PRI Principles for Responsible Investment

UNEP Finance Initiative
Changing finance, financing change

United Nations Global Compact

An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

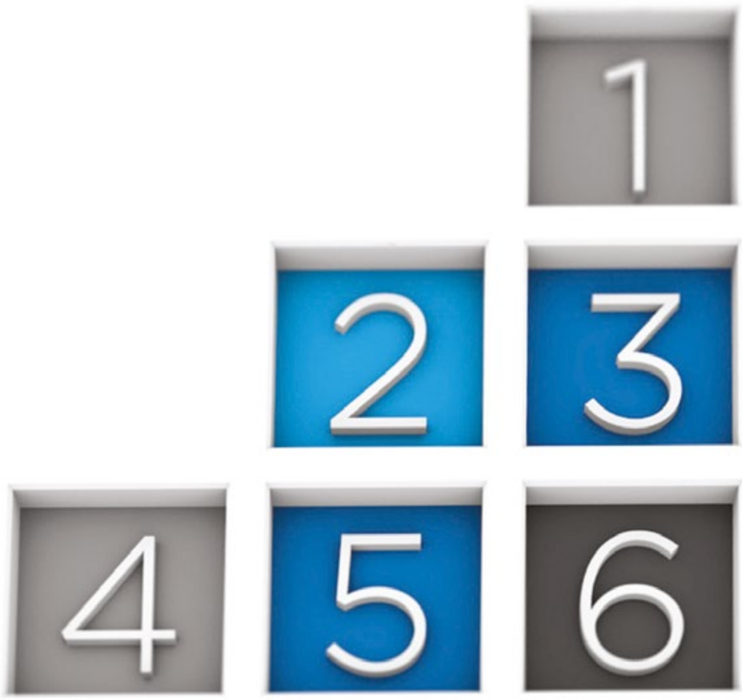
DIRECTOR NOMINATION PROCESS: DISCUSSION PAPER*

PART I:
AN ENGAGEMENT FRAMEWORK

*Open for comments until 15 November 2014

THE SIX PRINCIPLES

1. We will incorporate ESG issues into investment analysis and decision-making processes.
2. **We will be active owners and incorporate ESG issues into our ownership policies and practices.**
3. **We will seek appropriate disclosure on ESG issues by the entities in which we invest.**
4. We will promote acceptance and implementation of the Principles within the investment industry.
5. **We will work together to enhance our effectiveness in implementing the Principles.**
6. We will each report on our activities and progress towards implementing the Principles.



This report focuses on supporting signatories implement Principles 2, 3 and 5 of the Principles for Responsible Investment (PRI). The Principles for Responsible Investment (PRI) Initiative was launched by the United Nations in 2006 after former UN Secretary-General Kofi Annan brought together a group of the world's largest institutional investors, academics and other advisors to draft a set of sustainable investment principles. At the heart of the six Principles for Responsible Investment is the premise that investors have a duty to act in the best long-term interests of their beneficiaries; this means taking into account environmental, social and governance factors.

Written content was provided by George Dallas (independent consultant), the PRI investor steering committee on director nominations consisting of Chris Anker (Church of England), Anne Kirkeby (previously with Governance for Owners), Bram Hendriks (ING Investment Management), Zineb Bennani and Stephanie Roussillon (Mirova), Kimberly Ryan (Nelson Capital Management), Ian Quigley (Qube Investment Management), Tim Bolton Carter (Rathbone Brothers plc), Frank Curtiss (RPMI Railpen), and Athanasia Karananou (PRI).

Editing and contributions were provided by Brett Phillips, Alison Biscoe, Olivia Mooney and Valeria Piani (PRI).

CONTENT

Please note that the Discussion paper/Part II covers research on good practices across seven markets and is available on the PRI website at http://www.unpri.org/publications/

BACKGROUND

After a consultation with PRI signatories and the Investor Engagements Steering Committee[1] (IESC), the United Nations-supported Principles for Responsible Investment (PRI) Initiative identified the director nomination process as a priority theme for its *corporate governance collaborative engagement programme*. This reflects the recognition that a robust nominations process is of fundamental importance to board effectiveness, and that shareholders have an active role to play. It also emphasises the need to identify what good practice on this topic looks like across different markets.

Director nominations and elections represent some of the most fundamental ownership rights for shareholders - namely the right to appoint directors to represent their interests in promoting long-term value creation, as well as to remove them. Shareholders can and should become involved not only in voting for director candidates at Annual General Meetings (AGMs), but also in engaging with companies to ensure that nominees are best suited to guide the long-term success of the company.

To this purpose, a steering committee[2] (SC) of PRI signatories was formed in 2013 to investigate what good practices could be distinguished to optimise the director nomination process from an investor's point of view, and to develop a *collaborative engagement* on the issue. The overarching mission of the SC was therefore to identify what investors could do to improve director nomination practices and enable boards to work most effectively in order to protect and create long-term shareholder value.

An initial review clearly showcased that different corporate governance models and market cultures have a significant effect on the topic and there is not a one-size-fits-all set of practices. As such, the SC concluded that a market-by-market focus would be best to allow for individual market characteristics to be considered (as opposed, for example, to a sector focus). At the same time, looking at various market perspectives is also important to improve company practices within the chosen market, address the impact of contextual characteristics on the nomination process, and promote good practices in other markets.

In an effort to narrow the scope of the project, the SC decided to focus initially on developed markets, for four key reasons:

- Enhanced disclosure of information on candidates, and the existence of formal structures such as nomination committees, does not necessarily ensure a transparent, independent and effective nomination process;

[1] The Investor Engagements Steering Committee (previously known as the Clearinghouse Steering Committee), consists of PRI signatories and acts as an advisory body on activities related to the Clearinghouse platform and collaborative engagements with investee companies and policy makers coordinated by the PRI Secretariat. More information on the composition of the IESC is available in the 2014 PRI Annual Report.

