UNEP

Integrated Governance

A NEW MODEL OF GOVERNANCE FOR SUSTAINABILITY

UNEP Finance Initiative
Changing finance, financing change

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MESSAGE FROM THE UNEP FI ASSET MANAGEMENT WORKING GROUP

There once was a debate over whether sustainability could be considered financially material. That debate has been fading from view as evidence becomes clear that the parameters of sustainability have a significant role to play in the financial performance of companies.

There are now well over 200 academic reports establishing positive and statistically significant relationships between sustainability performance and financial performance, and an increasing volume of sell-side financial reports covering sustainability issues ranging from climate change and energy efficiency to gender diversity, safety and health. Sustainability is no longer a fringe issue in finance.

That being so, sustainability comes under the umbrella that shelters every other issue in corporate finance and performance: governance. Corporate governance is the overarching structure under which everything else—competitiveness, strategy, performance, capital budgeting, and operations—occurs. Investors and other stakeholders interested in sustainability policies and performance of corporations expect to see the inclusion of sustainability in corporate governance.

Yet more often than not, governance structures and operations still tend to either ignore sustainability or pigeonhole it. This should perhaps not come as a surprise. Even the traditional parameters of good governance are not always common in today's publicly traded companies. For example, while there is a lively debate about remuneration, succession planning, especially for sustainability, is rare.

Though many investors agree on what good governance looks like, companies that manifest all the attributes of good governance are in the minority. For example, a recent study[1] found evidence that proxy access—the right to nominate directors to serve on corporate boards, and for those nominees to be on the company's annual proxy ballot—is valued on financial markets, yet it is rare for companies in most developed markets to provide shareholders with access to the proxy for director elections. A recent article in the *New York Times* described proxy access as "dead" in the United States.[2] A report by the Global Compact in 2010 found that only 39% of the 1,300 companies surveyed had boards that addressed corporate sustainability issues on a routine basis.[3]

1 *Bo Becker, Daniel Bergstresser & Guhan Subramanian, "Does Shareholder Proxy Access Improve Firm Value? Evidence from the Business Roundtable Challenge," Harvard Business School Working Paper 11-052, January 19, 2012.*

2 *Steven M. Davidoff, "A Lesson for Boardroom Battles," The New York Times Dealbook, August 30, 2013. http://dealbook.nytimes.com/2013/08/30/a-lesson-for-boardroom-battles/?_php=true&_type=blogs&_r=0.*

3 *Cited in Aron Cramer, "CSR in the Boardroom: The Board's Role in Advancing Sustainability," Business for Social Responsibility, April 19, 2011. http://www.bsr.org/en/our-insights/bsr-insight-article/csr-in-the-boardroom-the-boards-role-in-advancing-sustainability.*

Is routine consideration of sustainability by boards sufficient to make sustainability an integral part of corporate strategies? This report argues that it is not. The report sets out a new model of governance that puts sustainability at the heart of governance and corporate boards' strategic agendas. The report makes a compelling case for the development and execution of sustainable strategies in corporations, and illustrates why the current state of governance is not well suited to advancing sustainability effectively. It then lays out a model of Integrated Governance, a model that moves sustainability issues from the periphery of corporate strategy to the heart of it. Examples are provided as illustrations throughout the report. We believe that this report can be a good starting point for investors interested in sustainability, and how that is handled in well-governed corporations.

Making integrated governance a reality will depend on the work of many actors—asset owners, investment managers, shareholders, and companies. One specific group of actors that could make a major difference is the proxy voting service firms. The AMWG reached out to major proxy voting service providers to seek their reactions to this report, and three of them—ISS, Glass Lewis and Proxinvest —responded. We believe that it will be useful and instructive for readers to compare the responses of these three firms, so we included their responses in this report.

A decade ago, the Asset Management Working Group of UNEP FI released its first report on the materiality of social, environmental and corporate governance issues to equity pricing. We have since released a series of reports on the materiality of sustainability measures, sustainability and fiduciary duty for investors and asset owners, and various specific issues in responsible and sustainable investing. We are pleased to introduce this report as our newest contribution to the field.

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1. EXECUTIVE SUMMARY

The focus of this report is to identify corporate governance practices that could promote a durable culture of sustainability within corporations. As companies increasingly recognize the need to develop a sustainable strategy, where sustainability issues are integrated into the core of the business model, a respective need is created for a governance model that is able to supervise the formulation and execution of such a strategy.

In this report we propose a new governance model, which we call "Integrated Governance." Integrated governance is "the system by which companies are directed and controlled, in which sustainability issues are integrated in a way that ensures value creation for the company and beneficial results for all stakeholders in the long term." Integrated governance combines bringing sustainability oversight in the boardroom together with addressing some of the identified current governance weaknesses that prevent boards from operating in the most effective manner.

Integrated governance expresses an end state of governance practices. Therefore any firms aiming to operate under those practices will have to go through a series of changes. We propose that the ultimate target for companies would be to move from "governance for sustainability" to an integrated governance perspective. There are three major stages, each with its unique characteristics that describe the journey each company has to go through to achieve a model of integrated governance. In phase 1 are companies, which are not integrating sustainability issues into their strategic agenda, and merely have some (or even no) sustainability projects. In phase 1 there is no discussion of sustainability risks and opportunities at the board level and the responsibility of any sustainability projects lies with small isolated teams. For these companies to move to the next phase in their journey for integrated governance, an understanding of the value creation process through sustainability is required. Setting up a sustainability committee could also significantly assist in driving companies through their journey from phase 1 to phase 2, from having sustainability outside of the board's agenda to having governance for sustainability become part of it.

Phase 2, governance for sustainability, describes firms that have established a sustainability committee. These firms usually start to measure the performance of their efforts through KPIs, issue a sustainability report, and frequently appoint a Chief Sustainability Officer. Although companies in phase 2 bring the sustainability issues onto the agenda of board meetings, sustainability is still being treated as a separate function and is compartmentalized. These companies have a sustainability strategy rather than a sustainable strategy. A progression to phase 3, integrated governance, would require a holistic integration of sustainability in the corporate strategy, without the need for a separate sustainability committee since each board member is now thinking in a way that would promote a sustainable strategy for the firm. Each board committee can integrate sustainability issues in their charter and replace the need for a dedicated sustainability committee. Adoption of integrated reporting adds significant value in monitoring the progress against both financial and environmental, social and governance (ESG) targets, and helps understand the benefits of the integrated governance approach. In order to achieve integrated governance a company needs to make sure four elements are in place: Independence both at the individual and at the group level, aligned incentives and investor long term active ownership

In section 2 of the report we discuss the increasing concentration of economic activity in a relatively small number of corporations and their increasing impact on the environment and society. Entrepreneurs and the corporations created as a result of the entrepreneurial spirit have provided enormous benefits to society fuelling unprecedented economic growth and raising billions of people out of poverty by creating job opportunities. We describe the process of value creation inside organizations, emphasizing that the results of externalities from corporate activities can affect corporate financial performance. Importantly, we show how company competitiveness depends on the viability of human, natural, financial, intellectual, physical, and social capital.

Having explained how environmental and social issues affect the viability of the different forms of capital and as a result company competitiveness, in section 3 we make the case for the development of a sustainable strategy, one that enables a company to create value for its shareholders, while at the same time contributing to a sustainable society. Evidence of superior financial performance from companies adopting sustainable strategies is presented. We highlight the importance of corporate governance and a well-functioning board as the necessary condition for the successful supervision and execution of a sustainable strategy. We list activities that the various board committees (corporate governance, audit, compensation, and nomination) could carry out as part of their sustainability oversight to show actual examples of integrating sustainability into corporate governance practices.

In section 4, we discuss the current state of governance practices and seek to understand some of the systematic problems that lead to governance failures. We review both board dynamics, such as the expertise of individual directors and the time they spend governing, and compensation structures, such as the level, form and time horizon of incentives provided to senior executives, to show that they are inadequate for the effective supervision of a sustainable strategy. Case studies of companies are presented throughout the section to provide examples of governance practices across firms.

Section 5 introduces the integrated governance model, as a response to the question: 'If current governance practices are ineffective in promoting a culture of sustainability, then what is the alternative?' We describe the journey that a corporation would have to go through to reform their corporate governance practices towards an integrated governance model. As companies move from treating sustainability as a peripheral issue that is not integrated into their strategic decisions to placing sustainability at the core of their business model, governance should move in the same direction. We discuss each component of the integrated governance framework and also present case studies. Integrated governance requires a better definition of director independence, one that covers both the individual and the group level, coupled with aligned interests and investor long-term active ownership. Throughout section 5 we outline our recommendations.

With this report we hope to provide institutional investors with insights and suggestions that they could consider when engaging with corporations and exercising their ownership rights. Corporations may also use the integrated governance model as a guide to benchmark themselves against this new practice and their competitors and identify areas for improvement in their governance practices.

We have chosen not to include in this paper an in depth investigation of the role of governmental intervention and regulations. While governments do have an important role in driving corporate governance transformations, they are not the only way to drive better integration of social and environmental factors, as well as financial ones, with governance. We believe that these transformations should happen even in the absence of regulation, as market forces push companies towards more robust configurations of their governance arrangements. In this report we shed light on what these configurations might look like, although we recognize that such configurations might differ across companies.

2. THE LARGE CORPORATION TODAY

2.1 Concentration of economic activity

Companies have been the engine behind the unprecedented economic growth of the past century. The big companies through their operations have managed to raise billions of people from poverty, provide employment and education opportunities and unlock the human potential for innovation and creativity.

By comparing the evolution of the world's largest 1,000 publicly listed companies (Global 1,000) from 1980 to 2012, the progressive concentration of economic activity around the largest corporations can be observed. In 1980, the world's largest 1,000 companies made $2.64 trillion in revenues or $7.0 trillion in 2012 dollars (adjusted using the consumer price index), whereas by 2012 they made $34 trillion in revenue. In 1980, the Global 1,000 directly employed 21 million people, whereas in 2012 they employed 73 million people. Finally, in terms of market capitalization, in 1982 they had a total of close to $900 billion ($2,4 trillion in 2012 dollars), or 33 percent of the world total, compared to a staggering $28 trillion market capitalization (50 percent of the world total) in 2012.

Given the size of these companies, the impact they have on society is becoming apparent. The Global 1,000 can now influence billions of people around the world, from employees to suppliers, customers, and even regulators. Out of 206 countries recognized by the United Nations, only 26 had nominal Gross Domestic Product (GDP) higher than the sales numbers reported by Royal Dutch Shell and Wal-Mart ($454 billion and $447 billion, respectively) in 2011.[1] Another example is the concentration of food supply in a handful of multinationals like Nestle, Kellogg's, General Mills, PepsiCo, Kraft, Unilever, and Procter & Gamble.[2] These companies have a large effect on the dietary lifestyle of consumers and therefore influence any impact this lifestyle has on consumers' health and well-being.

2.2 The socioeconomic ecosystem

Corporations do not operate in isolation, but as part of a broader ecosystem consisting of the society as a whole and the environment (Figure 1). The large corporations today have enormous power to do good, beyond the benefits arising from their operations. As just one example, many corporations provided support to the victims of the Indonesian tsunami, a support that was much more than what could have been mobilized in such a short timeframe by governments.

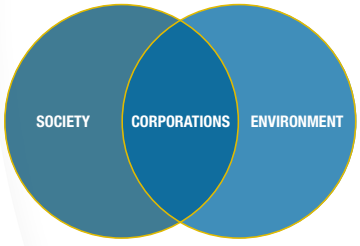

Figure 1
The Socioeconomic ecosystem

At the same time, the goods, services, and wealth corporations create come at a cost. Their operations require the consumption of vast amounts of natural resources, they pollute the local and global environment at little or no cost, they can throw economies into recession due to poor risk management as in the case of large financial institutions, and can hurt individual employees' well-being if wages and working conditions are inadequate. Dow estimates that it is consuming on a daily basis as much energy as Australia does. Some food supply companies have been accused of consciously contributing to the increasing problem of obesity.[3] Foxconn, the Chinese electronic contract manufacturer, has been repeatedly criticized over its labor practices.

Society consists of numerous stakeholders that affect and can be affected by a company's operations.[4] Employees, consumers, governments, local communities and institutional investors are examples of some of these stakeholders. The various stakeholders within the society do not necessarily have aligned interests. Consumers of goods and services require high quality products at reasonably low prices. This is not necessarily aligned with what employees want (job security, fair compensation, and comfortable benefits). Investors want a good return on the money they invested in the company. Local communities want an environment as undisturbed as possible and some compensation for giving companies a license to operate in their area. The larger a company is, the more diverse the range of stakeholders that are affected by its operations and the more pressure they will apply to satisfy their needs. Globalization has led to further complexity, since companies that now supply their goods and services in other geographies will face a divergence of interests and incentives.[5]

Almost as a response to the immense growth of the world's largest corporations, national and trans-national non-governmental organizations (NGOs), which exist to represent the interests of the civil society, have also grown in power and influence.[6] More people now than ever show trust in NGOs as recent public opinion surveys show.[7] Their human capital and financial resources have significantly grown in size. NGOs in 26 countries account for 31 million employees, or almost 7 percent of the total workforce of those countries. Annually, NGOs in these 26 countries spend about $1.2 trillion, almost as much as the largest 1,000 companies of the world spend in capital expenditures.[8] These resources have been mobilized to produce more effective and impactful campaigns. Aided by information technologies such as the internet and social media, their campaign reach has expanded, since now a large number of people can be informed.

NGOs often work in collaboration with corporations. The Investor Network on Climate Risk (Ceres/INCR), the Institutional Investors Group on Climate Change (IIGCC), the Carbon Disclosure Project (CDP) and several other investment-oriented NGOs work with corporations to bring sustainability issues in the discussion and into public policy. A good example is the Climate Declaration, a project of Ceres, which is a statement that companies sign as a declaration of their efforts to fight against climate change.[9]

With this rapid expansion of access to information it is increasingly difficult for corporations to indulge in activities that could harm people, communities or the environment without attracting negative attention. This negative attention could damage a company's reputation and brand name and reduce its social capital. Now that most companies' market capitalizations are more than double the value of their tangible assets, a loss of reputational or brand value could prove detrimental. Regulatory actions have also come as a result of such campaigns, together with shifts in customer attitudes, in some cases putting a company's license to operate or even entire industries at risk.

2.3 The role of governance

Corporations should aim to create sustainable shareholder value over the long term while at the same time managing their relationships with the various stakeholders from society and minimizing any negative impact on the environment. Since corporate governance is the system by which corporations are directed and controlled, it is through corporate governance that the interests of all these stakeholders and the interaction with the environment can be managed.

Directors as fiduciaries acting in the best interests of the corporation have several important responsibilities. Some of these responsibilities are approving the corporate strategy, reviewing risk management, setting performance objectives and ensuring that audit and accounting controls are in place. Several publications include comprehensive lists of these responsibilities.[10, 11]

By examining and understanding the responsibilities of the board of directors, the key role of corporate governance in the relationship of corporations with society and the environment becomes apparent. Institutional investors will engage directly with the board about their request for governance reforms. The NGO campaigns might trigger business model changes at the corporate level. Decisions about how to manage negative externalities such as carbon emissions, or waste become items on the board's strategic agenda. Customers and shareholders will seek accountability at the management level in the case of a bribery scandal or ethics breach. These are just a few examples of the multiple way that governance is the mechanism driving the corporate interactions with society and the environment.

2.4 The value creation process

Firms use resources to produce and provide their products and services. These resources can be classified as natural capital, such as water, forest, and minerals; human capital, such as skills, capabilities, and experiences of people; and financial capital, such as funds from investors and lenders or from the reinvestment of funds obtained from operations. Firms use these resources during the production process to develop additional resources. These additional resources can be classified as physical capital, such as factory equipment; intellectual capital, resulting from employee efforts that generate intangible assets; and social capital, deriving from the relationship between a firm and society that secures its license to operate. Leveraging these additional resources, firms sell products and services in exchange for financial compensation.

