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Engagement 360

2024 Q2 Report



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

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Stewardship Approach

Engagement 360 is a holistic stewardship offering that promotes and protects the world's leading asset owners' and managers' long-term shareholder values through consistent engagement outcomes. Engagement 360 addresses ESG risks and strives to create positive social and environmental outcomes.

ESG 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.

Morningstar Sustainalytics' ESG Voting Policy Overlay provides vote recommendations that align to widely accepted ESG principles, sustainability objectives, ongoing corporate engagements and ESG issues most important to investors.

Executive Summary

Palle Ellemann
Director/Product Manager, Stewardship
Engagement 360
Morningstar Sustainalytics

We are delighted to report on the activities and results of the Morningstar Sustainalytics' Engagement 360 in Q2 2024. The quarterly report provides an overview of the activities and insight into the results of the stewardship work throughout the past quarter. This quarter, we are adding more case studies on active engagements and continuing to offer a wide range of articles from our subject matter experts.

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 second quarter, we have a total of 720 engagements. The Thematic Engagements are ramping up and establishing the engagement dialogues and setting the expectations with the companies.

The ESG Voting team has been through the peak season of Annual General Meetings (AGMs) and delivered 1,074 voting recommendations plus 375 engagement company meeting commentaries. Our recommendations and meeting commentaries covered 849 meetings across 41 markets. The report includes a review of the 2024 proxy voting season in the US and Canada.

The whole Stewardship team has been busy, and:

i. Conducted 182 meetings, including 3 meetings in-person;

ii. Exchanged 2,057 emails and phone calls;

iii. Achieved 82 Positive Developments and 208 Milestones; and

iv. Resolved 16 engagements successfully.

Good/Excellent Response and Progress has dropped about 10 points since the beginning of the year, which is due to the transition in the Thematic Engagements, where we are closing the old engagements and opening new themes. We are typically seeing the dialogue maturing and producing more outcomes as the engagement managers establish relationships with trust.

Looking Ahead

In the coming quarters, we will continue seeing Thematic Engagement adding companies to the programmes, and Strategy & Risk will replace some of the many engagements resolved with new companies.

For general questions or feedback regarding Engagement 360, please email engagement.support@sustainalytics.com or reach out your regional client team.

Note: Executive Summary will not be adjusted to client portfolio.

Stewardship Overview

626
active engagements during Q2 2024

65
new engagements

816
vote recommendations delivered to clients

Utilities
is the most engaged industry

Highest number of engagements
in a single market is the US

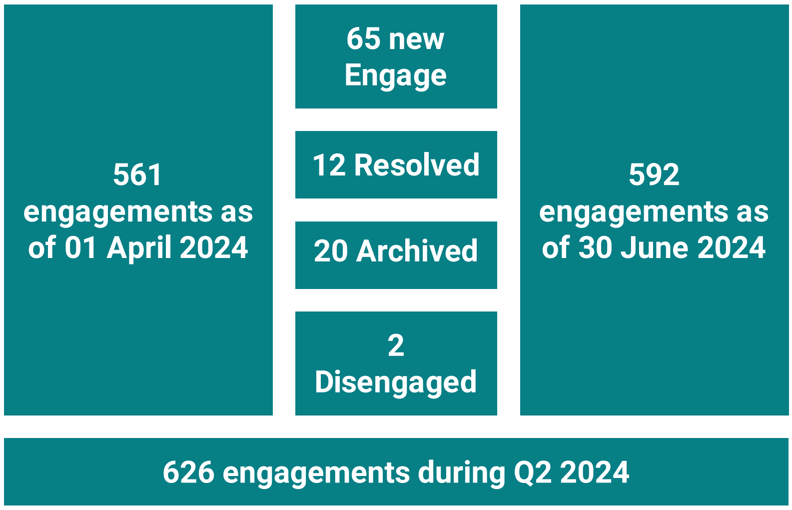
Net Zero/ Decarbonization and Climate Change
are the most engaged topics

SDG 13 Climate Action (57%)
linked to engagement objective

Engagement Status

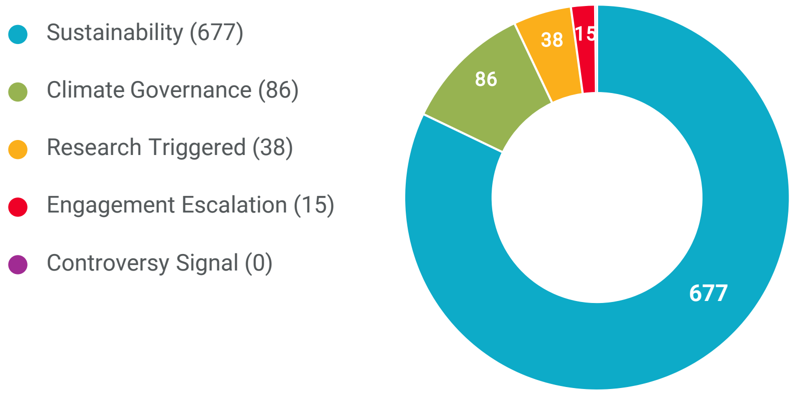
When we open an engagement, the status is Engage. We will then pursue engagement until we change status to:

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.



On a regular basis, universes are rebalanced and issuers might therefore be delisted and removed from our data set. In such circumstances, the opening and closing engagement counts will not match.

