
Global and Regional Trends in Corporate Governance for 2018

Introduction and Background

At the end of each year, Russell Reynolds Associates interviews over 30 institutional and activist investors, pension fund managers, public company directors, proxy advisors, and other corporate governance professionals in five key markets regarding the trends and challenges that public company boards will face in the following year.

Across all of our interviews this year, an overriding theme was the importance of board quality and composition—and the components that go into both. Investors of all types (including institutional and activist) are continuing to ratchet up their focus on the quality of a company's board of directors, both collectively and individually. The focus on quality and composition is even greater than in previous years. Investors are motivated to hold boards accountable for company performance

and are willing to take action to ensure that boards are meeting governance standards. Governance expectations continue to rise across markets and industries. Investors and proxy advisors are relying on traditional metrics (e.g., tenure, overboarding) to assess board quality, but a number of investors have talked about needing to have greater insights into the board to assess quality.

Based on the events that have unfolded in 2017, it is likely that the world's largest investors also will pay closer attention to cybersecurity, climate change risk, and corporate culture in 2018. This may require boards to revisit their approaches to risk oversight, including broadening their perspectives on what constitutes risk management and is therefore within the scope of a board's oversight responsibilities.



OVERVIEW OF GLOBAL TRENDS

Based on our interviews and research, we see seven key global trends in governance of which directors should be aware.



1 **Better Investor Stewardship:** An enhanced interest in investor stewardship by governments and investors is impacting corporate governance globally. Since the last financial crisis, there has been a drive for more investor accountability in how they use their influence and votes to steer the strategic direction of investee companies. This has combined with a dramatic increase in the popularity of, and cash flows into, index tracking funds, which have increased the voting power of the major asset managers. In 2017, the top five global asset managers controlled over \$8.2 trillion of equity investments and that number continues to grow. A consequence of the emphasis on stewardship is that many of the world's largest institutional investors are expanding the staff and resources dedicated to engaging with investee companies and proxy voting.

2 **Board Quality & Composition:** Institutional investors will continue to prioritize gender diversity, director skills and experiences, composition refreshment, and the appointment of directors who have enough time to dedicate to the company as key indicators of board quality. Boards and nominating and governance committees in certain markets should expect increased votes against directors where there are fewer than two women on the board. Activists and some institutional investors will pay close attention to the number of directors with direct industry experience when assessing composition and quality.



Compensation: Executive pay will continue to remain in the spotlight as investors are looking for additional engagement and/or disclosure around total compensation and its link to long-term strategic goals and business performance. Boards and compensation committees should expect more inquiries related to incentive compensation schemes and how they drive desired employee behavior.



Activist Investing: Many boards often feel trapped between what appear to be competing demands: Institutional investors want to see long-term shareholder value creation, and activist investors often call for short-term value enhancement. The companies that have had the most success navigating activist campaigns have been the ones with boards that are willing to have a meaningful dialogue with activists to achieve a resolution. Boards that fight with activists will face intense scrutiny of the value-creation history of each director, both in their executive and board careers.



Environmental, Social, & Governance Risk: While climate change risk and sustainability have been emerging areas of focus for several years, investors now consider the topics to be mainstream priorities. Though companies in extractive industries are likely to receive the greatest levels of scrutiny, other sectors will also see more engagement from institutional investors. Guidance laid out by the Financial Stability Board Task Force on Climate-related Financial Disclosures (TCFD) will lead to a greater investor focus on recommendations, such as the use of two-degree scenario planning to prepare for the Paris Accord goal of minimizing global temperature increase to two degrees Celsius. Under a two-degree analysis, companies assess the risks and opportunities of climate change on the business.



Cybersecurity: Cyber risk continues to be a growing concern for global investors in light of multiple security breaches (in the political, government, private sector, and consumer spheres) worldwide. Cyber threats will be an important area of focus for boards to monitor. Many institutional investors will use 2018 to formulate their policies on cyber risk and the role of the board, leading to further engagement on this topic.



Human Capital: Institutional investors are increasing their focus on human capital. There are various aspects to their interest, including effective succession planning at the C-suite level and beyond, the impact of company culture on performance, and gender pay disparity.

In the following sections, we explore these trends and their implications in more detail across five key markets: the United States, the European Union, Japan, India, and Brazil.