Products and services are not the only output generated by a company. Externalities are another outcome of a company's activities. Positive externalities arise when a company's actions generate marginal private benefit that is smaller than the marginal social benefit. Consider, for example, the case of employee training. While the company benefits by improving the skills of its employees, it also creates benefits for other companies that these employees might join in the future. Negative externalities arise when a company's actions generate marginal private costs that are smaller than the marginal social costs. Consider, for example, child labor. Employing children adversely affects other companies because the pool of skilled employees in the future will be smaller, since children that are working are unable to attend school. Figure 2 illustrates the interrelationships in the value creation process.

While both positive and negative externalities can be imposed by a company on society, negative externalities in particular have affected the value creation process described above. Negative externalities such as pollution, human rights' violations, and excessive risk taking have significantly impaired many corporations' social capital, putting their license to operate at risk. The public revolt against financial institutions that assumed excessive risks and caused one of the worst financial crises in history has resulted in limitations on the bonuses that bankers can receive in Europe. As of 2012, many large financial institutions had been forced to divest many of their high-risk businesses and increase their capital requirements. The result has been a drastic reduction in their profit margins and stock market valuations.[12]

Case study

In 2011, UBS announced a strategic plan to reshape its investment banking division and transform the group in order to create the UBS of the future, a firm focused on its core business lines committed to deliver more sustainable and attractive returns. UBS is not the only bank to be scaling back its investment banking activities and restructuring in accordance with the new operating realities; almost all big European banks are doing so in one way or another. UBS has accelerated the implementation of this restructuring in 2012 to protect the bank's reputation. «Capital strength, cost discipline and strong operational risk framework are critical to our long term success», was announced in a June 2013 investor relations presentation. As a result, UBS will exit non-core and legacy portfolio positions to achieve its Basel III requirements. Business lines, predominantly in fixed income, that have been rendered uneconomical by changes in regulation and market developments will be closing down by 2015 and UBS's headcount will be reduced as a consequence. «As a result of these actions [...] UBS will be capable of maximizing value for its employees and shareholders.

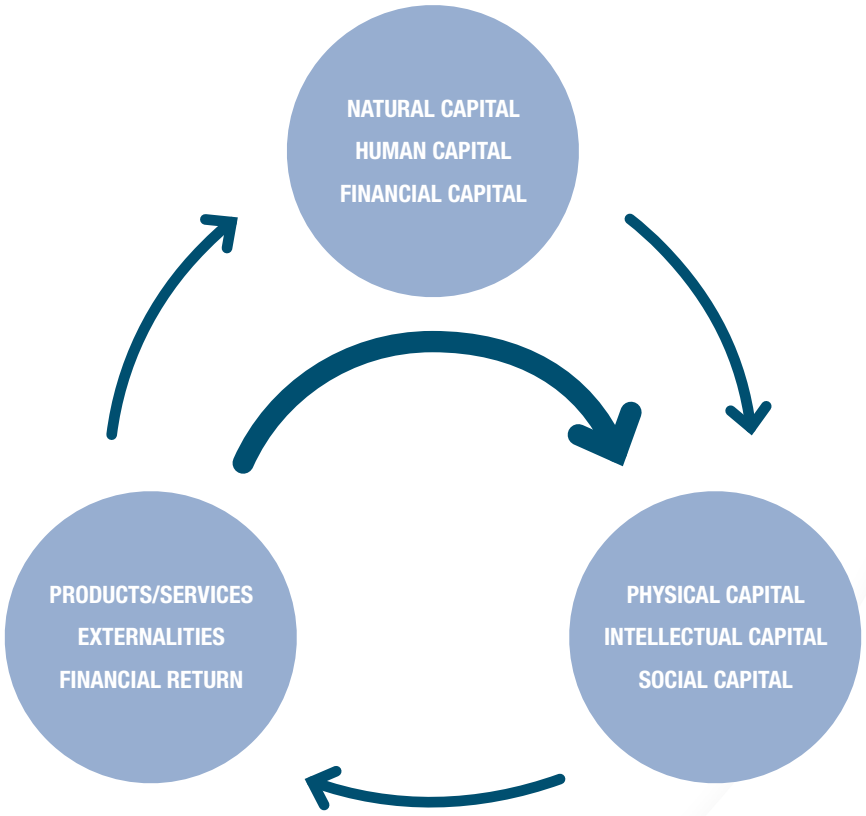

Figure 2

The value creation process

The nature of the products and services delivered has also been under intense scrutiny in recent years. Tobacco companies were among the first to be affected by a public outcry against the negative externalities of their products. However, health concerns from the consumption of products and services have not been restricted to tobacco companies. Many food and beverage companies, including McDonalds and PepsiCo, are also under scrutiny for the health effects of their products.

Moreover, environmental concerns about many natural resources have disrupted business models even if these natural resources have been regulated by the price system and as a result would not be considered externalities. For example, Coca-Cola was accused of depleting water wells in India to make carbonated sugar soft drinks, leaving local communities without water supplies. Coca-Cola's plant at Plachimada was shut down in 2005 following a protracted legal battle and a sustained campaign by civil rights groups. Coca-Cola responded by increasing the water efficiency of its plants and working to replenish 100 percent of the groundwater that the company uses throughout India. As of 2012, the company claimed to replenish approximately 93 percent of the groundwater it uses through the creation of rainwater harvesting structures, restoration of ponds, and traditional water bodies and interventions focused on improving water use efficiency in agriculture.[13]

Similarly, social concerns, such as employee safety, fair wages, and child labor, have also disrupted business models. In 2012, platinum mine workers in South Africa went on a series of strikes over pay negotiations. Violent clashes between rival groups of miners and the police resulted in the death of 46 workers at the Marikana platinum mine. The mine's owner, Lonmin PLC, resolved the strike by offering workers a pay increase of up to 22 percent but unrest soon spread to other mines.[14] Within a few weeks, approximately 25 percent of all mineworkers in South Africa had gone on strike according to the Chamber of Mines, capital was flying out of the country, and production had stopped. Gold, platinum, coal, diamond, and iron ore mines had all been affected. President Jacob Zuma claimed that work stoppages, including strikes, had cost the government $368 million in the first six months of 2012.[15]

Firms with products and services that are thought to generate negative externalities face difficulties in attracting talent and raising finance.[16, 17]On the other hand, research has shown that firms with better CSR performance have better access to finance, due to superior stakeholder engagement and increased transparency originating from publicly disclosing CSR metrics.[18] Research has also shown that a company can use its corporate social performance activities to attract job applicants and therefore develop a competitive advantage. Employees will be attracted to companies with a good reputation regarding quality products and services, treatment of the environment and issues of diversity.[19]

These environmental, social and governance (ESG) issues have made many observers question the appropriate role of the corporation in society. Should companies try to eliminate negative externalities and provide positive externalities? How should companies respond to changing social expectations? Will integration of ESG issues in the strategy and business model of a company increase or decrease its competitiveness?

Integrating environmental and social issues in the business strategy of a company can present tremendous opportunities for innovation and growth while failing to do so might result in significant risks. If integration of ESG issues is necessary to manage all these risks and to also create a competitive advantage for the company then corporate governance mechanisms should be mobilized to ensure that this integration happens. Governance is the mechanism that ultimately affects everything a corporation does; hence, making sustainability an integral component of corporate governance is both prudent and necessary.

3. ENABLING A SUSTAINABLE STRATEGY

3.1 Integration of ESG issues in the business strategy. Does it pay off?

George Serafeim and Robert Eccles of Harvard Business School have proposed a framework showing how a company's competitiveness depends on preserving and enhancing the different types of capital in order to deliver excellent products and services, while concurrently minimizing the amount of negative externalities.[20] This can be achieved through the systematic integration of ESG factors in the business strategy and as a result, firms succeeding in this integration will outperform their competitors in the long-term.

However, the mechanisms to improve long-term performance will not be the same for every company since it is dependent on how critical each form of capital is for a company. Although these mechanisms are unique to each company, there is one common underlying factor and that is governance. All companies have some sort of governance structure and most, if not all companies, rely on that governance structure to provide guidance and feedback to the accomplishment of specified goals. Therefore these ESG factors need to be brought into their governance structures and processes if their ultimate goal is integration of ESG issues in their business strategy.

Companies are currently facing the challenge of deciding how they will adapt their strategy to satisfy the needs and respond to the pressure of multiple stakeholders. In doing so, they need to understand the relationship between adopting sustainability initiatives and their effect on their financial results.[21] If there is a direct positive correlation of environmental and social performance with financial performance, then any decision becomes more straightforward. A significant study investigating this relationship has examined a matched sample of two virtually identical sets of firms in terms of size, financial performance, and growth prospects of 180 US companies over the period from the beginning of 1993 to the end of 2010.[22]

The authors classified 90 of these companies as High Sustainability firms because long ago they adopted corporate policies regarding commitments to enhance environmental and social performance; the other 90 were classified as Low Sustainability firms because they had not. The Low Sustainability firms correspond to the traditional model of profit maximization in which social and environmental issues are predominantly regarded as "externalities" created by the firm's actions. The High Sustainability firms, in contrast, take into account these externalities in their decisions and operations; this is manifested in their relationships with stakeholders such as employees, customers and NGOs representing civil society. In other words, the notion of "sustainability" appears to be embedded in a holistic and multidimensional manner within and throughout the organization.

The authors found that firms in the High Sustainability group significantly outperformed firms in the Low Sustainability group in terms of both stock market performance (although both sets did better than the market as a whole) and accounting measures. Investing $1 in the beginning of 1993 in a value-weighted (equal-weighted) portfolio of sustainable firms would have grown to $22.6 ($14.3) by the end of 2010, based on market prices. In contrast, investing $1 in the beginning of 1993 in a value-weighted (equal-weighted) portfolio of traditional firms would have only grown to $15.4 ($11.7) by the end of 2010. Similar results were found for the measures of return-on-assets and return-on-equity.

Importantly, the High Sustainability group exhibited fundamentally different governance procedures and practices from the Low Sustainability group. Boards of directors were formally delegated responsibility over sustainability, and executive compensation was more likely to be linked to ESG metrics for this group. Moreover, High Sustainability firms were more likely to measure and disclose their ESG performance, and to allocate resources to a rigorous stakeholder engagement process.

Other studies have added evidence for the positive correlation of ESG and financial performance. A meta-analysis carried out by Deutsche Bank in 2012 concluded that 89 percent of more than 56 academic studies, research papers, and meta-studies showed that companies with high ESG performance ratings exhibit market-based outperformance compared to industry peers, and 100 percent of the academic studies agree that companies with high ESG ratings have a lower cost of capital in terms of both debt (loans and bonds) and equity capital.[23]

Further evidence is provided by the California Public Employees Retirement System (CalPERS) engagement process. CalPERS engages with selected firms from their Governance Focus list due to concerns around their weak sustainability performance. These firms produced cumulative returns averaging 39 percent below their benchmarks in the three years prior to CalPERS engaging with the companies and 17 percent above their benchmark returns for the five years after the engagement was undertaken.[24] Moreover, as we already mentioned in the previous section, there are a number of studies documenting benefits for companies that have better ESG performance in capital and labor markets.

Therefore the answer to the question 'Does integration of ESG issues in the business strategy pay off?' would be: it can, if implemented successfully. Key points for ensuring successful implementation are: appropriate governance processes and practices, stakeholder engagement, measurement and reporting of ESG performance and the ability to think and act with a long-term view.

3.2 Effectively implementing a sustainable strategy

A sustainable strategy is one that enables a company to create value for its shareholders, while contributing to a sustainable society. A sustainable society is one that meets the needs of the current generation without sacrificing the needs of future generations. Thus a sustainable strategy is one that minimizes its negative externalities and integrates the material sustainability issues for its sector and strategy into the core of its operations. Since there is clear evidence of benefits from successfully implementing a sustainable strategy, the next logical question is how do you effectively implement a sustainable strategy?

Despite the fact that research has shown that better ESG performance of a corporation is positively associated with financial performance and more specifically to access to finance, customer loyalty and satisfaction, and employee engagement, not all companies have embedded sustainability issues in their strategy. The main reason behind this is the complexity of integrating these ESG issues in a way that improves financial performance. The same applies to companies that have formulated a sustainable strategy but failed to effectively execute it.

A recent publication introduced the concept of the 'Performance Frontier', an illustrative way to show the relationship between financial and ESG performance. According to the authors, in the absence of substantial innovation, the financial performance of a firm declines as its ESG performance improves. To simultaneously improve both kinds of performance, companies need to innovate in terms of new products, processes, and business models.[25]

Although many companies have managed to pluck the low-hanging fruit of introducing minor innovations, especially around energy efficiency programs and reduction of carbon emissions, this has only pushed the performance frontier up a bit. Major innovations are required to shift the overall slope and create a positive relationship between financial and ESG performance, innovations that would include large-scale investments and long payback periods.

The correlation between financial performance and ESG performance has highlighted the criticality for companies to consider the interests of a broad range of stakeholders in their decision making process. The focus is no longer only on the corporation's shareholders as stakeholder theory, introduced by Edward Freeman, has shown.[26] Later empirical research has demonstrated that superior stakeholder relations (e.g., with employees, customers, and local communities) can be a source of competitive advantage by not only enabling a firm with above average performance to sustain its competitive advantage for a longer period of time, but also by helping poorly performing firms to recover from disadvantageous positions more quickly.[27]

3.3 Board committees and their link to sustainability

Corporations that have grasped the importance of sustainability in the value creation process and the necessity for innovation in products, processes, and business models have made the first important step towards a sustainable strategy. However, realization on its own is not enough if it is not followed by implementation. To enable innovation and make sustainability considerations core to a company's strategy and operations, a company needs to have a governance structure and process that is supportive of developing and executing a sustainable strategy. The decisions around sustainability need to be made at the top, as a result of discussions about the overall strategic agenda. Corporate governance has a key role in the implementation of a sustainable strategy as the board of a firm is responsible for setting the overall direction and creating the appropriate systems that will facilitate it.

By examining archival data on how many firms embrace this approach today, we have found that the governance of sustainability is still at an embryonic stage. Using Bloomberg data for the 2011 fiscal year, we found that out of 3,512 companies (in a total universe of about 60,000 companies) that report at least one ESG data point, only 56 companies had a non-executive director with responsibility over sustainability. Another 14 companies had an executive director with similar responsibility. Only 374 companies had a sustainability committee that reports directly to the board but none of its members were part of the board. Similarly, only 10 companies linked compensation to ESG metrics for the board and only 32 for top management. These very low numbers suggest that most companies still have not taken responsibility for sustainability issues at the highest governing body of the corporation.[28]

Studying committee charters can provide further insight into how different companies are assigning the accountability for sustainability issues. A recent study examining names and charters of board committees at North American companies to identify board-level oversight of environmental and social issues identified several important trends:[29]

- In the Russell 3000 only 8 percent of committees have a name that suggests oversight of environmental and social issues.
- In the S&P 100 there is a much higher sustainability oversight through at least one committee (65 percent of the companies). However the focus of these committees is concentrated on only a few items. The report lists seven key factors that boards should be addressing: oversight for policies and compliance, trend assessment, strategy and performance, risk management, stakeholder engagement, sustainability reporting, incident management and environmental and social impact assessment of business decisions. Most of the committee charters examined in the report focus on reviewing and monitoring of policies and compliance around corporate responsibility. Less than half of these committees provide oversight on any of the rest of the categories or require their directors to monitor and make forward-looking recommendations about sustainability trends, strategies or targets.

In order to examine how a board can integrate these sustainability issues, the typical charters of several board committees were examined and the possible link each committee could have with sustainability is described.

CORPORATE GOVERNANCE COMMITTEE

This committee is usually responsible for setting the overall approach to corporate governance of an organization and for reviewing and assessing with the board the appropriate skills, experience, and background that the company is looking for in its board members. The corporate governance committee also decides on the size and composition of the board and is responsible for evaluating the diversity of the board members in terms of gender, ethnicity and age. Other responsibilities might include setting the board's meeting schedule or identifying directors who should leave the board and facilitating that transition. All of this needs to be done in close coordination with the Board Chair and the CEO and so most governance committees are chaired by the Board Chair and have the CEO on them.

