Institutional investors tell us they want boards to help set the tone at the top for diversity and culture and better articulate how the company is investing in talent and transformation. They want to understand how companies are integrating business-relevant environmental and social considerations into a sustainable strategy that creates long-term value for a wide range of stakeholders. And they want to know how the board is overseeing emerging threats and opportunities amid continued market volatility and evolving risks.

Many investors are also further integrating environmental, social and governance (ESG) considerations into their stewardship programs and broader approach. For example, some asset managers are doing more to embed such factors into their investment processes and offering new ESG products and solutions; and asset owners are asking more questions around how their current and potential external managers are approaching ESG matters.

These are some of the themes emerging from our conversations with more than 60 institutional investors representing over US$32 trillion in assets under management, including asset managers (42% of participants), public funds (22%), labor funds (13%), socially responsible (13%) and faith-based investors (8%), as well as investor associations and advisors (3%).

This is the eighth year the EY Center for Board Matters has engaged with governance specialists from the investor community to learn about their priorities for the coming year. This report brings together investor input and draws on our tracking of governance trends across more than 3,000 US listed companies, and focuses on:

• The top three areas investors want boards to focus on in 2019
• Opportunities for enhancing communications around long-term strategy
• Key factors investors use to assess board oversight of risk
• Tips for more effective engagement
• Shareholder proposal trends
Top three areas where investors want boards to focus in 2019

Board diversity — investors push for diverse directors as focus on board composition continues

Just over half (53%) of the investors we spoke with emphasized that board diversity, primarily inclusive of gender, race and ethnicity, should be a top board focus in 2019, up from one-third three years ago. An additional 19% cited diversity as part of a broader set of board composition considerations, including skill set, refreshment and assessment approaches.

Many investors said they want to see boards recognize and truly embrace the value of diversity to decision-making and performance, including by fostering an inclusive board culture as well as embedding diversity considerations into recruitment and assessment policies. They further shared that the dynamics of engagement conversations on diversity can reveal whether boards are “checking the box” or genuinely upholding diversity as a value.

Many investors also noted the value of board diversity in setting a tone at the top that reflects a dynamic and inclusive view of talent. Relatedly, more investors are also expanding their focus to senior executives. Fourteen percent of investors explicitly raised both board and executive diversity as an important focus for boards, up from 4% three years ago. Some characterized a lack of diversity among directors and executive leadership as a human capital risk, particularly given today’s war on talent and the spotlight on corporate culture.

The push for diversity is occurring against a backdrop of slow-moving change in the boardroom. From 2017 to 2018, the percentage of women-held S&P 1500 directorships inched up two percentage points from 19% to 21%. That is double the annual one-percentage-point rate of increase we have observed since 2013.

Assessing racial and ethnic board diversity continues to be challenging for investors given the lack of disclosure. Thirty percent of investors who want boards to focus on diversity told us they are asking companies for better disclosure of director demographics. However, some directors may not want to self-identify for personal reasons.

Key board takeaway

Consider whether the board’s diversity and related communications (e.g., proxy disclosures regarding board composition and the role of diversity in board recruitment and assessment) set the appropriate tone at the top for the value the company places on diversity.
Top three areas where investors want boards to focus in 2019

Company-relevant environmental and social issues, particularly climate risk

Around half (49%) of investors said a top board focus should be business-relevant environmental and social factors. That is, those that are most likely to impact the company’s strategy, risk profile and brand, such as water management for food and beverage companies; access and affordability for health care companies; and plastic pollution for consumer goods companies. Generally, these investors want to understand how boards and management are connecting these kinds of environmental and social issues to their long-term success and embedding related considerations into their risk management and strategy setting. And they want to see this integration consistently communicated in company disclosures on strategy and risk.

Most of these investors — more than a third (38%) of investors overall — are specifically focused on climate change, which is up from 15% three years ago. Notably, the types of investors citing climate risk were evenly divided among mainstream asset managers, public funds, and faith-based and socially responsible investors, reinforcing the increasingly broad spectrum of investors focused on this issue.

