# Engagement 360
## 2024 Q3 Report



Stewardship is where insights become action. Engagement 360 supports a holistic approach to mitigating ESG risks and capitalizing opportunities.

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This report summarizes the shareholder engagement activities that Morningstar Sustainalytics performed between July and September 2024. If there is no specific reference to date in graphs and tables, the data is presented as per end of the reporting period. The report has been produced December 2024 and uses data for the quarter ending 30 September 2024. Version 1 was disseminated 6 December 2024. Use of and access to this information is limited to clients of Morningstar Sustainalytics and is subject to Morningstar Sustainalytics legal terms and conditions.

# Stewardship Approach

Engagement 360 is a holistic stewardship offering that promotes and protects institutional investors' long-term shareholder values through consistent engagement outcomes. Engagement 360 addresses ESG risks and strives to create positive social and environmental outcomes.

STRATEGY AND RISK promotes and protects long-term value by flagging high- and severe- risk companies to proactively engage unmanaged and financially material ESG issues. The focus is on companies with unmanaged ESG risk greater than 30 as identified by Morningstar Sustainalytics' ESG Risk Ratings.

INCIDENT engagements address companies that severely or systematically violate international standards, such as the UN Global Compact and OECD Guidelines for Multinationals to ensure that investors are managing associated reputation risk. This engagement aims to not only to verify how a company addresses the incident but also to effectuate change in the company's policies and/or processes to ensure proper policies and programmes are in place to avoid future reoccurrences and improve its ESG disclosure. Companies flagged as Watchlist or Non-Compliant as identified by Morningstar Sustainalytics' Global Standards Screening research are targeted for this engagement.

THEMES are SDG-aligned proactive engagements that enable investors to align their interests in addressing specific systemic issues across the ESG spectrum. Thematic engagement's philosophy centers around systematic change, collaboration, root causes and best practice sharing at its core. The purpose of this engagement is to influence companies to proactively manage specific ESG risks and capitalize on opportunities.

# Executive Summary

**Desiree Wareman**
Expertise Center Lead, Treasury & Asset Management

We are pleased to present the results of the engagement activities for Q3 2024 on behalf of Coöperatie Menzis (hereafter Menzis). This report includes our engagement statistics, along with detailed insights that extend beyond our investment portfolio. Our commitment to making a positive impact spans not only our portfolio companies but also potential investments where we observe meaningful changes through our engagement. Additionally, we have highlighted specific cases that we consider important to report.

### Highlights of the Quarter

The transition from the former Thematic Engagement to the new Thematic Stewardship Programme continues, driving up the total number of engagements, so by the end of the third quarter, Morningstar Sustainalytics has a total of 743 engagements. The Thematic Stewardship Programmes are ramping up and establishing the engagement dialogues and setting the expectations with the companies.

The Stewardship team of Morningstar Sustainalytics has 119 active engagements related to Menzis portfolio and achieved 80 milestones year to date. One engagement was resolved successfully this quarter.

For the remainder of this report, we will specifically focus on the engagement activities undertaken by Sustainalytics. These activities extend beyond the Menzis investment portfolio. In alignment with our Responsible Investment Policy, we engage with companies outside our portfolio to promote positive change on specific themes (for instance climate change and biodiversity). Such changes may ultimately lead to these companies reentering our investible universe. Additionally, we actively participate in collaborative engagement initiatives with other parties, including VBDO and UNPRI, to amplify our impact and drive meaningful progress in responsible investment practices.

### Looking Ahead

In the coming quarters, Morningstar Sustainalytics will continue seeing Thematic Stewardship Programmes adding companies to the programmes, and Strategy & Risk will replace some of the many engagements resolved with new companies. Finally, where 'we' has been used in this Engagement 360 report, this refers to Morningstar Sustainalytics and reflects the total of the engagement activities that Morningstar Sustainalytics performs, including on behalf of Menzis.

# Stewardship Overview Menzis Portfolio

**119**
active engagements in the Menzis portfolio

**80**
milestones achieved in the Menzis portfolio in 2024

**Financials**
is the most engaged sector

**SDGs: 1 (6%), 3 (32%), 13 (34%)**
Menzis in focus Sustainable Development Goals

**Highest number of engagements**
in a single market is the US

**Disclosure and Board Composition**
are the most engaged topics

## Engagement Status

When we open an engagement, the status is Engage. We will then pursue engagement until we change status to:

| | |
|---|---|
| **Resolved** | The company has achieved the engagement objective. |
| **Archived** | Engagement is concluded, the engagement objective has not been achieved. |
| **Disengage** | Engagement is deemed unlikely to succeed. |

720 engagements as of 01 July 2024

65 new Engage

9 Resolved

31 Archived

2 Disengage

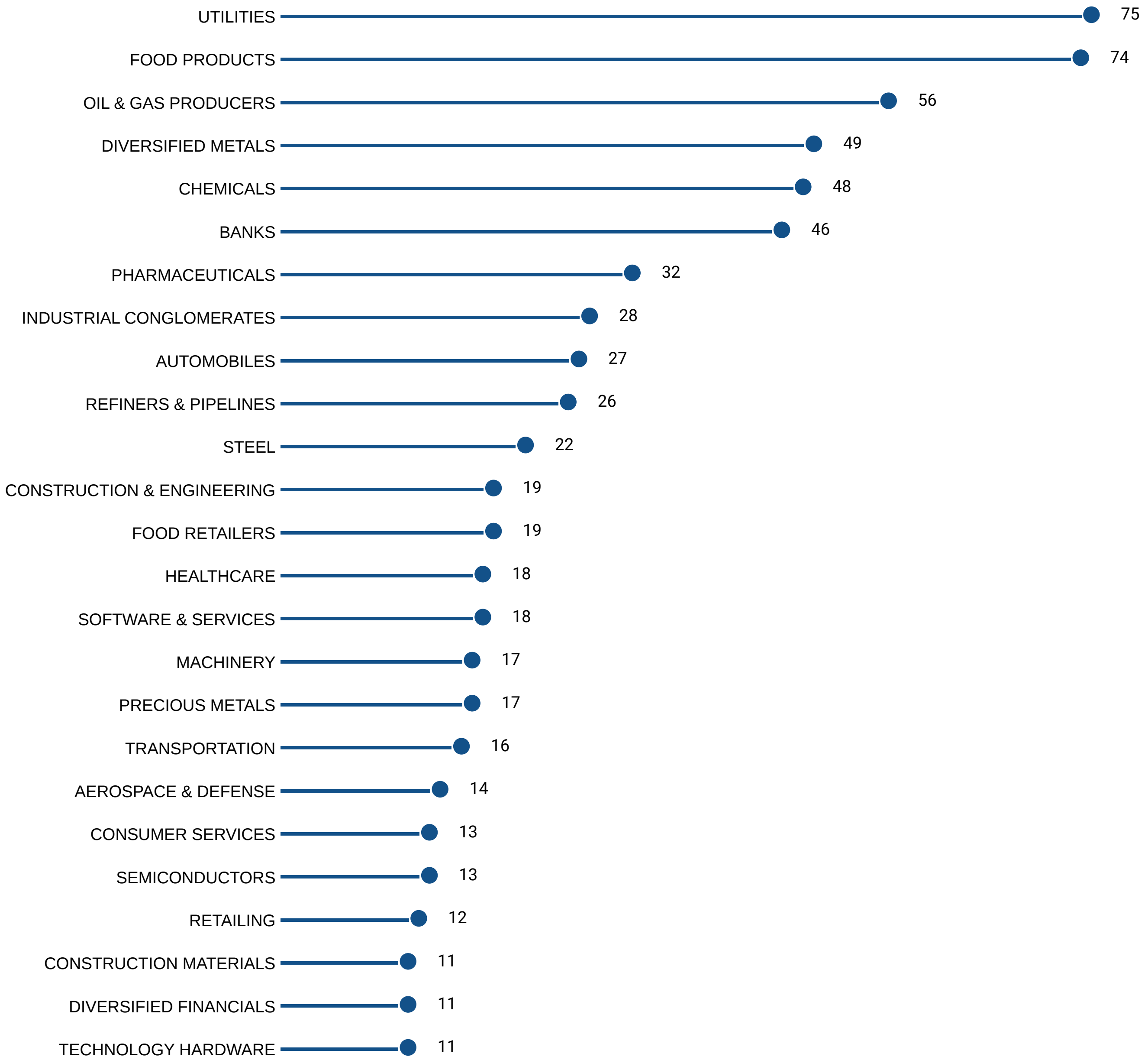
743 engagements as of 30 September 2024

785 engagements during Q3 2024

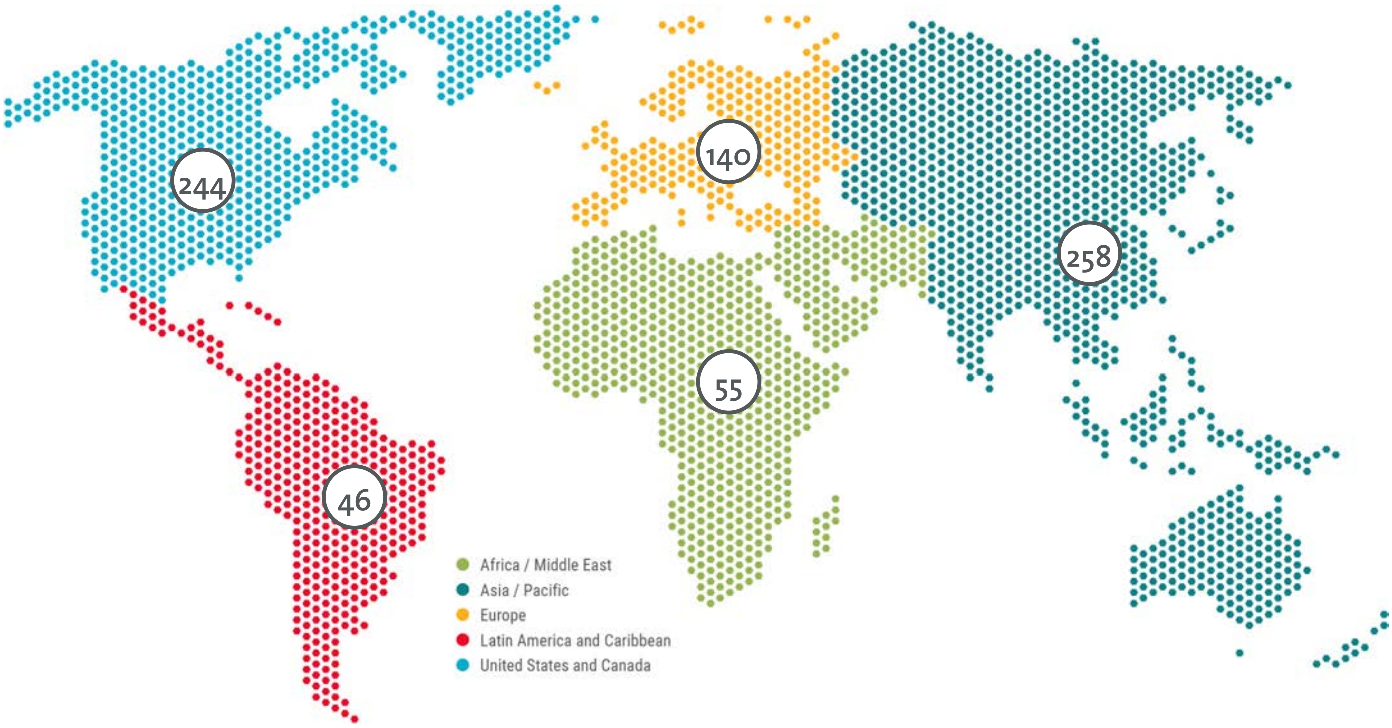
On a regular basis, universes are rebalanced and issuers might therefore be removed from our data set. Corporate changes can also affect case status. In such circumstances, opening and closing engagement counts will not match. Impacted companies may or may not overlap with investor holdings.