Corporate governance committee and sustainability:

The corporate governance committee has the very crucial role of assessing the appropriateness of the board's diversity and mix of skills and experiences. Identifying the right size for the board is also very important, as will be discussed in further detail in section 5, since it has been found that it is directly related with the board's effectiveness in governing an organization. The corporate governance committee can build the right environment for decision-making and create and sustain a board that can effectively support and oversee a company's activities.

In companies that have no stand-alone sustainability committee or are in the process of integrating sustainability issues into every committee's agenda, the corporate governance committee would have in its charter several of the sustainability related activities like monitoring sustainability trends, reporting on sustainability risks and opportunities and overseeing sustainability projects.

Some of the responsibilities the corporate governance committee could undertake as part of its sustainability integration are the following:

- Oversee matters of corporate governance, corporate responsibility, sustainability (including sustainability trends) and the impact of environmental, social and governance issues to the business.
- Review the director orientation and education program for ensuring the appropriate expertise and knowledge is present overall. Include training around sustainability.
- Assist in monitoring and reviewing corporate governance and reputational risk exposures.
- Review company wide policies regarding Corporate Governance Principles.

AUDIT COMMITTEE

Every board has an audit committee. This committee is mandated with the task to provide oversight of the CFO function, the auditors, and related matters like tax compliance, SEC compliance etc. Some of the responsibilities of the audit committee are the following:

- Monitor the integrity of financial statements and the company's accounting and financial reporting processes
- Oversee the company's compliance with legal and regulatory requirements
- Ensure the risk management process is comprehensive
- Evaluate the performance of the company's independent auditor and internal audit function
- Discuss with management and the independent auditor the annual and quarterly financial statements, earnings results, earnings guidance

Audit committee and sustainability:

One of the most important links of the audit committee with sustainability is that of ESG reporting and disclosure. A recent study has shown that 60 percent of CFOs at companies with average annual revenue of $17 billion indicated that sustainability challenges will change financial reporting and the associated auditing activities.[30] Since sustainability reporting is becoming mainstream, pressure for greater transparency and focus on the ESG reporting is building up, and the concept of integrated reporting is gaining momentum, the audit committee needs to understand the challenges presented.[31]

The International Integrated Reporting Council (IIRC) defines integrated reporting as: a process founded on integrated thinking that results in a periodic integrated report, by an organization about value creation over time and related communications regarding aspects of value creation. An integrated report is a concise communication about how an organization's strategy, governance, performance and prospects, in the context of its external environment, lead to the creation of value over the short, medium and long term."[32] The Association of Chartered Certified Accountants (ACCA) has recently become the first global accountancy body to introduce integrated reporting into its qualification.[33]

Another link of the audit committee with sustainability is that of corporate communications. There has been a strong belief that the provision of regular earnings guidance is an effective and efficient way for managers to communicate their beliefs to the market, differentiate their companies from peers and allow investors to make better-informed decisions. Earnings guidance is the regular disclosure of point or tight range earnings forecasts for future quarters or the next fiscal year. However, some of the perceived benefits of earnings guidance have recently been scrutinized.

A recent report has studied in depth the costs and benefits of this managerial practice.[34] The report found that some of the perceived benefits like lower information asymmetry, higher analyst coverage and reduced stock volatility have not been thoroughly investigated up until now. There are also several potential costs associated with regular earnings guidance that could undermine a company's long-term vision and financial health. The most important costs identified are: earnings management, attracting short-term investors, analyst herding and insider trading. Some big corporations have already introduced changes in their corporate communications towards an elimination of earnings guidance (e.g. Coca Cola, Unilever and Google).[35]

The audit committee could greatly support the development of sustainable strategies by understanding the new reporting challenges and proactively introduce integrated reporting and also manage the risks arising from earnings guidance by appropriately adapting corporate communications.

Some of the responsibilities the audit committee could undertake as part of its sustainability integration are the following:

- Significant effort has been put into promoting listing standards for stock exchanges that include requirements for sustainability disclosure.[36] The audit committee could have the responsibility of carrying out an ESG materiality assessment, and of discussing the company's process for determining the ESG factors material to the business as well as the outcome of the assessment within the annual financial filings.[37]
- Understand any risks and opportunities related with reporting on the sustainability performance of the firm.
- Ensure the quality of communications and data around sustainability. Assist in defining what the company should be reporting on and understand how the investment community, regulators, consumers and the public, will perceive the information.
- Modify corporate communications towards the elimination of Earnings Guidance. To achieve this, the audit committee should identify appropriate long-term strategic financial benchmarks that could be communicated and establish ways to measure the progress towards these goals.
- Introduce integrated reporting and ensure the quality of information reported.
- Actively monitor latest research and development in the world of sustainability.
- Ensure compliance with new regulations around sustainability.
- Ensure the appropriate ethical standards are set that reward good behaviour and at the same time discourage excessive risk taking

COMPENSATION COMMITTEE

The compensation committee provides oversight of the Company's compensation plans, including equity compensation, and also is directly involved in setting the compensation of the CEO and often the senior management team. Some of the responsibilities of the compensation committee are the following:

- Review and recommend remuneration arrangements for the senior management including the CEO.
- Ensure that the organization's compensation plans are appropriate to allow attraction and retention of the best talent in the market.
- Ensure that there is no loss of value for the shareholders due to over 'generous' compensation.
- Decide on the structure of the compensation plans (restricted stocks, options, bonuses etc.).
- Decide on the incentive strategy (short-term vs. long term performance targets).

Compensation Committee and Sustainability:

The compensation committee has a very tight link with sustainability in that it is the committee that should structure compensation packages with appropriate short and long-term incentives that are challenging and lead to the creation of sustainable social as well as financial returns on investment that are durable over long term spans.

The compensation committee needs to strike the difficult balance of attracting and retaining the right talent but at the same time avoiding excessive compensation packages and loss of value for the shareholders. The compensation committee needs to be aware of the market trends and current compensation levels among competitors, which means access to information. Caution should be exercised when compensation consultants are used, in order to avoid any possible ratcheting of remuneration as will be discussed in further detail in section 5.

Some of the responsibilities the compensation committee could undertake as part of its sustainability integration are the following:

- Link sustainability issues material to the business to ESG targets.
- Determine the percentage compensation from meeting ESG and financial targets for the CEO and the executives and compare with market data of comparable companies or competitors.
- Identify any risks related to the compensation structures and the time horizon of the associated targets.
- Review the annual performance evaluations of the objectives relevant to their compensation of the CEO and other executives.
- Engage with investors and stockholders around their proposals related to compensation matters.

NOMINATING COMMITTEE

The nominating committee is responsible for overseeing the recruitment and on-going development of board members. Some of the responsibilities of the nominating committee are the following:

- Identify appropriate candidates in the event of a board vacancy.
- Review and recommend to the board, the criteria for a board membership and the desired competencies of board members.
- Oversee the evaluation of the performance of the board and the management, including the CEO.

Nominating committee and sustainability:

Succession planning is one of the most important responsibilities of the nominating committee and a key requirement for the creation of sustainable strategies.

The nominating committee has to ensure that there is an existing process behind appropriate succession planning. Succession planning is recognized as one of the weaknesses in current corporate governance practices and an area that boards need to focus further effort and attention. Succession planning should be considered part of the board's agenda and not an event that is triggered only when things are not going well. If it is integrated as part of the sustainable strategy of a firm then it will not be perceived as a sensitive and sometimes awkward issue for current CEOs who are performing well. Keeping this in mind, the CEO succession planning should almost start the first day a new CEO starts their job. The same principle would apply for the succession of any board members.

The nominating committee is also responsible for identifying prospective new board members to replace departing ones or to expand the board. Therefore if the board does not have the necessary expertise in sustainability, it is the nominating committee's responsibility to identify the appropriate candidates who do have the expertise needed.

Some of the responsibilities the nominating committee could undertake as part of its sustainability integration are the following:

- Maintain an up-to-date skills record for board directors. Introduce sustainability skills in the directors' selection process.
- Establish an assessment of performance of the board as a whole and its individual members. Ensure that sustainability metrics are part of the overall assessment
- Proactively communicate the succession plan.

Case study

Some examples of how companies have so far addressed integrating sustainability issues in their committee charters are presented in the list below:

CORPORATE GOVERNANCE COMMITTEE

- Review on a regular basis the Company's practice for director orientation and education (Biogen Idec).
- Review and report to the Board on a periodic basis with regards to matters of corporate responsibility and sustainability performance, including potential long and short term trends and impacts to their business of environmental, social, and governance issues, including the company's public reporting on these topics (INTEL).
- Review with the Board from time to time the appropriate skills and characteristics required of Board members in the context of the current make-up of the Board, including issues of diversity, age, skills such as understanding of manufacturing, technology, finance and marketing, and international background (INTEL).

AUDIT COMMITTEE

- Review any significant changes in accounting principles or developments in accounting practices and the effects of these changes upon the Company's financial reporting (IBM).
- Review the consolidated social and environmental statement in the Annual Report. Monitor and review the adequacy and effectiveness of the systems of internal controls over financial, social and environmental reporting and approve significant changes therein. Monitor the effectiveness of the risk management systems in relation to financial reporting and review and discuss policies with respect to risk assessment and risk management. Review long-term incentive programs and the calculations and achievement of financial targets in the long-term incentive programs for Senior Management (Novo Nordisk).
- Discuss with management and the independent registered public accounting firm, as appropriate, earnings results, earnings guidance, and significant financial disclosure issues (Biogen Idec)

Case study, continued

COMPENSATION COMMITTEE

- Assess the results of the company's most recent advisory vote on executive compensation (INTEL)
- Review and make recommendations with respect to stockholder proposals and stockholder engagement related to compensation matters (INTEL)
- Annually review an assessment of any potential conflicts of interest raised by the work of compensation consultants, whether retained by the Compensation Committee or management, who are involved in determining or recommending executive or director compensation (INTEL)
- Review the succession plans and leadership development for the executive officer positions, including a review of the Company's development, succession management and diversity efforts (NIKE)
- Review the Company's overall philosophy and practices regarding executive compensation (NIKE)
- Oversee the leadership development (Unilever)

NOMINATING COMMITTEE

- Regularly discuss long term succession planning for the Board and present a proposal to the Board (Novo Nordisk)
- Annually review developments in respect of required and desired diversity aspects for boards of directors and review the composition of the Board in relation to diversity (Novo Nordisk)
- Develop and oversee orientation materials or programs for new Board members (NIKE)
- Oversee an annual self-evaluation of the Board and each committee of the Board (NIKE)

3.4 Promoting effective corporate governance practices

Several governments and organizations have been contributing to the creation of an imperative for companies and investors alike to take sustainability issues seriously and to implement more effective corporate governance processes in this regard. Their efforts have come mostly in the form of regulations and reporting standards.

Some of the organizations that have been established to promote governance reforms and help mitigate agency problems, train individuals and disseminate knowledge are the following:

ICGN: The International Corporate Governance Network (ICGN) is an investor-led organization of governance professionals with the mission to inspire and promote effective standards of corporate governance to advance efficient markets and economies worldwide.

PRI: The United Nations-supported Principles for Responsible Investment (PRI) is an international network of investors working together to put the six Principles for Responsible Investment into practice.

GCGF: The Global Corporate Governance Forum (GCGF) is part of the International Finance Corporation (IFC) Corporate Governance group. The GCGF supports corporate governance reforms in emerging markets and developing countries like the United Kingdom, have made significant progress towards regulations promoting effective corporate governance.[38] The UK Corporate Governance Code sets out standards of good practice in relation to board leadership and effectiveness, remuneration, accountability and relations with shareholders.[39] A requirement has been added to the Listing Rules of the London Stock exchange, that companies filing for a premium listing should report on a "comply or explain" basis, either confirming that they have complied with the recommendations, or (where they have not), providing an explanation why they have not done so.

A Premium Listing means the company is expected to meet the UK's highest standards of regulation and corporate governance and as a consequence may enjoy a lower cost of capital through greater transparency and through building investor confidence. In 2010 the UK Stewardship Code was published, which aims to enhance the quality of engagement between asset managers and companies to help improve long-term risk-adjusted returns to shareholders.[40]

Disclosure and reporting standards can also be a driver for change. As an example, sustainability reporting can have a significant effect on key country characteristics. Countries that mandate sustainability reporting through various laws and regulations enjoy an enhanced social responsibility of business leaders within society, with companies attributing higher priority to both sustainable development and employee training.[41] In countries that adopt mandatory sustainability reporting, the adoption of ethical practices by firms and efficient corporate governance becomes significantly more widespread.[42]

Some of the key organizations behind efforts to create frameworks and standards around reporting of ESG information are:

GRI: The Global Reporting Initiative (GRI) is an organization promoting the use of sustainability reporting as a way for organizations to become more sustainable and contribute to sustainable development.[43] Their vision is a sustainable global economy where organizations manage their economic, environmental, social and governance performance and impacts responsibly and report transparently.

SASB: The Sustainability Accounting Standards Board (SASB) is a non-profit organization that provides standards for use by companies listed in the U.S.[44] SASB seeks to develop sector-specific sustainability accounting standards suitable for disclosure within the Securities Exchange Commission's Forms 10-K and 20-F (or other standard filings). Although SASB's work is mostly US-centric, given that most large US companies operate and compete globally, and that ESG issues that are material for a sector will largely be the same all over the world, SASB's standards are highly likely to be transferable and applicable to most corporations around the world.

IIRC: The International Integrated Reporting Council (IIRC) is non-profit organization that has created the "International <IR> Framework", which it is testing with a Business Network Pilot Program.[45] The IIRC is seeking to build a consensus around the case for an integrated reporting framework and also develop a consistent methodology. In this multi-stakeholder engagement process, corporations, investors, accountants, securities regulators, standard-setting organizations and the civil society have been involved.

4. CURRENT STATE OF GOVERNANCE

4.1 Are current governance practices adequate?

Although the role of governance is fundamental for implementing a sustainable strategy, there are currently several fundamental weaknesses hindering the seamless integration of sustainability and business strategy. Some of these corporate governance weaknesses and their effect in corporations today will be discussed in this section. We illustrate the importance of those weaknesses by providing specific examples.

BOARD OVERSIGHT OF SUSTAINABILITY

As previously discussed in section 3, there are several responsibilities that the various board committees can integrate into their charters to ensure sustainability oversight.

So far boards of companies in the sectors that have been traditionally scrutinized for their negative externalities (e.g., environmental impact and poor labor practices) like the Energy, Basic Materials and Utilities Sectors are more likely to have committees that have been assigned corporate responsibility and sustainability oversight.[46] Other sectors that were so far considered to face fewer concerns of this kind like the Technology, Communications and Financial sectors are less likely to address environmental and social matters with a board committee focused on the issue. A recent report examined Cisco Systems as a case study. In its 2009 annual report Cisco mentioned that the board of directors is involved in oversight of sustainability issues, but a following review of their committee charters revealed that the company had failed to assign these responsibilities to any one of their committees.[47]

The integration of sustainability issues in the board committees' charters is of paramount importance because it demonstrates commitment to these issues and also defines accountability. Defining targets and performance measures will follow assigning accountability. Without these crucial steps taking place, there can be no significant progress towards a sustainable strategy.

BOARD DIRECTORS: DO THEY HAVE THE EXPERTISE TO GOVERN AN ORGANIZATION?

The composition of skills and experiences of a company's board of directors must match the strategy of the company. As businesses expand globally, a diversified board of directors with experience in international markets is of increasing importance. Directors with a deep knowledge of foreign markets can provide the company with guidance on foreign expansion and operations, increasing their chances of success.[48] In addition, a director's industry experience and skillset must be relevant to the company and complement those of the other board members.

The audit committee is a good example of how important particular skills are in carrying out the work involved. For audit committees there are several requirements around the director's expertise to ensure the appropriate qualifications are in place. For example, the New York Stock Exchange has established this listing requirement: Each member of the audit committee must be financially literate, as such qualification is interpreted by the company's board in its business judgment, or must become financially literate within a reasonable period of time after his or her appointment to the audit committee. In addition, at least one member of the audit committee must have accounting or related financial management expertise, as the company's board interprets such qualification in its business judgment.[49]

The same rationale should apply for the rest of the committees. Therefore either in the case of a sustainability committee or in the case of integrating sustainability issues into an existing committee's charter, the directors should have the required skills and experience or be given the tools to develop it.