[2] Director nominations SC members: Chris Anker, Church of England; Anne Kirkeby, previously with Governance for Owners; Bram Hendriks, ING Investment Management; Zineb Bennani & Stephanie Roussillon, Mirova; Kimberly Ryan, Nelson Capital Management; Ian Quigley, Qube Investment Management; Tim Bolton Carter, Rathbone Brothers plc; Frank Curtiss, RPMI Railpen

- Box ticking by companies and a lack of attention to the issue by investors affects the quality of director candidates and hence board effectiveness, which translates into significant risk;
- Governance failures related to board composition at companies in developed markets may have a far reaching impact, both in their home market and other markets where they operate;
- Establishing good and effective nomination processes for developed markets could set a paradigm for improvement in other markets.

The SC proceeded to identify good practices in three regions and seven different markets, building on the expertise of committee members. The markets selected included Australia, Canada, France, Italy, Sweden, the UK, and the US. For each of these markets, SC members looked into existing good practices based on an assessment of current local sets of rules and guidelines (i.e. legislation, listing rules, corporate governance codes, industry bodies etc.) and in-depth company case studies.

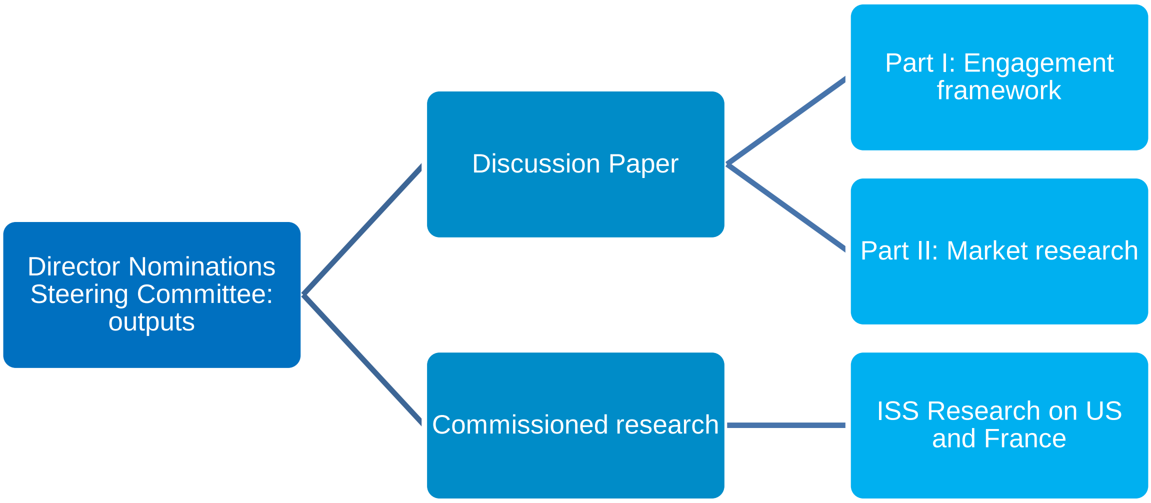
Figure 1: Setting up a Steering Committee and narrowing the focus of the project

In an effort to focus even further and to pilot a collaborative engagement programme with companies, the SC selected France and the US for more detailed research. These two markets were identified based on the following criteria:

- Clear need for market improvement
- Investor/company engagement is critical (versus, for example, investor dialogue only with regulators)
- A global collaborative engagement may achieve high impact
- Relevance to a potentially large number of signatories due to the size of the market
- Relevance to a potentially large number of signatories due to extensive foreign ownership of the market.

As a result, the SC and the PRI commissioned ISS to conduct a study benchmarking companies in the S&P 100 in the USA and the CAC 40 in France. The study was based on a series of good practice indicators and with a view to identify a set of engagement candidates for each market. The indicators were derived mostly from the market research and case studies that had been produced for both markets by SC members, and were further developed in cooperation with ISS. The results of the research are available on the PRI website and constitute the additional output of the SC work as summarised in the figure below.

Figure 2: The SC outputs to support the collaborative engagement



DISCUSSION PAPER PARTS 1 AND 2: SUMMARY

Part I of the discussion paper presents an overview of the director nominations process. Overall findings of the SC in relation to engaging with companies on the topic and markets' good practices are shared in this document which is co-authored by SC members and corporate governance expert, George Dallas. Its purpose is to promote a greater understanding of director nominations as a critical part of corporate governance, as well as to provide investors with a basic framework to undertake meaningful company engagement on this theme.

Chapter 1 provides a short overview of how board quality can be affected by director nominations and elections, and offers a summary of *good practice in promoting board accountability, effectiveness and transparency* – the three main pillars of a robust nomination process.

Chapter 2 summarises the research undertaken by the SC on the director nominations process in the seven selected regions, all of which have differing legal traditions and ownership structures. By examining these country studies, investors can not only begin to frame and understand best practice of director nominations in the specific markets under review, but also identify what might be expected of other companies in a broad range of jurisdictions. The full research of each market, including a market overview, company case study and identified good practice recommendations is included in part 2.

Chapter 3 focuses on the role of investors in engaging on director nominations. Voting in director elections can be routine but scope and responsibility does exist which allows shareholders to exert greater influence over the characteristics of candidates put forward for election as directors. Companies with performance which suggest insufficient director attention to investor interests, or ineffective oversight of strategy and risk, would be most likely to benefit from improvements in this regard. This chapter therefore considers investor challenges in engaging with companies on this issue, and how these challenges can be addressed.

In an effort to further assist investors in their engagement on the nomination process, *Chapter 4* identifies a series of possible questions (illustrating the three main pillars and associated core issues) investors may wish to draw from and customise for their own use. Finally, *Chapter 5* offers some brief conclusions.

Part II presents the research by SC members for each of the seven markets, including an overview of regulation and best practice, a detailed company case study and identified recommendations for good practice for each market.

