Climate change and sustainability

Shareholders press boards on social and environmental risks

Is your company prepared?

Ernst & Young
Quality In Everything We Do

The triple bottom line

Today's shareholders expect organizations to meet standards of social, environmental and economic performance

Environmental

- Energy-fuel, oil, alternative
- Water
- Greenhouse gases
- Emissions
- Waste reduction: medical; hazardous; non-hazardous; construction
- Recycling
- Reprocessing/re-use
- Green cleaning
- Agriculture/organic foods
- Packaging
- Product content
- Biodiversity

Economic

- Accountability/transparency
- Corporate governance
- Stakeholder value
- Economic performance
- Financial objectives

Social

- Public policy and advocacy
- Community investments
- Working conditions
- Health/nutrition
- Diversity
- Human rights
- Socially responsible investing
- Anticorruption and bribery
- Safety

As proxy season begins, the shareholder proposals currently pending reflect a growing belief on the part of institutional investors that a company's social and environmental policies correlate strongly with its risk management strategy — and ultimately its financial performance.

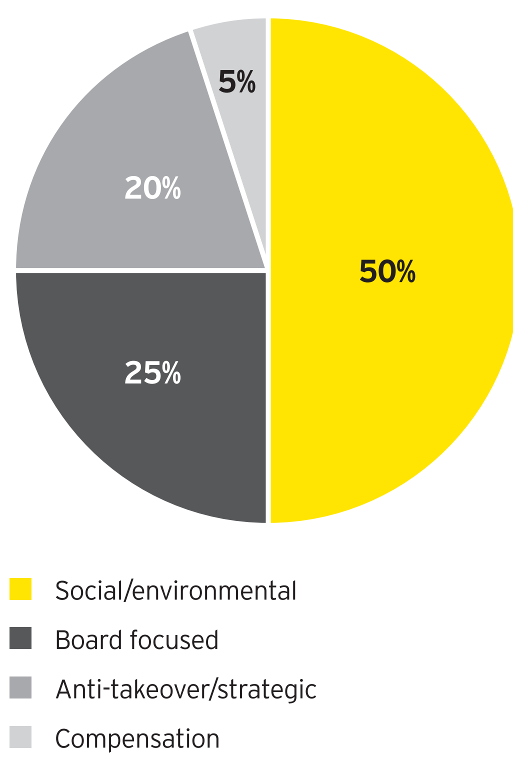
In 2010, resolutions focusing on social and environmental issues made up the largest portion of all shareholder proposals. That trend is expected to continue this year: we estimate that half of all shareholder resolutions in 2011 will center on social and environmental issues.

Estimates for key shareholder proposals in 2011

And it's not just that there are more of these proposals than there have been previously. Rather, the degree of support for these types of resolutions is growing among mutual funds and other important investors. Partly, this is because investors and regulators such as the Securities and Exchange Commission (SEC) are becoming more aware of the reputational and financial risks associated with social and environmental issues. Shareholder proposals have become increasingly prescriptive in asking boards to mitigate risks tied to evolving regulations, shifting global weather patterns and heightened public awareness of climate change issues — any of which can affect a company's business.

These developments have placed more pressure on companies to show that they appreciate such risks and are taking appropriate steps to manage them. Board members and senior management need to understand requests for information related to environmental subjects. Just as important, they must work actively to mitigate shareholders' concerns about environmental issues. Increasing support on shareholder proposals will put pressure on boards to respond. Further, failure to respond to a shareholder proposal that receives 50% or more of votes cast may result in votes against directors in the following year. First steps toward addressing shareholder concerns related to environmental risk include understanding their investment philosophies and voting policies; knowing who is responsible for key voting decisions; and becoming familiar with shareholders' history of activism with other target companies.