Directors that lack the necessary experience or background can have negative effects on the effective functioning of the board and the future performance of the company.

Case study

NVIDIA, an American global technology company, had revenues of $4 billion in 2012.[50] According to NVIDIA's 10-K report, «a majority of our revenue is generated from customers located outside the United States, and a significant portion of our assets, including employees, are located outside the United States.»[51] NVIDIA generated 78 percent, 83 percent, and 84 percent of total revenue for years 2012, 2011, and 2010, respectively, from sales to customers outside of the United States and other Americas.[52] NVIDIA has a nine-person board, yet only one board member has international work experience, and none have an academic degree from an institution that resides outside of North America.[53]

Amazon.com, Inc. is an American e-commerce company, with $61 billion in revenue in 2012.[54] Amazon has a diversified board of directors, with members coming from the investment community, technology sector, law, and philanthropy. In 2010, when Amazon was expanding its offering in the Ebook and tablet field, the company elected Jonathan Rubinstein, head of Hewlett-Packard's Palm smartphone unit, to its board of directors.[55] And in 2012, Amazon elected Jamie S. Gorelick, Deputy Attorney General during the Clinton Administration, to its board. Ms. Gorelick's experience includes representing corporations in the regulatory and enforcement arenas.[56] Each election represents a strategic move by Amazon to cultivate a board with the expertise necessary for Amazon's strategy.

BOARD OF DIRECTORS AND TIME SPENT GOVERNING

The amount of time spent by the board of directors with a company has been recently scrutinized because of the trend observed of directors acquiring several directorships. The time spent by these so-called 'busy directors' has been proven to be associated with weaker corporate governance and inferior financial performance. Directors are considered busy if they serve on three or more boards.[57]

Serving on a company's board of directors requires a serious time commitment, requiring both preparation and attendance at the board meetings. In addition, most directors join at least two board committees, which demand additional preparation and meetings.[58] Tracking the number of board meetings a year can provide an accurate gauge of the amount of time directors spend on corporate matters.[59] In 2010, 41percent of boards met between four and six times, while 35percent met between seven and nine times.[60] The average number of meetings was 7.8.[61] Another measure to gauge director commitment and time spent is the total number of boards that directors sit on. Those directors sitting on a higher number of boards will necessarily have limited time for each company.

The number of directorships an individual holds is also related to board meeting attendance. Directors with multiple board seats exhibit a higher tendency to be absent from board meetings.[62] The number of board meetings and the frequency with which directors attend these, has been found to be positively related with firm stock performance during the latest financial crisis.[63] Board meetings and the attendance at these meetings are important channels through which directors obtain firm-specific information and fulfill their monitoring role.[64]

Case study

Sirius XM Radio, an American broadcasting company, had revenues of $3.4 billion in 2012.[65] Sirius's board is composed of 13 members, and has seven meetings a year. Members sit on an average of 2.9 boards, with three directors sitting on more than four boards.[66] In 2011, one member failed board attendance minimums (75percent).[67]

Hertz Global Holdings, Inc., is an American car rental company with locations in 145 countries. In 2012 the company had revenues of $8.8 billion.[68] Hertz has 12 board members, and 14 board meetings a year. Members sit on an average of 1.5 boards, and no member sits on more than five boards.[69] In 2011, no members failed the attendance minimum (75percent).[70]

COMPENSATION - CEO REMUNERATION

CEO pay has increased dramatically in recent years, and a significant divergence from the average employee has been created. Median CEO-to-employee pay in the US has risen from 42 in 1980 to 343 in 2010.[71] Ron Johnson, former CEO of J.C. Penney, got a compensation package worth 1,795 times the average wage and benefits of a US department store employee when he was hired in 2011.[72]

According to an Economic Policy Institute study, CEO compensation grew more than 725 percent between 1978 and 2011.[73] The CEO-to-employee compensation ratio, which measures the ratio between CEO pay and that of the average employee, has also changed dramatically, going from 18.3-to-1 in 1965, peaking at 411.3-to-1 in 2000, and decreasing to 209.4-to-1 in 2011. Large CEO salaries are defended on the grounds that they are necessary to attract and retain top talent in a globalized marketplace and that the amount is just compensation for an extremely challenging job that includes motivating employees, crafting a vision for the company, and successfully executing a strategy. Furthermore, CEOs are capable of earning huge amounts for their company's shareholders, such that their salaries pale in comparison.[74]

Arguments against high pay include the fact that high pay packages distort a CEO's outlook and create perverse incentives. A high compensation package can reward decisions and behaviors that are not in the long-term interest of the company, to the detriment of employees, shareholders, and stakeholders.[75] High executive compensation can also negatively affect employee motivation, productivity, and turnover.[76] A recent working paper has found that "firms that pay their CEOs in the top 10 percent of excess pay earn negative abnormal returns over the next three years of approximately 8percent."[77] The use of executive compensation consultants has been suggested to be contributing to spiraling CEO pays.[78]

Apart from the absolute CEO pay, the pay disparity, the difference between the CEO pay and that of other senior executives has recently been at the centre of attention. Investors, rating agencies and regulators have begun to examine the effect pay disparity has in efficient corporate governance.[79] Moody's would consider as a red flag for credit risk a large pay disparity between the CEO and other senior executives, more specifically when CEO pay is more than triple that of any other executive named in the proxy statement.[80] Through the Dodd-Frank law, listed companies are required to disclose the ratio of a CEO's pay to the median pay of all other employees of the company. Shareholders can view a large pay disparity as a symptom of CEO entrenchment, implying more opportunistic behaviors during his tenure and higher succession risk when he leaves. Bebchuk et al. have found that executive pay disparity is associated with lower firm value and lower future cash flows.[81] Further research by Chen et al. has shown that there is a significant and positive correlation between executive pay disparity and the cost of equity capital implied in stock prices and analysts' earnings forecasts. The positive association is more pronounced the more likely the CEO is to leave in the near future and the more difficult it is to find a suitable successor.[82] These results highlight the importance of succession planning.

European executive pay levels tend to be lower than in the US. A recent paper examining CEO pay found that US CEOs made 26 percent more than their foreign counterparts for the year 2006, after controlling for the size of the firm, its sales, and the type of board and ownership.[83] However, CEO pay is rising similarly in Europe as the US, with Germany providing a representative example: "Average employee wages have increased by 6.1 percent since 2000, while the salaries of senior executives at companies traded on Germany's DAX stock exchange index have risen by almost 55 percent during that time period."[84] There has been regulatory pressure in both the US and Europe to cap CEO pay, with the US proposing the disclosure of the CEO-to-worker pay ratio at public companies, and different European countries wanting to cap bonuses, allow shareholders to set executive compensation, limit golden parachutes, and more heavily tax severance packages.[85]

Examining the data in Table 1 can provide an insight into the costs of excessive CEO pay. The list of CEOs in table 1 is taken by a report of executives who were awarded the largest pay packages during the period 1992-2005.[86] These firms were identified in a Wall Street Journal article in 2006. For those firms we collected data of company stock price performance over six years (2008-2013) and compared it to the performance of their main competitors for the same period. The purpose of this exercise was to identify any systematic competitive advantage given by employing members from this list of highly paid CEOs. In other words, what is the competitive advantage and financial health of firms that awarded the largest pay packages to their CEOs? If CEO compensation reflects also the extent to which board directors take into account how well the firm is positioned for long-term success then one would expect these firms to outperform competitors in the future. In contrast, if CEO compensation reflects potentially above normal current performance at the expense of building a long-term sustainable competitive advantage then one would expect these firms to underperform their competitors in the future. Rather consistent with this second explanation, 12 out of 20 companies have underperformed their competitors. Interestingly out of the 8 companies in the list that did outperform their competitors, three had CEOs who were either founders or co-founders of the companies (Lawrence Ellison – Oracle, Irwin Jacobs – Qualcomm, Dwight Schar – NVR).

Case study

Novartis AG is a multinational corporation based in Switzerland, specializing in the research, development, manufacture, and marketing of a range of healthcare products driven by pharmaceuticals.[87] The company had revenues of $56.7 billion in 2012. Novartis's CEO, Joe Jimenez, is the highest paid CEO in Switzerland, with total compensation of 13.2 million Swiss francs in 2012.[88] In comparison, the average pay for CEOs of companies in Europe's Stoxx 600 index which disclosed executive salaries was 2.7 million euros (3.3 million Swiss francs).[89] Novartis recently sparked public outrage within Switzerland when it proposed a $78 million compensation package for outgoing Chairman Daniel Vasella.[90] In March 2013, Swiss voters approved a referendum that will require publicly listed companies to give their shareholders a binding annual vote on top executives' pay, while also eliminating the practice of "golden handshakes" and "golden parachutes."[91]

Swedbank is a Sweden-based bank offering retail banking, asset management, and financial services. In 2012, the bank had revenues of SEK 14.4 billion.[92] Swedbank's CEO, Michael Wolf, earned SEK 11.3 million ($1.69 million) in 2012.[93] Along with other top executives at the bank, he is not eligible for a bonus.[94] Commenting on his compensation, Wolf stated, "And I'm not underpaid - relative to many workers in Sweden, I am very well paid."[95]

INDUSTRY (S&P CLASSIFICATION)	COMPANY	CEO	COMPANY STOCK PRICE (%) CHANGE	COMPETITORS STOCK PRICE (%) CHANGE	INDUSTRY ADJUST
Managed Care	United Health Group	William McGuire Stephen Hemsley	27.3	57.0	-29.7
Systems Software	Oracle	Lawrence Ellison	82.7	33.7	49.0
Diversified Banking	Citigroup	Sandford Weill	-90.6	8.2	-98.8
Movies & Entertainment	Disney	Michael Eisner	90.0	62.2	27.8
Consumer Finance	Capital One Finance	Richard Fairbank	-13.7	29.7	-43.4
Internet Software & Services	IAC/ InteractiveCorp	Barry Diller	-32.3	48.0	-80.3
Oil & Gas Drilling	Nabors Industries	Eugene Isenberg Anthony Petrello	-47.0	32.3	-79.3
Computer Hardware	Dell	Michael Dell Kevin Rollins	-48.9	71.0	-119.9
Internet Software & Services	Yahoo	Terry Semel	5.0	100.0	-95.0
Communications Equipment	Cisco Systems	John Chambers	-7.3	11.1	-18.4
Communications Equipment	Qualcomm	Irwin Jacobs	65.1	-4.3	69.4
Biotechnology	Genentech (26 March 2009 acquired by La Roche)	Arthur Levinson	16.1	-25.3	41.4
Internet Software & Services	Google	Omid Kordestani	96.7	30.9	65.8
Home Building	NVR	Dwight Schar	53.4	-31.2	84.6
Pharmaceuticals	Forest Laboratories	Howard Solomon	-13.6	80.0	-93.6
Trucking	Avis Budget Grp	Henry Silverman	41.0	72.0	-31.0
Oil & Gas Refining & Marketing	Valero Energy	William Greehey	-30.5	79.0	-109.5
Restaurants	Starbucks	Howard Schultz	97.2	72.7	24.5
Thrifts & Mortgage Finance	Countrywide Financial	Angelo Mozilo	-90.0	-23.9	-66.1
Aerospace & Defence	United Technologies	George David	59.2	31.6	27.6
Investment Banking & Brokerage	Lehman Brothers	Richard Fuld Jr.	-100.0	-30.3	-69.7

Table 1

List of CEOs who have profited the most from stock options in the period 1992-2005 together with their company's stock performance over six years 2008-2013. The performance of the main competitors for the same period is given for comparison

COMPENSATION - STOCK OPTIONS

The short-term nature of some of the current incentive based compensation schemes has often been associated with excessive risk taking and short-term opportunism. Variable pay packages consisting of bonuses based on yearly financial performance create the wrong incentives, the results of which one can clearly see within the financial sector. While the idea of stock option-based compensation appears to be a good solution for aligning managerial and shareholder incentives, recent research has shown that some of its unintended consequences can be damaging to organizations and markets.[96]

Stock options are increasingly part of a CEO's remuneration package and are quickly becoming universal. However, there are several caveats that make this alignment considerably less than perfect. First, stock options allow a CEO substantial upside without much downside. When the stock price increases, the CEO gains, and when the stock slides, the CEO doesn't lose money but rather makes less. This promotes a degree of risk taking, as the payoff can be quite large if the risk pays off.[97] Second, stock options aren't usually granted with any regard to the performance of other companies.[98] Most options will pay out even if companies perform worse than their competitor firms. In a bull market, with the market lifting all stock prices, everyone will benefit, even the industry laggards.[99]

Dennis Michaud and Yunwei Gai investigated the relationship between CEO compensation and the effect on a firm's performance.[100] 276 firms were selected (out of the S&P) for a 10-year period (1995-2004) for which firm performance was measured by return on equity, return on equity average and economic value added. CEO compensation was measured by six categories: CEO salary, restricted stock grants, options awarded, bonus, long term incentive pay-outs and total CEO compensation. Interestingly the authors found that a firm's performance is not affected by CEO compensation, nor by the incentive components of the compensation like bonuses and stock options.

Case study

Oracle, an American multinational computer technology company, had $37 billion in revenues in 2012.[101] Lawrence Ellison, the CEO of Oracle, was the highest paid CEO of any US public company in 2012, with a total compensation of $96.2 million. Although his salary was only $1, he received $90.7 million in stock options, representing about 94 percent of his salary.[102] He did not receive any restricted stock awards or incentive awards.[103] In fiscal 2012, Oracle's stock price fell by 22 percent.[104]

Tesoro, a Fortune 100 company, is a Texas-based refiner of oil and petroleum products. Its revenues in 2012 were $33 billion.[105] The company has begun to move away from stock options as a form of executive remuneration. Rob Patterson, managing director of compensation and benefits at Tesoro, commented, « It is not the ideal vehicle to use any longer. »[106] They have attempted to incentivize employees with other means, including time-vested restricted stock and rewarding employees with cash for hitting certain performance targets.

COMPENSATION - TIME HORIZON

Executives often have minimal time horizons for compensation. A 2012 study of the 1,500 largest companies in the US found that less than 8 percent tied executive compensation to metrics with performance periods longer than four years.[107] Recent studies from financial industry groups have recommended that variable compensation and bonuses be deferred more than three years.[108] Longer tenure and time horizons for compensation are necessary so that CEOs don't sacrifice short-term financial gains for the long-term strategy and financials of a company.[109]

A board that is engaged in a sustainable strategy formulation is more likely to focus more heavily on a CEO's strategy implementation and long-term success, rather than short-term financial results.

Case study

Voestalpine AG is an Austria-based company that produces, processes, and distributes steel products. The company supplies the automotive, household appliance, railway, and oil and gas industries.[110] In 2011/2012, their revenues were €12 billion.[111] Voestalpine AG's CEO, Wolfgang Eder, received compensation of €2.3 million in 2012. His compensation did not include any long-term incentive plans.[112] The CEO's time horizon to meet full compensation was only one year, and no management or board members had remuneration linked to targets or objectives more than two years forward looking.[113]

Eaton Corporation, a US-based power management company, had revenues of $16.3 billion in 2012.[114] In addition to using a four year performance period when setting pay for executives, part of the incentive compensation is based on the cash flow return generated by capital.[115]

SUCCESSION PLANNING

One of the most important responsibilities of the board is a sustainable CEO succession plan. The process of succession planning includes the selection, development, evaluation and compensation of the CEO. The high turnover rate of CEOs being recently observed and the increased shareholder pressure for new CEOs at some companies, make succession planning a key strategic subject in a board's agenda. A recent report carried out by PwC showed that CEO succession was the second matter after strategic planning that directors would like to devote more time, with 66 percent expressing a desire to spend more time discussing it.[116]

Succession planning and internal talent development have become a fundamental component of risk management for companies. Investors, rating agencies and government entities are starting to request more information about succession planning.

A lack of proper CEO succession planning shows underpreparedness and a weakness in corporate governance, and has been scrutinized by investors. Recent examples are the retirement of Steve Ballmer as a CEO for Microsoft and the lack of replacement and the case of Bank of America, which had its board directors caught by surprise from the announcement of Ken Lewis leaving the firm.[117, 118] It took the board almost three months to find a successor, during which time the company's stock fell 10 percent.

