say on pay votes remained high at 91%, and only 1% of companies had less than 50% support and these were mostly small companies.

Europe: Glass Lewis published a Proxy Season Review for Continental Europe for 2023.[41] A few key statistics are summarised below.

- Glass Lewis voting recommendations for director elections range from an average of 85% 'for' in Germany to 97% for Switzerland. Shareholder votes range from an average of 66% in Germany to 94% in Finland.
- On retrospective remuneration votes, Glass Lewis 'for' recommendations range from 54% average in Italy to 95% in Denmark. Only a few markets have a reasonable number of remuneration votes receiving less than 50%, such as 8% of votes in Germany. This suggests investors often ignore a proxy advisor recommendation to vote against remuneration.

Europe: A review by Georgeson covers AGMs for seven European countries for 2024.[42]

- Director elections: 14% of votes had over 10% opposition. ISS recommended to vote against director elections in 11% of votes and 5.5% for Glass Lewis. This suggests investors often ignore proxy advisor benchmark guidance to vote against directors.
- Remuneration: 33% of pay resolutions had more than 10% opposition. ISS recommended to vote against in 20% of cases and 25% for Glass Lewis.
- 22 companies put forward a board sponsored climate resolution which received 93% support on average.

- This review also shows investor support per resolution and how it was recommended by the main proxy advisors. This shows how even when the proxy advisors recommend an against vote investor support rarely falls below 50%.

Global: Minerva 2023 Roxy Season Review.[43]

- Average dissent across all resolutions (shareholder and management) was 3.5% in the UK, 4.2% Europe and 6.9% US. Resolutions with the highest dissent was remuneration in the US and Europe, and capital authorities in the UK. Only three director votes failed to receive enough support across all markets.

ESG resolutions: ShareAction report that in 2023 only 3% of the 257 environmental and social shareholder resolutions presented to Annual General Meetings (AGM) they assessed received majority support, down from 14% in 2022 and 21% in 2021.[44]

Appendix E: Weak evidence for standard governance metrics

This appendix reviews some of the empirical literature assessing the relationship between corporate governance and company outcomes. The literature naturally focuses on the widely available governance metrics. It shows the evidence is surprisingly weak that these metrics are associated with improved company outcomes. Below are some observations from the literature.

- Empirical studies can only test the commonly available governance metrics, which many would argue have significant limitations and do not accurately assess what a chair or non-executive director would describe as good governance.
- Empirical studies covering the 1990s found a relationship between corporate governance and improved company outcomes, but the results are more mixed for recent time periods. One argument is that post 2000 investors have learnt to factor governance into the valuation and so there is now a limited relationship to stock returns, but there is still a relationship to valuation and operating performance.
- The other view is that the relationship between the available governance metrics and company outcomes is quite weak with varying views by governance trait – board independence, staggered boards, CEO-chair separation, board size, diversity, and ownership (family, founders, dual-class shares).
- There is a lack of recent comprehensive empirical academic studies on the relationship between corporate governance and company outcomes. This could be because studies find a limited relationship and so are hard to publish.
- Based on interviews there appears to currently be a weak feedback loop from academic research into practice. People interviewed did not feel the need to continually update their view on 'good governance' based on the latest evidence. There were two broad views – 1) it is known and proven what is 'good governance', or 2) the evidence is too inconclusive to be useful and hence there was no basis to deviate from the current governance consensus.
- It is hard to find statistically significant relationships between any company inputs and outputs as there are so many other factors. Hence, a lack of evidence for governance metrics could just be part of the wider challenge on statistically testing any company input-output relationship.

Studies in the 1990s found a link to performance

The seminal paper on assessing the connection between governance and company performance was Gompers, Ishii, and Metrick (2003).[45] This paper made a governance index with 24 indicators as a proxy for shareholder rights and assessed 1,500 companies with data from the 1990s. It found that companies with higher shareholder rights had *'higher firm value, higher profits, higher sales growth, lower capital expenditures, and made fewer corporate acquisitions'*.