# Industry Distribution

(Industries with a minimum of 10 engagements)



## Engagements by Headquarter Location

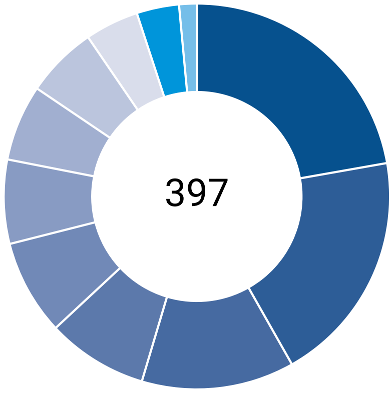



# Engagement Topics

At the end of the reporting period, our engagements addressed a number of topics across the environmental, social and governance pillars.

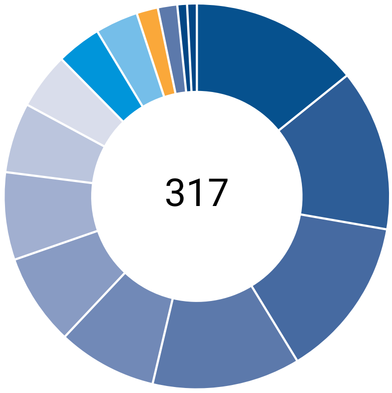
## Environmental

- NET ZERO DECARBONIZATION (234)
- CLIMATE CHANGE (206)
- WATER SECURITY (134)
- WATER QUALITY (88)
- DEFORESTATION (83)
- BIODIVERSITY (73)
- LAND POLLUTION AND SPILLS (66)
- WASTE MANAGEMENT (62)
- NATURAL RESOURCE USE (46)
- CIRCULAR ECONOMY (36)
- AIR POLLUTANT EMISSIONS (14)



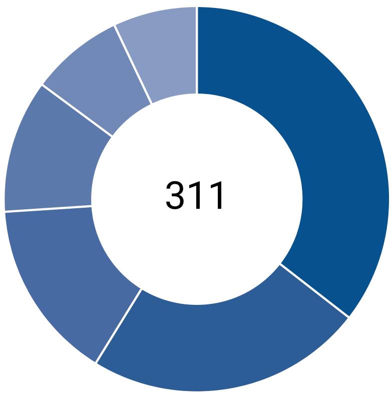

## Social

- COMMUNITY RELATIONS (86)
- HUMAN RIGHTS (82)
- PRODUCT QUALITY AND SAFETY (82)
- HUMAN CAPITAL (75)
- OCCUPATIONAL HEALTH AND SAFETY (50)
- LABOUR RIGHTS (46)
- DIVERSITY, EQUITY AND INCLUSION (DEI) (44)
- INDIGENOUS PEOPLE (35)
- JUST TRANSITION (28)
- CHILD LABOUR (22)
- DATA PRIVACY AND SECURITY (21)
- FORCED LABOUR (10)
- MARKETING PRACTICES (9)
- HIGH-RISK TERRITORIES (4)
- WEAPONS (4)




## Governance

- DISCLOSURE (231)
- ESG GOVERNANCE (151)
- BOARD COMPOSITION (98)
- BUSINESS ETHICS, BRIBERY AND CORRUPTION (72)
- ACCOUNTING AND TAXATION (50)
- SHAREHOLDERS RIGHTS (45)




Note: An engagement can cover one or more issues and objectives reflected in overlapping issue statistics.

## Sustainable Development Goals — Mapping Engagements

All engagements are mapped to the 17 UN Sustainable Development Goals (SDGs). The mapping is done by Morningstar Sustainalytics and refers to the focus and objective(s) of the engagement.

| | |
|---|---|
| 1 No Poverty | 4% |
| 2 Zero Hunger | 2% |
| 3 Good Health and Well-Being | 27% |
| 4 Quality Education | 4% |
| 5 Gender Equality | 6% |
| 6 Clean Water and Sanitation | 10% |
| 7 Affordable and Clean Energy | 22% |
| 8 Decent Work and Economic Growth | 25% |
| 9 Industry, Innovation and Infrastructure | 28% |
| 10 Reduced Inequality | 9% |
| 11 Sustainable Cities and Communities | 10% |
| 12 Responsible Consumption and Production | 55% |
| 13 Climate Action | 51% |
| 14 Life Below Water | 8% |
| 15 Life on Land | 14% |
| 16 Peace and Justice, Strong Institutions | 38% |
| 17 Partnerships to Achieve the Goal | 4% |

# Case Study: Mowi ASA

## Biodiversity and Natural Capital Stewardship Programme — Engagement Since: August 2022

Industry: **Food Products**

Base Location: **Norway**

Mowi is the world's largest producer of Atlantic salmon, supplying one-fifth of global demand. As a vertically integrated company, Mowi's operations span from broodstock to sales, playing a crucial role in the seafood industry.

Progress: **Good** | Response: **Standard** | Latest Milestone: **3**

### Engagement Update

In February, we hosted a conference call discussing Mowi's nature-related impacts and dependency analysis, risk mitigation strategies in response to disease outbreaks in Scotland, and their sustainable salmon feed practices. We reviewed its TNFD report, which was comprehensive for a first iteration. Mowi presented an overview of its sustainability progress shared with clients in August, highlighting its post smolt strategy aimed at enabling sustainable growth and its approach to sourcing fish feed raw materials.

### Focus Area

Moving forward, we will encourage Mowi to pursue fulll alignment with the Global Biodiversity Framework. Specifically, we aim to encourage Mowi to set science-based targets to address its nature-related impacts. We will also engage with the company to enhance its salmon feed supply chain traceability to ensure that it avoids contributing to ecosystem conversion and the depletion of wild fish stocks within its upstream supply chain.

### Engagement Outcomes

Mowi has demonstrated leadership in biodiversity management by disclosing a detailed Biodiversity Framework and publishing a comprehensive TNFD-aligned report. These documents reflect the company's advanced understanding of its biodiversity impacts, dependencies and risks. Mowi's Biodiversity Framework outlines policies, mitigation actions, and targets, and provides scenarios that illustrate financial risk and opportunity related to biodiversity. However, despite these strengths, the company continues to face significant challenges, particularly related to disease outbreaks at its farms. To address these challenges, Mowi is implementing a post smolt strategy to reduce the time salmon spend at sea, thereby minimizing their exposure to risks such as diseases linked to changes in sea temperature.

### Insights & Outlook

The engagement has highlighted Mowi's proactive and comprehensive approach to managing biodiversity risks. While the company's leadership in this area is evident, ongoing controversies, particularly those linked to disease outbreaks, underscore the need for continued vigilance and improvement. With increasing scrutiny, especially from the expected expansion of marine protected areas, Mowi must sustain and deepen its efforts to address nature-related risks and capitalize on opportunities, such as increasing the proportion of low-impact raw feed materials.

# Engagement Results

**133**
meetings, including 4 in-person meetings

**1,829**
emails and phone calls exchanged

**9**
engagements Resolved

**77**
Milestones achieved in Q3 2024

## 76 Positive Developments

**39%**
of engagements show Good or Excellent Response

**25%**
of engagements show Good or Excellent Progress

## Engagement Progress

Progress reflects the pace and scope of changes towards the engagement objective that the company is making, assessed on a five-point scale.

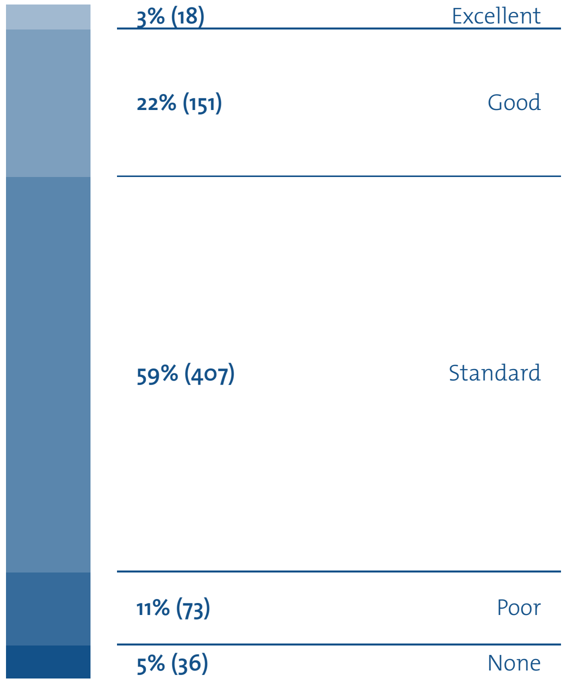
**Excellent** The company has adopted a proactive approach and addressed the issues related to the change objective.

**Good** The company has taken sufficient measures to address the issues related to the change objective.

**Standard** The company has undertaken a number of measures to address the issues related to the change objective.

**Poor** The company has indicated willingness to addressing the issues related to the change objective, but no measures have been taken yet.

**None** The company has not made any progress against the engagement objective.




## Engagement Response

Response reflects the company's willingness to engagement dialogue with investors, assessed on a five-point scale.

**Excellent** The company is proactive in communicating around the issues related to the change objective.

**Good** The company addresses all the issues related to the change objective.

**Standard** The company provides responses to some of the issues related to the change objective.

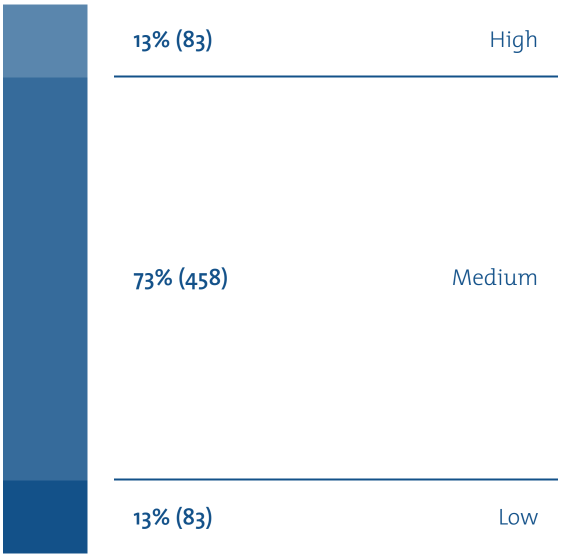
**Poor** The company has initially responded but not properly addressed the issues related to the change objective and is unwilling to engage further with us.

**None** The company has not responded to the inquiries.

## Engagement Performance

Performance describes the combined company Progress and Response.

| | |
|---|---|
| **High** | Good or Excellent Progress in combination with Good or Excellent Response. |
| **Medium** | Standard level of Progress and Response. |
| **Poor** | Poor or None Progress in combination with Poor or None Response. |




## Engagement Milestones

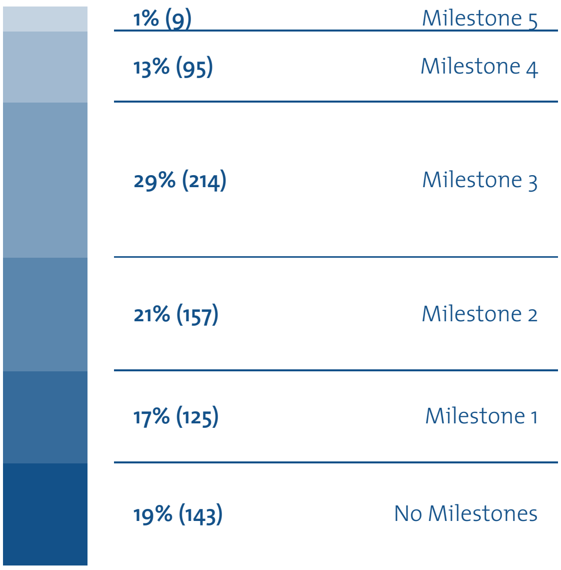
Milestones are our five-stage tracking of progress in achieving the engagement objective.