Case study

Occidental Petroleum is a California-based oil and gas exploration and production company. The company had revenues of $24.1 billion in 2012 operating primarily in USA, Middle East and Latin America. Concerns over Occidental's governance practices triggered a joint letter from Anne Sheehan, the director of corporate governance at the California State Teacher's Retirement System (CaLSTRS) and Ralph Whitworth, founding member and principle at Relational Investors LLC, an activist investment fund. In their letter, they criticized the company's compensation, succession planning and board composition. Some observations along different board dimensions are given in table 2. The non-executive directors of the board are listed together with some key characteristics around their background. The summary results of the overall row are subjective based on our analysis. The analysis reveals that directors have very long tenure and high median age. Their industry expertise seems to be relevant for the business. There is a good match between the geographic locations of the operations of the firm and the director's geographic expertise. The board has low gender diversity and seems to be relatively busy. The size of the board has been found to be relatively large with respect to the main competitors (15 directors for Occidental vs 11 for ExxonMobil, 13 for Chevron and 10 for Anadarko)

	TENURE	AGE	INDUSTRY EXPERTISE	INDUSTRY RELEVANCE	GEOGRAPHIC EXPERTISE	GEOGRAPHIC RELEVANCE	BUSY	GENDER
Abraham	7	57	Politics	Yes	USA	Yes	5	M
Chalsty	16	76	Finance	Yes	USA	Yes	4	M
Djerejian	16	71	Diplomat (Politics)	Yes	Middle East	Yes	3	M
Feick	14	66	Engineering	Yes	USA	Yes	4	M
Gutierrez	3	56	Finance	Yes	USA/Latin America	Yes	4	M
Maloney	18	79	Computer equipment	No	USA	Yes	1	M
Poladian	4	58	Real estate	No	USA	Yes	5	M
Segovia	18	73	Construction	No	USA/Latin America	Yes	3	M
Syriani	29	67	Conglomerate	Yes	Middle East	Yes	4	M
Tomich	32	72	Construction	No	USA	Yes	4	F
Weisman	10	74	Healthcare	No	USA	Yes	2	M
Overall	✓	✓		✓ ✓		✓ ✓ ✓		✓

Table 2

Occidental's non-executive directors as of 2011 and a list of key characteristics

5. INTEGRATED GOVERNANCE

The next question to answer is "If current governance practices are ineffective in promoting a culture of sustainability, then what is the alternative?" Integrated governance is a model that combines bringing sustainability oversight in the boardroom together with addressing some of the identified current governance weaknesses that prevent boards from operating in the most effective manner.

In the first part of this section we describe the journey that a corporation would have to go through to reform its corporate governance practices towards an integrated governance model. As companies move from treating sustainability as a peripheral issue that is not integrated in their strategic decisions to placing sustainability at the core of their business models, governance should move in the same direction. In the second part we discuss in more depth how some of the current governance weaknesses can be addressed.

5.1 The Integrated Governance Framework

Integrated governance is "the system by which companies are directed and controlled, in which sustainability issues are integrated in a way that ensures value creation for the company and beneficial results for all stakeholders in the long term. We call this new model of governance "Integrated Governance" to highlight the need for the governance model of the organization to ensure the management of all types of capital, described in section 3, in an integrated way. Integrated governance is the mechanism that can enable the realization of a sustainable strategy.

Integrated governance expresses an end state of governance practices. Therefore any firms aiming to operate under those practices will have to go through a series of changes. We propose that the ultimate target for companies would be to move from "governance for sustainability" to an integrated governance perspective.

We have identified three major stages, each with its unique characteristics that describe the journey each company has to go through to achieve a model of integrated governance (shown in figure 3). Phase 1 depicts sustainability outside of the board's agenda. In phase 1 are companies, which are not integrating sustainability issues in their strategic agenda, and merely have some (or even no) sustainability projects. In phase 1 there is no discussion of sustainability risks and opportunities at the board level and the responsibility of any sustainability projects lies with small isolated teams. As discussed earlier, for these companies to move to the next phase in their journey for integrated governance, an understanding of the value creation process through sustainability is required.

The establishment of a board level sustainability committee with the purpose of overseeing sustainability initiatives could add significant value. Having board members responsible and accountable for managing sustainability issues would bring the conversation directly in the boardroom. Clearly identified action owners, with set targets and performance measures are the keys to success of such a committee. The members of such a committee should be equipped with the appropriate tools to be able to carry out their responsibilities. This involves training and keeping up to date with the latest news in the world of sustainability. Attending conferences and seminars when needed can help them develop a better understanding of the current issues and get to know how their peers are dealing with similar problems, and the innovations they have developed to address them.

A sustainability committee should have a clear mandate to support value creation by integrating ESG issues into the daily business activities of the corporation. Some of the key objectives a sustainability committee should have in its charters are:

- Develop and communicate a strategy for sustainability initiatives and link those initiatives to business priorities. Increase stakeholder awareness of the benefits of a sustainable strategy.
- Establish the material issues that could affect a company's operations and based on these develop a detailed materiality matrix. A materiality matrix is a visual tool that displays the issues that pose risk or present opportunities to the business balanced against the issues that are of most concern to the external stakeholders.
- Identify potential short and long- term trends and impacts to the business of ESG issues. Determine the key risks that might impact the long-term competitiveness of the firm.
- Oversee sustainability initiatives and make recommendations to the board regarding any activities the company should be engaging in.
- Set sustainability goals and targets and monitor the reporting and progress against these.
- Collaborate with the Audit Committee to ensure accurate reporting on ESG information.
- Collaborate with the Nominating Committee to identify the key sustainability skills and expertise required by directors with respect to understanding the major sustainability challenges of the business.
- Collaborate with the Compensation Committee to create the appropriate incentive schemes and compensation packages. Introduce ESG metrics in compensation performance reviews.
- Integrate sustainability issues into the company's "Code of Ethics," creating one if it does not exist.

Setting up a sustainability committee could drive companies through their journey from phase 1 to phase 2, from having sustainability outside of the board's agenda to having governance for sustainability become part of it. Phase 2, governance for sustainability, describes firms that have established a sustainability committee. These firms, usually following the creation of the sustainability committee, start to measure the performance of their efforts through KPIs, issue a sustainability report, and frequently appoint a Chief Sustainability Officer. Although companies in phase 2 bring the sustainability issues onto the agenda of board meetings, sustainability is still being treated as a separate function and is compartmentalized. These companies have a sustainability strategy rather than a sustainable strategy.

Currently sustainability oversight is either at the board level (main board or one of its committees like the nominating/corporate governance committee) or falls into the realm of an executive that reports to the CEO. This depends on the size of the company, with larger companies assigning sustainability oversight at the board level and smaller companies delegating it to the CEO. Only a small number of companies have a dedicated standing sustainability committee at the board level (7.5 percent for nonfinancial services, 2.9 percent for financial services; the report analysed findings from a survey of 359 business corporations issuing equity securities registered with the US SEC).[119]

As Aron Cramer, President and CEO of Business for Social Responsibility (BSR) has well articulated: "Over the long run, the best solution is to integrate sustainability into all board activities so that it becomes «mainstream.» This mirrors the indispensable effort by many company leaders over the past decade to integrate sustainability into business strategy and operations. Ideally, dedicated board committees would be seen as redundant in a decade's time but they might be needed now to catalyze the transition."[120]

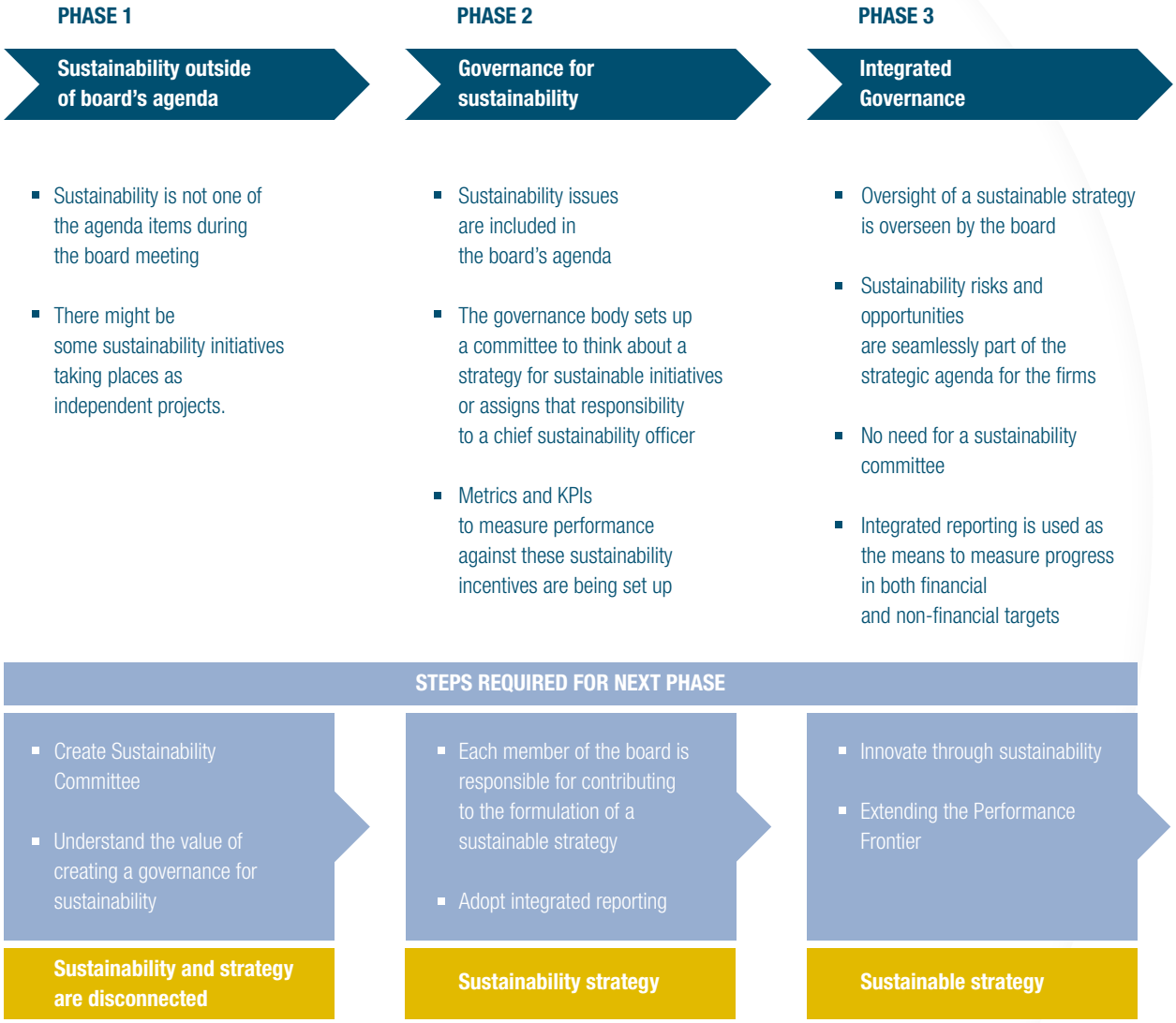

Figure 3

The journey in their corporate governance practices companies have to go through to adopt an integrated governance model

While in Phase 2, assigning the accountability of sustainability needs to be coupled with the appropriate incentives. Targets should be established and the progress towards these should be monitored. The compensation schemes of the directors and any other employees involved should have the right incentive structure. The pay levels and stock options should have a long-term horizon and awarded as a function of the performance against these targets.

A progression to phase 3, integrated governance, would require a holistic integration of sustainability in the corporate strategy, without the need for a separate sustainability committee since each board member is now thinking in a way that would promote a sustainable strategy for the firm. As described in section three each board committee can integrate sustainability issues in their charter and replace the need for a dedicated sustainability committee. Adoption of integrated reporting adds significant value in monitoring the progress against both financial and ESG targets, and helps understand the benefits of the integrated governance approach.

In order to achieve integrated governance, as described in phase 3 of Figure 3 a company needs to make sure four elements are in place: independence both at the individual and at the group level, aligned incentives and investor long term active ownership.

We redefine independence as an independent way of thinking. Independence starts at the individual level, from the capabilities required by the directors to be able to serve effectively on a corporate board. For an independent way of thinking at the individual level we consider it essential that directors have functional expertise, time to spend governing the organization, a record of integrity and high ethical standards, and no material affiliation to executives in the company. We consider all four as necessary conditions in order to have an independent board.

Once independence is ensured at the individual level, the second step is establishing independence at the group level, by identifying the best structure for the board. We suggest that the size of the board is appropriate for the company after taking into account the needs of the firm, but also considerations of optimal board size. Keeping the board diverse is also a very important. By diversity we aim to cover more than the traditional gender and race definition and include diversity in the background and experiences of the different directors.

After the board is fully functional it has to make sure that the third element, executive compensation, is structured in a way that long-term incentives are used and excessively high compensation packages are not awarded. Finally, the fourth element concerns the investment community. We propose that investors act and engage with companies as long-term owners. Figure 4 below depicts the four elements of integrated governance.

Figure 4

The four key elements of Integrated Governance. The steps from the individual level of board independence to the group level and then the alignment of incentives are supervised by investor long-term active ownership.

5.2 Board independence at the individual level

There are several key attributes that a board of directors should exhibit to be able to perform appropriate corporate governance. Availability, independence, diversity of experience, competitiveness of remuneration, transparency and evaluation are some, as described in the European Corporate Governance Report.[121] The traditional definition of board independence revolves around a director's character and judgment. Companies are meant to be reporting in their annual report their non-executive directors considered to be independent and also identify any circumstances that could affect this independence. Some of these circumstances that could affect a director's independence are the following: i) if the director has been an employee of the company or group within the last five years, ii) if the director has had a material business relationship with the company, iii) if the director has received or receives additional remuneration from the company, iv) if the director has close family ties with any of the company's employees, v) if the director has links with other directors through directorships he might hold in other companies, vi) if the director represents a significant shareholder and vii) if the director has served the board for over nine years.[122]

The traditional definition of independence could serve well as a compliance checklist but is not adequate. By independence we mean an independent way of thinking. Several key elements are needed to characterize a director truly independent to carry out the responsibilities and his fiduciary duty at the individual level. Together with ensuring there is no affiliation with the company, a director should have the appropriate expertise to be on the board, devote enough time and effort in understanding the business and exhibit high integrity.

5.2.1 Expertise

It is imperative that the board of directors, as the governing body of an organization has the expertise required for decision making. A long list of qualities could characterize 'expertise', but the most important are: appropriate qualifications and skills, experience, functional expertise and geographic/market knowledge.

The board of directors need to have a minimum level of qualifications and skills in order to be truly independent.[123] Too many times directors do not have the necessary qualifications or deep understanding of the industry the company is operating in. Consider directors of financial institutions that do not understand pricing of exotic derivatives, multi-factor volatility models, and how to price illiquidity in financial markets. If directors do not understand these concepts then how can they understand how a financial institution creates value, be able to raise their voice and act independently? It is no surprise then that directors of most financial institutions were taken by surprise when the companies they were governing were suddenly bankrupt. A recent study has shown that while many non-executive directors have C-suite experience, former or current CFOs are less represented in the board of financial services companies than it would be expected, with the percentage of CFOs, financial directors and treasurers in manufacturing and nonfinancial services being 9 percent and 9.2 percent respectively while in financial services 6.7 percent (the report analysed findings from a survey of 359 business corporations issuing equity securities registered with the US SEC).[124]

By functional expertise we mean expertise on the types of capital that are considerably important for the firm. For a company for which human capital is important, directors with HR expertise are valuable, for companies for which innovation capital is the most important, directors with experience in entrepreneurship are essential.

The need for expertise has also been highlighted by a recent study, finding that some of the most desirable attributes for board candidates are industry expertise (48 percent), financial expertise (41 percent) and operational expertise (37 percent).[125]

Equally important is understanding the value creation process within an organization. Unfortunately, this is not the case currently. Only 43 percent of nonexecutive directors of listed companies believe that they can affect their organization's strategy.[126] Of course, affecting an organization's strategy does not only require a deep understanding of a value creation process, but the ability to implement change in the presence of powerful corporate executives. Instead of focusing on reviewing the strategy and sustainability of an organization, they focus on checking boxes on a long list of legal requirements. We do not argue that directors should ignore their legal duties, rather that they should be more actively engaged in the strategic issues that an organization faces.