The direct relevance of climate risk is different for each company, and most investors focused on climate are engaging heavy greenhouse gas (GHG) emitters, such as those in the industrial or energy sectors. Regarding these companies, investors raised the need for concrete and significant GHG reduction goals and climate scenario planning that tests the resilience of company strategy against a 2 degree Celsius or lower scenario — both core elements of the Financial Stability Board’s Task Force on Climate-related Financial Disclosures’ (TCFD) recommendations. Thirty-eight percent of investors citing climate change raised that they are actively asking companies to take these steps.¹

Another key theme arising from the conversation on climate risk was the need for enhanced reporting. Close to half (46%) of the investors citing climate risk raised the TCFD as a reporting framework they support.² These investors noted the importance of such reporting for companies’ strategic planning and risk management, and many noted that they are part of the Climate Action 100+, an investor-led initiative that promotes voluntary disclosure in line with the TCFD’s recommendations.³

Investors seek board engagement, enhanced reporting and to understand how these considerations are embedded into strategy

As for expectations around board governance of environmental and social factors, including climate risk, investor expectations may vary based on company-specific circumstances. Nonetheless, most investors told us they recognize effective oversight can come in different forms, such as charging a dedicated board committee or one of the key committees with related oversight, recruiting directors with business-relevant sustainability expertise, talking to external independent experts, or setting a clear and ongoing agenda for the board to discuss sustainability impacts.

¹ The Climate Action 100+ is a five-year investor-led initiative to engage key global companies on achieving the goals of the Paris Agreement.
² The TCFD provides a framework for companies to report climate-related risks and opportunities through existing financial reporting processes and has developed recommendations structured around governance, strategy, risk management, metrics and targets.
³ The Climate Action 100+ is a five-year investor-led initiative to engage key global companies on achieving the goals of the Paris Agreement.

Key board takeaway

Challenge whether the company’s risk management processes, capital allocation decisions and strategic planning integrate business-relevant environmental and social considerations, and whether the company’s reporting process consistently demonstrates this integration. Consider the extent to which key stakeholders support external frameworks, such as the TCFD and the Sustainability Accounting Standards Board (SASB), and how company disclosures align with these frameworks.
Human capital management – investors seek to understand how boards are governing talent and culture

More than a third (39%) of investors told us human capital management and corporate culture should be a top board focus, up from just 6% three years ago. While some are focused on particular issues (e.g., workforce diversity, pay equity), most are taking a broad view of the topic.

Several investors shared that recent business, technology and societal trends have played a role in them paying closer attention to human capital and culture, including a more discerning and empowered consumer base, radical shifts in the workforce and the growing importance of talent to an organization's intangible value in today's digital economy.

At a high level these investors want to understand the role of human capital management in the company's long-term strategy and how the company is evolving, investing in and developing its talent to further innovate and meet future needs, particularly in industries or geographies where talent scarcities are on the horizon, such as technology and financial services. They also want to understand how companies are addressing, including how boards are assessing, potential cultural and workforce issues to support long-term strategy and enhance and protect the company's reputation, brand value and ability to attract the best talent.

Twenty percent of the investors citing human capital management seek increased disclosure around related topics, and some view the pay ratio as an opportunity for companies to provide deeper context around their investments in human capital. Most told us that, at least for now, they are prioritizing dialogue over disclosure. Some even indicated that this kind of information need not be for public consumption, and that they are seeking assurance that boards are actively engaged in reviewing related metrics. Overall, there was consensus that investors would like to better understand how boards are engaged and exercising oversight in this space.