77
Milestones achieved in
Q3 2024

### Milestone Framework Structure

| | |
|---|---|
| **Milestone 5** | Change objective is considered fulfilled. |
| **Milestone 4** | Implementation of strategy has advanced meaningfully, and related issuer disclosure maturing. |
| **Milestone 3** | Strategy is well formed and has moved into early stages of implementation. |
| **Milestone 2** | Issuer establishes a strategy to address the issue. |
| **Milestone 1** | Acknowledge of issue(s) and commitment to mitigation. |

### Engagements by Highest Milestone Achieved



# Engagements Resolved Menzis

| COMPANY | COUNTRY | INDUSTRY | ISSUE |
|---|---|---|---|
| Sanofi | France | Pharmaceuticals | Quality and Safety - Human Rights |

# Resolved - Sanofi

## Engagement Since: 29 May 2020

INDUSTRY:

**Pharmaceuticals**

BASE LOCATION:

**France**

ISSUE:

### Quality and Safety - Human Rights

Sanofi has faced a series of controversies concerning the negative impact on patients of its anti-epilepsy drug, Depakine, in Europe, and its anti-dengue vaccine, Dengvaxia, in the Philippines.

CHANGE OBJECTIVE

Sanofi should have a robust governance, compliance, and risk management system in place with respect to its research and development of new products. Sanofi should also ensure appropriate levels of disclosure of the risks and side-effects of its products.

## Engagement Outcomes

- Sanofi has an appropriately certified Quality Management System, along with many quality and safety-related policies, a thorough drug development process and good oversight of product quality and safety.
- The company has a risk management plan for all its products, and appropriate monitoring, labelling, communication, pharmacovigilance, and training.
- Both products, Depakine and Dengvaxia, have up-to-date labels and disclosures and approved by the US and EU regulators.

**Conclusion:** Based on the company's response to product quality and safety issues, and improvements the company made to address the matters, Morningstar Sustainalytics decided to resolve this engagement.

# Thematic Engagement Updates

## Biodiversity & Natural Capital Stewardship Programme

The Biodiversity and Natural Capital Stewardship Programme continues to advance engagement with companies through ongoing research, detailed agenda development, and in-depth dialogues. From July to September 2024, we hosted 18 meetings via conference call or in-person. The team sent a total of 190 emails to companies and received 113 emails. We also began work within our PRI Spring engagement group in preparation for our collaborative engagement with **Golden Agri-Resources Ltd**.

Throughout 2024, our engagements have been progressing to address specific gaps between company disclosure and the programme's Outcome Assessment. In the third quarter, we observed two companies progress on Governance and Transparency Markers. This reflects **Olam Group Ltd**. identifying biodiversity as a material topic and joining the early TNFD adopter list and **ICL Group Ltd**. demonstrating board oversight of biodiversity-related risks. The momentum in nature-related disclosure is likely driven by both regulatory mandates, such as the Corporate Sustainability Reporting Directive, and the growing focus on TNFD recommendations by companies.

### Universe Changes

During this quarter, **Sime Darby Plantation Bhd.** case and all related information has now been transferred to **SD Guthrie Bhd.**, due to the company rebranding.

### Company Selection

We have archived the **Costa Group Holdings Ltd.** case due to limited engagement potential, following the company's privatization and delisting earlier this year.

This case will be replaced by **Coles Group Ltd.**, an Australian food retailer. In making the final decision we also considered the current distribution of industries and geographies within our programme, as well as investor input on five shortlisted companies.

### Overview of the Proxy Voting Season

The first half of 2024 has seen a sharp increase in the number of shareholder proposals addressing biodiversity and nature related topics such as, deforestation, plastic packaging, sustainable farming practices, water management and community impact. According to Morningstar Sustainalytics' ESG Voting Policy Overlay data, shareholder proposals for these topics more than doubled from 12 in 2023 to 27 in 2024. However average adjusted support levels for biodiversity and natural capital-related proposals mirrored the general decline in support for sustainability-focused shareholder proposals, from 36% in 2023 to 22% this year.[1] Nevertheless, some nature-related themes continued to see strong levels of support in 2024. Proposals related to the management of water risks received on average 36% adjusted support, while a proposal on sustainable farming practices received 27% adjusted support in its first year of appearing on the ballot at Kellanova. In addition, proposals related to plastic packaging pollution saw average adjusted support of 24%. This indicates that biodiversity and natural capital continues to be a key area for investors, and we expect this momentum to continue, particularly with COP16 taking place later this year.[2]

### Looking Ahead: COP16

We will be attending the upcoming UN Conference of the Parties (COP16), the first biodiversity-focused conference since the adoption of the Global Biodiversity Framework. Dubbed the "implementation COP," it will evaluate progress and explore proposals to implement the Framework. Ahead of the conference, countries are expected to revise their National Biodiversity Strategies and Action plans (NBSAPs) aligning to global biodiversity goals. NBSAPs will be the primary tool to formalize the roles and responsibilities of non-state actors, such as businesses. We hope there will be a strong private sector presence at COP16, as seen at COP15, to encourage governments to strengthen their political ambition.

# Human Capital Management Stewardship Programme

The Human Capital Management Stewardship Programme continues to advance engagement through ongoing research, detailed agenda development, and in-depth dialogues. Shifting into our second full quarter of stewardship activities, the Human Capital Management Stewardship Programme continues to build capacity towards understanding and influencing human capital management practices across global industries. Following the initial company selection, we have expanded our selection to include a total of 27 issuers. Our second batch list can be found within this report. Our intention remains to expand our engagement activities to cover a total of 50 issuers in the final quarter of 2024.

The focus of the quarter has remained on establishing rapport with companies, further establishing dialogue with a new of batch companies with three intro calls held, with more scheduled for early October. Beyond this we have focused on building out engagement agenda's and further reviewing reporting as preparatory work for our full engagement dialogues. In our work to date we have observed majority of companies continue to lack detailed insights into workplace and workforce transformations driven by emerging trends, as such in our first rounds of engagement dialogues we will center engagement around understanding of the challenges faced by companies practically in further expanding upon this as a key first step. This capacity building will be key to leveraging further change.

### Looking Ahead

Our goal is to develop tailor-made change objectives for each engaged issuer, focusing on actionable and realistic engagement outcomes. This approach enables us to collaborate with companies on tangible actions, ensuring we can track and showcase meaningful outcomes from engagement. Alongside this we have been diligently working at a programme level on developing the Theory of Change (ToC) for the programme, identifying key objectives for the engagement that we will work towards, into and throughout 2025. Our theory of change allows us to set out clear outcomes and act as a framework for continued betterment of our engagement approach.

## Company Selection: Second Batch List

In the initial phase of our engagement, we are focusing on large-cap companies with large/global workforces. These organizations span the healthcare, retail, industrial, and transportation sectors, providing a broad perspective. This diversity across sectors enables us to collect insights, data, and best practices.

| COMPANY NAME | GEOGRAPHY | SECTOR |
|---|---|---|
| Anheuser-Busch InBev SA/NV | Europe | Food Products |
| AT&T, Inc. | United States and Canada | Telecommunication Services |
| BT Group Plc | Europe | Telecommunication Services |
| Compass Group Plc | Europe | Consumer Services |
| George Weston Ltd. | United States and Canada | Food Retailers |
| J Sainsbury Plc | Europe | Food Retailers |
| L'Oréal SA | Europe | Household Products |
| Royal Caribbean Group | United States and Canada | Consumer Services |
| Sodexo SA | Europe | Consumer Services |
| Target Corp. | United States and Canada | Retailing |
| Tesco Plc | Europe | Food Retailers |
| T-Mobile US, Inc. | United States and Canada | Telecommunication Services |
| Vodafone Group Plc | Europe | Telecommunication Services |
| Walgreens Boots Alliance, Inc. | United States and Canada | Food Retailers |
| Wal-Mart de México SAB de CV | Latin America and Caribbean | Food Retailers |

# Human Rights Accelerator Theme Updates

The goal of the Human Rights Accelerator (HRA) thematic engagement is to encourage companies to set and implement effective human rights due diligence (HRDD) as per the United Nations Guiding Principles on Business and Human Rights (UNGP). Ultimately, the impact to be sought is to improve in the livelihood of workers, farmers and local communities directly involved in the focus sectors -- electronics, mining, and cocoa. To this end, companies will need to implement robust HRDD that considers the operating context and root causes of their salient human rights risks. This biannual Human Rights Accelerator report covers the months from April 2024 to September 2024. This report provides an update on progress made to date with an overview of insights on KPIs. Input is also provided regarding sector-specific developments as well as challenges faced by companies. The UNPRI Advance Initiative was launched on 1 December 2022 and Morningstar Sustainalytics was selected to lead or collaborate on the following five engagements:[3]

- AngloGold Ashanti Limited (Co-Lead Investor)
- Newmont Corporation (Co-Lead Investor)
- BHP Group Limited (Collaborating Investor)
- First Quantum Minerals (Collaborating Investor)
- Freeport-McMoRan Inc. (Collaborating Investor)

Joining PRI Advance is an opportunity to have more scale and impact through collaboration with other investors. The complexity and scale of the human rights issues we engage companies on require multistakeholder collaboration. By coming together, investors get the opportunity to learn from each other and increase their leverage with the common goal of triggering greater alignment with the UNGPs –ultimately to prevent adverse impacts on people.

### Update on Engagement Efforts

Over the biannual period, which took place between April 2024 to September 2024, the Human Rights Accelerator has been engaging with 19 active companies. During this period, we exchanged 71 emails and organized 11 conference calls.

The main focus of the discussions centred around living income and wages, the prevention of forced and child labour, and operational-level grievance mechanisms. For companies in the mining sector, we emphasized their relationships with local communities, particularly their commitment to and implementation of Free, Prior, and Informed Consent (FPIC).

We have observed that participating companies are becoming increasingly open to discussing human rights issues. This trend is evident in several ways: companies are more responsive to communication, and scheduling meetings has become easier. Some have even explicitly requested our expertise and resources to support their learning. For example, one company requested additional time during an engagement meeting to gain further input on grievance mechanisms. Other companies sought our insights on forced labour indicators and examples of best practices.

### Engagement Insights

*Alignment with human rights due dilligence*

The foundation set of indicators of the HRA is around their practice of Human Rights Due Diligence (HRDD). We engage extensively with companies, discussing their commitment, implementation, and challenges regarding human rights due diligence. During this reporting period, we shared resources with companies on establishing operational-level grievance mechanisms and promoted the UNGPs' effectiveness criteria. Depending on the company's maturity, our relationship with them, and their specific characteristics, we either shared good practice examples directly during meetings, engaged in in-depth discussions with the companies or provided them afterwards.

We have observed substantial improvements across companies. Many have enhanced grievance channel accessibility, while others have improved the transparency and predictability of their mechanisms. For example, a company upgraded its reporting system to a mobile platform, allowing supply chain workers to anonymously submit grievances and receive timely updates. The platform also provides them with information on local laws and labour regulations, empowering workers to better understand their rights and make informed decisions when reporting grievances.

We have also initiated discussions on preventing forced labour in supply chains across all three sectors. While several companies recognize forced labour as a salient human rights risk, most remain confident that the likelihood of it occurring in their supply chains is low. As a result, many have not implemented robust mechanisms to identify these risks. We challenged this by sharing the comments of civil society organisations and research reports by academia. We suggested that companies reflect on and improve their practices.

*Livelihood and living income*

Supply chain mapping is a crucial indicator and the foundation for due diligence, as well as ensuring the payment of a living wage and living income. We continue to engage with companies on product traceability and urge them to adopt transparent disclosure practices.

We are witnessing slow but gradual improvements in traceability at the farm level within the cocoa sector. Companies approach this in various ways, depending on their specific business models and sizes. For example, one company provided a detailed explanation of how they prioritize supply chain mapping based on risk. Their approach involves three levels of traceability: country level, regional or subnational level, and facility level. In high-risk countries, they implement deeper traceability measures, while in countries with stronger labour law enforcement, traceability remains at the subnational level. Although this method is not without its challenges, prioritization is necessary due to the extensive size of their supply chain.