Voting Insights and Recommendations



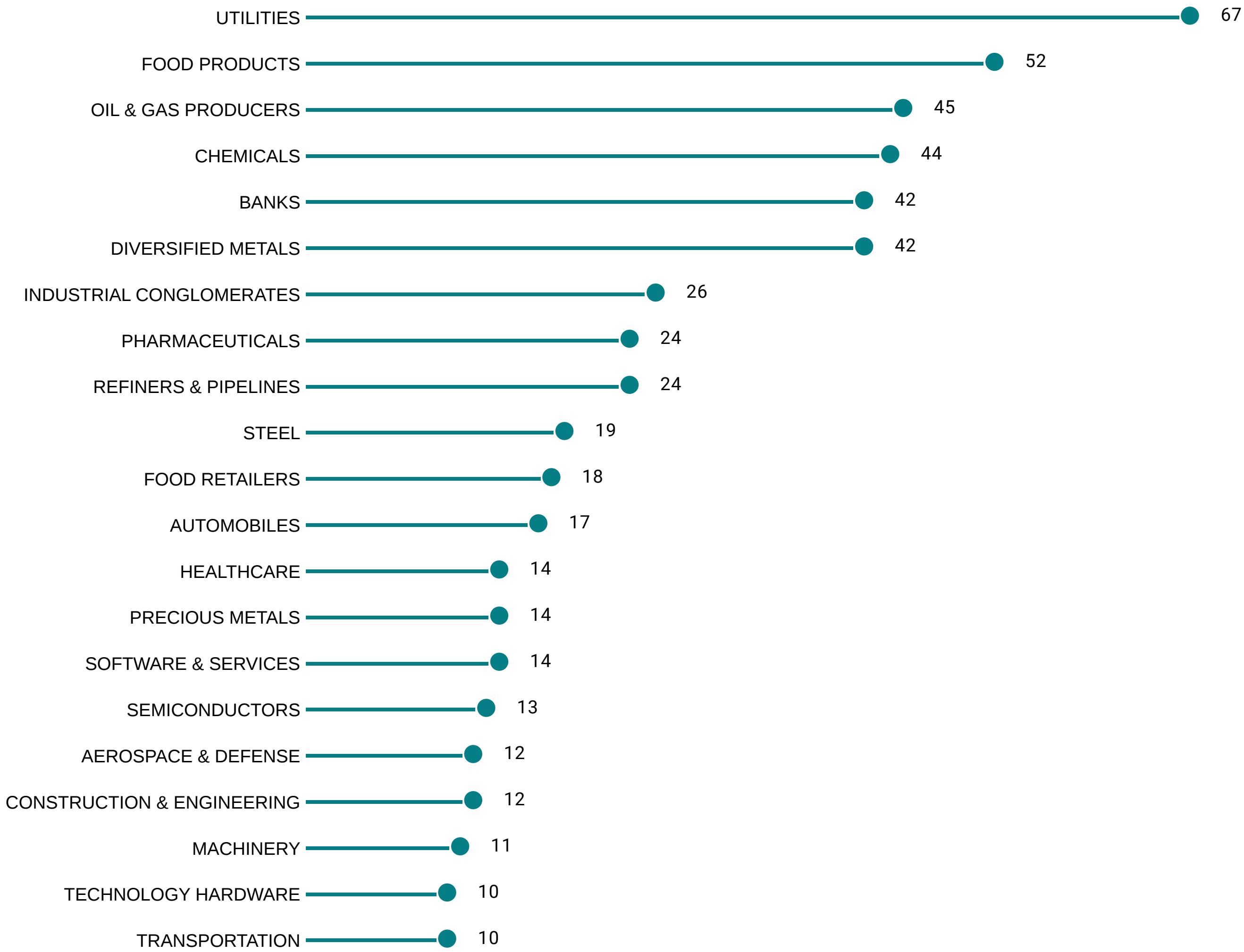
Triggers for Vote Recommendations

Vote recommendations can be triggered by five different reasons.

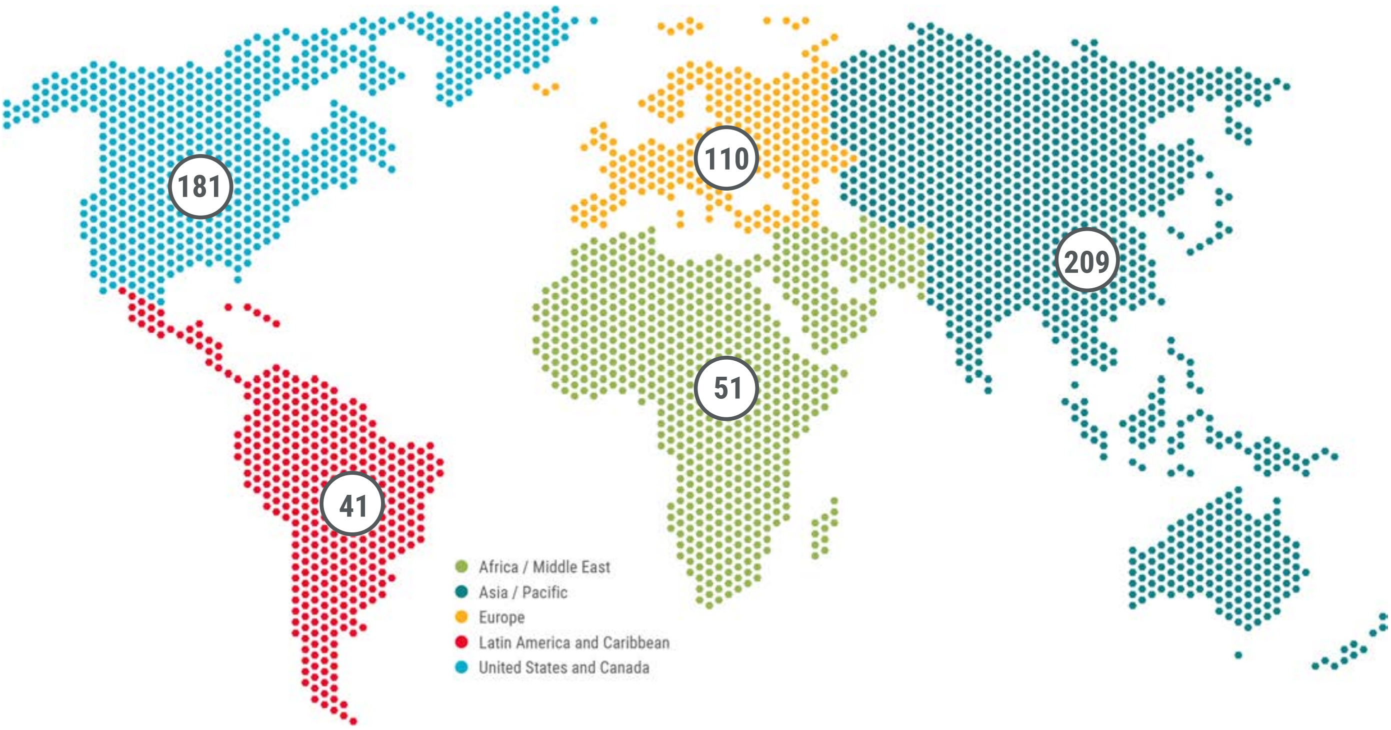
Sustainability	ESG-related resolutions
Engagement Escalation	Poor performance in engagements
Climate Governance	Misalignment between executive performance metrics and decarbonization targets
Research	Poor performance in climate, human rights, DEI (Diversity, Equity & Inclusion), biodiversity, and circular economy
Controversy Signal	Recent incidents leading to a controversy rating of 3 or higher, with significant governance underpinning

Industry Distribution

(Industries with a minimum of 10 engagements)