UNITED STATES

With the Trump Administration's deregulation agenda and a lack of congressional action, we expect increased investor engagement with companies and the private ordering of governance changes to continue. U.S. boards can anticipate continuing pressure from investors to enhance disclosures regarding board composition, climate change risk, and cybersecurity.

- Investors remain focused on improving board quality and want more insight into the composition of the board. The New York City Pension Funds' Boardroom Accountability Project 2.0 will continue to put a spotlight on enhanced disclosure of board composition through the request for disclosure of a formal board matrix. Though most large institutional investors are unlikely to be as prescriptive, they do want to see greater insights into why a director is on a board and the skills he or she brings. Boards should consider how they can improve the narrative around their current board composition and the link to the company strategy, as well as their plans for refreshment.
- Several large institutional investors, including State Street Global Advisors (SSGA) have reached the limit of their patience on the lack of gender diversity in boardrooms. These investors are now willing to vote against either the chair or the entire nominating committee of companies with either no or only one female director if they have previously attempted to secure change at these companies through engagement. During 2017, SSGA voted against the reelection of directors at about 400 companies due to their failure to address the gender diversity deficit on their boards. Companies with fewer than two women on the board can also expect to see more outreach by other institutional investors. In 2019, Glass Lewis will also start recommending investors vote against the nominating committee chairs of companies with no female directors.
- Most investors continue to prefer boards to conduct a rigorous evaluation to encourage refreshment, rather than implement blunt age or tenure limits. Investors are reluctant to prescribe the specific manner of evaluation and expect companies to "demonstrate they have the right board to move the company forward." Investors would like to see more detail on the evaluation process disclosed in the proxy, as is common in much of Europe.
- Activist investors will continue to influence board decision-making, process, and composition. Expect an increased level of scrutiny of an individual director's track record of value creation and industry expertise. Activists will further magnify CEO compensation and pay disparity (against other named executive officers) as they benchmark against peer companies. They use this analysis as a potential flag around company culture and as a signal of an "imperial CEO."
- Investors continue to promote the relevance of climate change and broader sustainability risks and opportunities as an area of focus. There is a drive toward comparability of disclosures, with institutional investors voicing support for the roadmap laid out by the TCFD guidelines cited earlier. Boards are expected to understand climate risk, but there is as yet no expectation that they will appoint climate change experts to the board.
- Cyber risk continues to be a major concern. Investors are less interested in adding specific expertise in the form of a single new director but would prefer a cyber-competent board overall. We expect to see more guidance on this from investors next year.
- 2018 will see the first disclosures around the CEO pay ratio mandated by The Dodd-Frank Act. This will undoubtedly attract media interest, but investors are likely to be more circumspect given the limitations of comparability in the first year. Boards need to consider how they will handle media scrutiny.



EUROPEAN UNION

The European Union enters 2018 in better shape economically, but with a degree of political uncertainty due to recent political events, from Brexit to rising populism. In some European countries, there has been a reaction against globalization and a growing sentiment to protect each country's most important companies from foreign takeovers. While the UK may see major impact in terms of governance changes, mainland European countries will be focusing on implementing the Shareholders' Rights Directive against a backdrop of increasing institutional investor engagement and activist investing. Similar to prior years, executive remuneration will remain a hot-button issue throughout the EU.