For all companies, traceability does not necessarily guarantee transparency. This is particularly evident in the electronics sector, where suppliers tend to be more technical and specialized. Companies can be reluctant to disclose information about their supply chains. Our plan is to continue understanding, challenging, and encouraging companies to enhance their disclosure practices, which can improve stakeholder relationships and boost investor confidence.

In this reporting period, we showed good practice examples and guidance, shared lessons learned in the industry and engaged in discussions about living wage and living income with companies. While there is agreement that farmers should achieve a living income, there are significant differences between the views of chocolate companies and NGOs.

Companies focus on increasing productivity, as pricing is largely driven by market mechanisms. From a business perspective, raising prices on their own and ignoring market principles is not seen as a sustainable solution to this problem. On the other hand, NGOs argue that the asymmetrical between large chocolate companies and small farmers is the root cause of issues like poverty and child labour in producing countries. Farmers are in a much weaker bargaining position, making the pricing unfair. Therefore, price is a crucial factor in addressing these problems. This fundamental difference in approach continues to create tension between companies and NGOs.

In the electronics and mining sector, the general understanding among companies is that their own staff already receive highly competitive wages. For these companies, the concept of living wages in the supply chain appears to be a relatively new and under-discussed topic in their communications with other stakeholders. Therefore, more efforts are still needed from the HRA to drive change in these two sectors.

Cocoa companies have increased their disclosure of information about their interventions and outcomes related to Child Labour Monitoring and Remediation Systems (CLMRS). The CLMRS is a systematic method used by most cocoa companies to remediate child labour. Although the implementation by companies varies, the principles are developed by the International Cocoa Initiative.2 While these programmes can effectively identify children in need and address immediate issues, achieving long-term impact is challenging, as many children return to work when their labour is needed on farms. Consequently, a more comprehensive and holistic approach is required to support the system. Cocoa companies have also expressed the need for collaboration among companies, governments, and local communities.

Companies in the electronics sector have made strides in disclosing the gender pay gap within their operations. While this is a positive development, not all companies align their understanding of the pay gap with international standards. For instance, while some companies report a gender pay gap of 15- 32%, they claim there is no pay gap, because it stems from the underrepresentation of women in managerial positions. This perspective is problematic. Although the lack of women in leadership roles may explain part of the pay gap, it does not justify its existence. We plan to provide companies with additional resources on gender equality and pay gap issues.

Engaging with communities and respecting the rights of Indigenous peoples is essential for mining companies. While companies have made improvements in identifying risks for local communities and conducting Human Rights Impact Assessments (HRIAs), there remains a significant gap in meaningful engagement with these communities.

Many mining companies believe they maintain good relationships with local communities, including Indigenous Peoples, often partnering with reputable organizations for various activities. However, they frequently face criticism for being perceived as disingenuous or not doing enough. This indicates a need for the HRA to provide more guidance and encourage better communication.

*Joint collaboration and policy change*

A slight increase has been observed during this reporting period. The main gap exists among companies in the mining sector. Despite advocacy efforts encouraging meaningful dialogue with local communities, there remains a significant disparity between what is claimed and what is practised.

Companies in the electronics sector face similar challenges in engaging with worker unions and organizations representing supply chain workers. Although most claim to have a significant unionized workforce, few have collective bargaining agreements in place, and even fewer have agreements on wage systems. This issue overlaps with our ongoing discussions on living wage, which will remain a key focus in the HRA's future engagements.

**Looking Ahead**

Over the next six months, we will continue conducting engagement activities. Stakeholder consultations, gap identification, and resource sharing will continue to support our company engagements. The overall focus is planned for each sector, while the engagement focus may be tailored to the specific needs of individual companies. For companies operating in the cocoa sector, living income, addressing child labour, and grievance mechanisms for farmers remain priority topics. In the electronics sector, the focus will be on grievance mechanisms for supply chain workers and the prevention of forced labour beyond the first tier. In the mining sector, the discussions will focus on social dialogue with unions, monitoring supply chains, implementing Free, Prior, and Informed Consent (FPIC) practices, and fostering meaningful engagement with local communities.

The HRA will be concluded in Q1 2025. The final report is planned to be issued in April 2025.

# Net Zero Transition Stewardship Programme

The Net Zero Transition Stewardship Programme continues to advance engagement with 100 companies through continuous research and engagement with issuers. Our team of experts collaborates closely with industry leaders to develop solutions aimed at achieving net zero emissions. In Q3, we successfully conducted nine calls and engaged in 305 email exchanges. Key focus areas during this period included the climate competencies of company boards, alignment of greenhouse gas (GHG) emission reduction strategies with the Paris Agreement and Scope 3 emissions accounting and reduction efforts.

We were also invited to the “Scope 3: Sharing Thought Leadership and Capacity Building in Supplier Engagement” event hosted by Schneider Electric Sustainability Business and CDP in September 2024 at Schneider’s Denmark Hub. The event featured industry speakers and provided a valuable opportunity to network with leaders, sustainability experts, and peers. Our team actively participated in discussions, sharing insights from our experiences in helping companies decarbonize their Scope 3 emissions.

### Addressing Engagement Pushback

Since the beginning of engagements within our programme, several companies (e.g., **A.P. Møller—Mærsk A/S**) have been unable to engage with us due to availability. To address this, we have sought to collaborate more effectively in joint efforts to re-engage them, demonstrating our commitment to finding practical solutions and engagement formats. While in our engagement with **Taiwan Semiconductor Manufacturing Company Limited** (TSMC), the company declined to engage with us in person, permitting only written engagement via email. We jointly contributed to the engagement agenda, ensuring that all interested parties could engage with TSMC. This approach underscored our belief that limited engagement is preferable to no engagement.

### Looking Ahead

For Q4, we have been actively organizing the first European Engagement Trip. This aims to learn firsthand about the unique challenges and opportunities faced by key European industry players. This event, scheduled for 4-7 November 2024, will give an opportunity to join in visiting company sites across Germany and Spain. Furthermore, we have been diligently working at a programme level on developing the Theory of Change (ToC) for the programme, identifying key objectives for the engagement that we will work towards into and throughout 2025. Our theory of change allows us to set clear outcomes and act as a framework for the continued betterment of our engagement approach.

# Scaling Circular Economies Stewardship Programmes

In Q3 2024, we expanded our initial selection of engagement companies from 16 to 32 companies, while diversifying our focus sectors within the automotive value chain. Our initial emphasis was on automotive manufacturers, battery and tire makers, and we have now added companies from the wider automotive value chain.

During the quarter, we exchanged a total of 123 emails with the 16 new companies and the original batch of 16. We have held introductory calls with **Aptiv Plc**, **Lear Corp.** and **Mercedes-Benz Group AG** and first substantive engagement calls with **Honda Motor Co., Ltd.**, **Mazda Motor Corp.** and **Bridgestone Corp.** We also booked calls in Q4 2024 with **Bayerische Motoren Werke AG** (BMW) and Lear Corp, while continuing efforts to establish dialogue with other companies. After a previous dialogue in 2023, **LG Energy Solution Ltd** remained responsive but declined our invitation for another round of dialogue. Given the apparent lack of significant investment exposure to the company among our clients, we will focus on other companies for now, including targeting some of LGES's industry peers, while we evaluate the next steps.

We believe it is important to coordinate our efforts with other investors and industry and civil society initiatives to ensure effective engagement efforts and avoid duplication. To this end, we have engaged with Planet Tracker and Chemsec during the quarter on their engagement programmes relating to the chemicals industry to complement our own value chain engagement. We have also connected with RISE (Research Institutes of Sweden) that runs a dedicated 'Circular Car' research and industry collaboration project in Sweden.

The average lead time to establish dialogue with engagement companies has been longer than desired. One factor in this may be the targeted companies' internal priorities. It is common among them to acknowledge the materiality of either the circular economy or a set of closely related topics such as resource circulation, pollution prevention and carbon neutrality. However, they may lack a sense of urgency to engage on the topic with investors as they perceive more long-term upside opportunity than short-term downside risk. To respond to this challenge, we will continue to follow up with companies to establish dialogue, articulating the business case for a circular economy and partnering with investors as appropriate. Furthermore, we have been developing the *Theory of Change* approach for the programme, also establishing priorities for 2025. Our theory of change allows us to define clear outcomes and acts as a framework for continuous improvement of our engagement approach.

Looking at the wider corporate landscape, in recent years we have seen some investors using the proxy voting process a means to lift waste and circularity up the list of company priorities. For example, based on data from our ESG Voting Policy Overlay team, there have been 17 shareholder proposals related to circularity in the US in the last three years. Three resolutions requesting the issuance of a plastic packaging report have passed, while nine of them have received 30-50% support. Two companies with significant petrochemical operations, **Phillips 66** and **Exxon Mobil Corp**, saw shareholder support in this range for 2022 proposals to report on a hypothetical shift in their business models from virgin to recycled plastic. We will continue to track proxy voting activity in the next year on promoting a circular economy. This may not only inform our dialogues with individual companies in the automotive value chain but may also influence their strategic thinking and internal priorities.

## Company Selection: Second Batch List

In consultation with investor clients, Morningstar Sustainalytics has selected a second batch of companies in the automotive industry to approach for engagement. The table below lists these companies.

| COMPANY NAME | GEOGRAPHY | INDUSTRY |
|---|---|---|
| Aptiv Plc | Europe | Auto Components |
| AutoZone, Inc. | United States and Canada | Retailing |
| Avis Budget Group, Inc. | United States and Canada | Transportation |
| DENSO Corp. | Asia / Pacific | Auto Components |
| Hertz Global Holdings, Inc. | United States and Canada | Transportation |
| Lear Corp. | United States and Canada | Auto Components |
| Localiza Rent A Car SA | Latin America and Caribbean | Transportation |
| Mahindra & Mahindra Ltd. | Asia / Pacific | Automobiles |
| Mazda Motor Corp. | Asia / Pacific | Automobiles |
| Mercedes-Benz Group AG | Europe | Automobiles |
| Nissan Motor Co., Ltd. | Asia / Pacific | Automobiles |
| O'Reilly Automotive, Inc. | United States and Canada | Retailing |
| Samsung SDI Co., Ltd. | Asia / Pacific | Technology Hardware |
| SK Innovation Co., Ltd. | Asia / Pacific | Oil & Gas Producers |
| Tofas Turk Otomobil Fabrikasi AS | Africa / Middle East | Automobiles |
| Valeo SE | Europe | Auto Components |

# Sustainability & Good Governance Stewardship Programme

In Q3 the Sustainability and Good Governance Stewardship Programme expanded its company pool. The number of covered issuers rose from 30 to 45. We scheduled engagement calls with **GSK Plc**, **Johnson & Johnson**, **Texas Instruments Incorporated**, and **Deutsche Börse AG** which will be held next quarter. We initiated dialogue with all newly added companies and intensified efforts to engage with previously unresponsive ones. This resulted in introductory calls with nine companies, including **Royal Bank of Canada**, **Itaú Unibanco**, and **Airbnb Inc**. We exchanged a total of 161 emails.[4]

Throughout the report we look at indicators showing engagement progress, performance, response, and milestones, additionally a summary of key markers towards our targeted Outcomes. While we also deep dive on recent global corporate governance changes aimed at attracting investors, including new rules by the London Stock Exchange, controversial changes in Italy, and proposed enhancements in Hong Kong. It also examines how **Alphabet's** dual class share structure undermines good governance by granting insiders excessive voting rights, leading to skewed vote outcomes and limited accountability.

### Looking Ahead

In the upcoming quarter, our goals are to convert the introductory calls already held into engagement calls, further enlarge the issuer scope of the programme, and look to address six issuers that have yet to be responsive (**Spotify Technology SA**, **Broadcom Inc.**, **Shopify Inc.**, **BNP Paribas SA**, **Canon, Inc.**, and **Amgen, Inc.**).