The PRI initiative and the Steering Committee welcomes comments from signatories and other experts on any of the content contained in this discussion paper.[3]

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[3] Comments can be sent by 15 November 2014 to Athanasia Karananou, Senior Manager of Investor Engagements, at athanasia.karananou@unpri.org

PART I

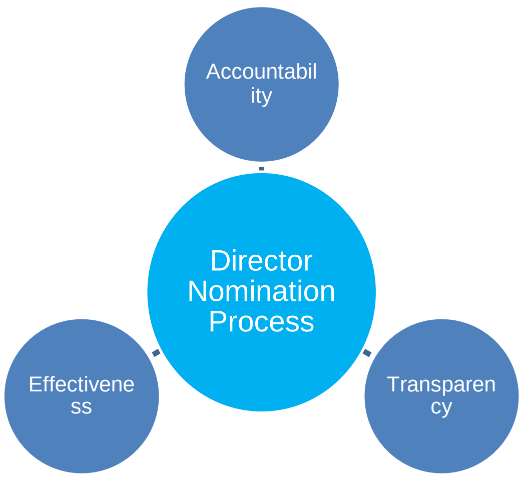
1. OVERVIEW OF THE DIRECTOR NOMINATION PROCESS: ACCOUNTABILITY, EFFECTIVENESS AND TRANSPARENCY

As a global reference for good governance practice, the OECD Principles of Corporate Governance establish as fundamental ownership rights the ability of shareholders to vote at shareholder meetings and to elect and remove directors from the board.[4] The Principles go further to state that it is the responsibility of the board to ensure "a formal and transparent board nomination and election process."[5] While individual country codes of governance may differ with regard to their specific approach to director nominations, it is generally accepted as a point of good corporate governance, at least in major markets, that shareholders should be able to participate in and influence the director nominations process.

While many supporters of corporate governance find intuitive the importance of a robust director elections process, it is useful to identify those **underlying factors** that demonstrate how and why the outcome of the director nominations process **can influence a company's governance and performance** – positively, if done well or negatively, if done poorly.[6]

These factors are grouped into three main pillars: *accountability, effectiveness and transparency*. **The endgame of a robust nominations process is the creation of a board that embodies these three pillars**. Accordingly, this framework can also be employed by investors to vet companies and identify candidates for engagement.

Figure 3: The three pillars of the director nomination process



[4] OECD Principles of Corporate Governance, 2004, Section II B, page 18. See: http://www.oecd.org/daf/ca/corporategovernanceprinciples/31557724.pdf

[5] OECD Principles of Corporate Governance, 2004, Section IV D 5, page 24. See: http://www.oecd.org/daf/ca/corporategovernanceprinciples/31557724.pdf

[6] While the case studies in this report are of companies operating with one-tier (unitary) boards, these same factors are relevant for the nominations process for companies with two-tier or alternative board structures.

For each of these three pillars, and in order to put the nomination process discussion into a more solid context, a list of key components has been identified below:

Figure 4: the key components of the director nomination process

Accountability	• *Independence of decision making* • *Voting rights related to director nominations and elections* • *Shareholder communications and engagement* • *Duty of care to respect shareholder rights*
Effectiveness	• *Composition* • *Diversity* • *Succession planning* • *Board evaluations* • *Nomination committee scope and structure* • *Link to company strategy* • *The human factor: ethics, tone and sustainability awareness*
Transparency	• *Public disclosures* • *Director information* • *Reporting on outputs*

Accountability

- ***Independence of decision making***. Decision making powers should lie predominantly with independent bodies to provide safeguards and limit the influence of both majority / controlling shareholders, and executive management.

Board independence[7] is a structural issue in corporate governance, and raises questions as to both accountability and board effectiveness. From an accountability perspective, an independent board is better positioned to provide the needed checks and balances on a company's executive management or controlling shareholders, fortifying the directors' collective fiduciary duty of care to the company as a whole. Though the definition and practical effectiveness of independent directors can be debated, it is widely accepted that an appropriate level of board independence is linked to the quality of a board's overall governance architecture.

The same standard applies to the board's nominations committee: while many governance codes are prescriptive about excluding non-independent directors from the company's audit committee, there is often less emphasis on full independence in the nominations committee. As a result, those companies whose nominations committees do not meet best practice standards on independence, are also potential targets in this engagement.

[7] For companies with a well dispersed shareholding, a majority independent board is regarded as best practice or even required under a comply or explain regime. For controlled companies, best practice is for the board to have instead a critical mass of independent directors; in practice, the influence or strong presence of controlling shareholders on the board means minority shareholders must often accept a lower level of board independence.

- ***Voting rights related to director nominations and elections***. Accountability to investors is improved by shareholder voting rights which can influence board outcomes and enhance the legitimacy of the director nominations process. As a basic right, directors should be elected by a majority of votes rather than a plurality[8] in uncontested elections. Another important voting right is the annual election of directors – a common feature of some markets, which can facilitate a dynamic and holistic review of board effectiveness and composition by both boards themselves and investors.

Similarly, shareholders should have the ability to place their own director nominees on the company's proxy card (called proxy access[9] in some markets) if they are dissatisfied with the candidates proposed by the board. In most cases, shareholders would prefer to see boards renewing themselves organically rather than through crisis, to ensure board composition remains appropriate. However, where board composition becomes chronically dysfunctional, it is important that investors have the tools available to take appropriate action to address the relevant deficiencies.

- ***Shareholder communications and engagement.*** While detailed public disclosure on director nominations (including succession planning) may have practical limitations in individual cases, accountability to shareholders is enhanced when they are adequately informed about the board's approach to director nominations and succession issues - in terms of both policy approaches and specific decisions.

In some cases, it is desirable that boards consult with key shareholders, both to clarify the board's perspective and to seek investor feedback. Investor dialogue relating to director nominations should be interlinked with engagement on the company's management of key strategic, financial, and governance issues.