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The Human Capital Management Coalition is a cooperative effort among more than 26 asset owners with more than US$3 trillion in assets under management. The group petitioned the SEC in July 2017 to adopt rules requiring issuers to disclose information about their human capital management policies, practices and performance.
Opportunities for enhancing communications around long-term strategy

We asked investors if they think most companies are doing a good job of balancing their investments for the short- and long-term. Nearly all qualified their responses, stressing that it is highly dependent on the company and acknowledging the market pressures that encourage short-termism. A quarter declined to answer, with most explaining that this is an evaluation they leave to their investment professionals and a few stating that this is a debate they avoid. But most revealing to us was this: nearly 20% said it is hard to answer the question because of the current lack of disclosure around long-term strategy.

Some of these investors applauded particular companies for doing a great job in communicating their long-term approach but noted that many companies maintain a heavy emphasis on the short-term, including businesses with what appeared to them to be unacknowledged and unmitigated long-term risks. Notably, some said that when there is external pressure, such as an activist waging a proxy contest, companies are very articulate about their long-term strategy, but there is opportunity to better tell this story as part of their regular communications.

Investors generally want to understand how companies are anticipating and responding to external market developments and industry trends. They would like to see that a company’s identification of key risks and strategic opportunities includes environmental and social factors that impact the company’s business sustainability, and they want to see consistent messaging across various communications (e.g., the 10-K, the sustainability report and investor presentations). They also want a clear picture of how short-term goals and executive pay tie into and support long-term strategy.

In order to assess whether companies are effectively balancing the short- and long-term, investors told us they are looking at:

- **The company’s story.** Is the company consistently communicating a strategy around long-term growth? Is there a strong articulation of the company’s purpose and how the company is managing its business to create long-term value?
- **Executive compensation.** Does the pay program promote longer-term focus or does it primarily emphasize a one-year time frame? Are companies rewarding innovation, investment in the company, and progress tied to environmental or social goals?
- **Capital allocation/stock buybacks.** How is the company investing in services, products, retraining or innovation that could build long-term value? And how do recent stock buybacks reflect the best use of cash?
- **Environmental and social metrics.** Is the company investing energy, focus and disclosures around long-term sustainability goals? Does company strategy address business-specific opportunities and risks on environmental and social matters?
- **Risk disclosures.** Does there appear to be an underappreciation of significant risks, such as environmental risks, cybersecurity or broader technology challenges?
- **Sell-side research.** Is the company articulating business planning for the long-term?

**Key board takeaway**

Assess opportunities for enhancing communication of long-term strategy, and how near-term goals and pay incentives support that strategy.

For more articles like this, please visit ey.com/boardmatters
We asked investors if they are raising particular risk issues (e.g., cybersecurity, talent/human capital management, climate, geopolitical) in company engagements and how they are assessing board oversight of those risks. Most said they don’t want to be prescriptive regarding board oversight; they want to see evidence that the board is engaged and to understand related oversight structures and procedures. Some of the key factors they raised included:

1. **Management reporting to the board.** Investors are interested in how management is reporting to the board on key risk issues at a high level and may raise related questions in engagement discussions, e.g., who from management is reporting, how often and what kind of information is discussed.

2. **Committee oversight.** Investors generally want to see that a board committee has responsibility over and is engaged on key risks, or that there are procedures in place to ensure sufficient attention to the issue by the full board.

3. **Director qualifications and use of outside experts.** Investors generally want the board to include relevant expertise tied to key risks the company is facing. They also want assurances that the board is accessing outside experts as needed to stay current on external developments and challenge internal bias, as appropriate.

4. **Directors’ ability to speak to risks disclosed in the 10-K.** Several investors said they expect board members to be able to speak fluently on how they are overseeing key risks identified in the annual report and may raise related questions in engagement conversations.