# Company Selection: Second Batch List

In consultation with investor clients, Morningstar Sustainalytics has selected a second batch of companies to approach for engagement. The table below lists these companies.

| COMPANY NAME | COUNTRY | INDUSTRY |
|---|---|---|
| AbbVie, Inc. | United States and Canada | Pharmaceuticals |
| Al Rajhi Bank | Africa / Middle East | Financial |
| Alibaba Group Holding Ltd. | Asia / Pacific | Technology Software |
| American Express Co. | United States and Canada | Financial |
| AXA SA | Europe | Financial |
| Brookfield Corp. | United States and Canada | Financial |
| Dassault Systèmes SA | Europe | Financial |
| Itaú Unibanco | Latin America and Caribbean | Financial |
| KKR & Co. | United States and Canada | Financial |
| Mizuho Financial Group, Inc. | Asia / Pacific | Financial |
| Moderna, Inc. | United States and Canada | Pharmaceuticals |
| Naspers Ltd. | Africa / Middle East | Technology Software |
| Regeneron Pharmaceuticals, Inc. | United States and Canada | Pharmaceuticals |
| SK hynix, Inc. | Asia / Pacific | Technology Hardware |

# Rising Climate Litigation: Financial Implications of Increasing Legal Action

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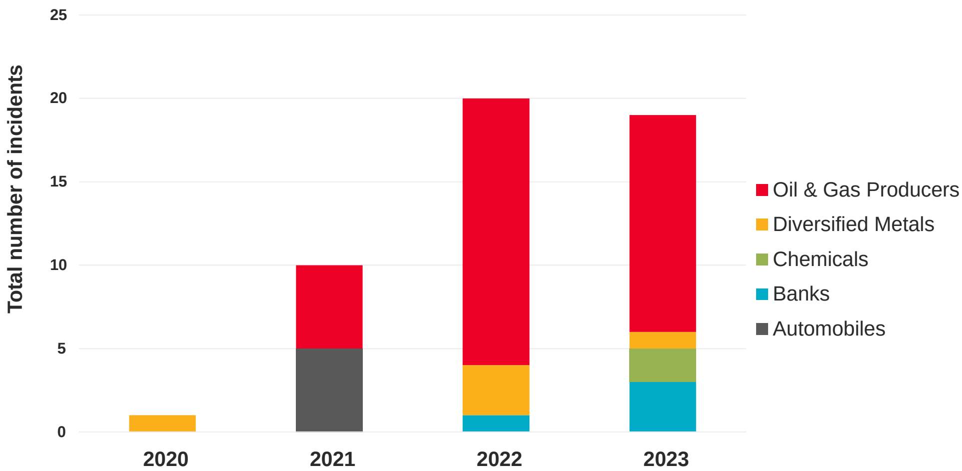
## Introduction

Growing evidence suggests that traditional climate risk analysis may not fully account for legal risks.[5] The increasing prevalence of climate litigation and enforcement actions amplifies financial risks related to climate change, extending beyond the scope of transition risks articulated by the Task Force on Climate-Related Financial Disclosures (TCFD). This article examines the trends in rising climate litigation, its impact on corporations, and the financial implications of legal risks associated with the low-carbon transition.

## Litigation is an Emerging Element of Climate Risk

The number of climate litigation cases has surged significantly over the past decade, with claimants increasingly achieving successful outcomes.[6] While governments were once the primary targets of such legal action, the 2015 Paris Agreement provided a strong framework to compel corporate climate action through the courts. Since the Paris Agreement, around 70% of climate litigation cases have been brought against corporations, reflecting a shift in how stakeholders hold companies accountable. Similarly, an analysis of Morningstar Sustainalytics data comparing the number of climate-related probes and litigation incidents between 2020 and 2023 across five heavy-emitting industries indicates an upward trend. Additionally, it shows that the degree of exposure varies by industry, with Oil & Gas Producers being the most affected (see Figure 1).

**Figure 1. Industry Comparison of Probes and Litigation Incidents Related to the Carbon Impact of Products and GHG Emissions (2020–2023)**




**Source: Morningstar Sustainalytics.** The data for this analysis was retrieved on September 10, 2024, from Sustainalytics Ratings Universe. For informational purposes only.

**Note:** Probes and litigation incidents refer to the status of allegations assessed under Sustainalytics' Controversies Research Event indicators:

**1. Carbon Impact of Products:** This assesses incidents related to the harmful environmental impacts of carbon dioxide emissions associated with the use of a company's products. For financial institutions, this may include the financing of projects or companies whose products result in significant carbon dioxide emissions.

**2. Energy Use and GHG Emissions:** This assesses incidents related to poor management or excessive release of greenhouse gas (GHG) emissions from a company's business activities.

A landmark case that may shape future litigation is *Milieudefensie et al. v. Royal Dutch Shell*, where a Dutch court ruled that **Shell** must reduce its global emissions by 45% by 2030, based on the Paris Agreement.[7, 8] While Shell's management is appealing the decision, recent court orders in the Netherlands to reduce emissions beyond the company's targets introduce additional risks in Shell's valuation associated with the energy transition. Shell has identified climate change and the energy transition as material risks based on societal concerns and developments related to climate change.[9] To achieve its emissions reduction targets, Shell proactively manages all climate-related risk components, including societal and litigation risks. The company acknowledges that evolving societal expectations may impact its license to operate, reputation, and competitive position and that litigation is perceived to be an increasing risk for the oil and gas industry. Shell notes that legal action may result in forced strategic changes, hydrocarbon divestment, regulatory permit denials, or paying fines and compensation to plaintiffs. While Shell believes these lawsuits lack merit, the company recognizes that unfavourable outcomes may have a material impact on earnings, cash flows, and financial condition.[10]

### Climate Legal Action in Reverse

In line with the global trend of increasing climate litigation against corporations, **ExxonMobil** is facing numerous lawsuits related to its historical emissions and climate change impact.[11, 12] The company acknowledges regulatory and litigation risks related to changes in environmental laws, which may increase compliance costs or delay business opportunities.[13] ExxonMobil further notes it could be adversely impacted by litigation outcomes, particularly in the US, where large and unpredictable penalties or lawsuits pushing policy changes or seeking financial gains may occur.[14]

In a surprising move, ExxonMobil has also taken legal action against activist investors challenging its climate strategy and mitigation efforts.[15] In January 2024, ExxonMobil filed a Texas federal lawsuit attempting to prevent activist shareholders from submitting future climate change proposals after they called for emissions reductions across its value chain. The lawsuit set a precedent, and some believe it could trigger a wave of corporate litigation in the reverse direction—targeting climate activists and environmentally focused investors. Despite the withdrawal of the proposal and the lawsuit's eventual dismissal, ExxonMobil faced reputational damage and financial risks, including the loss of support from the California Public Employees' Retirement System.[16]

### Climate Litigation Exposes Corporates to Financial Risk

Climate litigation poses direct threats to companies through successful lawsuits, but it may also carry broader financial implications. Exposure to litigation can lead to higher borrowing costs, subsidy cuts, stricter climate regulation with added compliance costs, and new disclosure requirements. Legal outcomes may further add complexity to mitigation and adaptation efforts of well-understood physical and transition risks. Additionally, reputational damage resulting from legal actions may exacerbate exposure to financial impacts, including reduced access to capital.[17]

Yet, little is known about the full financial impact of climate litigation on corporate value. While still a developing field, some evidence suggests that unfavorable rulings can negatively affect company valuations, with the largest emitters being the most vulnerable.[18] Such findings imply that lenders, insurers, and financial regulators should treat climate litigation risk as a material financial issue.

Climate-related litigation and its impact on the financial sector in Europe has been discussed for several years, and it was identified as an emerging source of risk for the financial sector as early as 2021.[19, 20] However, others contest that despite the rapid rise in climate-related lawsuits, uncertainty surrounding court rulings and potential costs means these lawsuits have yet to significantly affect credit quality.[21]

### Conclusion

Policymakers, investors, and companies are increasingly recognizing the need to understand climate risk exposures. However, addressing these risks effectively requires a holistic approach that integrates legal reasoning with financial analysis and climate science. The growing attention from regulators, shareholders, and investors on climate litigation underscores the importance of developing proactive strategies to minimize vulnerabilities and mitigate future exposure to climate-related legal risks.

### Case Study: Greenpeace Canada vs. Pathways Alliance

A current application by the nongovernmental organization (NGO) Greenpeace Canada to the Canadian Competition Bureau alleges that the claims made by **Pathways Alliance** (a consortium of the six largest oil sands producers in Canada) of, "actively reducing emissions and helping Canada achieve its climate targets," are false and misleading. Greenpeace Canada has asked the Competition Bureau to have Pathways remove all the representations about reducing emissions, achieving net zero, cleaning air, and combatting climate change as well as issue a public retraction of these statements and pay a fine that is the greater of $10 million or 3% of worldwide gross revenues to organizations for the rehabilitation and clean-up of oil sands production.[22]

# Engagement Techniques: Appreciative Enquiry

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### Introduction

Successful engagement is built on trust. For companies to meaningfully respond to our advances, to embed our recommendations and then create lasting strategies, they need to recognize the value in what we are bringing to them. It should not be a 'one way street' of the company providing responses to our queries, this being the conventional approach. Building trust requires consistency and honesty and needs to show mutual respect. To achieve this, we adopt a palette of techniques with one powerful approach being the use of *Appreciative Enquiry (AE).*

*Appreciative Enquiry* is identified as a transformative assessment approach focusing on identifying and leveraging an organization's strengths and successes. It was developed by David Cooperrider and Suresh Srivastva during the 1980s at Case Western Reserve University.

Unlike traditional problem-solving methods that concentrate on identifying and fixing issues, *AE* seeks to uncover what works well and build upon it unlocking positive change that may have become 'trapped' in less positive actions. This strengths-based approach has been shown to lead to profound changes in organizational culture, employee engagement, and overall performance.[23]

### Facilitating a New Conversation

*Appreciative Enquiry* is a collaborative and constructive process. The very nature of the collaborative approach makes it an ideal tool for use in engagement, from one-on-one discussions to round tables and webinars. By talking about the strengths of the company and repeating these strengths across the scope of the engagement, positive attributes and actions are cemented. This is especially relevant when we want to create a dialogue around controversial or sensitive topics that may be challenging for the company to discuss openly. *Appreciative Enquiry* is based on the premise that organizations grow in the direction of what they consistently ask questions about and focus on. Through our engagement we can influence both the tone and content of those questions by facilitating a new dialogue. Importantly *AE* fosters a culture of continuous improvement and innovation by emphasizing positive potential and possibilities.

### Delivering Appreciative Enquiry

Adopting appreciative enquiry is not technically demanding but it does help to understand and deliver using the 5D's framework below:

- Define: Establish the focus of the enquiry. This involves identifying the topic or area that the company should want to improve—this may be the delivery of quality improvement processes, improved health and safety, or an awareness of what is strong 'culture'. This is what we want the company to achieve through the engagement.
- Discover: Gather stories and examples of when the company was at its best. This stage involves engaging stakeholders to share their experiences and insights and sits very comfortably into the engagement approach. This is a key part of the trust building, where we seek the company's view on what it thinks it does best and highlighting to them where we have identified its strengths. This does not necessarily have to be linked to the controversy but can be used to show that the company can deliver good practice.
- Dream: Envision the future by imagining what the company could achieve if it builds on its strengths. This is the 'new' more resilient company, one that for example understands how to deliver effective and meaningful human rights commitments.

- Design: Develop concrete plans and strategies to achieve the envisioned future. This involves co-creating actionable steps and initiatives and is the strategy that we want the company to adopt to get to the ‘dream’. This is where we can employ our palette of engagement techniques—best practice, peer recognition, sector intelligence. We can co-create the strategy.
- Destiny/Deliver: Implement the plans and monitor progress. This stage focuses on sustaining the momentum and ensuring that the positive changes are embedded in the organizational culture. Culture change is one of the more challenging aspects of our engagements but in many instances is necessary to ensure sustainability and build resilience.