- Activists continue to focus on European markets, including the UK, Germany, Switzerland, the Netherlands, and France, as large companies like AkzoNobel, Commerzbank, Danone, Nestlé, Parmalat, and Safran have been targeted. 2018 is likely to see more activity as U.S. and European activists look for new opportunities in Europe.
- Across the EU, climate change and sustainability remain an investor-driven and governmental focus, and there will be demands for more sustainability reporting, particularly around two-degree scenario planning. Investors want assurance that the quality of board discussions on climate change risk is high. To date, investors are not calling for climate experts to be appointed to the board.
- Though Brexit subsumes UK politics, there has been some activity on corporate governance. The government is pushing for a thorough review of Section 172 of the Companies Act 2006, which covers director responsibility toward stakeholders such as customers and employees. The Financial Reporting Council is charged with strengthening the voice of employees and other non-shareholder interests at the board level through changes to the Corporate Governance Code. The revised code is also likely to address board oversight of succession planning and corporate culture. Consultation on the Stewardship Code for investors will begin in 2018.
- In the UK, there also will be renewed engagement around remuneration and incentives, with the phasing out of LTIPs in favor of stock programs. The government also may legislate for mandatory disclosure of the CEO pay ratio. Remuneration committees may be asked to review pay for the broader organization. Though gender diversity rates have been improving over the past several years (particularly among FTSE 100 boards), there is continued pressure for more progress toward the government's 33% target. Ethnic diversity will receive more attention following the Parker Report, which recommends that FTSE 100 and 250 boards have at least one ethnically diverse director by 2021 and 2024, respectively.
- German investors, for the first time, will have an opportunity to weigh in on remuneration through implementation of the EU Shareholders' Rights Directive, which requires companies to implement a binding vote on executive compensation (with the possibility to opt for an advisory vote). Together with the new Remuneration Transparency Act, which requires companies to report on how they maintain fair wages for employees, compensation and equal pay are likely to become a primary focus for investors. Supervisory board engagement with shareholders is expected to increase, as German companies are showing a willingness to meet. The focus of this engagement is likely to include director tenure, as directors are normally voted in for terms of five to six years.

- In France, there will be more focus on board effectiveness, as investors grow impatient with superficial box-ticking exercises. Shareholder engagement requests will increase with a push for more direct dialogue from the board, rather than management or the board secretary. Engagement priorities in France will focus on areas of concern from previous years, including how the company considers the perspectives of all its stakeholders. Investors also may engage on chairman independence, as recent Thomson Reuters data suggests a steady increase in combining the CEO and chairman roles.



JAPAN

Japan continues to implement a government-led overhaul of its corporate governance system. Following a string of prominent accounting scandals in recent years, there is acknowledgment from investors and other stakeholders that more changes are needed.

- Institutional investors agree that adopting Western standards will not necessarily result in stronger accountability and oversight if cultural norms are not yet aligned. For example, large global institutional investors often push for companies to have at least three independent directors, but in Japan, the concept of independence is relatively new and not understood in a Western context. Instead of focusing on precise compliance with this standard, institutional investors are focused on more immediate remedies, such as ensuring that the board is not composed of any directors who are former senior executives from the same company and looking for other signs of board accountability, as evidenced by independent thinking and the board's ability to effectively challenge management. The Tokyo Stock Exchange also is expected to increase pressure on companies to better disclose the existence and role of former senior management on the board, as a recent survey by Japan's Ministry of Economy, Trade, and Industry found that nearly 60% of companies have a former CEO or president serving as a "special advisor."
- Global institutional investors will soon start pushing for gender diversity on the boards of Japanese public companies due to Japan's low representation of female directors. In some cases, investors are planning to share guidelines with Japanese public companies to help them increase gender diversity on boards.
- More companies are signing on to the Japan Engagement Consortium (led by Governance for Owners Japan), which already has around 300 signatories. There is a growing sense that Japanese firms are more willingly engaging with investors, while investors are becoming more active as well, evidenced by Japan's Government Pension Investment Fund (GPIF) taking on a leadership role regarding domestic asset owners. Earlier this year, the GPIF decided to increase its environmental, social, and governance (ESG) allocation from 3% to 10%. Going forward, companies will see more shareholder dialogue as a result, primarily focused on driving long-term value by addressing strategic, financial, and ESG issues.
- Given recent enhancements made to Japan's Stewardship Code for investors following a triennial review, companies can expect efforts to encourage cultural alignment, accountability, and transparency. Some of the relevant changes include encouraging asset managers to take stewardship more seriously, an emphasis on collective engagement, enhanced disclosure around investors' rationale for proposal voting, and connecting ESG issues to long-term shareholder value. As a result of the code amendments, it is anticipated that investors are prepared and willing to vote against some management proposals, particularly any anti-takeover measures (e.g., poison pill).



INDIA

India has faced some challenges in terms of aligning corporate governance with an evolving business environment. Following several public and high-profile governance lapses, the Securities and Exchange Board of India (SEBI) appointed the “Kotak Committee” to review corporate governance principles. The committee recently proposed a set of tougher corporate governance norms aimed at increasing transparency, strengthening board independence and board composition, and enhancing disclosures. It may take some time for the Ministry of Finance and SEBI to finalize the changes, but boards can still expect pressure to implement fully the spirit of the Companies Act 2013 and existing SEBI regulations in order to further align with international best practices.