Finally, as part of the engagement process, boards should demonstrate an appropriate level of responsiveness to shareholder concerns. Such concerns could take the form of a shareholder proposal related to nominations (i.e. proxy access) or election issues (i.e. majority voting). In these cases it is essential that the board be transparent about requests and subsequent actions taken. It is also important that the board disclose evident lack of support for a candidate, especially in election systems which allow those directors failing to receive the majority of votes cast to remain on the board, including companies where a director resignation policy exists, but the board maintains discretion not to accept the resignation. In this case, there should be a clear policy in place including actions taken and timeframes.

- ***Duty of care to respect shareholder rights***. Investors want directors who unambiguously promote the long-term success of the company and who protect the rights of all

[8] See Council of Institutional Investors policy on majority voting: http://www.cii.org/majority_voting_directors

[9] Proxy Access is a mechanism by which management of the corporation allows shareholders to post their nominees for the board on the official proxy circular. Without proxy access, the shareholder is left to print his or her own proxy card and mail to all of the shareholders of the corporation at his or her own cost.

shareholders - sometimes against pressures from company management or controlling shareholders whose interests may not align with those of long-term minority shareholders. While formal fiduciary responsibilities of directors nominally require that they demonstrate a duty of care to the firm as a whole, it remains the case that directors on many boards face competing interests that can affect judgements and decisions. Undoubtedly, it can be seen that duty of care cannot be readily translated into measurable indicators. However, taking into account the company's individual circumstances (i.e. presence of a controlling shareholder, differential voting rights, history of pressures from management). Investors should therefore exercise caution in supporting director candidates where demonstration of this duty of care is unconvincing.

Effectiveness

- ***Composition***. Putting together a well-structured and balanced board is a complex process and one of a nominations committee's key objectives. The complexity arises from the need to achieve an appropriate mix of skills, diversity and competencies within a board structure that is not so large that it becomes ineffective. There is no universally accepted "right" board composition; each company must find for itself what works best. This requires careful reflection of company specific factors and attributes required for the board to operate effectively. A matrix or mapping exercise is one way for boards to identify where gaps in expertise may exist.[10] This in turn can help focus the search process for additional/alternative director candidates.

Director tenure on the board runs the risk of eroding individual director's independence and objectivity over time. Whilst a small number of long serving directors may add value to the board as a dimension of healthy diversity, the presence of a significant number of board members with lengthy tenure represents a potential red flag in terms of entrenchment and intransigence. "New blood" is essential for fresh thinking, but this need not exclude longer standing directors with strong institutional knowledge. For this reason, nominations committees should also consider director tenure when evaluating overall board composition and committee memberships.

- ***Diversity***. Diversity is an important dimension of board composition and has been the subject of considerable public policy attention, particularly with regard to attacking the acute problem of lack of gender diversity on most corporate boards. A robust approach to diversity should encompass many attributes beyond gender, including diversity by nationality, race or ethnicity, or a specifically sought-after skill or expertise. In addition to ensuring that required competencies are represented in a board, diversity also the benefit of facilitating board reflections that are both objective and which might stimulate a wider scope of discussion and constructive criticism. While some attributes, such as gender, allow for relatively easy benchmarking, other aspects of diversity in a company board may be more subtle and therefore more difficult to assess. Even if board diversity were approached as a more qualitative element, as opposed to a benchmark or quota, this is

[10] See Lawrence J. Trautman, "Corporate Director Selection and Recruitment: A Matrix", The Conference Board, May 2013, www.conferenceboard.org

an area ripe for more assertive shareholder engagement, especially with regard to the existence of a diversity policy and reporting towards its implementation.

- ***Succession planning****.* Succession planning (the process of preparing for the replacement of executive and non-executive directors, whether anticipated or not) is one of the board's fundamental responsibilities. Investors need assurance that succession planning takes into consideration the long-term interests of not just the company, but also the investors themselves. Particularly in the case of family-controlled companies, succession planning can raise important issues with regard to the legitimacy of connected individuals assuming senior executive roles or board seats. The frequency of review of the succession plan is also important as an outdated plan may prevent the board from delivering an appropriate transition. In addition, the role of third party consultants is essential: investors should be cautious of the influence held by external consultants who may not be ideally positioned to interpret the board's needs and source candidates from a narrow pool, but must not disregard the importance the right consultant can play in ensuring efficiency and independent advice.

- ***Board evaluations****.* An effective board is one that undertakes regular self-assessments - sometimes organised internally, sometimes externally - to identify and monitor the strengths and weaknesses of directors, and guide remedial action plans. The absence of a board evaluation process could be a significant cause of concern for investors and a strong engagement point. A proper evaluation process can identify areas of weakness requiring attention, including those regarding director performance, board composition and director nominations. It can be difficult for shareholders to discern the rigour of a board evaluation process, particularly one that is undertaken internally. As such, an independent third party might be in a better position to conduct such assessments. The frequency of evaluations is another important factor linked to the systematic review of board composition and succession planning, with annual assessments being the ideal scenario for any nominations body. Even smaller companies with limited resources should conduct and report on board evaluations with the option of considering, for example, annual internal assessments and regular external evaluations.

- ***Nomination Committee scope and process****.* Nomination committees have become a common, but not ubiquitous, feature of boards in many jurisdictions globally. Simply having a nominations committee does not ensure an effective nominations process; however, its absence in markets where such a committee is a common structure would be a possible red signal for investors and an agenda item for engagement.[11] The scope of the nominations committee charter is also important and subject to variability. The scope should not be limited to single issues such as succession planning or recruiting individual candidates. The broader agenda of developing a matrix for talent and skills relative to the board's recognised strengths and weaknesses should be a clear feature of the overarching strategic approach to director nominations and nominations committees.

[11] Investors should be prepared to show more flexibility for small companies, particularly those in an early stage of development. For boards that are small the nominations process is something that they may legitimately wish to reserve as a matter for the whole board. However, as companies develop and grow over time, the introduction of a standalone nominations committee is normal progression.

As a minimum, companies should make readily available the nominations committees' charter, and report on how well the committee performed its duties during the year.