This analysis was extended in Bebchuk, Cohen, and Ferrell (2009) which created an E-index of six indicators – *'four constitutional provisions that prevent a majority of shareholders from having their way (staggered boards, limits to shareholder bylaw amendments, supermajority requirements for mergers, and supermajority requirements for charter amendments), and two takeover readiness provisions that boards put in place to be ready for a hostile takeover (poison pills and golden parachutes)'*. The paper found companies with higher shareholder rights for 1990-2003 have higher returns and firm value.

A subsequent paper found that the governance-return correlation did not persist into the 2000-2008 period – Bebchuk, Cohen, and Wang (2012).[46] The paper argued that this was because in the 2000s investors learnt to take more account of the quality of governance. For example, governance was still correlated with Tobin's Q (valuation) and operating performance. Since then, over 1,500 empirical studies have used the E-Index.[47]

Less clear recent evidence

Recently there are more academics, and others, disputing the evidence that the currently available metrics on good governance are associated with improved company outcomes. Of course this varies widely depending on the definition of good governance, metrics used, and the sample of companies. There also appears to be a lack of recent comprehensive empirical studies. Below are some examples.

- A useful summary of the empirical literature is provided in section B of Kershaw and Shuster (2020) – The Purposive Transformation of Corporate Law.[48] It highlights the empirical evidence is inconclusive on the impact of shareholder legal rights on shareholder value.
- Cremers, Masconale, and Sepe (2016) disputed some of the earlier findings linking managerial entrenchment and firm value.[49] This study looked at an expanded dataset 1978 to 2008. It found that protective arrangements that require shareholder approval (e,g, staggered boards and supermajority requirements) are associated with increased firm value. The paper argues that firm value is enhanced when the board is protected in the short-term, but shareholders have rights in the long-term.
- David Larcker (director of corporate governance at Stanford Business School) in 2023 published Seven Gaping Holes in our Knowledge of Corporate Governance, which stated *'This has resulted in a mountain of research, evaluating such elements as CEO/chair duality, board classification, board tenure, diversity, busy directors, board size, director age, professional qualifications, active or retired CEOs, etc. While too extensive to summarize here, the vast majority of this research finds that most of these attributes are not associated or only loosely associated with outcomes (with the possible exception of busy boards, which appear to be an impediment to board effectiveness)'*.[50]
- A further paper co-authored by David Larcker analysed data 2001-2016 and concludes that the connection between the available metrics on governance and company outcomes is weaker than most people believe.[51] It states, *'Our results seem consistent with corporate*

governance theories offering little in terms of explanatory power for firm outcomes. Perhaps further work is needed to develop models and measures with greater predictive power. Alternatively, it may be that the effects of corporate governance on firm outcomes, if any, are too small to be detected even in large samples'.

- A literature review on the connection between corporate governance and financial misconduct stated, *'Our review of 98 archival studies indicates that many studies on corporate governance variables find inconclusive results on firms'* financial misconduct'.[52]
- A 2022 empirical study concluded that good governance stocks outperformed poor governance stocks before 2001, after which the relationship disappeared. Then in 2008 this relationship reversed such that poor governance stocks outperformed good governance stocks.[53]
- A Morningstar study looked at the Sustainalytics governance score vs 10 year returns for companies listed on the LSE and found no clear relationship.[54]

The next sections look at the empirical evidence for specific governance traits. Again, this is not a full review, but simply highlights the evidence is not clear and hence there is a need to revisit how good governance is defined and measured.

Independent directors

The literature on independent directors is quite complex due to varying definitions of independence. There appears to be evidence of beneficial impacts of independent directors, though perhaps not as strong as many might expect. There can be a difference between statistical significance and economic significance. The most comprehensive literature review found was from 2019 and covered 135 studies. The paper says there is a lack of evidence on the relationship between board independence and firm performance and so focused on the relationship to corporate misconduct. The paper finds higher board independence is associated with lower rates of misconduct, and the relationship is strongest for audit committee independence.[55] This conclusion of weak positive evidence is supported by a summary by David Larcker of evidence on independent and outside directors.[56]

CEO-chair separation

Having a separation between the roles of CEO and chair is a core element of all good governance definitions, but surprisingly it is one of the governance traits with the weakest evidence.