### Conclusion

Our engagement outcomes seek to build lasting positive change in companies, to build their resilience confirming them as good corporate citizens. The logic-led approach we adopt in creating our outcome strategies using *theory of change* lends itself effectively to delivering a range of engagement techniques that probe the company at every level and offers recommendations to strengthen performance.[24] *Appreciative Enquiry* is a tool that takes as its basis the strengths of the company and uses those strengths to develop a strategy to deliver change. The collaborative nature of the framework is an idea for developing robust engagement opportunities and allows us to build the necessary trust with the company.

# Have You Ever Felt Like Your Phone Was Listening to You?

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If you have ever wondered whether your phone was listening in on your conversations to be able to serve you ads, then you have, essentially, been asking whether your privacy has been violated. Most tech companies will tell you that their privacy policies prohibit listening to users' conversations, but it is an open question whether users believe that to be true. A report from the Pew Research Center noted that 77% of Americans do not see social media executives as trustworthy when it comes to taking responsibility for data misuse.[25] It is not hard to infer an expectation from users that their data will be misused by the companies to which it has been entrusted.

Choice and control are critical to the concept of privacy. Privacy does not necessarily refer to secrecy. Instead, it refers to a user's ability to make informed choices about how their personal information is being collected and used. Privacy, in its most basic sense, may be the right to be left alone, but in the age of the Internet, privacy is more about giving each of us the ability to choose where our information goes, to know how it will be used, and to correct what is incomplete or inaccurate. It is also about safeguarding our information, not just while it is at rest in databases and servers, but also while in transmission.

Privacy has both a psychological component, as well as a regulatory/legal component. The feeling that an app you are using may be using your data for purposes you did not consent to or do not understand? That's the psychological component. It gets much more sinister when totalitarian governments and 'despotic' regimes that are willing to use force and coercion to control their populations are in the mix.

Elsewhere, privacy is well represented by international standards and regulation. The European Union's General Data Protection Regulation is the reference point for many privacy rules. It influences privacy practice among issuers even in nations that do not have a similarly strong standard. The ESG community will be familiar with the UN Declaration of Human Rights, wherein privacy is recognized as a fundamental right. It is also included in the International Covenant on Civil and Political Rights, the OECD Guidelines for Multinational Enterprises, and in many other international and regional treaties.

So why do investors and companies care about privacy? Privacy, when not adequately respected, raises reputational, legal, and regulatory risks for companies. One only needs to take a short trot through recent headlines to see where data, and so privacy, are at play.

- In Europe, the Irish Data Protection Commission (DPC) announced it would investigate whether Google acted appropriately before it began processing personal data of European subjects in its PaLM 2 large language model.[26] This news comes only a couple of months after Meta halted its plan to train its AI on data from users in Europe and the UK after the Irish DPC and UK Information Commissioner's Office raised concerns around user consent.[27]
- PricewaterhouseCoopers (PwC) announced it would begin surveilling its UK employees in an effort to force them back to the office.[28] The move raised questions regarding erosion of employee wellbeing and loyalty, as well as privacy questions over how PwC might conduct the surveillance and to what extent location data will play a role.[29]
- Finally, in Canada, a federal appeals court reversed an earlier decision and found that Meta had not adequately informed users about privacy risks when signing up to the Facebook social platform.[30]

That's just a select few from the beginning of September 2024.

Privacy, as an issue, can be somewhat ethereal and exist in the abstract. However, when things go wrong, it can have very tangible impacts on citizens, including identity theft, censorship, or online bullying, as well as on issuers, in the form of fines, restrictions on business strategy, or reputational damage. Society's reliance on digital applications is only set to grow. We would do well to ensure our understanding of, and respect for, privacy matches that growth.

# A Field Trip to SD Guthrie's Plantation in Malaysia

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SD Guthrie Berhad (SD Guthrie), formerly known as Sime Darby Plantation Berhad, is one of the world's largest producers of certified sustainable palm oil. Serving customers in over 90 countries, SD Guthrie has business presence in 12 countries with over 84,000 employees worldwide. With a total planted area of almost 600,000 hectares, its upstream plantations are spread across Malaysia, Indonesia, Papua New Guinea and the Solomon Islands. Downstream, SD Guthrie has 11 refineries in seven countries with a total refining capacity of approximately four million metric tons, as well as other plants and sales offices across 11 countries in Asia, Oceania, Europe, Africa and the United States of America (USA).

**Figure 1.** Picture of fresh oil palm.

Morningstar Sustainalytics has been in dialogue with SD Guthrie for more than five years, focusing on various environmental, social and governance (ESG) matters such as human rights, climate change and biodiversity. We have seen many positive initiatives in various ESG areas by the company. The senior executives we engage with at SD Guthrie provide honest, transparent and detailed responses to our enquiries and are willing to receive feedback and further insights from Morningstar Sustainalytics. This March, we conducted an engagement trip to SD Guthrie's Palm Oil Experience Center on Carey Island, Malaysia, where we had in-depth conversations with SD Guthrie's experts regarding its net zero journey and nature conservation efforts. The following section provides a glimpse of our engagement dialogue.

**Figure 2.** Group photo with SD Guthrie, investors and Sustainalytics at SD Guthrie's Palm Oil Experience Center.

**Morningstar Sustainalytics:** *SD Guthrie announced its Net Zero Roadmap at the beginning of 2023 with comprehensive action plans across Scopes 1, 2 and 3. In December 2023, SD Guthrie's near-term and long-term climate targets were approved by SBTi, making it the world's first palm oil company with validated reduction targets for emissions from 'Forest, Land and Agriculture' (FLAG) as well as energy and industrial sources. Can SD Guthrie share its experience from the decarbonization journey? What are the key challenges and opportunities?*

**SD Guthrie:** We started our decarbonization journey much earlier than other companies. Twelve years ago, while other companies were just beginning to calculate their carbon footprint, we had already established Scope 1 and 2 baseline emissions with a 40% reduction target from the 2009 baseline. But we also recognized that addressing Scope 3 emissions generated from third-party suppliers or others in the value chain, presented the greatest challenge in our net zero journey. As a vertically-integrated company, SD Guthrie needs to fully gauge the extensive supply chain to develop a carbon baseline, addressing emissions from the entire value chain comprehensively. Besides our internal project team coordinating tasks in a timely manner, we also engage with external advisors for technical guidance, scenario analysis and SBTi requirements. Of course, there are challenges along the way, but we continuously work on enhancing processes to overcome obstacles. One major challenge is collecting and managing emissions data from third party supplying estates, as not all suppliers measure their emissions, and their methodologies may differ. To address this, we are enhancing our supplier engagement approach and aim for collaborative efforts with suppliers. In addition, we continue to explore opportunities to work with financiers to develop incentives that motivate suppliers towards sustainable practices, especially small and medium enterprises (SMEs).

**Figure 3.** Meeting with SD Guthrie team.


**Morningstar Sustainalytics:** *As the first palm oil company to have its emission reduction targets validated by the SBTi, including the FLAG requirement, what key learnings would SD Guthrie like to share with its industry peers?*

**SD Guthrie:** The industry should concentrate efforts on reducing emissions from key sources, such as peat drainage, indirect land use change, palm oil mill effluents (POME) and field emissions, to make a meaningful impact on climate change collectively. In the oil palm industry, there are several opportunities we can leverage. For example, one key area is eliminating deforestation throughout the supply chain and ensuring no new development on peatlands. To achieve this, SD Guthrie works closely with suppliers to ensure they are also committed to No Deforestation, No Peat and No Exploitation (NDPE). Additionally, the industry should look into land transformation to enhance land use, such as reforesting unproductive areas to increase carbon sinks and implementing effective solutions to manage emissions from peat areas. To address emissions from POME, companies should consider using methane capture to reduce emissions. SD Guthrie is happy to connect with peers and share our practices with a wider group.

**Figure 4.** SD Guthrie's R&D colleague presenting on using natural predators to combat pests in the plantation.


**Morningstar Sustainalytics:** *You mention land transformation as a key approach to achieve net zero. Does SD Guthrie consider biodiversity while conducting land transformation?*

**SD Guthrie:** Yes of course. This is connected to SD Guthrie's Conservation and Biodiversity Approach (CBA) with three key steps: Protect, Restore and Connect. The land transformation strategy expands existing restoration and conservation initiatives. SD Guthrie's approaches include reforesting non-productive agriculture land and large-scale tree-planting as a nature-based solution to increase carbon sinks.

Under the company's CBA initiative, which was launched in 2021, we determine whether a particular site within our operations needs to be protected, restored or connected with other important landscapes, and draw up appropriate action plans:

i. Protect – We use this approach for areas that are in good condition and have the potential for conservation. These could be areas that have been untouched and require less maintenance, depending on their present condition/quality.

ii. Restore – This approach is used for areas that require intervention in order to increase the conservation and biodiversity values. Our focus in these areas will be on ecological services such as ensuring erosion control and waterways' health and quality.

iii. Connect – This is for areas that have the potential to be connected with important habitats landscapes and ecosystem. Our focus in these areas will be on creating corridors/connectivity/stepping stone and extension to such habitats and ecosystem.

**Morningstar Sustainalytics:** *Can SD Guthrie provide some examples of how it is managing the conservation areas? What kind of natural conservation efforts is/has SD Guthrie been working on?*

**SD Guthrie:** To provide a broader picture, the total conservation areas in SD Guthrie make up about 8.16% of our total planted area, with over 2.28 million trees planted as of 31 December 2023. For example, we initiated a Plant A Tree Programme in 2007 to support our commitment to conserving the environment and ecosystems, increasing biodiversity values in plantations and preserving rare, threatened and endangered (RTE) forest species of trees in Malaysia. The programme is implemented in various estates, each with different objectives, such as connecting forest patches, preserving wildlife habitats and creating a gene bank for rainforest trees and RTE species. SD Guthrie not only plants trees but also ensures the areas are maintained over time. In an effort to better monitor the success of our reforestations projects, we have also initiated efforts to geo tag the individual trees planted. Besides our own initiatives, we also collaborate with other corporates, governments, academia and NGOs in a diverse range of projects, such as mangrove rehabilitation, peatland rehabilitation, carbon sequestration initiatives, rehabilitation of orangutan habitats and managing human-wildlife conflicts. In 2023, we established our Biodiversity Policy, supporting the principles of our Responsible Agriculture Charter where we follow standard operating procedures (SOP) and national guidelines for managing conservation set-aside and biodiversity areas.

**Figure 5.** The owl is a natural predators to catch rats in the plantation.

**Morningstar Sustainalytics:** *How can SD Guthrie balance the needs between biodiversity and carbon sequestration, given that the species needed for biodiversity might not be the same as those for carbon sinks?*

**SD Guthrie:** Our approach to conservation and biodiversity takes into consideration the landscape and local conditions. Usually, trees that are harder to grow are better for carbon sequestration. Our current approach considers multiple factors based on the context of each project location. For example, we work with the Forest Research Institute Malaysia (FRIM) who provides advice on suitable tree species that will enhance biodiversity in a certain area. FRIM also provides us with seedlings for certain trees, particularly those which are rare, threatened and endangered as well as native and endemic species. We also explore the benefits of planting fast-growing trees. So, it's a combination of both and we strive to plant the native species in any particular locations.

**Morningstar Sustainalytics:** *How does SD Guthrie handle human-wildlife conflicts in plantations? What conflicts does SD Guthrie encounter and what are the solutions?*

**SD Guthrie:** One primary reason for the increasing instances of human-wildlife conflict is the loss of habitats due to human activities such as urbanization and agriculture. Habitat fragmentation and degradation, particularly affecting apex species such as elephants and tigers, are the consequences of converting natural forests into human-dominated land use, which heightens the risk of confrontations between humans and these animals. Additionally, wild boar and macaques have been noted to damage oil palm fields, causing crop loss and property destruction. We have taken proactive steps to manage human-wildlife conflicts within our operations through a standard operating procedure (SOP) aimed at managing such conflicts responsibly and effectively. The overall objectives of human-wildlife conflict management in SD Guthrie is to increase awareness of wildlife conservation among our employees, societies, and operational stakeholders, and to set the standard for human-wildlife conflict management best practices, aiming for human-wildlife co-existence within our operations. More information about the SOP can be found on SD Guthrie's website at www.sdguthrie.com.