- ***Link to company strategy**.* The director nominations process must be designed to ensure the board can fulfil its ongoing obligation to provide strategic oversight of the company's operations. This places a premium on a director's understanding of the company, its sector, competitive strategies, operational risks and stakeholder concerns. Candidate directors should have relevant skills or expertise which complement those of existing directors and help the company succeed in any of these strategic areas. Although an independent perspective is important, this alone does not guarantee effective director oversight, particularly in cases where directors have a limited understanding of the company's main strategies and risks. As with previous elements, the link to company strategy cannot be readily translated into measurable indicators. However, investors should make this a key overarching focus when reviewing a nomination process and in their dialogue with companies; ideally, company reporting would demonstrate this link clearly and sufficiently.

- ***The human factor: ethics, tone and sustainability awareness**.* Ethical conduct and director integrity should, in principle, be implicit characteristics for any director candidate in any company. However, in the wake of the recent global financial crisis and ongoing public scrutiny about corporate misdeeds in a range of sectors, corporate business ethics remain in the spotlight. Boards need directors with sensitivity to a company's impact on its direct stakeholders and on wider society; negative impacts and poor stakeholder relations pose business risks that can have negative long-term commercial consequences for the company and its investors.[12] Nevertheless, the argument remains that a principled approach to business is the best way for companies to "future proof" themselves from future ethical crises.

The takeaway, from a nominations perspective, is to highlight the importance of director integrity and sensitivity to potential company impacts on key stakeholders and society. Although this is another aspect that does not seem easy to translate into clear measurable indicators, investors should engage to address any serious concerns related to director ethics or integrity.

Finally, shareholders should also monitor whether the proposed board of directors has an appropriate understanding of environmental, social, governance and ethical factors that impact on the company's bottom line[13].

[12] For example the 2014 Edelman Trust Barometer identified stakeholder engagement and establishing a culture of integrity as the core components for companies seeking to build (or rebuild) trust. See http://www.scribd.com/doc/200429962/2014-Edelman-Trust-Barometer

[13] For a more detailed discussion on how to introduce sustainability skills in the directors' selection process see the Integrated Governance report by the Asset Management Working Group of the United Nations Environment Programme Finance Initiative: http://www.unepfi.org/fileadmin/documents/UNEPFI_IntegratedGovernance.pdf

Transparency

- ***Public disclosures***. The more transparent the nominations process, the greater its legitimacy. While transparency is less of an end unto itself as compared to accountability and board effectiveness, it is a critical factor that allows for investor scrutiny and provides the necessary basis for meaningful engagement. In addition, relevant disclosures should be made readily available, in a timely manner, through the company website, proxy statements and annual reports (even at the risk of some duplication).

- ***Director information***. It is important for investors to be well informed so that they have a sound basis from which to assess both new and incumbent director candidates. This should enable shareholders to take comfort in a director candidate's ability to contribute positively to the company's long-term governance and performance. Director disclosures should not only contain basic biographical information, but also articulate the specific skills and capabilities the individual director brings to the board, how this relates to the boards' skills needs and, how the appointment of new directors helps fill skills gaps. For those directors considered independent by the board, it is important that their independence is assessed against clear independence criteria. In such cases, special commentary or explanations are warranted.

In addition to standard disclosures relating to board tenure and other board commitments, there should also be disclosure around existing or potential conflicts of interest relating to individual director candidates, whether of a commercial nature or otherwise i.e. cross-directorships, previous relationships with other board members etc. This could have an impact on assessing overall suitability for board membership, or it could steer the director's involvement away from specific decisions or company activities where interests may be conflicting.

- ***Reporting on outputs***. Investors should expect meaningful narrative on the nominations process and reflection on its appropriateness, taking into account the most recent strategic review of the board's effectiveness. Company reporting should demonstrate how the committee performed their duties during the year, the link to company strategy, and progress towards implementation of policies and meeting objectives (i.e. diversity targets).

Very importantly, boards should report on evaluations and succession planning processes, and how they work, and provide at a minimum a summary of the results and next actions, avoiding boilerplate language. Disclosure should allow investors to develop an understanding of the quality and rigour of the evaluation and succession processes, and how the subsequent actions of the nominations committee arose from the board evaluation process. Recognising the delicacy and sensitivity of issues addressed, granular reporting of all board evaluation outcomes, and succession planning discussions, may not be a practical expectation for investors. However, there is definite scope for greater clarity when reporting these issues.

2. COUNTRY STUDIES: COMPARATIVE PRACTICES

This section presents a summary of the detailed country reviews that are presented in Part II, written by SC members. These reflect comparative approaches to the nominations process in seven major markets (Australia, Canada, France, Italy, Sweden, the United Kingdom and the United States[14]) and are illustrated with company case studies to provide examples of typical, and for the most part good, nominations practices in these jurisdictions. The country studies conclude with a list of good practice indicators for nominations processes relative to local standards, which can be used to conduct engagement dialogue with companies in these markets.

While the number of countries reviewed, and the multi-faceted nature of the nominations process does not allow for granular comparisons along every dimension of similarity or difference, it should be noted that the seven countries are all developed markets. Although none are without their challenges, they generally rank comparatively well in a global context in terms of corporate governance quality. Furthermore, while the approach to director nominations is by no means identical across these markets, it is fair to say that governance codes and practices are generally progressive, with some exceptions. Examples of this include addressing those challenges related to majority voting for medium sized and smaller companies, and proxy access in the United States. As explained further below, there are also specific/different approaches to nominations through the "*voto di lista*" slate system in Italy for example, or in shareholder involvement on nominations committees in Sweden; these approaches raise questions as to whether useful models for companies in other jurisdictions may exist.