Engagements by Headquarter Location

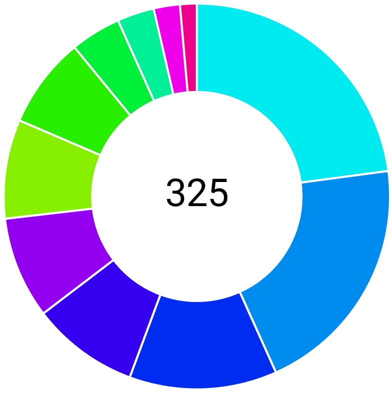


Engagement Topics

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

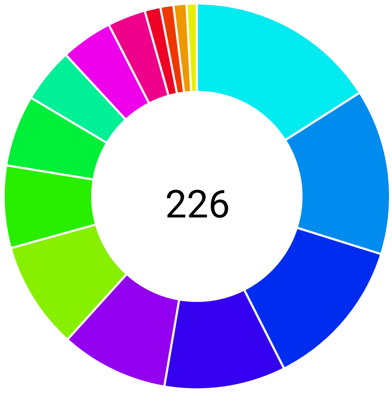
Environmental

- NET ZERO DECARBONIZATION (200)
- CLIMATE CHANGE (179)
- WATER SECURITY (108)
- DEFORESTATION (78)
- BIODIVERSITY (74)
- WATER QUALITY (72)
- LAND POLLUTION AND SPILLS (66)
- WASTE MANAGEMENT (36)
- NATURAL RESOURCE USE (26)
- CIRCULAR ECONOMY (18)
- AIR POLLUTANT EMISSIONS (11)



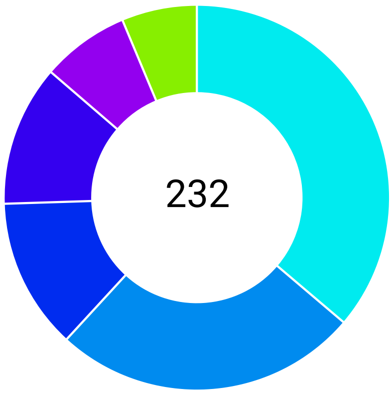
Social

- COMMUNITY RELATIONS (68)
- HUMAN RIGHTS (59)
- PRODUCT QUALITY AND SAFETY (54)
- HUMAN CAPITAL (43)
- LABOUR RIGHTS (38)
- OCCUPATIONAL HEALTH AND SAFETY (38)
- INDIGENOUS PEOPLE (29)
- DIVERSITY, EQUITY AND INCLUSION (DEI) (25)
- CHILD LABOUR (19)
- DATA PRIVACY AND SECURITY (18)
- JUST TRANSITION (13)
- FORCED LABOUR (5)
- HIGH-RISK TERRITORIES (4)
- MARKETING PRACTICES (4)
- WEAPONS (3)



Governance

- DISCLOSURE (170)
- ESG GOVERNANCE (120)
- BOARD COMPOSITION (59)
- BUSINESS ETHICS, BRIBERY AND CORRUPTION (55)
- ACCOUNTING AND TAXATION (34)
- SHAREHOLDERS RIGHTS (29)



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%	10 Reduced Inequality	7%
2 Zero Hunger	10%	11 Sustainable Cities and Communities	10%
3 Good Health and Well-Being	28%	12 Responsible Consumption and Production	58%
4 Quality Education	3%	13 Climate Action	57%
5 Gender Equality	4%	14 Life Below Water	10%
6 Clean Water and Sanitation	13%	15 Life on Land	16%
7 Affordable and Clean Energy	26%	16 Peace and Justice, Strong Institutions	38%
8 Decent Work and Economic Growth	23%	17 Partnerships to Achieve the Goal	4%
9 Industry, Innovation and Infrastructure	28%		

Case Study: Fortum Oyj

Net Zero Transition Stewardship Programme — Engagement Since: 16 November 2023

Industry: **Utilities**

Base Location: **Finland**

Fortum is a state-owned energy company from Finland. The company operates power plants, including co-generation plants, and generates and sells electricity and heat. Fortum aims to achieve carbon neutrality across all Scopes (1, 2, and 3) by 2030 and plans to cease all coal-based energy production by the end of 2027.

Engagement Update

Morningstar Sustainalytics held an engagement call with Fortum in March 2024. The company sped up decarbonization efforts at the beginning of the 2022 Russian invasion of Ukraine. In May 2022, Fortum decided to pursue a controlled exit from the Russian market, including divestment of its Russian operations. As a result, Russian authorities seized control of Fortum's assets, such as seven thermal power plants, significantly reducing the company's carbon footprint. Additionally, in late 2022, Fortum completed divesting its ownership in Uniper SE, a German multinational energy company with strong connections to Russia. Fortum's disclosure is very detailed and provides excellent information.

Focus Area

The discussion focused on Fortum's governance and strategic approach to climate issues, including the status of designating a board member for climate change and transition efforts, providing climate-related training for board members, and incorporating emissions reduction targets into remunerations. Furthermore, the discussion encompassed the assessment of strategy resilience in various climate scenarios and the details of the company's 2027 coal exit plan which includes its transition strategy to alternative energy sources, like gas and biomass.

Engagement Outcomes

Sustainability is at the center of Fortum's business. Currently, approximately 98% of the electricity the company generates is renewable. Moreover, the company is committed to phasing out coal by the end of 2027. In 2023, Fortum established a Green Finance Framework, strengthening the integration of sustainability ambitions into the company's financing. The company is pursuing its net zero strategy across all pillars, including governance, risk management, strategy, target setting, and transparency. Morningstar Sustainalytics suggested to Fortum to include in its next public disclosure that its board members attended several training courses focusing on the transformation to a net zero business model.

Insights & Outlook

The engagement confirmed that Fortum is a net zero transition leader in its sector. The company demonstrated how a significant geopolitical impact sped up its net zero transition. Fortum has yet to complete its coal exit, which is moving according to schedule. Future engagement calls will focus on discussing the practical implementation of the Green Finance Framework and its role in financing Fortum's path toward net zero transition.

Case Study: Volvo Cars AB

Scaling Circular Economies Stewardship Programme — Engagement Since: 15 February 2024

Industry: **Car Manufacturer**

Base Location: **Sweden**

Volvo Cars, headquartered and listed in Sweden, but Geely, a Chinese automobile company, owns the majority. Production plants are located in Belgium, China, Sweden, and the US. The company aims to become all-electric by 2030 and operate as a circular business by 2040.

Engagement Update

In Q2 2024, Morningstar Sustainalytics established an engagement dialogue with Volvo Cars on transitioning the automotive value chain to a circular economy. By establishing dedicated circular economy and biodiversity teams, in addition to the Climate Action and Global Sustainability teams, it is easier for Volvo Cars to make the circular economy topic matter to the business. Its strategy is not subordinated to climate action or site-specific environmental compliance agendas.