Some companies have also started to include sustainability and corporate responsibility skills as one of the criteria for board member selection. Prudential Health is one example of such a company. In their 2012 sustainability report Constance J. Horner, Chair of the Governance and Business Ethics Committee clearly states: "Sustainability is firmly entrenched in the values and principles that guide Prudential's Board. Our commitment is clear and tangible: environmental, sustainability and corporate responsibility experience are among the skills that should be represented on Prudential's Board.[127]

Although the nominating committee would drive the decision around the recruitment of new directors and identifying that they have the required expertise, it would be the responsibility of the corporate governance committee to further develop that expertise and skills. In particular, providing ESG education could significantly help in assigning sustainability oversight to every board member.

★ Recommendation:

Carry out a careful examination of the appropriateness of the qualifications and experience each individual board member brings to the table and always with respect to the industry and markets the company is operating in.

5.2.2 Time spent governing

The time spent governing has been touched upon in section 4 where the concept of 'busy directors' and their adverse effect in corporate governance and financial performance of a company was investigated.

The director's work is increasingly becoming more demanding and complex. Companies are evolving more rapidly than ever before in terms of business models, innovations and technology breakthroughs. More demanding regulatory requirements are being put in place. These changes need to be inevitably reflected in the effort required by the board of directors. A significant point to be made is that by time spent governing we do not simply consider attendance of the board's meetings i.e the quantity of time spent but also the quality of time spent. The quality of time spent includes any preparation needed for the meetings, further training required, personal effort and time spent etc.

Several surveys have been carried out, examining board attendance numbers. The average number of board meetings per year in Europe is 9.4 and even given the low number of yearly meetings, some countries have less than 50 percent average attendance.[128] Research has shown that female directors have better attendance records than male directors and gender-diverse boards spend more time monitoring.[129] Board attendance is not a matter of good practice and shouldn't be dealt as such. It is a prerequisite to fulfil the obligations a director has towards the shareholders and stakeholders.

Directors should account for time that would be used to engage with the mid-level management and low-level employees. This type of engagement would contribute to a greater degree of independence in directors' thinking and decision-making. There is currently a significant disconnect between the directors and the employees of the firm, with directors only engaging with the senior management. A link to the rest of the employees could provide them with a deep understanding of the front line and the everyday problems of the firm. It could also serve in empowering employees by having their voices heard by the most senior management, and therefore improve employee engagement.

Together with this engagement with mid-level management and low-level employees, directors should account for the time allocated to govern their organisations, and the time needed to process information from multiple resources. This requires information access to independent information from multiple audiences that is complete and verified. The sources of the information would include mid-level management, front line employees, customers, suppliers, communities, analysts, investors etc.

★ Recommendation:

Review board attendance metrics and take appropriate action when these numbers are low. Expectation should be set for full attendance given the low number of meetings required every year.

★ Recommendation:

Make sure that the board members have the access to information required and that they utilize this information in their decision-making.

5.2.3 Business ethics

The management of business ethics and conduct is one of the most important aspects of good corporate governance. Codes of ethics are now commonplace for most corporations but they have proven to be ineffective especially when they are very broadly stated or when they are not followed by the appropriate behaviors, starting from the management. Directors are facing the challenge to establish appropriate ethical standards and communicate them to the CEO and the management and ensure that these business ethics and standards of business conduct are followed in every level of the organization.

Although many people think that ethics are inherent in individuals and built long before they get their first job, research has argued for the opposite. Ethics have to do with managerial decisions, exemplary behaviour, and of course policies.[130] The influence of the corporation as a moral environment is significant. A CEO who is willing to immediately recall a product because of a quality defect in a number of untraceable shipments, at the cost of millions of dollars, sends a very strong message to his management and employees.[131] Even ethical people within an organization can act in an unethical way, mainly because of their cognitive biases and incentive systems surrounding them.[132]

The boards' place at the apex of the incentive structure for companies brings them in the unique position to be able to drive behaviors by eliminating any internal pressures and temptations for executives and staff to behave unethically.[133] By implementing meaningful corporate codes that foster individual ethical behavior, responsibility, and openness, ethical issues and concerns can be addressed.[134] These codes can help foster a long-term sustainable strategy for the company.

Lacking an ethical corporate behaviour can prove to be detrimental for corporations. The internet and social media have increased transparency and made it easier to identify and track unethical corporate behavior. Unethical corporations eventually get exposed, while companies with strong principles and values may be rewarded in the marketplace. More concretely, companies with strong ethics can reduce potentially costly governmental fines, decrease vulnerability, improve reputation, increase employee productivity and commitment, increase access to capital, and enhance customer loyalty.[135] The company wide code of ethics is also a good place to communicate and drive better behaviors around sustainability issues.

★ Recommendation:

Ensure that not only a code for ethics exists but also that the board members and CEO are champions of that code with their actions and behavior, setting an example for the whole company.

5.2.4 No affiliation

No affiliation for non-executive directors with the company still remains one of the key elements for true board independence. Board members should be independent of the company and the company management. The board directors should be meeting regularly without the presence of the management. The concept of no affiliation has been the subject of extensive research over the years. Several corporate governance codes exist that outline the key principles for ensuring that the board has no affiliation with the company.[136]

★ Recommendation:

Ensure there is no affiliation with the company that would affect the decision-making of the members of the board.

5.3 Board independence at the group level

At the group level there are two main elements for ensuring board independence. Directors should be surrounded by an appropriate number of other directors that would limit the CEO's influence on key decisions. Diversity is the second component and one very commonly neglected. Both these important constituents of group level board independence will be examined below.

5.3.1 Size of the Board

The size of the board is directly related to its independence, especially in terms of the influence the CEO can exert. The larger the board, the more powerful the CEO is likely to be. Research has shown that CEO compensation is higher when the board is larger.[137] A number of reasons can be contributing to this effect as described by Bebchuk and Fried:[138]

- Larger boards are less cohesive because of the lower level of responsibility felt by each individual director
- Less threat of public outrage, because is it harder to identify a board member responsible for a decision
- More difficult to challenge the CEO and her decisions due to the amount of directors that need to be convinced.

Is there an optimal board size? The answer is that it depends on the company under investigation. Research has shown that larger boards are needed for firms with higher advisory (instead of monitoring) needs from their directors.[139] Specifically, research has found that larger boards create financial value in more diversified and higher levered firms.

★ Recommendation:

Ensure that the size of the board is appropriate for functioning independently at the group level.

5.3.2 Diversity

Diversity includes several aspects: gender and race diversity but also diversity in the directors' backgrounds and experiences. In terms of gender diversity, some countries have imposed a target number through regulations or "comply or explain" provisions. Gender quotas for female representation in the board (ranging between 33-50 percent) have been set by several countries with penalties for non-compliance.[140] One of the pioneers, the Norwegian government, has established a 40 percent female quota for compliance by 2006 for state-owned firms and 2008 for publicly traded firms with very strict sanctions for non conformance (non-complying firms are forced to de-list from the stock exchange and/or relocate the headquarters to another country).[141] In France, boards will have to comprise 40 percent of women directors by 2017.[142] Other countries have adopted non-binding gender quotas in their corporate governance codes, enforcing the "comply or explain" principle. Nevertheless, the numbers are still relatively low: across 67 countries, females comprise only 10.3 percent of board directorships, with the European average of women on the board being currently at 12 percent.[143,144] In the UK, members of the 30 % club (a group of Chairmen voluntarily committed to bringing more women onto UK corporate boards) have adopted a voting approach whereby they vote against the re-election of the nominations committee chair if the board is not diverse and the explanation absent or poor.

A board of directors that is composed by members with a diverse professional and educational background, and different industry experiences could prove to be much more creative and better positioned to make decisions. Diverse groups foster creativity and suffer less from group thinking.[145] Group collective intelligence is more efficient in performing different kinds of tasks than the individual abilities of single members, especially when the members of these groups have higher levels of 'social sensitivity' (how well the group members perceive each other's emotions).[146] Interestingly, it has been found that groups containing more women demonstrated higher levels of social sensitivity and in turn greater collective intelligence.

The demographic characteristics of the board (in terms of age, tenure, education, specialization, and training) can also influence the propensity to change the corporate strategy. It has been found that firms with more diverse management teams are more likely to undergo changes in corporate strategy.[147]

Other potential benefits of diversity can be: access to different resources and connections, employee engagement in the case minorities are represented, improvement in the investor and public relations by representing societal expectations.

We note that functional diversity could present a challenge because it could have the potential cost of creating a lack of collective expertise by the directors within the specific industry the company is operating.

★ Recommendation:

Balance a diversified board in terms of gender, race and experiences/background without compromising the existence of the necessary expertise to remain independent.

5.4 Aligning interests

A very important aspect of integrated governance is the alignment of interests and incentives through the use of appropriate long-term compensation structures that include both financial and ESG performance metrics.

5.4.1 Compensation Structure

Compensation is one of the major challenges of corporate governance. Compensation decisions especially around CEO and managerial pay can possibly create friction between the CEO and their management teams and the board. As previously mentioned, the board should be independent, meaning no financial or nonfinancial incentives to favour a specific CEO and his management team. Nevertheless, even if the board is truly independent, one should note that there is no actual cost to directors to pay compensations that could possibly hurt shareholders. This lack of financial incentives makes submitting to a CEO's compensation demands easier.

For compensation that is structured around performance-based incentive schemes, the objectives that are set and their time horizon are of crucial importance. The difficult balance of financial and ESG goals and short and long-term performance needs to be achieved. The way these compensation schemes are structured will drive the behaviour of the CEO and the management team for meeting these objectives, which in turn will reflect on the decisions made for the rest of the company.

Another very important aspect is the means by which these objectives are met, since it could be the source of unethical behaviour.[148] The challenge with creating a universal framework around compensation schemes is that one size doesn't fit all, since different companies have different business strategies, objectives and risk profiles.

Considering the first part of a compensation scheme, the balance of financial and ESG goals, the directors need to understand that setting and meeting the right ESG objectives will also create financial benefits. These are tightly linked and their relationship has been investigated in several academic reports. A recent study by Ceres of 600 large publicly traded companies and their progress on sustainability based on the Ceres Roadmap for Sustainability Framework revealed that only 7 percent of them tie executive compensation explicitly to ESG performance targets, 9 percent tie executive compensation to ESG but do not cite explicit targets and the remaining 84 percent do not link ESG performance to executive compensation.[149]

The use of balanced scorecards, as a means of translating the vision and mission statements into comprehensive objectives and quantifiable performance measures has been proven to be a valuable managerial tool. The categories typically included in a balanced scorecard are financial performance, customer value performance, internal business performance, innovation performance and employee performance. All these categories can cover most of the financial and ESG aspects important for a company, but the important question is how much weighting each one should have regarding an employee's compensation and most importantly regarding the CEO and the management team's remuneration. These scorecards are being constructed and implemented by the management team, so they should be following the principles set by the board of directors.[150]

★ Recommendation:

Tie ESG performance targets to executive compensation and communicate those targets.

5.4.2 Long-term compensation structure

Useful life of the firm's assets needs to be carefully considered. Depending on the specific assets of a firm (i.e inventory, properties, IP, patents, oil fields etc.), this could vary significantly. The key point is that the compensation structure should account for these and make sure that the quality of these assets does not deteriorate with time. The same logic applies for discouraging short-term thinking or ship jumping, even by omission. Claw-back provisions in CEO contracts is a trend that is not strong enough at the moment and could prove to be beneficial in aligning compensation and incentives.

The measures most directors use to evaluate corporate performance are too focused on earnings growth and often do not weight a company's return on assets, equity or invested capital. One measure for the creation or destruction of shareholder value is the return on invested capital, because it reveals how effectively a company is using its money to generate returns. If boards ignore this measure when setting pay, executives could be rewarded even when their companies' financing costs exceed the returns on their investments.[151]

Currently there is no universal guidance around linking sustainability metrics to executive compensation. The difficulty in creating one lies in the materiality of different sustainability issues for firms operating in different industries. Thorough work around identifying the material issues is essential. This would be the work of the board level sustainability committee previously discussed, to understand the material issues. Once these have been identified, then appropriate sustainability metrics can be introduced to measure the performance against those issues and these metrics can serve as proxies for a company's long-term success.

★ Recommendation:

Utilize measures like return on assets, equity or invested capital to define executive performance targets.

★ Recommendation:

Use sustainability metrics as proxies for measuring the company's long-term success.

5.4.3 Ratcheting and the use of compensation consultants

One of the most important recommendations to make is to avoid simply following the example of others. Board decisions should be firm-specific, serving the interests of the corporation. The use of compensation consultants that has contributed to the ratcheting of CEO compensation is frequently cited as a concern. The convention of paying a CEO above average compensation means that the specifics of each individual firm are not taken into account. Of course highly performing individuals should be rewarded, based on performance in the long-term, depending on the time-horizon and risk profile of the individual company.

The 'average' salary cited by compensation consultants for evaluating a future CEO's compensation against the peer firms depends always on the sample used for peer firms. A study by the IRRC examined systematic biases in compensation benchmarking processes. A group of companies from the S&P 500 that were identified to have high CEO pay relative to peers which is not justified by corresponding performance was compared to a baseline sample of the remaining S&P 500 companies. The results showed the following interesting results:

- Companies tend to select larger peers for benchmarking (market capitalization and revenue)
- The companies in the high CEO pay group were 25 percent smaller than their peers in terms of revenue and 45 percent smaller in terms of market capitalization whereas baseline companies were 17 percent smaller in terms of revenue and just 5 percent in terms of market capitalization

The companies in the high CEO pay compensated their CEOs an average of 103 percent above the median of their selected peer group. The baseline companies on the other hand paid their CEOs an average of 15 percent lower than the median of their selected peer group.

Studies have also shown that when firms performed poorly relative to the industry or the CEO was already highly paid with respect to the industry, the sample of peer firms was expanded beyond industry boundaries and that two-thirds of the largest 1,000 corporations reported beating the performance of their industry peers over the last five fiscal years.[152, 153]

Compensation shouldn't be expected to always show an upward trend. Companies need to have the appropriate claw-back mechanisms in place, both in case of materialized financial or sustainability risks. A good guidance point has been provided by the Principles for Responsible Investment: "Incentive compensation should be subject to downward discretionary adjustments by the compensation committee to account for unusual events or unintended consequences as well as claw-back provisions".[154]

★ Recommendation:

Executive compensation should not be expected to always show an upward trend. Claw-back provisions should be in place in the case of value destructing events.

5.5 Investor Activism in Executive Compensation

Shareholder resolutions that criticize managers' high compensation and propose that it be limited are very important and can be influential. A study has found that during the two-year period following the passage of shareholder resolutions criticizing executive pay in particular firms, total compensation (adjusted for industry) in those firms declined by a statistically significant average of $2.7 million.[155] Higher negative votes in management-sponsored stock option proposals during the late 1990s slowed the increase in CEO compensation in subsequent years.[156]

Investor activism can bring change. A good example around this is summarised by Bebchuk and Fried.[157] The example the authors cite is about the California State Pension Fund for Public Employees' (CalPERS) and their practice of identifying poorly run companies. For several years CalPERS used a 'focus list' of poorly performing firms with which they decided to engage on issues of corporate governance and in many cases those engagements were successful. In 1991, CalPERS adopted a more 'kind' approach, eliminating the public shaming after several CEOs request. The result was that, firms were not cooperating enough in the engagements with CalPERS, lacking the threat of negative publicity. In 1992 CalPERS reinstated the policy of publicly shaming uncooperative firms. This practice by CalPERS has brought measurable results, with firms in the focus list being more likely to reduce the number of inside directors on their boards, and more likely to experience CEO turnover. There were also costs in the director's future career, with shaming negatively affecting the chances of departing executive directors to land other board positions.