Key takeaways from these country reviews include the following:

- A standing nominations committee is generally regarded as best practice, even if it is not required in some jurisdictions (Australia and Italy, for example). Though some nomination committees are completely independent, majority independence is the prevalent standard.
- There is broad consistency across jurisdictions in terms of encouraging greater narrative and disclosure on nomination processes and policies, in particular how this links to company strategy.
- Board evaluations and succession planning feature as part of the advocated nominations process in most jurisdictions, though disclosure standards on these processes are inconsistent and in need of standardisation.
- Some jurisdictions approach the charters of nominations committees relatively narrowly - for example, Swedish committees articulate a main focus on fielding candidates at the next AGM and French nominations committees focus primarily on succession planning as a key objective. However, the general focus of the nominations process across the

[14] In an effort to focus and in order to pilot collaborative engagement with companies on the director nomination process the SC selected two key markets for further, more detailed research: France and the USA. These two markets were identified based on the following criteria: clear need for market improvement; company engagement is critical (versus, for example, only dialogue with regulators); a global collaborative engagement may achieve higher impact; relevance to a potentially large number of signatories due to the size of the market; relevance to a potentially large number of signatories due to extensive foreign ownership of the market.

jurisdictions tends to be broader in scope, focusing on the larger issues of board composition, skills, independence and diversity.

- Diversity as a theme is prominent as a nominations consideration across all the jurisdictions. Gender diversity is attracting much of the attention, and is an increasing focus of the nominations process. Of the countries reviewed, France has taken the most prescriptive stance, with a legislative requirement of 20% gender diversity by 2014, rising to 40% by 2017. Sweden's governance code also establishes a target of 50/50 gender diversity for corporate boards.

In terms of geography, there are broad similarities between the nominations processes in Australia, Canada, the UK and the US—all of which share roots in the "Anglo-American" governance system and share a common law tradition, and whose capital markets include significant numbers of widely-held companies. One of the main commonalities is the prevalence of predominately, if not exclusively, independent committees that serve as the drivers behind director nominations, board and committee composition, board evaluation and succession planning.

Controversial voting and nominations practices in both the US and Canada, warrant particular attention given their marginalisation of shareholder voting rights. Though it is common for companies in markets around the world to allow for investors of sufficient critical mass (typically 3-5%) to put forward director candidates on the company's proxy card, this has not been the tradition in the US, in part given concerns that rogue shareholders might want to influence company boards along the lines of "special interests" that are not shared by other company shareholders. In spite of legislative initiatives to allow for proxy access, this remains a right that US companies are not obliged to offer and as such, further investor engagement with companies and policy makers merits consideration.

The continued existence of plurality voting in the US is also problematic. In an uncontested election, plurality voting is effectively a "rubber stamp" vote for the director being put forward. The alternative is to call for majority voting in uncontested elections, so that a majority of shareholders will have the actual teeth to remove a director candidate if required. While it is the case that plurality voting is on the decline among the S&P 500 companies, it remains a common practice in smaller companies, and should be an area of attention and engagement for investors in US small and midcap companies.

France, Italy and Sweden offer alternatives to the Anglo-American model, based on their own legal traditions and ownership models. France shares some governance characteristics with the US, including the still common combination of the Chief Executive/Chairman role, which has implications for board structure and director nominations. In a possible reflection of its civil code roots, the French system is also more prescriptive in matters affecting board composition, with its 20 percent gender diversity requirement, its six-year term limitations, and its restrictions on the number of board positions an investor might hold. While many regard this as best practice, it is a matter of discretion, not law, in Anglo-American jurisdictions, which are subject to a comply or explain approach.

French board structures also warrant attention because of legal requirements prescribing that companies over a certain size have employee representation on the company board. This reflects a longstanding social tradition in France,[15] and results in boards that have a built-in partiality for stakeholder interests, or at least for the interests of the company's workforce. Investors should be sensitive to this feature of French boards, and engagement on questions relating to board composition and effectiveness in France should reflect the impact and role that employee representatives play in French corporate governance. Investors may nonetheless wish to engage to ensure that directors remain focussed on fulfilling their fiduciary responsibility to support the long-term success of the company as a whole.

Italy and Sweden offer differing approaches to director nominations and elections, given that their governance frameworks are built on a concentrated ownership model. Ownership blocks are a distinct feature of Italy's market structure and the slate voting system that was introduced in 2011, known as "*voto di lista*". This system is a mechanism under which minority investors are assured that at least some of the candidates they propose will be put forward for nomination on a company's board.

Given Italy's ownership concentration, the "*voto di lista*" system helps to give minority investors a seat on the table they might not have otherwise. That should be regarded as positive in terms of enhancing board accountability and independence; however, what is less clear is how the "*voto di lista*" system affects board effectiveness. For example, the processes undertaken by many nominations committees to carefully and systematically identify director nominees through techniques such as competency matrices are potentially marginalised in importance by the slate voting approach. which can ultimately force director election outcomes that do not reflect a coherent or holistic nominations process. In sum, while the "*voto di lista*" mechanism may address specific features of a market characterised by controlled ownership, more time may yet be needed to judge its success in an Italian context and its potential applicability to other markets with strong ownership concentration.

The Swedish nominations model – where shareholders sit on the nomination committee -- is one of the most intriguing innovations, particularly given its direct emphasis on the investor role in the director nominations process. Despite remaining issues such as shareholders not being able to vote on individual directors but rather a slate of candidates (contrary to best practice internationally), the Swedish model has stood a longer test of time than the Italian "*voto di lista*" system, and has many advocates—including investors who believe this can help to ensure an appropriate minority voice in companies with controlling shareholders.

Exporting the Swedish model to other jurisdictions continues to be a matter of discussion in governance circles, as a way to promote meaningful investor dialogue with companies.[16] There are many attractions to the Swedish approach, but there are also a number of practical or

[15] Germany, though not reviewed specifically in this report, is an even more pronounced example of worker representation (Mitbestimmung) on corporate boards, in that half of a German company's supervisory board (Aufsichtsrat) is comprised of company employees elected by fellow employees, not shareholders.
[16] Tomorrow's Company, "Bridging the UK Engagement Gap through Swedish-style Nomination Committees", March 2010.

institutional factors that may inhibit its adoption in other markets. Key to making the Swedish model work are investor representatives on the nominating committees who have both a thorough understanding of the company's strategy, and the time and ability to apply this strategic understanding to the nominations process. This requires a clear and potentially significant commitment of senior resources, and could lead to over reliance on a small number of large shareholders. In addition, it poses particular challenges in those countries whose capital markets have a large number of issuers. In such markets, applying this approach would be impractical, at least given current investor resourcing models.