Focus Area

Among the companies targeted so far in our programme, only Volvo Cars established a circular economy revenue generation target.[1] Remanufacturing, waste trading, and Volvo on Demand qualify as sources of circular revenue. Besides a social need for mobility, there is an environmental need to displace the demand for more vehicles. Volvo on Demand is a promising mobility-as-a-service initiative but can only be replicated in more markets and thrive commercially if national governments support infrastructure investments and fiscal incentives. From a resource productivity perspective, the initiative deserves more uptake, considering how it can improve vehicle utilization. The company's latest annual report (2023) quantifies the usage of materials per vehicle model and accounts for the average share of recycled plastics and bio-based materials (4%), recycled steel (15%), and recycled aluminum (10%). This type of accountability is an important first step. Like its peers, the company has yet to significantly reduce its dependence on primary materials.

Engagement Outcomes

Despite having a long way to go, Volvo Cars has made a promising start on its journey to becoming all-electric and circular business. While the latter ambition may come across as an aspiration than a hard commitment, our engagement dialogue illustrated Volvo Cars is "walking the talk," covering a comprehensive range of circular economy opportunities.

Insights & Outlook

Presently, the reporting of Volvo Cars offers practical ideas on how the transition to a circular economy can be defined and accelerated by a commercial business. The company has been among the most responsive companies in our Scaling Circular Economies Steewardship Programme to date. The engagement highlights the company's progressive approach to the circular economy topic and its curiosity about best practices and what investors value.

Case Study: Vistra Corp.

Material Risk/Strategy & Risk Engagement — Engagement Since: 25 February 2021

Industry: **Utilities**

Base Location: **United States**

ESG Risk Rating: **29.3**

Vistra is a leading US-integrated retail energy provider and power generation company based in Texas, serving 4 million residential, commercial and industrial retail customers. Vistra is also the largest competitive power generator in the US.

Engagement Update

Four conference calls with Vistra have been held since 2021. The latest meeting in May 2024 focused on material risk and net zero transition, and we discussed the Vistra's progress towards its low carbon transition strategy and its disclosures on non-GHG air emissions, effluents and wastes. While the company demonstrates consistent improvements in its disclosure practices and climate transition strategy development, challenges remain regarding disclosure of the company's capital allocation to finance the low carbon transition and specific details regarding how these investments will contribute to achieving the company's GHG emission reduction targets and long-term net zero goal.

Focus Area

Discussions focused on the Vistra's effluent and non-GHG emissions management, decarbonization targets, climate transition strategy and associated metrics, data, and incentivization programs. Dialogue around Vistra's biodiversity and nature-related risks was underpinned by its decommission and conversion processes of its coal plants. Vistra described its current evaluation of utilizing land distribution for new solar power generation and battery storage systems on its properties, including those with decommissioned coal plants.

Engagement Outcomes

Positive developments were observed with Vistra's enhanced reporting regarding scope 1 and 2 GHG emissions, stakeholder relations, emergency response and spill management. The company remains open to suggestions to improve its disclosure practices. Vistra's 2023 Sustainability Report will include disclosure of its recently performed materiality assessment.

Insights & Outlook

The engagement showcases Vistra's ambitious yet cautious approach to achieving its decarbonization goals and demonstrates the company's proactive viewpoint to reclaiming decommissioned coal plants while underscoring areas requiring enhanced disclosure. Investor queries on biodiversity and nature-related risks, supplier engagement for scope 3 emissions reductions, and adequacy of disclosures regarding public policy engagement indicate growing interest in these areas.

Case Study: Hangzhou Hikvision Digital Technology Co., Ltd.

Global Standards/Incidents Engagement — Engagement Since: 29 November 2019

Industry: **Technology Hardware**

Base Location: **China**

GSS Status: **Non-Compliant**

Hikvision is the world's largest manufacturer of video surveillance equipment. The controversy focuses on the use of the company's products and services in activities involving forced labour practices at vocational education centres in Xinjiang, China.

Engagement Update

Hikvision has actively participated in dialogues, seeking our recommendations and making progress in line with the advice provided since the start of the engagement in 2019. In June 2024, we held two in-person meetings with the company and investor clients. Hikvision stated it recently obtained permission from the Xinjiang local government to terminate the service contracts. The company also developed its human rights policy and became a member of the UN Global Compact. Hikvision shared that it has a robust system to incentivize employees to restrict sales to high-risk areas or high-risk use cases. A corporate culture of respect for human rights is being fostered. While these are significant improvements, the implementation of due diligence principles still needs to be strengthened.

Focus Area

The company leverages AI in facial recognition technologies in its products. Such technologies can pose significant human rights risks, especially when used in geographical areas where laws and regulations conflict with internationally recognized human rights. The engagement discussions focus on downstream due diligence addressing human rights risks associated with the use of company's goods. Specifically, this engagement focuses on both the remediation of current projects in Xinjiang and the prevention of future misuse of the company's products and services.

Engagement Outcomes

Encouraging developments have been observed in the Hikvision engagement case. We have built a trustworthy relationship with the company. From being unwilling to speak to investors and denying the company's exposure to forced labour risks, Hikvision has grown to become confident in discussing sensitive human rights issues.

Insights & Outlook

The engagement showcases Hikvision's commitment to downstream human rights due diligence and its willingness to communicate with stakeholders. Although the company announced the controversial contracts would be terminated, confirmation is still pending. Hikvision needs to continue its efforts to regain stakeholders' trust and confidence. This will be a time-consuming process. We will encourage Hikvision to increase disclosure and improve implementation of due diligence principles. Specifically, we advise the company to develop systems that will prevent distributors from selling its products in high-risk areas.

Engagement Results

162
meetings, including 3 in-person meetings

1,691
emails and phone calls exchanged

12
engagements Resolved

160
Milestones achieved in Q2 2024

52
Positive Developments achieved

38%
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.

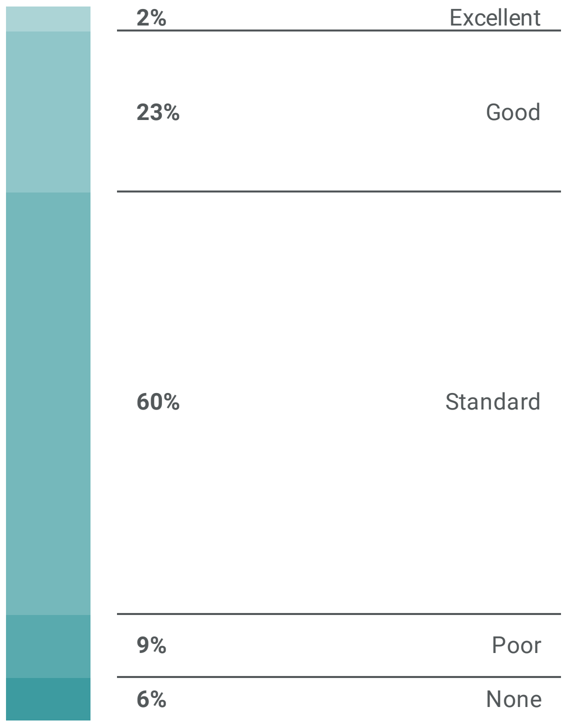
Excellent The company has adopted a proactive approach and addressed the issues related to the change objective.