5.6 Long term Active Ownership

Changes to the governance practices don't need to always come from within. Beside what regulation can do, external pressure can trigger the desired reactions and investors are in the best place to apply that pressure.[158] Investors can be a major source of pressure on executive management and boards, given their influence on the share price, the power of their votes, and their engagement with the management.[159]

Investment time horizons also play a role in implementing sustainable strategies. The average holding periods have declined significantly across most stock exchanges, from over 8 years in 1960 to under one year in 2005 for the NYSE, making short termism in capital markets a well-documented effect.[160] Investor short termism ultimately affects companies, by creating corporate short-termism.[161] Arbitrages are then made by companies between what would be needed to develop and implement a long-term strategy, and actions with an immediate impact on the next quarterly earnings report. Yet, there are ways the market, i.e. investors and corporate issuers together, could work on realigning their long-term interests. Instruments as potential reward for investors' loyalty would need to be further elaborated and reviewed, as such mechanisms already exist, but have not yet been developed to a large scale, nor has their effectiveness been evaluated.[162]

For very short-term investors, sustainability is often considered irrelevant, but even for investors whose time horizons are longer (which would include many asset owners as well as asset managers), five years is still a fairly long-term investment horizon for many managers. The important thing to recognize, however, both for companies and for investors, is that sustainability isn't always a long-term proposition, particularly on the risk side. ESG risks can explode into a significant loss of value at any moment, and it is often impossible to predict that moment. One of the most important reasons to integrate sustainability into governance, therefore, is the precautionary principle: the way to deal with risks whose term is indeterminate is to avoid investing in, or be active in improving, companies that are more prone to a value-destroying event, such as the Deepwater Horizon blowout of BP or the mine explosion at Massey Energy.

For investors to act as owners means an understanding of the business models and the effectiveness of the management and the board. This can be a very challenging task given the diversification strategies followed by many institutional investors. A balance between diversification and active ownership could prove to be beneficial as more concentrated positions enable an investor to devote more resources per portfolio company in monitoring and engaging. Concentrated portfolios can actually prove to perform better as research has shown.[163] Of course this needs to happen by taking into account and respecting the risk controls in place to monitor and prevent excessive concentration of investments.

Case study

Three case studies of firms that exhibit elements of integrated governance are given below. The integrated governance framework was used to drive the collection of data around these. The process used was to evaluate first the independence at the individual level, progressing to independence at the group level of the board as a whole and finally examining any data around aligning interests. The information presented is publicly available and has been gathered from the companies' websites, annual reports, proxy statements etc.

BIOGEN IDEC

Biogen Idec is an American biotechnology company based in Weston, Massachussets. Biogen Idec had revenues of $5.5 billion. Biogen Idec has 12 directors on its board.

The directors' backgrounds vary, from Richard C. Mulligan who is a Professor of Genetics at Harvard Medical School and the director of the Harvard Gene Therapy Initiative, Robart W. Pangia who has an investment banking background to the Honorable Lynn Shenk who is an attorney and has worked as chief of staff to the governor of California.

Only 2 out of the 14 directors sit on more than 3 boards (17 percent). 91.67 percent of the directors are independent and were elected by shareholders, 100 percent of the compensation committee members are independent and 100 percent of the audit committee members are independent. Out of the 12 directors, 3 are women, representing 25 percent. The Chairman position is separate from the Chief Executive Officer. The Board of Directors met 10 times in 2012. No current director attended fewer than 75 percent of the total number of meetings of the Board of Directors and the committees on which he or she served during 2012. The independent directors are required to meet without management present twice each year. All of the directors and director nominees are expected to attend the annual meetings of stockholders. All of the directors attended the 2012 annual meeting of stockholders.

Biogen as part of conducting business ethically and with integrity has established a comprehensive compliance program developed in accordance with the laws applicable to the industry and the «Program Guidance for Office of the Inspector General of the U.S. Department of Health and Human Services". Biogen's compliance program also requires compliance with the PhRMA Code which is voluntary code adopted by the Pharmaceutical Research and Manufacturers of America and the pharmaceutical industry's trade group.

Biogen for their 2012 Annual Cash Incentive Plan, selected Company goals and assigned weights that reflected the Company's established financial, strategic and operational objectives. In 2012, they assigned a total of 40 percent weight to financial and commercial market share goals, 50 percent to product development and launch, pipeline and lifecycle goals and 10 percent to organizational and cultural goals. These goals and weights reflected the importance of linking reward opportunities to both near-term results and the progress toward longer-term results, and aligned management incentives with the enhancement of long-term stockholder value.

Case study, continued

INTEL

Intel is an American multinational based in Santa Clara, California. The company specializes in semiconductors and is the largest and highest valued semiconductor chip maker in the world based on revenue. Intel had revenues of $53.3 billion in 2012. Intel's board is composed of 10 directors. Intel's board consists of directors with a variety of qualifications and experiences. James D. Plummer is a Professor in Electrical Engineering in Stanford, John J. Donahoe is the CEO of ebay whereas Ambassador Charlene Barshefsky was the chief trade negotiator and principal trade policy maker for the U.S. from 1997 to 2001 and a member of the President's Cabinet. The academic background of the directors is mostly originating from the U.S.. In terms of time spent governing only one out of ten directors would be characterized 'busy' (having more than 3 directorships) by having 4 directorships. 80 percent of the directors are reported as independent directors.

Women represent 20 percent of the board (2 out of 10). The Chairman position is separate from the Chief Executive Officer. The Board held seven meetings in 2012. Each director is expected to attend every meeting of the Board and the committees on which he or she serves, as well as the annual stockholders' meeting. All directors attended at least 75 percent of the meetings of the Board and the committees on which they served in 2012. Since 2008, Intel has linked a portion of every employee's variable compensation package (from front-line employees to the CEO) to the achievement of environmental sustainability metrics. Intel is committed to the highest standards of business ethics and corporate governance as it is described in their annual report and is a member of the United Nations Global Compact LEAD program. Intel states that they have received over 60 corporate responsibility awards and recognitions in 2011.

DANONE

Danone is a French food-products multinational organization based in Paris, France. Danone had revenues of $21 billion in 2012. Danone's board is composed of 14 directors.

Danone's directors have different educational backgrounds and professional experiences. Jacques-Antoine Granjon is the Chairman and CEO of vente-privee an e-commerce company, Virginia Stallings is a Professor of Pediatrics at Children's Hospital of Philadelphia and Isabelle Seillier is head of J.P Morgan's Financial Institutions Group for Europe, the Middle East and Africa. 6 out of 14 directors (43 percent) are considered 'busy' (having more than 3 directorships). Out of the 14 directors, 8 are reported as independent (57 percent). There are 3 women on the board (21 percent) and non-French directors account for 28 percent of the board. The Chairman of the board of directors, Franck Riboud also serves as the Chief Executive Officer. Danone is a signatory to the U.N Global Compact.

Danone has created a governance body called the Social Responsibility Committee to assist the company's decisions on CSR issues. The company has a Business Conduct Policies document, which integrates texts such as the Universal Declaration of Human Rights, the Organization for Economic Cooperation and Development guidelines and the Fundamental Social Principles. The social dimension is a powerful element to bring meaning and commitment to Danone's employees. For performance management, the criteria used to evaluate the performance of the company's 1,400 managing executives since 2008 are based on a three-part bonus system: one-third for economic objectives, one-third for social and environmental objectives and one-third for individual performance objectives.

5.7 Conclusions

Integrating environmental and social issues into a company's corporate strategy can present tremendous opportunities for innovation and growth while failing to do so can result in significant risks. Since corporate governance is the mechanism by which companies are directed and controlled, it is through reforming current governance practices that sustainable strategies can be formulated and implemented.

The integrated governance model is the system by which companies are directed and controlled, in which sustainability issues are integrated in a way that ensures value creation for the company and beneficial results for all stakeholders in the long term.

Each company that is in the process of integrating sustainability issues into its business strategy needs to go through a journey of adapting its corporate governance practices accordingly. According to the integrated governance framework the very first steps of companies in Phase 1, sustainability outside of board's agenda, involve understanding the value of creating a sustainable strategy and the link to financial performance. The creation of a board level sustainability committee can accelerate the process by bringing sustainability issues directly into the boardroom. Transition to phase 2, governance for sustainability, would have occurred when sustainability issues are included in the board's agenda, a sustainability committee is in place and KPIs are established to measure progress against sustainability initiatives. Companies can move to phase 3, integrated governance by having each board take responsibility for ensuring that the company has a sustainable strategy. The target would be assigning sustainability oversight to each member of the board and integrate it seamlessly in the board's strategic agenda and decision-making progress. In the integrated governance model, the dedicated sustainability committee is no longer needed since sustainability is not compartmentalized.

Adopting an integrated governance model and developing sustainable strategies requires a collective effort from companies, asset owners, asset managers and regulators.

Companies need to assess their current state of governance practices with respect to the integrated governance framework. Depending on the phase they currently are operating in, they can identify the appropriate steps involved to move to the next phase. Companies could also use the integrated governance framework to benchmark themselves against their peers.

The asset owners could assist companies in this process by reducing any incentives that lead to short-termism. This can be achieved by increasing the capital allocation to asset managers based on long-term performance.

The asset managers need to integrate sustainability issues into their capital allocation decisions. The integrated governance model provides a framework to identify the governance characteristics that would position corporations in a better place in the journey of creating a sustainable strategy. Investment managers could also use the model in their engagements with companies around good governance practices.

Last but not least, the role of regulators could significantly catalyse the process of adopting integrated governance and creating the environment for sustainable strategies. Governments for example can ensure that all national corporate governance codes promote integrated corporate governance. Governments can also call for proxy advisers covering at least 80 percent of the market to be integrating corporate sustainability performance into their advice to asset managers and asset owners on director (re-)election, directors/remuneration and corporate disclosure.

6. RESPONSES FROM PROXY VOTING AGENCIES

6.1 Glass Lewis

GLASS LEWIS & Co.

1. Do you have any views on the Integrated Governance concept?

Glass Lewis views the Integrated Governance concept («the Concept») as a positive step in helping shareholders partner with directors, executives and regulators to improve corporate governance and engagement. We believe this will lead to enhanced, sustainable company performance and will help companies maintain good stakeholder relationships. The Concept coalesces many constructive ideas into a workable framework for use by investors and companies alike, as well as by government regulators and advisers to both investors and companies. Glass Lewis believes companies that integrate governance into corporate culture and strategy will have more effective boards, enjoy better returns, have more fruitful relations with shareholders, do a better job of identifying and managing risks, and be more insulated from prevailing short-termism implicit in certain investors' behavior. Glass Lewis believes the Concept may serve as a catalyst for boards to indentify director candidates with the willingness and skills to develop and implement the integrated governance model.

2. To what extent are the recommendations already embedded in your voting recommendations?

Glass Lewis' guidelines are underpinned by the firm's belief that shareholders can promote long-term, sustainable value creation by promoting director accountability; encouraging robust risk oversight, mitigation and management; protecting and enhancing shareholder rights; and fostering sound compensation practices, in particular a close link between remuneration and performance. Glass Lewis systematically analyzes the many risk factors faced by companies that threaten sustainable value creation, including those relating to financial, accounting, governance, compensation, environmental, legal, regulatory and social issues.

In examining boards, Glass Lewis not only routinely examines the more basic aspects of directors such as their independence and other commitments (e.g., attendance and service on other boards) but examines director performance at the subject company and other companies where the director currently is or formerly was a director or an executive. As such, Glass Lewis will recommend shareholders vote against directors for oversight lapses, including those relating to governance, safety, environmental practices, compensation, audit, financial statements, ethics, etc. Further, Glass Lewis will also recommend voting against ratification of supervisory and management board acts and against the receipt of accounts and reports for similar reasons. Glass Lewis also recommends supporting shareholder proposals that will increase or preserve shareholder value, such as those that would enhance shareholder rights, increase director accountability, improve corporate governance, better link remuneration with performance, preserve a company's license to operate and enhance disclosure of relevant risk factors.

Glass Lewis' approach is informed by its own Special Report research including *Greening the Green*, a study of how executive compensation is linked to sustainability metrics; *Mind the Gap*, a study of board gender diversity, director independence, tenure and other aspects of female representation in leadership positions; and *Sustainability Reporting*, a study of sustainability reporting frameworks and shareholder initiatives aimed at improving sustainability reporting by companies. Glass Lewis' approach is also informed by external studies, such as PRI's 2012 report «Integrating Environmental, Social and Governance Issues Into Executive Pay: Guidance for Investors and Companies,» to which Glass Lewis was a named contributor.[164]

For further information when evaluating companies' sustainable business practices, Glass Lewis leverages data compiled and analyzed by EIRIS, a global provider of research of the environmental, social, governance and ethical performance of companies. Glass Lewis has also partnered with EIRIS to develop a proxy voting service enabling institutional investors to incorporate accountability for environmental and social performance into their voting for company directors.

3. How/can your recommendations further embed these recommendations, particularly in relation to remuneration of corporate executives, appointment and re-election of corporate directors and corporate reporting?

Since Glass Lewis conducts a comprehensive analysis of directors, executive remuneration and companies' corporate governance, among other issues, in each Glass Lewis Proxy Paper report, the firm already includes most of the main themes of the Concept's recommendations in its current approach. Consistent with the elements listed in the Concept as necessary for integrated governance achievement, while Glass Lewis currently provides clients significant information on board and director independence and remuneration – including a thorough breakdown of incentives – Glass Lewis would be eager to provide clients with even more of the data and tools they would need to allow them to be more active owners. Glass Lewis recognizes that the firm could analyze whether boards as a whole and individual directors at every company have the appropriate skills and experience relevant for the company. Given that Glass Lewis reviews thousands of companies annually, Glass Lewis has generally only conducted such individual director assessments at companies with poor performance and governance failures, among other issues, as well as in contested elections. Further, Glass Lewis could routinely provide a more thorough analysis of the quality of companies' financial statements but the firm is unsure how useful that exercise would be to clients relative to the many other factors Glass Lewis analyzes.

4. Would you recommend that your clients adopt such an approach?

Glass Lewis believes it is prudent for all shareholders to evaluate all risk factors in buying and owning shares in a company. Therefore, Glass Lewis recommends clients closely review a broad range of risks and, in cases where companies' boards or governance are deficient to the extent shareholder value is at risk, Glass Lewis will recommend voting against culpable directors, proposals to approve accounts and reports, proposals to ratify management and supervisory board acts, and/or in favor of shareholder proposals to improve disclosure or practices. However, most Glass Lewis clients have their own voting policies, relying on the firm's data and analysis to make informed voting decisions. Therefore, since the Glass Lewis recommendations have relatively limited influence on clients' voting decisions, similarly a recommendation from Glass Lewis to adopt the integrated governance model may have an equally limited effect. While we would generally recommend clients examine these issues and consider adopting this approach, Glass Lewis recognizes that clients have different investment philosophies, strategies and time horizons; as such, not all clients may favor the integrated governance model at all companies, despite the fact that most Glass Lewis clients tend to share the same long-term investment perspective.

Robert McCormick
Chief Policy Officer
Glass Lewis

6.2 ISS

1. Do you have any views on the Integrated Governance concept?

Institutional Shareholder Services (ISS) has been in the business of supporting institutional investors with services related to good corporate governance and responsible ownership for nearly 30 years. We have developed into a leading global provider of governance research and proxy voting services, with the consistent aim of providing services to our clients that enable them to embed their views on good governance into their investment portfolios, their working practices, and their voting decisions related to the corporations they own. ISS views the concept of integrated governance as focusing on the importance of good governance practices and integrating that with investment decisions in order to promote long-term corporate sustainability policies and practices. As the growth in the number of PRI signatories shows, many investors have been increasingly integrating their chosen approaches on governance and sustainability into their overall investment processes and working practices, including by ensuring they are able to make informed voting decisions that comport with their investment philosophies.