This is acknowledged by Norges Bank Investment Management (one of the largest asset owners in the world). Its position is that the roles of CEO and chair should be separate, but in its position paper it acknowledges there is a lack of evidence as one of the arguments against, stating, *'No clear evidence that separate roles lead to higher performance – Many successful companies have a combined chairperson and CEO. Empirical research is inconclusive as to whether separate roles create superior value. If the company is financially successful, there is no reason to insist on a separate chairperson'*.[57]

Numerous academic empirical studies have struggled to find a relationship. A 2014 review of 48 papers from 1989-2013 found no clear link between CEO-chair separation and firm performance.[58] A more recent literature review of 314 studies also found mixed results.[59]

Dual-class shares

Asset managers strongly resist dual-class shares as seen in the response from the ICGN to the UK government's proposal to allow dual-class shares.[60] Or a recent report by the Investor Coalition for Equal Votes also makes the case against dual-class shares.[61] However, there is another side to the debate as captured in this HLS article – Re-Thinking The Hostility Towards Dual-Class Share Structures: When Dual-Class Shares Work Better.[62] There is extensive literature on dual-class shares with strong views on both sides. It appears the fierce resistance of investors to dual-class shares is at odds with a more nuanced empirical literature.

Family ownership

Family controlled companies are normally viewed as having poor corporate governance due to lower board independence and dual-class shares, but family companies are very prevalent, especially outside of the US. For example, a report by the World Federation of Exchanges found that family companies provide 40-60% of GDP and employment in most countries.[63]

There is a wide literature on the link between family ownership and company outcomes. The results are mixed, but overall, it appears to find a positive link between family ownership and company performance. A 2016 literature review of 145 papers concluded that family ownership has a slight positive impact on performance where equity ownership is aligned with voting rights as well as strong legal rights in the country.[64]

Appendix F: Investor surveys on governance focus

Surveys of investors place governance as the most important ESG topic. However, these surveys do not cover what is meant by governance and how it is incorporated. There may also be a disconnect between what investors say they consider and what influences investment decisions. The true test of whether investors consider governance assessments in investment decisions is if there is an impact on valuation, and the empirical evidence is mixed on this.

- **Amundi Institutional investors' approaches to responsible investing:** A survey of investors by Amundi stated the following on governance, *'investors in all continents have long considered governance as a key element in their analysis of companies. In our survey, we observed a widely-shared focus on board diversity – this is all the more important for Australia's NGS Super as about 70% of participants in its plan are female – Management remuneration and shareholders rights are other frequently cited components of investors' governance analysis'*.[65]
- **Schroders asset owner survey:** A survey of asset owners by asked which are the most important topics for active ownership. Corporate governance was top at 71%, followed by climate change 58%, human capital 47%, diversity 44%, human rights 41% and nature 37%. There were some differences by region with corporate governance being less important in Europe vs other regions.[66]
- **PwC investor survey:** PwC's annual survey of investors asked which of a list of non-financial factors were the most important. Corporate governance was top at 40% followed by innovation at 37% and climate in 7th at 28%.[67]
- **Sustainable Investing: Evidence From the Field:** 2024 survey of 509 equity portfolio managers looked at how they incorporate ESG factors.[68] One question asked individuals to rank a series of factors on their importance to long-term value creation. No surprise that 'strategy and competitive position' and 'operational performance' were a long way ahead of

any ESG factors. Somewhat surprising is that governance was 3rd and ahead of E&S performance. However, the survey did not ask portfolio managers what they meant by governance.