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.

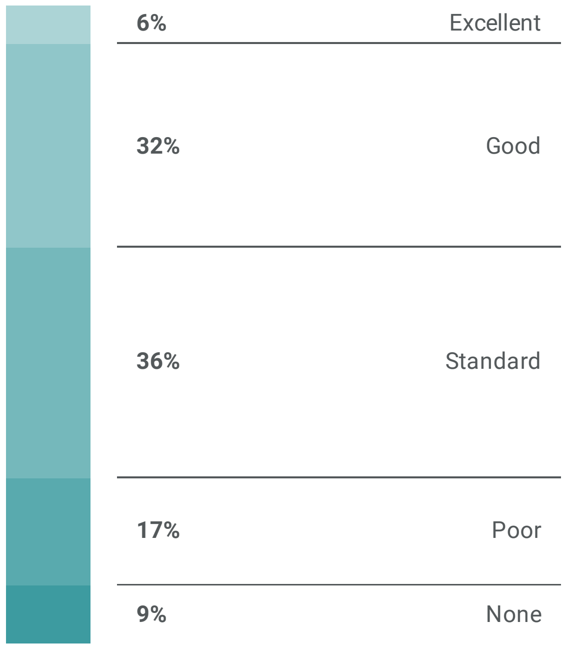
Excellent The company is proactive in communicating around the issues related to the change objective.

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.



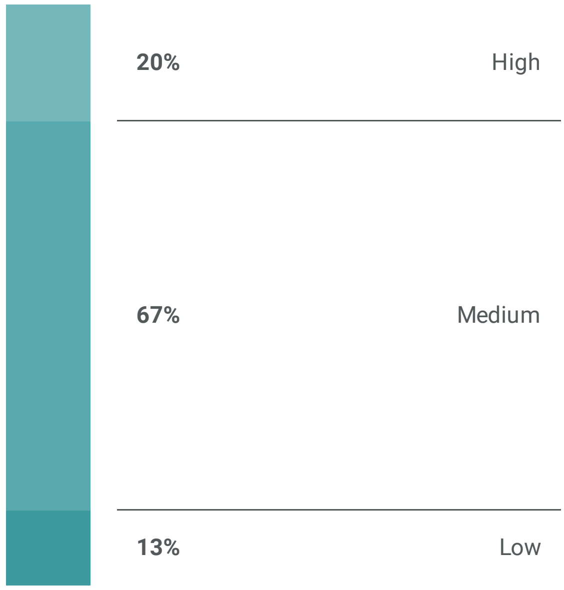
Engagement Performance

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.

160
Milestones achieved in
Q2 2024

Milestone Framework Structure

Milestone 5 Change objective is considered fulfilled.

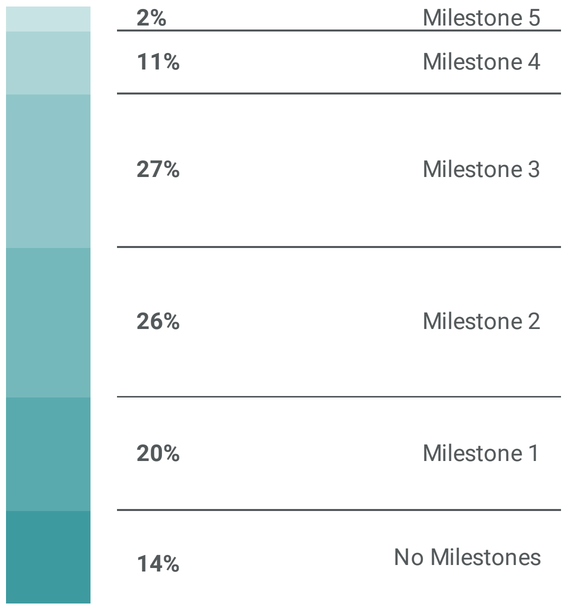
Milestone 4 Implementation of strategy has advanced meaningfully, and related issuer disclosure maturing.

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

COMPANY	COUNTRY	INDUSTRY	ISSUE
Adani Ports & Special Economic Zone Ltd.	India	Transportation Infrastructure	Involvement With Entities Violating Human Rights
CF Industries Holdings, Inc.	United States	Chemicals	Focus on Carbon and Emissions, Effluents and Waste
Chemical Works of Gedeon Richter Plc	Hungary	Pharmaceuticals	Focus on Access to Basic Services
Conagra Brands, Inc.	United States	Food Products	Focus on Product Governance
Graco, Inc.	United States	Machinery	Focus on Risk Assessment and ESG Disclosure
Grupo Bimbo SAB de CV	Mexico	Food Products	Focus on Corporate Governance
Hyundai Engineering & Construction Co., Ltd.	South Korea	Construction & Engineering	Focus on Risk Assessment and ESG Disclosure
Hyundai Motor Co., Ltd.	South Korea	Automobiles	Focus on Product Governance
Mitsubishi Heavy Industries, Ltd.	Japan	Machinery	Focus on Carbon Products and Services
PPL Corp.	United States	Utilities	Focus on Carbon and Emissions, Effluents and Waste
Shin-Etsu Chemical Co., Ltd.	Japan	Chemicals	Focus on Carbon Own Operations
Sumitomo Chemical Co., Ltd.	Japan	Chemicals	Focus on Carbon Own Operations

Resolved - Adani Ports & Special Economic Zone Ltd.

Engagement Since: 28 May 2021

INDUSTRY:
Transportation Infrastructure

BASE LOCATION:
Myanmar

ISSUE:
Involvement With Entities Violating Human Rights

In May 2019, Adani Ports & Special Economic Zone (APSEZ)'s wholly owned subsidiary, Adani Yangon International Terminal Co., signed a build, operate and transfer agreement for 50 years with Myanmar Economic Corporation (MEC) to develop a new port. In August 2019, MEC was found to have commercial and management linked to the Tatmadaw, a military group accused of human rights abuses and violations.

CHANGE OBJECTIVE

APSEZ should ensure to undertake human rights due diligence of its businesses in Myanmar, adapting to the specific situation of the region. As a result, APSEZ should engage with relevant stakeholders and take any necessary actions to ensure the business relationship with MEC does not become complicit in any human rights violations or withdraw from the partnership should that not be possible.

