Heading into the 2017 proxy season, investors continue to focus on whether boards are fit for purpose. The pressure on boards to increase gender diversity is intensifying, as is the push for them to become climate-competent, foster a corporate culture of accountability and integrity, and better communicate long-term strategy.

Investors continue to press for change in spite of regulatory and legislative uncertainty, with some expressing confidence in their power to affect corporate behavior regardless of the regulatory environment.

The EY Center for Board Matters talked to more than 50 institutional investors, investor associations and advisors about their corporate governance views and priorities for the 2017 proxy season. Participants represented US$24 trillion in assets under management and included global and US-based asset managers, public funds, labor funds, and faith-based and socially responsible investors.

This report brings together this broad-based input and draws on our tracking of governance trends through our corporate governance database. What follows are five things boards need to consider heading into the 2017 proxy season.
1. Board composition remains in the spotlight – with a growing focus on gender diversity

Around 70% of investors we spoke with said board composition and assessments should be a board priority in 2017. Most stressed the importance of having a diversity of talent, thought and tenure on the board that evolves over time in ways consistent with strategy. They also underscored the need for a nominating process that identifies the highest qualified candidates and a robust assessment process that challenges the board’s status quo.

One particular dimension of board composition is at the forefront for many investors: gender diversity. Just over half of the investors we spoke with said board diversity, particularly gender diversity, should be a board priority in 2017. While racial and ethnic diversity is certainly a component of investor interest, for now gender diversity is the primary focus for many – in large part due to the lack of disclosure on racial diversity and the prevalence of gender data and resources.

Gender diversity on boards continues to advance at a sluggish pace in the US. The proportion of women-held directorships among S&P 1500 companies grew just 1% in 2016, with 18% of those directorships now held by women. This growth is the same rate as each of the past 5 years – suggesting that parity will not be reached for more than 30 years.

Many investors are growing increasingly frustrated with this slow pace of change. They stress that board diversity is about boards making better, more robust decisions, as well as setting the tone at the top for the diverse talent the company seeks to attract. They want to see boards make diversity an active consideration and develop a culture of inclusion that brings diverse director voices to bear in board discussions.

Key takeaway for the board

Board members should prioritize building and expanding diverse personal networks to help develop the diverse director pipeline. Board actions and communications should demonstrate a commitment to enhancing the diversity of the board, as well as the company’s employee base and talent ladder. The board’s communication opportunity here is critical.

Think high support for director elections means investors are satisfied with board composition? Think again.

Does high proxy voting support for director elections mean most boards have composition right?

Investors overwhelmingly expressed that board composition concerns are largely disconnected from current proxy voting practices. In comments to us, investors shared the following:

- Some prefer to express their concerns via engagement, because while proxy votes may be misinterpreted, engagement conversations can create a deeper understanding of investor concerns and board succession planning challenges.
- They have limited bandwidth to assess board composition within the constraints of proxy season and find it difficult to evaluate director contributions.
- Some are reticent to vote against directors, especially in the age of majority voting, absent an egregious governance failure or compelling evidence that a director or committee has been ineffective.
- Director opposition rates may increase going forward.

Proxy access offers investors another outlet for board composition concerns

The ongoing push for proxy access is arming investors with a new power to directly influence the boards of the companies they own – though it is expected to be used only as a last resort. A majority of S&P 500 companies have adopted proxy access bylaws.
2. Environmental and social risks – particularly climate change – are front and center for a broadening range of investors

The management of environmental and social risks is recognized by a growing number of investors as linked to long-term financial risks, and the urgency around climate change in particular is increasing. Close to a third of the investors we spoke with said that climate change should be a board priority in 2017. That’s more than double the number of investors who said so last year. Also, when asked what topics the investors will focus on in 2017, climate risk was the most-cited topic.

These investors seek to engage companies to better understand how company strategies are evolving to deliver shareholder value in a carbon-constrained world, including planning around operations and supply chains, resource efficiency, and energy sources. Some are calling on companies to publicly support the 2015 Paris agreement on climate change. Many said they seek assurance that boards are considering climate risks and opportunities as part of strategic and capital allocation decision-making – and gaining the competency needed to do so effectively. We are also expecting a rise in shareholder proposals related to climate risk, which have been receiving increasing support in recent years, averaging 29% support last year, up from just 7% in 2011.