ISS makes available to institutional investors (both asset managers and asset owners) many different policies and approaches upon which ISS research and voting recommendations can be provided. ISS is also transparent about its support for the principles of good corporate governance. Our Global Voting Principles, which can be found on our website, issgovernance.com, are at the core of ISS policies. The principles and voting recommendations provided by ISS are intended to assist institutional investors in meeting their fiduciary and other requirements with respect to voting by promoting long-term shareholder value-creation and risk mitigation through support of responsible global corporate governance practices. Such practices should respect shareholder rights and provide appropriate transparency, taking into account relevant laws, customs, and best practice codes for each market and region, as well as the right and responsibility of shareholders to make informed voting decisions in accordance with their philosophies and mandates.

As a provider of independent research and recommendations based on investors' own views, requirements and choices, ISS does not support the concept of any "one-size-fits-all" approach that may either mandate or restrict the diversity of approaches to governance and sustainability that can be taken by investors. The conclusion of this report, which suggests that governments can consider mandating that proxy advisors integrate particular sustainability measures into their advice for asset managers and asset owners, would diminish investor choice. Such information is already available to investors. ISS believes that the most effective way we can continue to support institutional investors in their role as owners and stewards of corporations is to continue to provide a diversity of information, research and advice, based on the views and requirements of each investor, rather than on any single mandated approach.

2. *To what extent are the recommendations already embedded in your voting recommendations?*

To give context to this answer, ISS provides many different voting recommendations, depending on each client's chosen requirements. In providing different options for governance research and voting recommendations, ISS enables investors, both asset managers and asset owners, to select the choices that best support both their own investment and ownership requirements, and those of their underlying clients or beneficiaries. All ISS policies (both benchmark and specialty policies) are founded on global principles of good governance but provide a range of different approaches and philosophies, and also take into account market and regional nuances around the world. ISS benchmark policies are market and regional specific, and are available to cover all markets globally. ISS speciality policies are also available and reflect the respective perspectives of SRI investors, mission and faith-based investors, public funds, labour funds, and PRI signatories. Additionally, ISS provides a fully customisable service for clients, delivering research and recommendations based on investors' own policies and guidelines. We currently manage approximately 500 such custom policies worldwide.

ISS benchmark policies embed the underlying tenets of integrated governance, including, for example, those regarding board expertise, board attendance, director affiliation, size of board, long-term compensation structure and many other compensation considerations. ISS benchmark policies are used to generate research and recommendations on companies in more than 110 markets around the world each year. ISS speciality policies reflect the varying perspectives and requirements of different investor approaches. ISS' Sustainability, SRI and Catholic voting policies incorporate a detailed analysis of ESG topics using the ISS ESG risk evaluation framework. Specifically, this approach to voting recommendations includes employing the use of ESG risk indicators to identify moderate to severe ESG risk factors. The ESG risk indicators cover several topics including environmental stewardship, human rights and the impacts of business activities on local communities, labour rights and supply chain risks, consumer product safety, bribery and corruption, and governance and risk oversight failures. This framework naturally aligns with the concept of integrated governance and is designed to support investors who choose an approach that reflects the perspective that governance and performance on sustainability issues should be integral components of sustainable corporate strategies.

3. *How/can your recommendations further embed these recommendations, particularly in relation to remuneration of corporate executives, appointment and re-election of corporate directors and corporate reporting?*

ISS offers research and recommendations to help investors stay well-informed about company practices, regulatory and best practice developments, and to meet their stewardship responsibilities effectively and efficiently. Many other elements that could be considered building blocks of integrated governance are available to our clients, including many factors analyses and policy considerations regarding the remuneration of corporate executives, the appointment and re-election of corporate directors, and the quality of corporate reporting. We also closely follow and work within the framework of relevant regulatory requirements and good practice developments around the world. Such changes inform the development of ISS policies and recommendations for our clients. Some recent examples and observations are as follows.

Compensation

ISS policies and recommendations are continuously developed to embed regulatory changes and evolving good practice guidelines. In 2014, for example, new binding pay policy votes in the U.K., many new regulatory and voting requirements in Switzerland arising from the Minder Ordinance, and, in France, new guidelines for corporations to give shareholders advisory votes on director compensation.

Environmental & Social (E&S) Shareholder Proposals

As the number of shareholder resolutions submitted on E&S topics in 2013 in the US has surpassed the number of proposals on governance topics, we see evidence of the rising consideration of E&S issues. Investor support for E&S shareholder proposals has increased substantially. For example, average investor support levels for E&S resolutions submitted at US corporations have almost tripled from the single-digits in the early 2000s. Shareholder support for E&S resolutions in 2013 was the highest yet seen, at over 21 percent on average. Notably, ISS is tracking close to 460 shareholder resolutions addressing E&S subjects submitted at US firms for the 2014 proxy season, representing more than one-half the total number of resolutions and the highest number of E&S proposals ever submitted in any given year, according to ISS records. ISS conducts an annual review of its policies on E&S topics and continues to provide information, data, and customized voting policies to our clients that incorporate the growing focus on E&S issues.

Director Tenure, Refreshment, and Diversity

Director tenure and its connection to the degree of board independence, refreshment/diversity, and accountability to shareholders has been the subject of considerable attention and regulation around the world. A number of markets globally have instituted governance codes or regulations that consider tenure when establishing a legal definition for director independence. The UK Corporate Governance Code requires companies to explain why a director is still considered independent after serving on the board for nine years. This comply-or-explain model is similar for Hong Kong, Singapore, and Malaysia, where the tenure cutoff for further explanation is also nine years. In some continental European countries, the tenure cutoff is considered to be 12 years. In Russia, a director who has served for seven years is no longer considered independent, in India it is 10 years, and, in China, an independent director may only serve for six consecutive years. ISS recently conducted a policy consultation on director tenure in the US market, to consider our clients' views on this topic. Boards that refresh their directorships either voluntarily or as part of market best practice, create opportunities for diversity.

4. Would you recommend that your clients adopt such an approach?

A large part of our client base consists of large and/or sophisticated institutional investors, often with extensive global portfolios and having many underlying clients or beneficiaries themselves. Whilst it is not the role of ISS as a service provider to determine what our clients' final approaches to ownership, governance and voting should be, it is ISS' role to offer services and choices that assist and enable institutional investors in undertaking the approaches that they wish to take themselves, or that are required of them by their own clients.

A further part of the role ISS plays is to help disseminate and share information and thought-leadership, including to those investors that are looking to further their sustainable ownership approaches, and who wish to learn more about current thinking and developments in the field of governance and sustainable investment. In this regard, ISS would also be able to assist clients by providing information on a variety of practices and concepts, including integrated governance. To conclude, ISS already has and will continue to develop services and options for investors that help enable them to implement the approaches of their choosing, including approaches in line with an integrated governance concept.

Dr. Martha Carter
Managing Director, Global Head of Research
ISS

6.3 Proxinvest

Introductory remarks

As the leading French proxy advisory company and Managing Partner of the Expert Corporate Governance Service (ECGS) partnership of local European governance research providers, we are pleased to be invited to comment on the topic of sustainability and corporate governance. We commend the effort made to analyze the shortcomings of our current modern governance model and to suggest a new paradigm for "Integrated Governance" by which companies ensure a value creation for all stakeholders in the long term.

We share your analysis of the increasing concentration of economic activity in a relatively small number of corporations and their increasing impact on the environment and society. Proxinvest and ECGS primarily share the major concern outlined in Section 4 on the worrying state of affairs of our economic system. Not only is the corporate governance model grossly uneven around the globe, not only is the imbalance of the financial markets leading to substantial risks of bubbles and theft for modest investors, but the big multinational groups model also has associations for many of a culture of unfair enrichment of a few, as demonstrated by the uncontrolled increase in pay for CEOs. The recent financial crisis has revealed that the community of tax payers has been forced to provide billions in favor of banking groups and that only a few of the individuals actively responsible for this crisis has lost their jobs because of it.

1. Do you have any views on the Integrated Governance concept?

We take seriously the proposal by the UNEP FI report to reform corporate governance practices towards an integrated governance model and generally welcome it as it appears genuinely inspired by a serious public concern.

We certainly share the ideas that good governance foster better performance, that shareholder engagement results in improved value creation and that ESG aware companies out-perform traditional companies. We share the view that the existence of specialized independent committees certainly improved the governance and the sustainability of the firms, as the very existence of these committees was intended to reduce the shortcomings resulting from a lack of independent oversight.

Furthermore, we think that most corporate governance weaknesses such as the lack of integration of sustainability issues in the Board committees' charters are more a symptom, a result, than a cause of these defaults. We see similarly other governance shortcomings such as the holding of several directorships by directors not completing the full expected attendance, the frequent absence of succession planning at the Board and the lack of sustainable strategy formulation as more results than a cause of our problems.

We have witnessed in the last year a serious deterioration in the classic financial reporting of companies and groups. This has taken place at the same time as the Sarbanes–Oxley requirement for a more extensive reporting on risks and control system including a new special audit report on the chairman's report over governance and risk control. This has added dozens of new pages to the average reports and accounts document. We consider that disclosure issues and weaknesses should not be an excuse for maintaining poor accountability of Boards. Actually, as long standing governance observers, we believe that the main obstacles to sustainability originate from the composition of the Board of our corporations, rather than from the Board's working methods.

Last we would like to make the observation that focusing on sustainability only at the Board level of corporations, might have the negative effect of avoiding questioning the sustainability and efficiency of the universal banking funding model.

2. To what extent are the recommendations already embedded in your voting recommendations?
3. How/can your recommendations further embed these recommendations, particularly in relation to remuneration of corporate executives, appointment and re-election of corporate directors and corporate reporting?

Proxinvest's and ECGS' voting principle is to serve the long term interests of all shareholders and therefore sustainability issues are deeply embedded in our voting recommendations.

We are glad to provide selected examples of our ECGS – Proxinvest voting policy:

On the election of Directors, our voting recommendation criteria include: the time availability with a limited number of external mandates, the personal investment in shares to be at least equal to one year's attendance fee for any candidate for renewal, the payment of attendance fees subject to real attendance, and the fair representation of women and foreign Directors on Boards. These are all favorable to the companies' sustainability.

On Executive Directors remuneration structure and share related incentives schemes, our ECGS policy is very clear about the need to allocate 50% of the full variable revenue to be based on performance criteria observed over a period of more than three years. Similarly we recommend for approval only share related incentives plans of more than three years of investment. In line with the ECSG - Proxinvest policy on mergers & acquisition and major strategic financial operations to be based on a long term strategic vision, sound financial conditions, including independent expert opinions and neutral governance and remuneration impacts. Proxinvest has been the only continental analyst to advise against the approval of the merger between the Alcatel and Lucent in 2006 or NYSE and Euronext in 2007.

4. Would you recommend that your clients adopt such an approach?

We recommend our clients to design their own voting policy and to select the criteria that are the most appropriate to enhance companies' sustainability.

In addition we would like to contribute to the current report by sharing recommendations that are aligned with and include the Integrated Governance model but that would also extend the debate to cover the role of active ownership and shareholder engagement. Our recommendations target our clients, but also the regulators, policy makers and we would invite UNEP FI to consider them as potential areas for development in this area.

<u>1/ Adopt a robust "stewardship" policy</u>

We perceive the risk of an investors bias toward short term solutions and minimal active engagement and voting when they are controlled by multi-business financial groups. While multi-business financial groups benefit from the capital strength of their group and indirect taxpayer support, there is here an additional unfair marker against independent competition. This is also why the try to mitigate their internal conflicts of interests, using so-called Chinese walls and employing numerous compliance officers. Actually, these mitigation efforts only reflect a final arbitration at the upper level, generally as stated earlier, with a priority bias for cash, i.e. the short term interest of the group and its managers. The long term interests of share owners or final investors in asset management and the long term lending tend to be sacrificed to the short term priorities. In order to introduce serious barriers to the influence of the mother companies into the decisions of lending or asset managing subsidiaries of multi-business groups, regulators should impose a rule that at least a third of the Board members of the lending or asset management entity be truly independent. Introducing some independence within the multi-financial groups has been explored for years by regulators: while it has been used successfully by some financial groups, this practice was opposed by lobbies.

In addition to such reforms in asset management methods, Proxinvest would also recommend investors dare to ask for redress against an issuer or a bank in case of wrongdoing.

2/ Dare Shareholders Engagement

This proposal would concentrate on the development of new investor initiatives as participants in the company's general meetings to contribute positive sustainability suggestions to management teams and Board members by tabling written questions of resolutions. The US experience was that the SEC control of external resolution had left open the agenda to non-business related questions and has also highlighted several hundreds of resolutions proposals on environmental, social and governance (ESG) issues.

Concerns of Board members and integrated reporting should be restricted to the usual business objectives and sustainability understanding of the group and we consider that the solution is not to impose supplementary reporting burdens on companies for sustainability considerations. However we see the opening of the shareholders' agenda as a result of initiatives from shareholders, unions, workers councils or not-for-profit organizations as a promising solution to foster discussions on sustainability issues.

3/ Dare to question banks on the universal banking model

The addition of competing businesses based on the implicit state guarantee has created both an internal and external bias toward short-termism as the banks inevitably give priority to the cash solution, to their non-recurrent income. The presence of banks in many diverse commercial, trading and derivatives activities no longer restricted to interest rate, currencies and credit (including CDS), but in areas such as metals, energy, food, real estate, shares, insurance... has increased the risk profile of these groups and reduces now because of increased coverage ratios, their lending capacity while having a negative unfair impact on the non-banker participants in these markets.

4/ Promote innovative sustainable products

The long term holding of shares has been long associated with the guarantee of a lower cost of capital for corporations. This has been the excuse for some questionable breaches of the "One share one vote" principle associated with doubling voting rights and increased dividends. Actually the equity principles are further affected by the no less questionable use of the company shareholders share registry for these benefits, which in effect disenfranchises foreign and institutional shareholders. Proxinvest demonstrated that in 2013 resolutions rejected by shareholders at French companies' AGMs would have been at least 60% superior if the double voting right provision had not favored the controlling shareholder positions.

Positive financial innovations exist today and should be encouraged. Proxinvest encourages the reform of the scrip dividend in France (dividend payment in shares) in order to make it a true encouragement to sustained shareholding instead of the current encouragement to riskless arbitrages. Similarly, Proxinvest welcomes the innovation of the use of the ISIN code changes to trace the shareholding seniority of investors, such as with the loyalty warrant developed by Bolton-Samama, recognized by many as an excellent way to reward long term holding of shares while discouraging share lending practices of institutional investors.

5/ Lobby for better protection of the shareholders rights

A final proposal would be to recommend regulators and governments to better protect the shareholders rights, i.e. the right to fair information and the right to a fair and equal treatment for shareholders. This serious protection is the basic prerequisite of better governance and concern for the long term interests of shareholders. We can commend the excellent recent initiative of the British Financial Conduct Authority (FCA) in favor of the creation of a "premium listing" group, where companies would proceed to the election of independent directors without the controlling or leading investor participating in the vote, where the Board would be 50% independent and where companies could only quit this "premium listing" status under a shareholders' vote without the participation of the controlling or leading investor.

As a conclusion, we certainly support the UNEP FI report proposal to integrate sustainability into all Board activities so that it becomes a general practice among the asset management community. We will certainly welcome the creation of sustainability committees at the Board level and we believe that the issue of encouraging long term investment practices requires today at all levels an assessment of the full impacts of our world banking model.

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United Nations Environment Programme Finance Initiative (UNEP FI)

The United Nations Environment Programme Finance Initiative (UNEP FI) was established in 1992 as a partnership between policymakers and financial intermediaries. With over 200 members representing banks, insurers and investors from around the world, UNEP FI contributes the perspectives of financial institutions to the United Nations and global activities on sustainable finance. UNEP FI's mission is to bring about systemic change in finance to support a sustainable world by "changing finance, financing change".

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About the UNEP FI Asset Management Working Group

This report is a project of the UNEP FI Asset Management Working Group (AMWG). The AMWG is a global platform of asset managers that collaborate to understand the ways that environmental, social and governance (ESG) issues can affect investment value, and to advance the integration of ESG issues into investment decision-making and ownership practices.

About KKS Advisors

KKS Advisors LLC is an advisory services firm, which leverages cutting-edge academic research to provide innovative, rigorous and effective processes and tools that enable integrated management of financial, natural, human and social capital for long-term value creation. KKS works with financial institutions, companies and governments to create a business environment that promotes the creation of both economic and social value along with environmental stewardship.