Engagement Outcomes

- In October 2021, APSEZ announced its decision to exit investment in Myanmar and took over two years to sell the port in the country.
- APSEZ made commitments to conduct enhanced due diligence in any new projects, considering lessons learned from its involvement in Myanmar.
- In its 2023 integrated report, APSEZ committed to significantly more widespread and detailed corporate responses to human rights.

Conclusion: Considering APSEZ is no longer operating in Myanmar and committed to enhancing its approach to human rights, Morningstar Sustainalytics decided to resolve this engagement.

Resolved - CF Industries Holdings, Inc.

ESG Risk Ratings Score

Negligible (0-10)	Low (10-20)	Medium (20-30)	High (30-40)	Severe (40+)

27.8

INDUSTRY:
Agricultural Chemicals

BASE LOCATION:
United States of America

ENGAGEMENT FOCUS:
Carbon – Own Operations
Emissions, Effluents and Waste

RATIONALE FOR RESOLVED STATUS:
CF Industries Holdings, Inc. improved its ESG Risk Rating score to below 28.

Positive Development Highlights:

- CF Industries established roadmaps to achieve its scope 1 C02e emissions intensity reduction goal by 2023 and scope 1 and 2 net zero goal by 2025, including details of decarbonization projects for each business area aligned with impacted emission scopes, broad indications of project timelines, and progression levels. Its roadmap discloses main decarbonization levers the company expects to achieve its goals, including Process CCS, N20 Abatement, Reformer Flue Gas CCS, Residual Emissions, Virtual Power Purchase Agreements (VPPA), Renewable Energy Credits (REC), and absolute C02e reductions associated with each lever.
- As part of its goal to reduce scope 3 emissions by 10% by 2030 (2020 baseline year), CF Industries purchased billion cubic feet (BCF) of natural gas, certified to have 90% lower methane emissions intensity than the industry average and the first known certified natural gas purchase for use in industrial manufacturing.
- In October 2022, CF Industries entered into the largest-of-its-kind commercial agreement with ExxonMobil to capture and permanently store up to 2 million tons of CO2 emissions annually from its Donaldsonville manufacturing complex in Louisiana.

In the latest ESG Risk Rating update, CF Industries' score improved by 1.6 points, bringing it into the medium risk category and below the 28-point threshold for engagement.

Resolved - Grupo Bimbo SAB de CV

ESG Risk Ratings Score

Negligible (0-10)	Low (10-20)	Medium (20-30)	High (30-40)	Severe (40+)

26.7

INDUSTRY:
Food Products

BASE LOCATION:
Mexico

ENGAGEMENT FOCUS:
Product governance
E&S impact from products
Carbon – Own operations
Human capital

RATIONALE FOR RESOLVED STATUS:
Grupo Bimbo has improved its ESG Risk Rating score to below 28.

Positive Development Highlights:

- Grupo Bimbo published its first Nutritional Guidelines, indicating efforts to improving the nutritional value of products in the portfolio, and developed various strategies to address obesity challenges in Mexico and elsewhere.
- Grupo Bimbo signed the RE-100 pledge to source 100% of its electric energy from renewable sources by 2025 and aggressively invested in renewable energy generation to cover their own needs. By 2020, the renewable energy capacity at Grupo Bimbo equalled 80% of its energy consumption, and operations will be 100% covered with renewable energy by 2025.
- Grupo Bimbo hired a new CEO thereby separating the roles of the CEO and the Chairman of the Board.

In the latest ESG Risk Rating update, Grupo Bimbo's score improved by 1.8 points, bringing it below the 28-point threshold for engagement.

Navigating Between What Companies "Say" and "Do": Assessing Impact in a Complex Landscape

Marta Patallo
Manager, Stewardship
Global Standards/Incidents Engagement
Morningstar Sustainalytics

Regularly, the Global Standards/Incidents Engagement team presents to clients detailed analysis of cases to offer an overview of challenges, opportunities and successes of the engagement process. One such engagement focused on a mining company assessed as negatively impacting the health of the members of several communities located near its operations as well as polluting their land and affecting the local ecosystem.

After presenting this case, we received a question from one of our clients: "When you have this dialogue with companies and analyze their disclosures…how do you know that what the company says it is doing is what is really happening?" The question while appearing simple, captures relevant dimensions on how Global Standards/Incidents Engagement assesses the outcomes and impacts of companies' operations and business activities on people and environment.

Global Standards/Incidents Engagement service is an incident-driven engagement. This means that we start engaging when a company has caused, contributed to, or is linked to alleged severe or systematic violations of international norms and standards concerning one or more principles of the UN Global Compact and related international conventions, norms, and standards.

Once the incident has been identified and the case has been opened, the engagement manager assesses, as a first step, the publicly available information about the negative impact of the incident as well as the gaps between the international standards and the company's disclosures. Alongside this, we define the change that is required to ensure no practical repetition of the negative impact. In a second step, we also establish an engagement strategy, in which we map the activities the company should do in terms of its commitments, policies, processes and practices to achieve the desired change.

These steps imply that we are constantly navigating between potential gaps and alignments about what the companies "should do," what the companies "say they do," what companies "do," and the "impact" they may or may not claim. The challenge here, as our client pointed out with his question, is to collect accessible, complete, reliable, and accurate information that allows us to identify and analyze these gaps and alignments and provide the highest quality analysis of the company's ESG performance and the impact to our investor clients. To achieve this, we triangulate internal information provided by the company and external information gathered from stakeholders.

From our experience, what the companies "should do" is easy to identify in relation to expectations set by international standards.

When it comes to what the companies "say they do," even if sometimes it is hidden in a labyrinthine website or report, we explore and evaluate it through the engagement dialogues and information the company discloses. Challenges present themselves when there are discrepancies between the directives from the head office and their interpretation by subsidiaries or ground teams, especially where negative impacts have occurred. Therefore, triangulating internal information gathered during the dialogues with various company levels is essential for a comprehensive understanding.

Furthermore, the engagement manager often faces the challenge of piecing together a puzzle from diverse sources such as annual reports, sustainability reports, policies, and press releases. The internal disclosed data is frequently incomplete, inaccurate, or lacks third-party verification and the complexity increases as companies are at different stages in their ESG journeys, operate in varied contexts, and are subject to different disclosure regulations.

To be able to analyze the gaps and alignments between what the company “says” and what the company "does" and its “impact,” it becomes particularly important to use external triangulation. Engaging and gathering data from different stakeholders is key for our work, as for a case to be closed successfully, we need to confirm that the negative impact has ceased, remediation has been delivered, and the company has made the necessary changes to its policies, processes, and practices so that similar incidents will not happen again.