3. INVESTOR ENGAGEMENT ON DIRECTOR NOMINATIONS

Why engage?

The importance of shareholder involvement in the corporate governance process is growing rapidly. The OECD's 2011 report, *The Role of Institutional Investors for Promoting Good Corporate Governance* underscores the role that institutional investors play, particularly in "jurisdictions characterised by both dispersed and concentrated ownership."[17] This report also makes reference to the annotations of the 2004 OECD corporate governance principles, which stated:

"the effectiveness and credibility of the entire corporate governance system and company oversight will, to a large extent depend on institutional investors that can make informed use of their shareholder rights and effectively exercise their ownership functions in companies in which they invest."[18]

The development of the Stewardship Code in the UK and other investor codes of best practice elsewhere continue to make the case for institutional investor involvement, including monitoring and engaging with companies on governance issues such as director nominations. There is a clear logic to this: shareholders appoint directors as their agents in the governance of a company in which they invest, and it is in their interest that the best available team of representatives is identified and selected to promote the company's long-term success.

Ideally, institutional investors would engage with all the companies they hold on their strategy, the ability of the board to support this strategy, and the resulting nominations requirements to plug any clear gaps. This in turn would enhance shareholder understanding of existing board composition and the individual candidates to be voted for at the company's AGM. However, such an approach may be possible in some investment strategies, including focus funds, hedge funds or private equity funds with a small number of holdings, but slightly more challenging for larger, global investment portfolios.

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[17] OECD, The Role of Institutional Investors in Promoting Good Corporate Governance, 2011, page 14. In the case of dispersed ownership investors need to hold management to account, whereas in the case of controlled companies the main challenge is to ensure that the controlling shareholder's interests are aligned with those of long-term minority shareholders.
[18] ibid, page 11.

Challenges

- ***Lack of investor resource***: At present, and under current models of operation (i.e. institutional shareholders with investment mandates has given rise to ownership of small percentages in a large number of companies) it is doubtful how much meaningful engagement takes place around the nominations process. For example, an investment manager holding 1,600 companies in the MSCI World Index as part of a tracking strategy is exposed to over 10,000 individual director candidates in a given year. Even for large investment firms, it can be difficult to mobilise sufficient resources to rigorously vet such a large director pool, particularly if doing so in the relatively compressed AGM season whilst conducting voting. In such cases, voting decisions are commonly made with little or no company engagement specific to the individual candidates. Many investors rely on automated voting rules to manage the large volume of votes, often implemented by proxy voting agencies. The nature of these rules can result in mechanical voting outcomes that may not capture the key strengths or weaknesses of individual candidates.

- ***Lack of market and company knowledge***: Investors active in a wide range of jurisdictions may not always have a complete understanding of a company's strategy, management and board, particularly those in remote markets. If engagement discussions are based heavily on governance scores and there is no clear link to the company's long-term strategy and performance, it is unlikely that investors will be able to build trust and credibility with company management and boards, even if the discussions themselves seem useful and constructive.

- ***Smaller companies***: While investors should hold all companies to high principles of good governance, account must be taken of available company resources. Director nominations practices and structures in smaller companies often have less complexity compared to those of larger firms whose scale may allow for greater formalisation. In addition, the level of resources companies can allocate to the process may differ significantly (e.g. limited resources to facilitate third party evaluations). In such cases, investors may need to be more receptive to reasonable explanations regarding board structure and director nominations. In a resource-constrained environment, engagements on nominations tend to be triggered by the combination of poor oversight structure and questionable past practice.

Addressing the challenges

For larger investment institutions with global portfolios, a **risk-based approach** which filters through large numbers of companies, identifying outliers for further inspection, and companies whose performance and board structure might suggest scope for improvement, could be effective. As a next step, beyond initial screening tools, investors should exercise their own judgement when interpreting results and prioritising candidates for proactive engagement with their investee companies – a process in which the above three-pillar framework should be useful.

Greater collaboration among investors also offers a way to address challenges, share specific market information and knowledge on companies, allow for economies of scale, and collect greater resources and shareholdings in order to develop more involvement in director nominations. An investor who is knowledgeable about a local market is usually better placed to understand and identify problematic board dynamics of individual companies that might escape the attention of more remote investment institutions. Investor networks and bodies such as the PRI Initiative can serve as coordination platforms for collective action amongst investors located in different jurisdictions and consequently, promote more robust director nominations and stronger boards. However, their success will depend on investment institutions demonstrating a willingness to become more actively involved in director nominations, both in engagement and in the actual voting decisions linked to this process.

While a more active investor focus on director nominations will require greater, or at least more creative, resourcing, an **asset owner call for further engagement** by their investment managers on the topic could also play a significant role.

As a macro engagement initiative, investors may wish to consider advocating for clearer and more meaningful standards of disclosure around the nominations process, through **engagement with policy makers and regulators**. Enhancing shareholder rights, such as proxy access, and increasing ability to effectively remove directors from the board, could also trigger greater shareholder involvement.

4. TRANSLATING THE THREE PILLARS INTO ENGAGEMENT QUESTIONS

Effective company engagement on the company nominations process inevitably calls for a bespoke approach that combines broad principles of governance with a clear understanding of the company's own situation, stage of development and even ownership structure. Part 2 of the SC work identifies key good practices as a basic framework for engagement for the seven markets covered in detail by this project.