**Figure 6.** Tree planting effort in a conservation area.

**Figure 7.** We visited SD Guthrie's biodiversity park on Carey Island which preserves various native wildlife.


In summary, the engagement trip allowed us to talk face to face with experts on SD Guthrie's sustainability journey and better understand the challenges within the context the companies operates, as well as strengthing our dialogue. We were able to see on the ground conservation efforts on Carey Island and listen to its conservation and biodiversity approach. The company values transparent dialogues between itself and investors and sees how it can lead to constructive improvements on ESG matters. It also appreciates feedback from us on investor expectations and insights on latest developments in leading sustainable practices.

Our continued engagement in the short term will look at SD Guthrie's pilot water risk assessment and in the longer term examine the company's public disclosures on setting targets for its most material impacts and risks ensuring that they are realistic, achievable and measurable in order to mitigate its biodiversity-related risks.

# The Role of the Board of Directors: Overseeing Human Capital Management and AI Integration

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In today's fast-paced business world, the Board of Directors must prioritize overseeing human capital management and AI integration.[31] Effective oversight ensures that AI initiatives align with the company's goals and that workforce impacts are managed ethically. Boards should be able to explain how the business integrates AI and the potential risks and impacts on the workforce, including job displacement, changes in job roles, and the need for new skills.[32] There are two key aspects critical when assessing Board oversight: talent strategy and workforce satisfaction, and ethical AI integration.

### Talent Strategy and Workforce Satisfaction

Investors are increasingly concerned about whether companies have the right people and skills to execute their business strategies. The EY Center for Board Matters highlights that two-thirds of investors prioritize talent strategy over issues like climate change.[33] In today's complex environment, the integration of AI and other technologies makes talent management increasingly complicated. There is no one-size-fits-all solution to address AI's impact on the workforce. A crucial element of this strategy is ensuring that boards understand and enhance employee experiences. This involves maintaining open engagement with the workforce and leveraging data and AI to demonstrate progress. The UK Corporate Governance Code 2024 recommend practices such as including employee representatives on boards, creating specific committees, or assigning a non-executive director for employee engagement. These measures ensure that workforce satisfaction is addressed at the highest levels of governance, which is key to effective AI integration and managing its impacts on workflow.[34]

### Ethical AI Integration

Companies should be aware that AI development it not impervious to biases and so AI systems must be consciously set up in a way that can limit ethical risks and bias potential. The process must be transparent.[35] Boards must oversee the integration of AI into core business goals and processes, ensuring that AI is used responsibly and ethically. This includes implementing specific governance structures to oversee AI initiatives across the business.[36] Moreover, boards must ensure that the company maintains a human-centric approach by understanding the potential impacts of AI on the workforce. This involves preparing employees to work alongside AI technologies effectively and ethically. Ethical AI integration also requires continuous monitoring and adaptation to new developments and potential risks.

### How to Assess a Company's Progress on This Topic?

Each Outcome within our Outcome Assessment framework has an established Best Practice Definition setting our expectations for any company we engage with. The Governance Outcome looks at effective Board oversight in talent management and AI integration. As part of our engagements with companies, we will look for:

1. Clear ESG Governance Practices: Establishing clear roles and responsibilities for overseeing human capital management.
2. Specific Governance Bodies: Implementing committees or task forces to oversee and ensure alignment of the human capital management strategy with business goals. It is also critical to understand how the Board receives training on this topic or plans to expand its level of expertise by adding new members.
3. Performance Oversight: Providing detailed information on board oversight of human capital strategies, ensuring alignment with business objectives.
4. Accountability Mechanisms: Linking executive compensation to human capital-related metrics that promote a healthy, engaged, and productive workforce.

The Board of Directors' oversight of human capital management and AI integration is vital for a company's success.[37] By prioritizing ethical AI practices, developing workforce skills, and ensuring transparent reporting, boards can drive sustainable growth and foster a productive workforce. Accountability through long term and short term incentives are also essential to ensure that companies are held accountable to delivery of long term strategy and objectives. For investors, understanding these aspects provides crucial insights into a company's long-term viability and strategic direction as well as confidence that companies are effectively addressing related risks to long term value.

# As Governments Advance, the Net Zero Paradox Unfolds

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Since late 2023, the number of predominantly United States (US)-based investors leaving Climate Action 100+ (CA100+) has risen.[38] In August 2024, Goldman Sachs left and joined the ranks of JPMorgan, State Street, Pimco, and Investco, who left several months earlier.[39] Additionally, BlackRock reduced its involvement with the group and transferred its membership in CA100+ to BlackRock International.[40] Although CA100+ remains a strong network of over 600 global investors across 33 markets, the disposal of vast amounts of capital and the departure of prominent US-based investors have to some extent impacted this network.[41]

The leaving parties justified their abandonment, citing fiduciary duty and potential legal risks as the main reasons. Moreover, arguing that the CA100+ Phase 2 (20232030) initiative could expose them to legal challenges, especially regarding their responsibility to act in the best interest of their clients. Phase 1 (20172022) of CA100+ focused on engaging with the world's largest corporate greenhouse gas (GHG) emitters to improve climate-related disclosures and commitments to net zero emissions.[42] Phase 2 shifts the focus from disclosure to implementing climate transition plans, aiming to drive tangible actions and results by 2030.[43] Phase 2 will further challenge investors primarily due to the increased focus on implementing climate transition plans. This phase requires companies to take tangible actions to reduce greenhouse gas emissions, which can involve significant upfront costs and operational changes that impact short-term profitability and create uncertainty in financial performance.[44]

Political pressure also plays a role. Several prominent Republican politicians in the US are actively campaigning against companies that pursue environmental, social, and governance goals, labeling them as anti-American.[45] This political backdrop further complicates the issue, making it more challenging for financial institutions to publicly align with climate initiatives without facing backlash.

Scaling down net zero ambitions has also been a trend seen with companies. Nestlé backtracked on its net zero target.[46] In July 2024, New Zealand Airlines became the first major carrier to drop its climate goal, naming the high price and non-safe availability of Sustainable Aviation Fuels as the main reasons.[47] BP has reduced its climate targets following a surge in record-breaking profits.[48] Meanwhile, Microsoft's expanding data center network, driven by the AI boom, has hindered its sustainability goals. In fiscal 2023, supply chain emissions rose by 30%, partly due to the infrastructure needed for generative AI.[49] BP and Microsoft are both engaged in the Net Zero Transition Stewardship Programme. The engagement with Microsoft centered on examining leadership competencies on climate change, integrating GHG reduction metrics into executive compensation, and accountability mechanisms. BP declined to engage with Morningstar Sustainalytics.

While some major companies and investors are retreating from their net zero goals, there is a notable push in the Organization for Economic Co-operation and Development countries (i.e., the European Union, the United Kingdom, the United States, New Zealand, South Korea, Australia, and Japan) to solidify these commitments into binding legislation.[50] This shift towards legal enforcement reflects a growing acknowledgment of the need to hold entities accountable and ensure tangible progress in reducing GHG emissions. Investors such as JPMorgan, State Street, Pimco, Invesco, and Goldman Sachs exiting CA100+, along with companies like BP, Microsoft, New Zealand Airlines, and Nestlé reducing their net zero ambitions, might encounter difficulties as legislation comes into force. Net zero is still a vital national strategy for combating climate change in their respective countries, and this could result in regulatory and reputational risks as these nations persist in enforcing strict climate regulations.[51]

The net zero trend highlights a complex dynamic between government policies and market behaviors. While many governments worldwide push forward with ambitious net zero targets to combat climate change, markets are retreating in some cases. However, this is not a trend that characterizes the entire market. There are still investors and companies actively pursuing net zero goals. CA 100+ still has over 600 investors engaging companies to improve climate change performance. Air Liquide, a multinational company that supplies industrial gases, has developed and commercialized Cryocap technology that captures and purifies carbon dioxide ($CO_2$) emissions. Air Liquide and Holcim have partnered to decarbonize Holcim's new cement production plant in Belgium. Using Air Liquide's Cryocap carbon capture technology, they aim to capture up to 95% of $CO_2$ emissions from the facility.[52] Holcim and Air Liquide are engaged in the Net Zero Transition Stewardship Programme.

This paradox unfolds as regulatory frameworks and incentives drive green initiatives while economic uncertainties and fluctuating investor confidence cause some market segments to pull back. Considering the challenges these investors and companies may encounter due to their changes in net zero commitments, it is crucial for them to adeptly navigate the evolving regulatory environment and align their strategies with current climate policies to mitigate risks and sustain their market positions.

# A Public Policy Perspective on Corporate Efforts to Build a Circular Economy

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A key aspect of our engagement is assessing how companies are navigating the evolution of key policies, particularly in the EU, which is fertile ground for public policy interventions on sustainability. We have heard from both European and non-European companies that European regulation has been dictating their reporting priorities to a significant extent.

The EU taxonomy for sustainable activities is a classification system that defines criteria for economic activities that are aligned with a net zero trajectory by 2050 and broader environmental goals, including the promotion of a circular economy.[53] The taxonomy came into force in 2020 and is aligned with objectives of the European Green Deal.[54]

Subsequently, the Corporate Sustainability Reporting Directive (CSRD) was adopted, requiring companies to report on their sustainability performance in line with the EU Taxonomy.[55] The directive requires large companies in its remit to submit their first reports by January 2025, with the European Sustainability Reporting Standards (ESRS) providing the reporting framework and methodology for CSRD compliance.[56] The directive also requires a double materiality assessment, which helps companies determine which of the individual standards of the ESRS are relevant to them.

The ESRS includes a standard specific to resource use and circular economy (ESRS E5).[57] It establishes accountability regarding companies' circular economy-related initiatives, targets and performance. Companies in scope of ESRS E5 are those involved in 'key products' under the EU Circular Economy Action Plan, including electronics and ICT, batteries and vehicles, packaging, plastics, textiles, construction and buildings and food, water and nutrients.[58] Prescribed reporting metrics cover the total weight of resource in- and outflows (also accounting for waste) as well as renewable and recycled content, and the volume and proportion of a company's products with circular design. The standards are mutually reinforcing, as, for example, the circular economy is connected to water, carbon and biodiversity.

Given the initial focus of this Thematic Stewardship Programme on the automotive value chain, it is worth considering the implications of two other pieces of European regulation. The first is the Directive on End-of-Life Vehicles, which has been in place since 2000.[59] The directive aims to reduce waste by setting clear targets for the reuse, recycling and recovery of end-of-life vehicles (ELVs). The directive mandates that at least 85% of the weight of each ELV is recycled and another 10% incinerated with energy recovery. The export of ELVs is already banned but proposed improvements to the directive will set minimum quality standards for cars before end of life to qualify for export.[60] The proposal will also add a target of 25% recycled plastic in new cars by 2030.[61] Our first engagement calls have shown that the industry is already responding to this requirement by working on their own recycled content commitments. As our dialogues progress, we will ask engaged companies to clarify whether and how their own targets extend beyond regulatory compliance.

The European Battery Regulation came into force in 2023 and over time builds up requirements on companies in relation to batteries. It starts with disclosure requirements, first regarding battery health (2024), then carbon footprint (2025), material recovery (2027) and recycled content (2028). It will also gradually introduce various performance classes, along with maximum carbon footprint limits. In our dialogues, we have heard from various car makers that they have already invested in 'battery passports' (linked to QR codes on batteries providing access to detailed information) and made use of a collaboration platform to improve supply chain traceability.[62] Some examples of pioneering non-profit or commercial organizations promoting better sustainability and traceability are Battery Pass, Global Battery Alliance, Everledger, Minespider and MOBI.