Listening to the voices of different stakeholders, including directly impacted individuals, such as workers, indigenous communities, and consumers, enriches our understanding of the potential or actual impacts. Interactions with civil society organizations, academics, unions, industry associations, certification bodies, and government agencies not only enhance our analysis but also provide access to independent third-party assessments, thereby ensuring a comprehensive and accurate understanding of the impacts.

Returning to the question, how do we know if what the company “says” and “does” is aligned? There is no definitive, one-line, answer to this. For many reasons, a company may not disclose the full facts about a situation, and statements may be at an elevated level and lack desired content. Our approach is to gather evidence that can provide support to clarify the company’s ESG performance and impacts on people and environment, offering additional assurance. Similarly, our multi-perspectives gathering may indicate that there is still significant work to do before the engagement resolution can be achieved. Either way, the analysis of information gathered from several sources and the engagement with stakeholders brings additional value to our work and supports the activities of both our investors and companies we engage with, building their resilience and strengthening their social license.

ESG in the Boardroom

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Boardrooms are still struggling to get ESG right. Morningstar Sustainalytics Stewardship Services often experience this through our engagements with companies around the world. Some of the main challenges discussed during these engagements are related to the role of ESG in strategy and performance management, and how integrated ESG should be in the company's governance structure. The emergence of ESG has also questioned the expectations for the combined skillset of the board and, for example, to what extent the board needs expertise on biodiversity, diversity, equity and inclusion (DEI), and climate change. In this article, I will argue that ESG should be integrated into company risk management, operations, performance management, reporting, and governance. Furthermore, the board should have enough ESG knowledge to hire the right CEO and ensure integration of the right material ESG issues into the company's performance management systems and processes.

ESG Has Reached The Board

During more than 12 years of engaging with companies across geographies, I have seen ESG rise on the agenda of most executive teams and board rooms. ESG is driven by different factors, not least regulation, and investors have played an important role with the integration of ESG into investment considerations. The fact that investors pay close attention means that company management and boards must also; because essentially, the board exists to serve shareholder interests.

Having realized that ESG is something they must now consider, boards have reacted in different ways. Some boards have tasked management to deal with ESG and have adopted a compliance perspective, where the board focuses entirely on making sure that the company is complying with regulatory requirements. This type of board would typically be addressing ESG once per year when they are signing off on ESG disclosure. In these companies, ESG strategy development is often slow or absent and relies on the CEO to drive—which is not happening because ESG is not a board (and therefore business) priority.

Other boards have adopted a radically different approach and decided ESG merits a new board committee, often named the Sustainability Committee. The advantage of this approach is that ESG and sustainability is visibly a highly prioritized issue on the board agenda and there is a clear board-level governance structure for ESG supervision. However, the fact that there is a sustainability committee does not mean that there is effective board-level ESG oversight. Some of the companies we engage with—in particularly in Asia—create a new board-level sustainability committee which also meets only once per year to sign off on the ESG disclosure. The sustainability committee is, in this case, a tick-box exercise and doesn't provide any meaningful governance oversight.

ESG Integration Builds Accountability From the Bottom to the Top

A more thoughtful and effective approach is to determine what ESG means to the company by way of an ESG materiality assessment. Through this exercise, the company identifies which ESG issues are material—preferably using a double materiality approach to include stakeholder perspectives and consider the impacts the company makes on society. The materiality assessment will typically highlight several ESG issues that are already addressed at the board level through existing board committees, such as business ethics and compliance supervised by a Risk Management and Audit Committee, occupational health and safety overseen by a Health, Safety and Environment Committee, and responsibility for human capital development with a Social and Ethics Committee. The board may also learn about new and emerging material ESG issues that it doesn't currently have a governance structure to oversee. At this point, it is up to the board (in collaboration with management) to define a threshold for what ESG issues are material enough to be supervised by the board, and which are not. The benefit of performing a meaningful ESG materiality assessment is the opportunity to make qualified decisions on what ESG issues to focus on, and what to give secondary priority.

Even if some material ESG issues are covered by existing board committees, it may be tempting for a board to establish a new sustainability committee to showcase how important sustainability is to the company. However, downsides of having a separate sustainability committee include unclear governance oversight (by way of interactions with various sub-committees) and unintentionally identifying sustainability and ESG as a separate functions in the company.

What Gets Measured, Gets Done

There is typically a sustainability or ESG angle to any function in a company. Therefore, if companies can integrate sustainability into the organizational fabric, then they can secure a deep ownership to the issues in the organization. For ESG, like many other issues, the thumb rule is; what gets measured, gets done. True ESG integration means that ESG is integrated into the company’s performance management systems with performance metrics, goals, and remuneration. The most effective companies build ESG metrics into their existing scorecards (or other performance management systems) and ensure consistent performance reporting, vertically in the organization, to align employees around the same goals and focal points. ESG integration also builds additional accountability at the top of the organization, such as the management and board, as they receive ongoing updates on company performance. Therefore, Material Risk/Strategy & Risk engagement managers will focus on a company's performance reporting, integration of ESG metrics, and frequency at which the management and the board recieves this information.

Who Knows Something About Biodiversity?

The emergence of ESG at the board-level questions the skills a board should possess. If biodiversity or DEI becomes a material ESG issue for a company, then does the board need an expert? Some boards have tried attracting senior climate change and biodiversity experts, but quite challenging as these experts are rare and often don’t have a business mindset. The question is also if it makes sense to have such deep ESG subject matter expertise on the board in the first place, as this could create an imbalanced relationship among board members on these issues. The expert could quickly bring any board-level discussion on the topics to a high level of detail, hindering other board member contributions. In this case, the board could also overstep its oversight function and become too detail-oriented. The board’s most important task is to hire the right CEO to manage the business, including ESG. Secondly, the board needs to know enough about the material ESG issues to ask management the right questions and collaboratively agree on the appropriate metrics to include in ongoing performance reporting to the board.

A company, like **Bayer AG,** uses ESG expertise constructively as Bayer has set up an independent external sustainability council to advise the Board of Management and other functions within the company on all sustainability matters. In this forum, the experts are among peers with a similar level of expertise, and they can develop more detailed discussions to the benefit of themselves and the company.

ESG Is Not New

Many of the issues that we deal with under the notion of ESG are not new, but the ESG framework has elevated boardroom discussion of these issues. Furthermore, materiality and impact analysis have broadened the scope of ESG issues that companies consider. ESG is not a new function or area, it is sound business risk management that is within the mandate and obligation of the board to address. The integrated approach is the most efficient and effective way of managing ESG issues—and a board can create oversight systems, so they do not have to be ESG subject matter experts to provide effective oversight.