- **Stanford 2024 Institutional Investor Survey on Sustainability:** Stanford Graduate School of Business published a survey of investors covering individuals from 47 institutional investment firms and asset managers.[69] It's unclear how many of the respondents were fund managers or from the ESG team, though the responses suggest a strong bias to ESG specialists.
    - 68% said governance ranks as the highest ESG factor in an investment decision, vs 23% cited environmental as the most important and 2% said social. The topics cited within governance were board structure, ownership structure, board diversity, and the quality of reporting.
    - 76% of respondents believed governance quality impacts two-year performance.
    - On whether governance risks are already priced in, 63% thought they were 'mostly reflected' in asset prices, and 35% 'somewhat reflected'. Hence, it implies that investors think governance generally already priced in.

Appendix G: Governance score components

- **ISS Governance QualityScore:** 280 governance factors are used with up to 195 for an individual company. It is based on the same principles as the ISS Benchmark Policy for proxy voting recommendations.
    - **Board structure:** Board commitments, board composition, board policies, board practices, controversies, diversity, key committee composition, related party transactions.
    - **Compensation:** Disclosure, controversies, equity risk mitigation, non-executive pay, non-performance-based pay, pay for performance, termination, use of equity.
    - **Shareholder rights:** Litigation rights, voting related issues, one share one vote, shareholder rights issues, takeover defences.
    - **Audit and risk oversight:** Audit and accounting controversies, environmental and social risk management and oversight, external auditor, information security risk management and oversight, risk oversight other issues.
- **MSCI ESG score:** The governance pillar of MSCI's ESG score is made up of two themes – corporate governance (board, pay, ownership & control, and accounting) and corporate behaviour (business ethics and tax transparency). There is a detailed methodology document for each of the six key themes under the governance pillar.
- **Sustainalytics ESG Risk Ratings:** One of the main building blocks is corporate governance and stakeholder governance. Corporate governance covers board/management quality and integrity, board structure, ownership and shareholder rights, remuneration, and audit and financial reporting.
- **LSEG (Refinitiv):** The governance pillar of the ESG score is made up of management (board structure, independence, diversity, committees, and executive compensation), shareholders (shareholder rights, takeover defences), and CSR strategy (CSR strategy, ESG reporting and transparency).

Appendix H: Proxy advisor capacity

To estimate the total revenue of proxy agencies. ISS is estimated to have a market share of 48% in the US (The proxy advisory industry: Influencing and being influenced), which if we extrapolate this globally and combine with 2020 reported revenue suggests a total market size for proxy agencies of around USD 500m.

The signatory statements for the Best Practice Principles for Shareholder Voting Research provide details of workforce capacity for the signatories, as summarised below (BPPG Signatory Statements). It shows the very high capacity for analysis provided by ISS and Glass Lewis.

- **ISS (acquired by Deutsche Börse):** 380 full-time research analysts, with additional employees for data collection and other functions. The 2020 press release for the acquisition of ISS stated it had over 2,000 employees and USD 280m revenue.[70]
- **Glass Lewis:** 355 employees stated in its signatory statement, and total employes are around 1,200 as stated in a Havard Law School article.[71]
- **PIRC:** 40 employees for a smaller universe of companies than ISS or Glass Lewis. During 2023 it issued 3,625 reports, of which 3,075 were AGM reports.
- **Hermes EoS:** 29 in engagement and 4 in support. The primary focus is engagement with a universe of 300 companies. It does not provide voting recommendations as a standalone service. It is a client of ISS and adds additional analysis and engagement on top of this.

Appendix I: Proxy advisor influence on investors

There is an extensive literature on the influence proxy advisors have on investors. A few studies are highlighted below. It is hard to prove causality. It could be that investors have very similar custom policies that they ask the proxy advisors to implement. Or it could be that the choices provided by proxy advisors influence how investors vote. Either way, the analytical capacity to determine voting decisions rests with proxy advisors.