5. **Explanation of differences between company’s disclosed risks and external frameworks/research.** Several investors said they often compare a company’s disclosed risks to other benchmarks (e.g., industry research, ESG ratings reports, the SASB framework) and may raise questions about perceived gaps or areas of misalignment.
Tips for more effective engagement

We asked investors what they wish were different about their engagements with companies. Close to a third (30%) said that overall engagement has improved significantly, with most citing increased director involvement and a more respectful approach as important developments. Still, 91% cited opportunities for continuing to improve the process. Here are some tips based on what we heard:

- **Avoid engaging for engaging’s sake – engage as needed outside of proxy season and avoid discussing proxy advisory firm views.** Investors said companies come across as tone deaf when they reach out in the spring (when investors are voting thousands of company ballots) or with no clear agenda, and when they focus on the views of proxy advisory firms that investors do not rely on for voting guidance.

- **Have a mutually agreed-upon agenda and the right people on the call.** Having an agenda that benefits both parties provides for a richer conversation and allows both sides to prepare accordingly. Having the relevant decision-makers and subject-matter experts involved – including directors as appropriate – can make conversation more productive and efficient. Some investors noted that when boards rely solely on sustainability officers to discuss environmental and social issues, that may reinforce concerns that these issues are isolated from board discussions on strategy and risk. Similarly, when a compensation committee defers to management or the compensation consultant, this may raise questions about the extent to which the committee owns the pay philosophy and decision-making. Overall, many expressed frustration at IR playing a lead role in engagement, given the perceived lack of familiarity on company-specific governance and sustainability topics and focus on “canned” messaging.

- **Make the discussion more investor-specific.** The more the company understands the investor’s approach and position on governance issues, the more focused the engagement. While many investors post their proxy voting guidelines and stewardship reports on their websites (and some send letters to portfolio companies identifying engagement priorities), many said they do not expect companies to do in-depth research before a meeting, but at least expect the company to understand whether they are talking to an active or passive manager, or an asset manager or owner. Further, several investors said they wish companies would review notes from previous conversations with them to help move the dialogue forward. Finally, recognize that some investors view the shareholder proposal process as an important part of investor-company engagement.

- **Be forthcoming about challenges and controversies, as well as changes made in response to feedback.** Several investors noted frustration around companies not directly raising challenges or controversies. They said that, when coupled with “all is well” type messaging, the communication raises concern that companies are obfuscating, which makes investors skeptical about what the company does share, and results in a missed opportunity for relationship-building. Conversely, companies that directly raise the challenges they face and discuss plans to address them build trust. Further, companies that reach out to share recent or potential changes made in response to feedback reinforce the value of engagement and relationship-building efforts.

One shortcut to understanding widely held investor expectations is the Investor Stewardship Group’s (ISG) framework of corporate governance principles, which reflects the common corporate governance standards of ISG members, which include some of the largest US-based institutional investors and global asset managers.
Shareholder proposal trends

Shareholder proposal submissions in 2018 were down 20% from five years ago based on our tracking of proposals submitted at Russell 3000 companies. Over the same time period, the portion of proposals that were withdrawn (in most cases because the proponents and the companies reached agreement) held steady at around one-third of all submissions. Notably, average support for proposals that went to a vote on environmental sustainability topics (e.g., asking companies to report on sustainability, climate risk, energy efficiency, greenhouse gas emissions) grew from 22% to 31%.

More changes to the shareholder proposal landscape may be ahead. Following a November 2018 U.S. Securities and Exchange Commission roundtable, Chairman Jay Clayton identified improving the proxy process as a key 2019 initiative for the Commission, specifically including examination of the share ownership and voting thresholds that determine whether shareholder proposals can be submitted and resubmitted.

To set the context for proxy season 2019, here are the top shareholder proposal topics by average vote support in 2018, a year in which a total of 281 companies had shareholder proposals voted.