In an effort to assist investors in furthering their engagement on the nomination process, core issues are illustrated below in a series of possible questions investors may wish to draw from and customise for their own use:

Accountability	
Independence of decision making	▪ Is there a sufficiently independent board and nomination committee to ensure appropriate oversight of the nomination process?
Voting rights related to director nominations and elections	▪ Can shareholders (of sufficient critical mass) place director candidates for nomination on the company's proxy? ▪ Are directors elected by a majority in uncontested elections? ▪ Are directors elected on an annual basis?

Shareholder communications and engagement	▪ Is the company open about its approach to succession planning?
Duty of care to respect shareholder rights	▪ Is there any evidence that a director is not showing sufficient duty of care to the company as a whole?

Effectiveness	
Composition	▪ Does board composition and the director nominations process appropriately reflect the strategic needs of the business? ▪ Are there obvious gaps in sector, geographical or other relevant subject matter expertise? If so, what does the board intend to do about this? ▪ Is there a concentration of directors with lengthy board tenure? If so, how does the nominations committee regard their performance and independence? Are any such long-tenure directors classified as an independent director for purposes of committee membership? If so, what does the board intend to do about this?
Diversity	▪ How does the board approach diversity: where are the areas of greatest strength and weakness? Is there a policy or established targets in this area?
Succession planning	▪ Does the board have a policy on succession for both executive and non-executive directors? What is the role of third party consultants?
Board evaluations	▪ Does the board undergo periodic board evaluations? How often? Are these externally facilitated? ▪ Can the company identify examples in which the board evaluations process has influenced the director nominations process?
Nomination committee scope and structure	▪ Does the company publish the charter of the nominations committee? If so, does the nominations committee adequately describe its role and scope? Does this scope extend to broader issues of board composition, skill mix and diversity?
Link to company strategy	▪ Does the company explain the link between the nominations process and strategic priorities?

The human factor: ethics, tone and sustainability awareness	■ Is the board confident that its directors have sufficient sensitivity to the company's environmental and social impact, as well as ethical issues that can affect the company's stakeholders and reputation? ■ Is the board confident about the ethical underpinning of its directors? If not, what does it intend to do about this?

Transparency	
Public disclosures	■ Does the company provide timely disclosure made readily available?
Director information	■ Does the company disclose meaningful biographical information on its directors, and how their skills contribute to board effectiveness? ■ Does the company disclosure on directors address potential conflicts of interest and how they are mitigated? ■ Does the board disclose connectivity between board members?
Reporting on outputs	■ Does the company disclose the board's approach to succession planning? ■ Does the board disclose if it has undertaken an evaluation—and if not, why not? ■ Does company disclose on how board nominations decisions are affected by the board evaluations process?

Policy recommendations for companies stemming from the above questions could include the following specific recommendations:

- An explicit definition of director independence should be provided publicly by the company, addressing tenure, term limits and interlocking history of board members
- Shareholder feedback on key changes should be gauged at regular intervals
- An independent report on the fulfilment of a required skills matrix should be published no less than every three years by the board
- The board should publish clear goals on board diversity, including gender
- A succession report should be published regularly
- The board should conduct an independent board evaluation no less than every three years, and publish a general summary and trending report for shareholders
- An ethics review should be conducted on each nomination for the board

5. CONCLUSIONS

This part of the report illustrates a range of different approaches to director nominations, elections and board structure, all framed in the context of promoting greater board accountability, effectiveness and transparency.

In sum, investors should allocate more resources to constructive engagement on the nominations process employed by the companies they own, and also to the relationship between the nominations process and the company's board structure.

There is strong evidence for good practice in the markets reviewed in terms of the promotion of progressive nominations practices, driven by boards taking a holistic and strategic view that supports investor interests and company long-term success.

However, poor structures continue to exist. Even where reasonable processes are in place, there remain risks regarding director nominations and their impact on board accountability and effectiveness. As a result, investors need to undertake constructive engagement on nominations. **Investors should apply a combination of risk-based analysis and qualitative judgement to identify candidates for engagement amongst their investee companies and collaborate more often to ensure effective engagement with these companies.**

The Principles for Responsible Investment (PRI) Initiative

The PRI Initiative is a UN-supported international network of investors working together to put the six Principles for Responsible Investment into practice. Its goal is to understand the implications of sustainability for investors and support signatories to incorporate these issues into their investment decision making and ownership practices. In implementing the Principles, signatories contribute to the development of a more sustainable global financial system.

The Principles are voluntary and aspirational. They offer a menu of possible actions for incorporating ESG issues into investment practices across asset classes. Responsible investment is a process that must be tailored to fit each organisation's investment strategy, approach and resources. The Principles are designed to be compatible with the investment styles of large, diversified, institutional investors that operate within a traditional fiduciary framework.

The PRI Initiative has quickly become the leading global network for investors to publicly demonstrate their commitment to responsible investment, to collaborate and learn with their peers about the financial and investment implications of ESG issues, and to incorporate these factors into their investment decision making and ownership practices.

More information: www.unpri.org

PRI Principles for Responsible Investment

The PRI is an investor initiative in partnership with UNEP Finance Initiative and the UN Global Compact.

United Nations Environment Programme Finance Initiative (UNEP FI)

UNEP FI is a unique partnership between the United Nations Environment Programme (UNEP) and the global financial sector. UNEP FI works closely with over 200 financial institutions that are signatories to the UNEP FI Statement on Sustainable Development, and a range of partner organisations, to develop and promote linkages between sustainability and financial performance. Through peer-to-peer networks, research and training, UNEP FI carries out its mission to identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations.

More information: www.unepfi.org

UNEP Finance Initiative
Changing finance, financing change

UN Global Compact

Launched in 2000, the United Nations Global Compact is both a policy platform and practical framework for companies that are committed to sustainability and responsible business practices. As a multi-stakeholder leadership initiative, it seeks to align business operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anti-corruption, and to catalyse actions in support of broader UN goals. With 7,000 corporate signatories in 135 countries, it is the world's largest voluntary corporate sustainability initiative.

More information: www.unglobalcompact.org

United Nations Global Compact