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FROM SHAREHOLDER ENGAGEMENT TO INTEGRATED GOVERNANCE

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Shareholder engagement is one of the most significant recent developments in the area of corporate governance. It covers the intense and regular dialogue taking place between issuers and their investors on topics related to the way a company is managed (composition and role of the board, balance of power, executive compensation, etc.), more particularly in the context of the preparation of the shareholders' annual general meeting.

Fostered by the European regulation (directive on shareholders' rights), this dialogue is part of the business logic of large institutional investors whose index strategy or the importance of investment stakes do not allow them to sell their shares easily. Favoring "voice over exit," their goal is to encourage issuers to put in place effective governance mechanisms to protect the long-term interests of shareholders.

The intensity and content of this dialogue are still heterogeneous, but a positive dynamic is underway. Investors are beefing up (or create) specialized governance teams capable of developing independent views (which could diverge from recommendations provided by proxy advisors) on how companies are governed. The best in class companies contribute to the training and the experience of the investment professionals by the quality of the dialogue which go beyond a reformulation of the characteristics (often stereotyped) described in the official documents.

Therefore, the analysis of the most sophisticated investors covers a much wider scope than that of the mere organization of the board of Directors and its relationships with the executives or of other technical issues related to the resolutions of the next general annual meeting.

Astute investors focus on three interrelated aspects of governance: structure, processes and policies.

1. **Governance structure:** the organization of the social organs and their organization is the first level of analysis. It is the choice of the legal form of the company, the dissociation or not of the functions of Chairman of the Board of Directors and the Chief Executive Officer, the existence of a lead director and its responsibilities, the nature and the role of the committees, the composition, the independence and the availability of the board, and all the institutional parameters usually addressed in governance codes. This analysis is enriched by a systemic approach which consists in examining the interaction of these bodies with the elements of the system in which they fit: investors, auditors, experts potentially commissioned by the Board, a potential Stakeholders Committee, Board Secretary, and Executives who work closely with a specific committee (internal audit for example). Each element of this complex system plays a complementary or a substitution role to one another. A smart board will have thought about the structure of the company's governance in all its complexity and will be able to explain it in a logical and clear manner during shareholder engagement.
2. **Governance processes:** the excellence of the structure is not sufficient to guarantee that of the decision. Directors are like any individuals: they are victims of multiple cognitive biases now well identified by behavioral science. We are all subject to confirmation, action, inertia, group or interest bias, the effects of which are mutually reinforcing. Unfortunately, being aware of them is not sufficient to avoid them: the isolated individual cannot expect eradicating them. But it is possible to mitigate them by putting in place structured decision-

making processes at the organizational level. Effective governance takes full advantage of the collective intelligence of the board by putting in place processes to:

- Properly inform directors by carefully selecting sources and calibrating information (such as key financial and non-financial leading performance indicators)
- Analyze the major strategic issues within its committees or board meetings: strategy, capital allocation, corporate social responsibility, internal control and risk management, succession plan, evaluation of CEO performances, compensation policy ...,
- Debate and decide: management of conflicts of interest, facilitation of the discussion to benefit from all points of view...

3. **Policies:** as the supreme organ of the company, the board is called upon to make major choices and arbitrages for the long-term future of the company. Whether they invest in the company on the basis of an intrinsic value analysis (fundamental investors) or follow a more mechanical process (index and quasi-index investors, smart beta,...) shareholders need to understand the board main approach in the following areas: the strategy theory (vision), how potential contradiction between the short and the long term are dealt with, how shareholders should be treated relative to stakeholders of the company, the risk appetite definition, financial policy and capital allocation strategy... Taken together, these policies help to understand the role of governance in creating value. Listed companies only make promises to their shareholders. Investors need indications to better understand the quality and priorities of the management and assess its ability and willingness to fulfill its promises. Information on critical policies will support fundamental investors decisions and will help index investors and ETFs in their voting choices at general meetings.

These three components of governance are intrinsically and logically interconnected. Thus, investors expect an acquisitive company to explain the involvement of the board in the M&A strategy:

what is the decision-making process for major transactions? What are the precautions taken to avoid strategic mistakes? How does the company make sure an acquisition is aligned with its defined risk appetite and its capital allocation strategy? Under what conditions and with what precautions can one derogate from these policies? What are the success criteria of acquisitions and how will these be monitored over time? How is the governance structure involved in this review and what is the validation process? What are the respective roles of the various committees potentially interested in M&A activity and how is their coordination handled? What are the consequences of these acquisitions for the assessment of the top management performance and the structure of its remuneration?

INTEGRATED GOVERNANCE

Company's ability to describe the three component of its governance and the links that unite them allows investors to better measure the maturity of the board and assess its progress towards "integrated governance". The consequences of this move towards a more demanding shareholder engagement are numerous for companies.

They must first **define their own model of governance**, the unique way in which the various elements are arranged considering the characteristics of the company (nature of its shareholding, economic maturity, strategic issues...). This philosophy, which must be translated into a "governance story" (linked to the "equity story"), must be set out in the annual report or the integrated report if it exists. It is a major evolution from the mere "comply or explain" principle, which has led companies to focus on compliance.

A governance model cannot be set for ever. On the contrary, it must be flexible to adapt to an ever-changing business environment. The **evaluation of the board** will have to evolve considerably to become a real governance management tool. Traditionally carried out by human resources experts, the usual approach is outdated: it is more a satisfaction survey for the directors than a real evaluation of how they meet investors and stakeholders' expectations.

Tomorrow, the evaluation of the boards will be less self-centered and more focused on the effectiveness of the governance model as expected by investors. It will lead to a real improvement in the functioning of governance, the main elements of which will be made known to investors.

The **shareholder dialogue** will also experience profound changes. The parallel universes in which governance experts and asset managers evolve respectively are getting closer. The rise of social responsible investing and the gradual integration of ESG factors into investment decisions (both in active and passive management) are incentivizing asset managers to take a greater interest in the governance of their portfolio companies. Many mainstream financial analysts are already sharing their ideas with SRI analysts and some asset managers are attending governance roadshows. For active asset managers, the challenge is to take full advantage of this dimension that complements financial information. For those following a passive strategy, the challenge is to improve the beta of their portfolios as they cannot generate alpha anymore.

Companies will have every interest in initiating a shareholder dialogue throughout the year both with their major investors and with the voting agencies by highlighting their holistic view of governance. This will allow them to get out of the piecemeal logic in which they lock themselves in too often during the preparation of AGM and which generate intellectual frustration among investors. They will also have to subtly integrate elements of their **"governance story"** into the classic financial communication for their fundamental investors. By exposing analysts and assets' managers to this dimension, they will make valuable allies in the event that a resolution presented to the AGM is criticized by the investors' governance experts or the proxy advisors. The Board Secretary / Investor Relations will be key players in this renewed dialogue.

Ultimately, this revolution in shareholder engagement will allow the most advanced companies in their governance to differentiate themselves from the markets. In addition to the direct benefits of "integrated governance" (strategic agility, better management of risks and human capital, more efficient allocation of capital), indirect benefits are to be expected. By demonstrating the quality of their decision-making structures and processes and the relevance of their policies, they will make their strategy more credible, which should result in a reduction in their cost of capital. This will lead to an increase in their value, which is exactly the objective the investors have in mind in the first place.

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