Half of 2011 shareholder proposals will center on social/environmental issues



Broader support for CSR-related proposals

Shareholder proposals in 2011

In 2011, shareholder proposals are expected to focus on the following issues:

- Social/environmental. Expected to make up the largest portion of proposals this year, these proposals will focus on political contributions and lobbying, human rights and labor practices, sustainability and greenhouse gases, environmental risk and toxic chemicals.
- Board-focused matters. Expected to represent the second-largest category of proposals, these initiatives will center on board composition, independent leadership, majority voting to elect directors and board declassification.
- Strategic and antitakeover-related-issues. Typically these proposals seek to eliminate supermajority vote requirements, and to allow shareholders to call special meetings or act by written consent.
- Executive compensation. As this is the first year for mandatory say-on-pay provisions giving shareholders the right to vote on executive pay, fewer proposals will relate to compensation arrangements.

Shareholder proposals are important because they shape the corporate landscape and often frame conversations that take place in corporate boardrooms. Resolutions linked to corporate social responsibility (CSR) historically have been skewed toward social issues. But now the environment has become the fastest-growing and most prominent issue area, as more institutional investors begin questioning the potential financial impact of CSR issues on their investee companies.

A 2010 survey conducted by Institutional Shareholder Services, a proxy advisory firm, shows that 83% of investors now believe environmental and social factors can have a significant impact on shareholder value over the long term. This belief is clearly visible in the rising level of support for shareholder proposals requesting action related to social and environmental issues.

The following table shows that the number of CSR-related shareholder proposals rose from 150 in 2000 to 191 in 2010. Moreover, those proposals garnered average voting support of 18.4% of votes cast, vs. just 7.5% a decade earlier.

Trends in shareholder proposals on corporate responsibility

	2000	2005	2010
Number of proposals voted	150	155	191
Average voting support	7.5%	9.9%	18.4%
Percent proposals receiving >10% support	16.7%	31.2%	52.1%

Sources: Investor Responsibility Research Center (2000 data); Ernst & Young

Broader support means that proponents gain more traction with investee companies and put greater pressure on their boards. This is especially true if the proposals reach critical thresholds. For example, many boards take note once support levels reach the 30% mark. In 2005, only 2.6% of all shareholder resolutions related to social/environmental issues received average support of more than 30% of votes cast, according to Ernst & Young. Last year, more than one-quarter of proposals reached the critical 30% support threshold.

Support thresholds as a percentage of total social/environmental proposals

2000	2005	2006	2007	2008	2009	2010
Not available	2.6%	8.9%	15.7%	15.2%	18.4%	26.8%

Source: Ernst & Young

Although shareholder proposals are generally nonbinding, the 50% support threshold is also important. At that level, many institutional shareholders will vote against director nominees in the following year for not responding to a majority-supported shareholder proposal.

Regulatory changes are also driving broader support for resolutions linked to environmental risks. In late 2009, the SEC began to allow shareholder proposals to include the phrase "financial risk" in discussing environmental and other issues. In February 2010, the agency issued guidance reminding companies of their responsibility to disclose their material risks related to climate change.

Five categories of risk

Risks associated with climate change can be broken down into five categories: *strategic, compliance, financial, reputational* and *operational*. These risk categories span multiple business functions but are especially relevant to supply chain management, since shareholders increasingly look at a company's suppliers as an extension of its business. In 2010, for example, shareholders of a large retail chain put forth a resolution requesting that the retailer publicly report on how it would assess and manage the impacts of climate change, specifically with respect to its supply chain. That proposal received support from 41% of the votes cast.

For more information on how climate change risk can affect vital business functions, please go to **ey.com/climatechange** to read *Five highly charged risk areas for Internal Audit* and *Five areas of highly charged risk for supply chain operations*.

How it's done: leading practices in CSR governance

Shareholder pressure and increasing legislative and regulatory requirements are driving boards to take a more active role in managing corporate strategy and engaging stakeholders.