Notably, the type of investors citing climate change (or environmental and social issues more broadly) as an area of focus continues to expand to include larger asset managers. And the pressure on these managers regarding environmental and social commitments is poised to increase. For example, some smaller asset managers and asset owners are questioning the alignment of large asset managers’ proxy voting practices with their public commitments relative to environmental and social issues, particularly climate change.

In response, some large asset managers have indicated to us that they plan to better communicate the behind-the-scenes engaging they’re doing with companies on climate risk and other sustainability topics, and the importance and rigor with which they approach such issues.

Key takeaway for the board

Boards should make sure they understand company-specific sustainability risks and integrate those risks into oversight of strategy. Board communications should explain how the board is increasing its sustainability expertise and how board policies, structure and assigned responsibilities are institutionalizing sustainability oversight.

Investors are divided on specialist directors

Are specialists (e.g., climate or cyber experts) the right direction for boards?

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<th>It depends</th>
<th>No</th>
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<td>22%</td>
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Common ground – Nearly all investors stressed that the board should not defer to any one or few directors, regardless of their background and expertise. Decision-making remains the joint responsibility of the board.

Investors who said “No” ...

- Acknowledge that certain directors will lead board discussion based on their personal backgrounds and expertise, but oppose the idea of having siloed experts, whom they believe may hamper collegial group decision-making. They also question whether specialized experts are best positioned to oversee company strategy. They believe recruiting generalist directors with a broad range of skills, including industry and key risk-related experience, is best practice, and that more specialized expertise may be gained through hiring outside advisors or forming external advisory committees.

Investors who said “It depends” ...

- Think different models work for different boards, but stress that even so-called specialists need to be well-rounded and bring something to the table beyond their key area of knowledge. They underscore that what matters is that boards are diligently and proactively addressing key risks, using whatever approach best suits their needs.

Investors who said “Yes” ...

- View specialized directors as uniquely placed to have the authority to challenge management and help the board navigate certain topics without relying on outside advisors. They stress that just as financial experts play an important role, individuals with different areas of specialization tied to the business will strengthen board oversight. They note that because key risk areas are rapidly evolving, such appointments would need to have limited tenure – and would signal that the company is proactive, nimble and able to innovate.
3. Regulatory and legislative uncertainty is a principal concern – and motivating factor – for some

Our investor outreach this year straddled the 2016 election, with just over half of the conversations occurring post-election. Among these conversations, many investors raised concerns about regulatory and legislative uncertainty under the new administration. Among the potential concerns raised were:

- **Legislative proposals that could impact the governance landscape**, including the SEC Regulatory Accountability Act, which they believe could stifle the SEC’s rulemaking ability, and the regulation of proxy advisory firms, which they believe could ultimately make it cost-prohibitive for proxy advisors to operate.

- **Backsliding on US environmental regulations and climate change commitments** that could halt the tailwinds currently helping to compel company action in adopting voluntary, proactive strategies to address climate change. However, some also expressed confidence that market forces will continue to drive change.

  - **Repeal of certain shareholder protections and governance provisions** written into the Dodd-Frank Act and the right to file shareholder proposals being revoked or severely narrowed. (Notably, a number of investors expressed that if the say-on-pay requirements are rolled back, they expect companies to retain the practice because it provides an outlet for opposition votes that might otherwise be cast to oppose directors).

Accompanying these concerns is a strengthened resolve to use private ordering to push for change. As public policy becomes less of an avenue to push for reform, these investors believe their own stewardship takes on even greater importance.

Some investors said the regulatory uncertainty does not impact them because they recognize their ability to effect change across the market through their own engagement and proxy voting practices, regardless of the regulatory climate.

### Key takeaway for the board

In the event of the rollback of shareholder rights and governance regulations, investors will be closely watching how companies respond. Boards should be aware of how their actions may impact relationships with company owners – many of whom have positioned themselves to serve as allies to companies that seek to deliver long-term, sustainable shareholder value.