- A PRI study on the role of proxy stated *'Our quantitative research looked at whether there was a correlation between certain proxy adviser benchmark policy recommendations and investor votes on ESG proposals. Our data showed that there is a correlation, particularly for some of the more standard governance or 'G' votes.'*.[72]
- An academic paper (Shu 2024) found that investors are 20% more likely to oppose management when a proxy advisor issues a recommendation to oppose management.[73]
- A 2021 study found that 114 institutional investors voted in lockstep with either ISS or Glass Lewis and these investors manage USD 5tn.[74]
- ISS published a report looking at the connection between the ISS Governance QualityScore and investor decisions for the Russell 3000. It found companies with a low governance score had higher short interest. Furthermore, boards with a low score for the board component of the QualityScore receive less support on average in director elections. For example, boards in the top decile had average support of 97%, while those in the bottom decile had average support of 90%.[75]

Appendix J: Sustainability framework governance assessments

Non-profits published sustainability assessments of companies normally include a section on corporate governance. These normally cover responsibility, expertise, and the inclusion of ESG metrics in executive pay. It is often a high-level assessment as it is small part of the framework.

Climate

Climate frameworks and assessments have a governance component that predominantly covers responsibility, expertise and incentives, which builds off TCFD/IFRS S2. The assessments are only at a high level, for example a binary assessment on if climate change has been incorporated into executive pay, rather than how well this has been done.

TCFD (now IFRS S2), has the following disclosure requirements – which governance body or individual is responsible for climate-related risks and opportunities; how this is reflected in mandates and terms of reference; appropriate skills; how often individuals are informed on climate change; how climate risks and opportunities are taken into account in strategy and transactions; how climate targets are overseen; and managements role governance processes related to climate change.

Following from IFRS S2 many climate frameworks include a section on board responsibility for climate change, climate expertise/competence, management responsibility, and climate metrics in executive pay.

- **CDP** include a section in their climate scoring questionnaire on governance (CDP Climate Change 2023 Scoring Methodology).
- **WBA's** Accelerate Climate Transition (ACT) methodology has a module on management that covers responsibility for climate change, board and executive expertise, GHG reduction metrics in exec pay (ACT Framework).
- **Climate Action 100+** has a section on governance that again covers board responsibility, expertise, and inclusion in executive pay (CA100+ Methodologies: Net Zero Company Benchmark).
- **Transition Pathways Initiative (TPI)** has a Management Quality framework that covers the normal topics of responsibility, expertise, and incentives, and includes some different topics such as having an internal carbon price. Detailed questions and notes are provided for each level in section 4.4 of the methodology (TPI's methodology report: Management Quality and Carbon Performance, v.5 November 2023). In 2023 TPI added a new high level – *'Level 5 - Transition Planning and Implementation: The company uses its strategic understanding of climate and transition risk/opportunity to create a detailed and actionable transition plan which aligns business practices and capital expenditure decisions with their decarbonisation goals'.* This has more focus on capex, quantifying impacts and lobbying. 10% of companies obtained level 5, 49% incorporate climate change into executive pay (TPI State of Transition Report 2024).
- **Carbon Tracker** company profiles have a section on corporate governance covering the largest shareholders, board members, remuneration and sustainable financing (Carbon Tracker company profiles).
- **Climate Arc** has a choice of governance analysis from TPI or WBA (Transition Arc). Both have a binary assessment on if climate change is incorporated into management incentives and if the board has said who is responsible for climate change.

Non-climate frameworks

Non-climate frameworks also often include a small section on governance.

- **WBA's** Corporate Human Rights Benchmark has components covering governance (WBA: The Methodology for the 2026 Corporate Human Rights Benchmark). 5% weight to board level accountability (commitment, responsibility, incentives). Incentives are also included in 15% company culture and management systems. And there is a 15% weight to human rights due diligence.
- **The Fashion Transparency Index** has a section on governance with a low weight of 4.4% (Fashion Transparency Index). This covers the following topics – board responsibility; how E and S are linked to employee, CEO and supplier performance; ease of contact; and responsible tax strategy.
- **Forest 500** has a few metrics related to governance in its assessment such as if the board have a committee, working group or high-level management position focused on deforestation (Forest 500 Assessment methodology 2024).
- **Access to Nutrition Initiative** has 15% weight to governance in its assessment, though this mostly focuses on if the company has a strategy to contribute to healthier diets, with two out of seven governance questions on oversight and responsibility by the board (ATNi Index Methodology).

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