Here are some steps your organization may want to consider taking to improve its CSR-related governance:

- **Board.** Make sure that the board has a standing agenda item to review emerging environmental and social issues, opportunities and risks.
- **Board committee.** Install a dedicated board sub-committee to oversee the company's management of environmental and social issues, opportunities and risks.
- **Committee composition.** Ensure that relevant committees are composed of executive and non-executive directors with the expertise to assess the organization's progress in environmental matters.
- **Materiality.** Apply a systematic process to determine which environmental and social issues are most relevant to the organization.
- **Accountability.** Hold individual leaders accountable for environmental performance, and schedule regular presentations to the appropriate committees to document progress.
- **Reporting.** Establish clear frameworks for reporting on the issues most material to the organization. Regularly publishing a sustainability report is one of the best ways to do this. Relevant board committees should sign off on all sustainability reports.
- **Assurance.** Obtain both internal and external assurance of all reports to gain independent insights on emerging risks and progress, and to be confident that disclosures are accurate.

Broader support: spotlight on mutual funds

A clear example of the growing support for environmentally related proposals comes from the mutual fund industry. According to an analysis by Ceres, a non-governmental organization, average support by mutual funds for climate change–related resolutions grew from 14% in 2004 to 27% in the 2009 proxy season. Opposition to those resolutions fell from 76% to 55% during the period, reflecting a sharp departure from traditional voting policies. The Ceres analysis evaluates proxy votes on climate change–related proposals by 46 mutual fund companies with more than $5 trillion in total assets under management.

Proposals focus on directors' expertise, compensation

A growing number of shareholder proposals are linking social and environmental matters to traditional governance issues such as compensation and the qualifications of board members. For example, some resolutions advocate tying performance metrics used for determining executive compensation to environmental goals. Others seek to ensure that board members have the environmental expertise needed to deal with sustainability and other environmental issues.

At a large oil and gas company's 2010 annual meeting, for example, shareholders filed a proposal requesting that the company have at least one board member with expertise in environmental matters relevant to hydrocarbon exploration, and that the board member be recognized by the business and environmental communities as an authority on environmental matters. This proposal received support from 27% of the votes cast. A similar initiative last year at a large mining and metals company was supported by 34% of votes cast. This year, shareholders of a major energy company demanded that the company spell out how it planned to strengthen its risk management function to better prepare for environmentally related incidents, and how it would move to a low-carbon economy.

Actions to consider

Risks related to sustainability, including climate change risk and other environmental issues, matter a great deal to shareholders. Yet many corporate directors lack a deeper understanding of these issues. Specialists can advise board members on how to respond to shareholder proposals related to these issues, and how to formulate a strategy for anticipating shareholders' future concerns. At a minimum, companies and their boards must be prepared to do the following:

- Enhance dialogue with shareholders and improve disclosure in key areas, particularly those related to social and environmental issues. Robust sustainability reporting can help with this. For more detailed information about sustainability reporting, please see *Seven questions CEOs and boards should ask about 'triple bottom line' reporting* at **ey.com/climatechange**.
- Ensure that directors' skills are relevant to the chief areas of stakeholder concern, including risk management tied to social and environmental matters. In particular, companies must communicate with shareholders. They could, for example, take advantage of the SEC disclosure rules around director qualifications to explain how the qualifications, backgrounds and skill sets of their directors — both individually and as a group — contribute to overall corporate strategy, including risk mitigation.
- Consider whether using non-traditional performance metrics — including those related to environmental/sustainability issues — could help align compensation with risk. In addition to financial metrics, performance goals could align with overall environmental strategy, including clearly defined metrics relating to energy efficiency, water usage and the reduction of carbon emissions.
- Shareholders are paying closer attention to environmental and social matters, believing them to bear closely upon the risk to which investee companies are exposed and, ultimately, upon the financial performance of those companies. The upcoming proxy season will reflect this deepening trend. Driven by concerns about the financial and reputational risks associated with climate change, institutional investors will likely push harder for action on these matters. Forward-thinking companies will be prepared to address their concerns.

Our point of view

Download our current thought leadership and research findings at ey.com/climatechange

Seven questions CEOs and boards should ask about 'triple bottom line' reporting

Although sustainability reporting is voluntary, the broad trend is towards greater disclosure. In this paper are seven things that CEOs and boards should ask in order to prepare for the possibility of reporting on sustainability for the first time, or to improve their existing reports by enhancing data collection processes.

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