### Top 20 shareholder proposal topics in 2018, based on average support received*

<table>
<thead>
<tr>
<th>Topic</th>
<th>Average support</th>
<th>Maximum support</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eliminate classified board</td>
<td>87%</td>
<td>96%</td>
</tr>
<tr>
<td>Adopt majority vote to elect directors</td>
<td>78%</td>
<td>98%</td>
</tr>
<tr>
<td>Eliminate supermajority vote</td>
<td>64%</td>
<td>87%</td>
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<tr>
<td>Allow shareholders to act by written consent</td>
<td>43%</td>
<td>86%</td>
</tr>
<tr>
<td>Report on sustainability</td>
<td>41%</td>
<td>80%</td>
</tr>
<tr>
<td>Allow shareholders to call special meeting</td>
<td>40%</td>
<td>94%</td>
</tr>
<tr>
<td>Address corporate EEO/diversity</td>
<td>39%</td>
<td>48%</td>
</tr>
<tr>
<td>Review/report on health care/medicine</td>
<td>32%</td>
<td>62%</td>
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<tr>
<td>Address political spending</td>
<td>32%</td>
<td>47%</td>
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<tr>
<td>Enhance pay-for-performance alignment</td>
<td>32%</td>
<td>48%</td>
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<tr>
<td>Address greenhouse gas emissions</td>
<td>32%</td>
<td>57%</td>
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<tr>
<td>Appoint independent board chair</td>
<td>32%</td>
<td>58%</td>
</tr>
<tr>
<td>Adopt/amend proxy access</td>
<td>32%</td>
<td>85%</td>
</tr>
<tr>
<td>Eliminate dual-class common stock</td>
<td>30%</td>
<td>41%</td>
</tr>
<tr>
<td>Limit post-employment executive pay</td>
<td>30%</td>
<td>43%</td>
</tr>
<tr>
<td>Address food/consumer products</td>
<td>28%</td>
<td>43%</td>
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<tr>
<td>Address lobbying activities</td>
<td>26%</td>
<td>41%</td>
</tr>
<tr>
<td>Address alternative, renewable energy</td>
<td>23%</td>
<td>46%</td>
</tr>
<tr>
<td>Address internet/data security risks</td>
<td>20%</td>
<td>36%</td>
</tr>
<tr>
<td>Address board diversity</td>
<td>18%</td>
<td>33%</td>
</tr>
</tbody>
</table>

*Where at least five proposals were voted. Accordingly, certain topics that received strong, and even majority support, in 2018 are not included (e.g., proposals to address climate risk averaged 42% support last year, but only four came to vote while 17 were withdrawn).
Conclusion

The ES of ESG is growing in prominence, and many investors want to understand how companies are embedding relevant considerations in their long-term strategy. Many investors also want boards to set the tone at the top for diversity and do a better job of articulating oversight of long-term strategy, including how the company is investing in and developing talent, living its values and navigating external risks.

While these high-level insights come from a broad range of investors, boards must remember that institutional investor views can vary significantly. Understanding the widely supported leading practices set forward in the ISG framework as a baseline and engaging key shareholders and reviewing their policies and voting records are paramount to understanding and meeting investor expectations.

Questions for the board to consider

- Does the board’s makeup and culture reflect the company’s broader commitment to diversity and inclusion? And how is the board challenging itself to find diverse director candidates and communicating those efforts to investors?
- Do the company’s various reporting channels (e.g., proxy statement, annual report, sustainability report, quarterly reports and earnings calls) tell a consistent story about long-term strategy and related risks, including business-relevant environmental and social factors? Is it clear how the executive pay program and short-term performance goals support that strategy?
- How is the company investing in and developing its talent as the business evolves? What is the company doing to provide for its talent needs in 3–5 years?
- Does the board understand how the company’s culture aligns with the company’s purpose, values and strategy, along with any particular cultural strengths or opportunities for improvement?
- Is the board able to articulate how it oversees the key risk factors disclosed by the company in its annual report? And has the company considered how its disclosed risks align to those of peers and external frameworks such as SASB or the TCFD?
- Are there opportunities to make the company’s shareholder engagement program more targeted and outcome-driven?
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SCORE no. 05475-191US
CSG no. 1901-3040746
ED None

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