4. Executive pay incentives, complexity and magnitude are under scrutiny

Just over a third of the investors we spoke with said that executive pay should be a board priority in 2017, with many citing frustrations regarding perverse incentives that may not align with the company’s culture and purpose.

Investors want to see a tone at the top of integrity and accountability that is integrated and supported throughout the organization – including through the compensation program. As part of this focus on culture, executive pay clawback policies are once again in the spotlight, with many investors insisting that boards should have wide discretion to claw money back.

The complexity of pay plans and the magnitude of executive payouts also continue to receive heightened investor scrutiny. Investors generally want pay programs to be simplified and closely tied to strategy – and to evolve over time along with company business models and strategy.

For some investors, excessive quantum pay is of particular concern this year in light of rising income inequality, and related political uncertainty. Gender and racial pay equity across the workforce is also featuring prominently in some investors’ focus on pay.

### Key takeaway for the board

Boards should establish that they have, and disclose, a robust clawback policy that gives the board ample discretion to confirm executive payouts are aligned with performance and culture. Boards need also consider whether the pay model is evolving along with the company’s business model and whether pay could be simplified and more directly tied to strategic goals.
5. Most investors believe there is a problem with short-termism in the marketplace and that they are part of the problem

We asked investors directly whether they believe there is a problem with short-termism in the marketplace. Most said yes, and many of these said short-termism is driven by a number of different forces, including short-sighted management, high frequency trading, investment bank research, quarterly earnings targets, the media – and investors themselves. Indeed, many investors noted the pressure on portfolio managers and pension funds to meet short-term performance targets and their own efforts to combat such pressures.

How are investors assessing whether companies are sufficiently long-term focused? They told us they look at factors such as:

- **The company's long-term strategy narrative** – Investors want to understand both the long-term vision and the short- and midterm goalposts leading to that vision. Many investors said their dialogues with company executives and directors provide the most valuable insight into whether the company is thinking long-term.

- **Executive pay incentives, especially changes to performance targets** – Many investors are looking at how companies define long-term pay and what metrics they are using. Many also noted that some companies set out long-term pay structures but then change pay targets to get short-term gains, which creates pay volatility and raises red flags.

- **Capital allocation** – Investors want to see that capital expenditures are enabling long-term strategy. Some investors are looking closely at the reasoning behind stock buyback plans, leveraged dividends, spin-offs and M&A – particularly when such moves are announced near the time when an activist investor has engaged the company.

- **Environmental, social and governance (ESG) factors** – A number of investors said that ESG factors tend to have a longer time horizon, and that a company’s focus on sustainability can be a proxy for long-term thinking.

**Key takeaway for the board**

Company communications – both in the proxy statement and in engagement conversations – should make clear what the long-term vision is and how the executive pay program and capital allocation decisions will enable that vision. Investors continue to stress that they can be allies to companies and help give them the space and support to look beyond the short term.
Want to know how the 2017 shareholder proposal landscape is shaping up?

We’re expecting a watershed year for proposals on environmental sustainability – especially climate risk – and another big year for proxy access. See our Corporate Governance by the Numbers for monthly updates on what proposals are topping the list in terms of submissions and vote results.

Questions for the board to consider:

- How is the board thinking about and assessing talent at the board level as the company’s strategy and risks evolve? What is the board doing to actively challenge its status quo on diversity?
- How is the company assessing the magnitude of sustainability risks as they relate to business risks? How does the board oversee this process – and establish that it has the competence to do so effectively?
- As the board considers policy impact and opportunities, is it also considering what kind of investors it wants to attract?
- In reading the proxy statement’s Compensation Discussion and Analysis section, is it clear how pay is tied to long-term strategy? Is the pay program straightforward and easy to understand?
- How is the company telling its story to investors about long-term strategy, including when milestones are missed or the company needs to pivot?

Endnotes

1 EY’s investor outreach conversations included asking specific and consistent questions to a broad spectrum of more than 50 institutional investors, investor associations and advisors. Investor views vary. All respondents are anonymous, and results are presented in aggregate.