Turning to global legal frameworks, we note that in 2022 the UN Environment Assembly created an Intergovernmental Negotiating Committee (INC), which aims to establish an international, legally binding instrument on plastic pollution, addressing the full life cycle of plastic, including its production, design, and disposal. Its ambition is to complete the negotiations for a UN treaty by the end of 2024. Reportedly, much more progress is needed to gain sufficient support for globally binding rules and coverage of the full life-cycle of plastics, which would not only reduce waste but also plastics production and restrict chemicals of concern. We may encourage engaged companies to advocate in their public policy engagement for measures aligned with the Treaty that are both ambitious and attainable. We may also highlight collaborative initiatives committed to addressing plastic waste and pollution, such as the Business Coalition for a Global Plastics Treaty, national and regional Plastics Pacts, and the Circular Plastics Alliance in the EU.[63]

We consider that these European and global policy initiatives create risks for automotive companies in terms of compliance costs and legal penalties, as well as opportunities, such as product innovation and enhanced reporting. We will review the development of these frameworks and encourage companies to respond to them proactively.

# Corporate Governance Global Developments

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### Markets Announce Corporate Governance Changes in a Bid to Attract Investors

There has been a global decline in Initial Public Offerings ("IPOs") with the market contracting 8% in volume and 33% in proceeds compared to the previous year, according to EY.[64] As a result regulators and lawmakers have taken steps to boost attractiveness by making the listing process smoother and more accessible for companies looking to raise capital in the public markets. In parallel, changes to corporate governance requirements have been announced across a range of markets aimed at improving transparency of practices and helping investors to make informed decisions, thereby making markets more appealing.

### London Stock Exchange Implements New Rules to Boost Growth and Competitiveness

The London Stock Exchange ("LSE") underperformed the global IPO market last year, with only 23 issuers listing, a 49% drop from 2022.[65] Notably, London failed to convince Cambridge-based chip designer Arm Holdings to opt for it for its IPO. The company, which had been listed both on the LSE and Nasdaq before being acquired by Softbank in 2016, opted for a New York listing instead, which became the year's largest.[66]

In a bid to become more attractive and boost growth, the UK has recently simplified the listing regime on the LSE to better align it with that of competitors in Europe and the US. The new listing rules introduced by the financial services regulator, the Financial Conduct Authority ("FCA") came into force on July 29, 2024, and represent the most significant change to the UK's listing regime in 30 years.[67]

One of the changes, which aims to reduce the complexity and streamline the listing process, is the creation of a single listing segment, the "commercial companies" listing category, that replaced the former "premium" and "standard" listing segments. All firms in the commercial category, irrespective of their size, will have to adhere to the same standards of corporate governance and transparency. All firms in the category will have to report on a comply or explain basis in respect of the provisions of the UK Corporate Governance Code. Additionally, companies will have to provide annual disclosures on diversity of boards and climate-related matters consistent with the Task Force on Climate-related Financial Disclosures.

While some of the requirements previously mandated for the premium listing segment have been relaxed, for example, shareholders no longer need to approve related party transactions, the FCA will continue to require shareholder votes for reverse takeovers and cancellations of listings, which are seen as providing protection to investors.

Perhaps most notably, the FCA has relaxed the requirements for listing of companies with dual class structures. The measure is intended to make London as attractive as the stock exchanges in the US where such dual class structures are common, mostly in tech companies. While natural persons, such as directors and founders, will be able to maintain their enhanced votes for an unlimited period of time, the regulator has imposed a 10-year sunset clause on the enhanced votes of pre-IPO institutional investors.

### Italy Adopts Controversial Corporate Governance Changes

Italy has changed legislation regarding multiple voting shares this year. Specifically, companies can assign up to 10 votes for each multiple shares, an increase from a maximum of three previously allowed. These multiple-vote structures allow certain investors to hold significant or controlling stakes in companies without having the same economic exposure.[68] Also, the voting rights that can be attached to loyalty shares can now go up to 10 from only two allowed by previous legislation.[69] Loyalty shares are a way of incentivizing long-term investors who have held company shares for at least two years. The new legislation is aimed at increasing the competitiveness of the Italian capital market and is expected to prevent companies from listing or moving to less restrictive markets.

In addition, Italy has also changed rules related to electing board directors,[70] a move that has attracted criticism for further complicating its already unique system.[71] According to the new rules, the outgoing board may propose a slate of directors which should include one third more candidates than the number of available board seats. Additionally, a second vote should be held on each candidate if the slate proposed by the outgoing board obtains the highest number of votes. The International Corporate Governance Network (ICGN) has recently expressed its concern regarding the change pointing to its increased complexity and potential disproportionate representation of shareholders on the board.[72]

### Hong Kong Moves to Enhance Corporate Governance Code and Listing Rules

The UK and Italy are not the only markets to implement changes in corporate governance rules. In June, the Hong Kong Stock Exchange published a consultation paper outlining proposed enhancements to the Corporate Governance Code and related Listing Rules.[73] The proposed amendments would upgrade Hong Kong's corporate governance framework by strengthening board independence and effectiveness and promoting gender diversity.

The changes, which are still subject to amendments based on responses received during the consultation period, will come into effect as of January 2025 and should apply to both main board-[74] and GEM-[75] listed companies.

One of the proposed changes to the Corporate Governance Code is to require issuers to designate a lead independent director for boards that are chaired by non-independent directors to facilitate communication with investors and provide leadership in situations where the Chair may be conflicted. Similar provisions are included in codes in other jurisdictions, on a voluntary or comply or explain basis, such as the UK or Singapore.

The stock exchange has also proposed that the listing requirements require all directors of the listed issuers to participate in mandatory continuous professional development annually.Additionally, the new rules would put a cap on the tenure of independent directors. The stock exchange will no longer consider a director to be independent if they have served on the specific board for nine years. The proposed listing rule is aligned with similar regulations in Europe or Asia, where such provisions are included either in the Corporate Governance Codes or local regulations.

The proposals also promote diversity, both at a board and workforce level. Currently, issuers' boards are required to appoint at least one director of a different gender. The proposals go further, proposing a gender diverse member is appointed to the nomination committee. Additionally, issuers should disclose a diversity policy for their workforce, including senior management.

### Conclusion

While some of the announced changes may enhance corporate governance practices and other may deviate from best practices, such as the relaxation of "one share, one vote" principle, they all serve a common goal: to stimulate IPOs in a challenging environment and align with more competitive markets.

# How Dual Class Shares Structures Undermine Good Governance: The Alphabet Case

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The principle of "one share, one vote" is a cornerstone of good governance, ensuring that shareholders have a voice, proportionate to their economic interest, on important issues brought to vote during a company's annual shareholder meeting. By granting company insiders voting rights in excess of their economic interests, dual class share structures violate this principle.

Tech companies have been commonly funded through dual class share structures, with many continuing to offer unequal voting rights much after their IPO. There are currently three tech companies in the S&P 500 index that follow a dual class share structure. Alphabet, which is part of the Sustainability and Good Governance program, is one of them.

Multiple-class share structures typically involve two classes of shares, where one share class, held by company founders, founding families and executives, holds superior voting rights with respect to a subordinate share class that is held by minority shareholders. In Alphabet's case, Class B shares grant insiders ten votes per share on every matter brought to the ballot, including director elections, compensation approval, and all other management- and shareholder-sponsored resolutions.

This arrangement presents risks by weakening two core principles of good governance: accountability and alignment. The separation of voting and economic interests among share classes both limit minority shareholders' ability to hold management accountable, but also management's ability to align with shareholder's interests.

Through significant ownership of Class B shares, Alphabet's founders, Larry Page and Sergey Brin, collectively control 52% of the voting power despite collectively owning only 6% of the company's economic value, as seen in the table of beneficial ownership in the 2024 Proxy Statement.

### Shareholders Concerned Over Pay Practices

Alphabet's dual class share structure skewed vote outcomes during the company's 2024 Annual General Meeting (AGM).

Looking at votes to approve director elections, Alphabet reported that all candidates were elected at its 2024 AGM to serve for a one-year term until its 2025 AGM. No directors received below 80% support. Adjusting to exclude Larry and Sergey's voting powers conveys a different picture. Only 58% of non-affiliated shareholders voted in favour of the re-election of John L. Hennessy for his 7th term as Chair of the board of directors. Hennessy previously served as Alphabet's Lead Independent Director during the period 2007-2018. This compares unfavourably to the S&P500, where chairs received 96% support, on average, during the 2024 proxy season, according to EY.[76]

Similarly, members of Alphabet's Leadership Development, Inclusion, and Compensation Committee averaged 66% support from minority shareholders. Low support levels are likely attributed to concerns over pay practices. The same EY study found that director approvals across the S&P 500 averaged 96.3% during the first half of 2024, compared to a 95.8% average support a year prior. Compensation committee chairs received 94.5% support, on average, during 2024. In Alphabet's case, only 66.61% of minority shareholders voted to support the re-election of Robin L. Washington, Chair of the compensation committee.

While a large majority of US companies hold annual votes on the approval of executive compensation, dual class share companies often opt to cast votes on a triennial basis. Shareholders at Alphabet last voted to approve the total pay package of its named executive officers (NEOs) in 2023. The next vote to approve pay practices at Alphabet is scheduled for 2026.

The 2023 vote requested the approval of total compensation for five NEOs for fiscal year 2022, including a total compensation for CEO Surdar Pichai of almost USD 226 million. Support stood at 76%, a low figure when considering that the S&P 500's average in 2023 was 88.7%, and that the average support across the S&P 500 had not dipped below 87% in the past ten years. Still, when adjusting to exclude Alphabet's insider votes in support, the vote outcome dropped to 43%.

In 2022, the ratio of CEO to median employee total compensation had skyrocketed to 808:1, likely attributed to the USD 218 million in stock awards that CEO Sundar would receive. Alphabet did not stand alone, with Amazon and Apple, which Alphabet's Compensation Committee selected as peer companies for 2022, reporting that their CEOs were paid over 1000 and 6000 times more than the median employee in 2022.[77]

### Distorted Shareholder Sentiment: How Insider Control Masks Support on Sustainability Resolutions

The impact of the company's dual class share structure extends beyond director elections and pay approval to resolutions that shareholders brought to the ballot. A 2024 proposal to collapse the company's dual class structure in favour of a "one share, one vote" system received 31% support, as reported by management. When adjusted to exclude insider votes, support for this proposal reached 77%.[78] This proposal, which has consecutively appeared on the company's ballot since 2016, consistently received majority adjusted support, underscoring the ongoing frustration among shareholders with the company's share structure.[79]

Proposals requesting companies to recapitalize to a single share class structure, like the one cast at Alphabet, were among the resolution topics with the highest support levels during the 2024 proxy season. On average, these resolutions receive 70% support when adjusting to exclude insider votes.[80]

Another shareholder resolution at Alphabet requesting further reporting by the board on risks of mis- and disinformation generated, disseminated, and/or amplified via generative artificial intelligence (gen AI), including steps to remediate potential harms, received 44% support when adjusting for insider's majority holdings.

Shareholder resolutions that receive more than 40% support from independent shareholders are typically categorized as key votes in a season. These resolutions tend to address material risks to investors and lead to subsequent post-AGM engagement between management and proponents.

To better understand the company's approach to shareholder engagement over matters of shareholder interest and priority, particularly regarding the recapitalization proposal, as well as to better understand the company's governance of sustainability matters, we have reached out to the company to arrange an engagement meeting during the coming quarter.

### The Path Forward: Why Companies Must Embrace Equal Voting Rights

The Sustainability and Good Governance Thematic Stewardship Programme advocates for the adoption of equal voting rights as a cornerstone of good corporate governance. Proxy voting is a vital barometer of shareholder sentiment on governance and sustainability matters, and separating economic ownership from voting rights allows poor governance practices to persist, hindering necessary reforms. Where multi-class share structures are in place, we believe these should be subject to a sunset clause that would see a company's share structure transition to a "one share, one vote" structure within a time period that is aligned to best practice, that being no more than seven years. We additionally encourage companies that operate under a dual class share structure to report voting outcomes per share class, distinguishing between those with standard voting power and those with enhanced voting power.

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