- If the Kotak Committee recommendations are accepted, there will be a greater demand for qualified board members in 2018, as the committee calls on all listed companies to have at least six directors on the board. Independence is a major concern in India and among minority shareholders, so the committee proposes that half the board be independent, rather than one-third as is required now. Related independence disclosures, such as what standard of independence is being utilized, are also proposed to help boost investor confidence.
- The Kotak Committee recommends the separation of the CEO and board chair roles in companies where more than 40% of the outstanding stock is owned by outsiders. An unpopular proposal among some business leaders, this would require leadership changes among half of India’s public companies, where the roles are currently combined.
- Responding to the trend of appointing a female relative to the board (as a way to comply with the 2013 requirement to have at least one woman on the board), the Kotak Committee recommends that at least one of the independent directors be a woman. In addition, the definition of overboarding, which is still considerably looser than in other markets, would be capped at eight directorships by April 2019 and seven by April 2020.
- As part of the push to strengthen a board’s oversight duties, the committee calls for a minimum of five board meetings per year (up from four), including one meeting dedicated solely to long-term strategy and any related matters, such as succession planning and board evaluation. Independent of the Kotak Committee recommendations, SEBI recently developed more prescriptive guidance about the board evaluation process and disclosures. Though the regulator has not yet taken any enforcement action in this area, it is expected to be a heightened area of focus. The Kotak Committee also has recommended that the board annually disclose relevant competencies and director skills.
- Local proxy advisors (such as IiAS) are steadily becoming more active across India and are having an impact on corporate governance despite pushback from the companies affected by their recommendations.
- Though it is still unclear how many of these proposals there will be and in what form they will be adopted, global institutional investors are focused on engaging with individual companies to seek protection of minority shareholders, rather than relying on the government.



BRAZIL

In Brazil, companies and their boards are concerned about the economy and the future of the government. Given the strong differences in the agendas of the country's leading political parties, Brazilian boards are grappling with political and regulatory uncertainty around next year's presidential election. Corporate governance still remains a priority as boards further professionalize and improve effectiveness.

- Institutional investors continue to focus on the importance of minority shareholder rights. Ensuring that board seats are reserved for minority shareholders and the election process is fair and transparent remains a priority for investors. While the new system of absentee/proxy voting being put into place faces some hurdles, institutional shareholders are hopeful that it will greatly increase their participation by not requiring in-person voting.
- Boards are redefining their role and oversight of their businesses. This new level of attention has been emerging for several years. There is a growing expectation that companies and boards will become more transparent and thus more accountable. In part, this is being accomplished through creating and working through committees to enable better workflow and oversight. Board calendars, once designed purely around financial results, are now being driven by strategic issues.
- Regarding board composition, there is a move to further professionalize the boardroom. With an eye toward director succession planning and the nomination process, boards are taking steps to reduce government control and politically-driven appointments, which are challenges for state-owned enterprises (SOE). New management teams and boards with more apparent independence are on the rise in SOEs. There also is a push for more independent director candidates and refreshment policies that focus on the link between director skills and the company's strategy.
- The recent launch of the Brazilian Stewardship Code has been welcomed by investors, who are keen to see its principles adopted (which include implementing a stewardship program, considering ESG issues, and exercising diligence through voting rights). While it is too early to assess the impact of the code, boards should anticipate more engagement requests from institutional investors.
- Investors have conveyed some skepticism of the changes in financial market regulation and the possibility of regulatory reform in Brazil. Recent changes in Novo Mercado are seen by investors as underwhelming and even as reducing shareholder protections. The level of progress in self-regulation is viewed by some in Brazil as not keeping up with leading governance practices. Vying to remain an attractive market for global investors, boards may start leading the charge to improve governance standards for themselves. As a result, we expect to see an even greater uptick in requests for more rigorous board evaluations over the next several years.
- Gender diversity is being discussed more than in the past, but diversity still has not become an actionable priority for institutional investors. Nevertheless, investors recognize the recent election of two shareholder-nominated female board candidates at Vale as historic and possibly signaling the beginning of a movement toward more diverse appointments.



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