Insights into the Palm Oil Industry: A Field Trip to Malaysia

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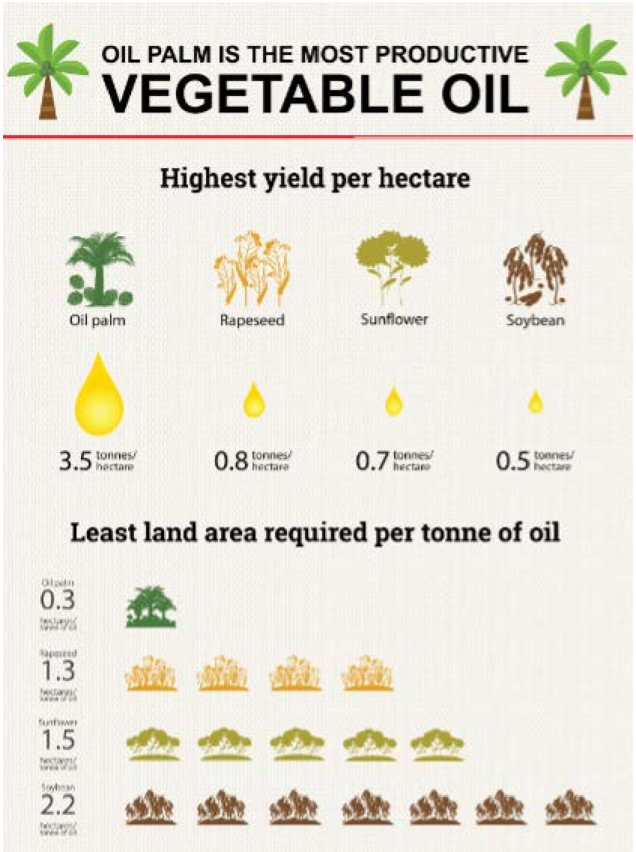
Palm oil is used in the making of a wide variety of supermarket products, from pizza and chocolate to shampoo and cosmetics. It is the world's most widely used vegetable oil due to its versatile properties and high yield, producing over five times more oil per hectare than sunflower oil (see **Figure 1**).[2] However, the industry is scrutinized by various stakeholders, including academia, NGOs, civil society groups and investors, due to its environmental and social impacts, such as deforestation, biodiversity loss, land grabbing and poor labour conditions. Achieving sustainability in palm oil production requires robust management and strategies to address these risks across supply chains.

Figure 1. Top Five Facts About Palm Oil That You Need to Know.



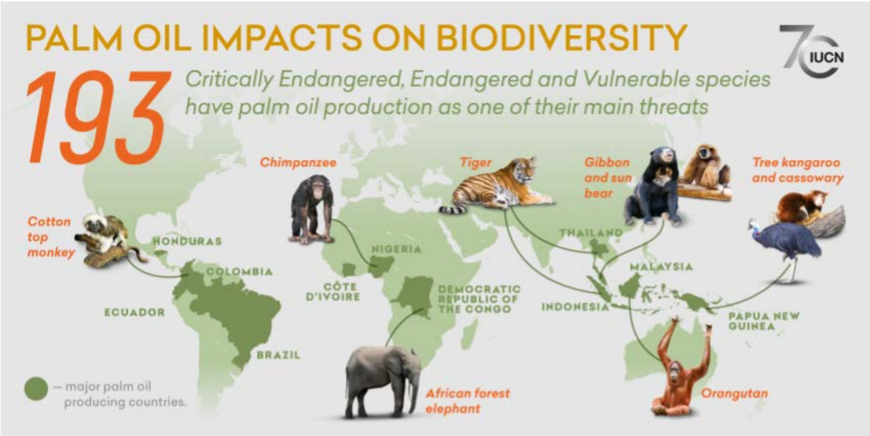
The Motives Behind the Palm Oil Plantation Field Trip to Malaysia

A briefing by the International Union for Conservation of Nature and Natural Resources (IUCN) reports that global palm oil production affects at least 193 threatened species, with potential impacts on 54% of all threatened mammals and 64% of all threatened birds (see **Figure 2**). Southeast Asia is one of the world's most biodiverse terrestrial ecosystems, and palm oil production is highly concentrated in this region, with Indonesia and Malaysia accounting for 85% of global production.[3]

In Malaysia, the palm oil industry is crucial for livelihoods, covering 18% of the country's territory. The industry directly employs about 441,000 people and many more indirectly.[4]

Recent improvements in supply chain practices among Malaysian palm oil companies have been noted by organizations such as World Wildlife Fund for Nature (WWF), World Resources Institute (WRI) and Chain Reaction Research (CRR). These improvements include reduced deforestation due to stronger law enforcement, certification schemes and corporate commitments to zero deforestation.[5] Additionally, companies are enhancing working conditions as seen across Morningstar Sustainalytics' engagements. For one engaged company, the US Customs and Border Protection lifted the Withold Release Order (WRO), allowing its palm oil products to re-enter the US market. In a location full of potential to make an impact on biodiversity, we wanted to see firsthand the work and the people involved in sustainable palm oil production.

Figure 2. Palm Oil Impacts on Biodiversity.



The field trip aimed to understand leading practices and transition challenges through meetings with four major global palm oil companies in Malaysia (see **Table 1**).To ensure a balanced perspective, we also met with the Roundtable on Sustainable Palm Oil (RSPO), which provides standards and certifications for sustainable palm oil at its headquarters in Kuala Lumpur and WWF in Singapore.

Table 1. Overview of the Palm Oil Companies Visited in Malaysia

Company	Company Description
Wilmar International Ltd.	One of the world's largest palm oil plantation owner, palm oil refiner, and biodiesel manufacturer in Indonesia and Malaysia.
Sime Darby Plantation Bhd.	The largest palm oil company globally listed, based on plantation area and fresh fruit bunch production.
FGV Holdings Bhd.	The world's second largest palm oil plantation company and one of the largest Crude Palm Oil (CPO) producer.
IOI Corp. Bhd.	A leading integrated and sustainable palm oil global corporation with plantations and downstream resource-based manufacturing businesses.

Key Takeaways From the Trip

The field trip provided a comprehensive exploration of ESG topics, including labour conditions, community livelihoods, nature conservation and climate initiatives. This section delves into the key strengths, challenges and opportunities in the industry.

Strengths: Global Standards as Catalysts for Corporate Commitments

Several key factors stimulated the sustainable transition of the palm oil industry in Malaysia, positively impacting the companies in our engagement:

- **RSPO:** The Roundtable on Sustainable Palm Oil (RSPO) has had profound impacts through its Principles and Criteria, providing certifications for compliant producers. The successful implementation of RSPO can also serve as a leading practice for other soft commodity industries to follow.
- **NDPE Commitment:** The No Deforestation, No Peat and No Exploitation (NDPE) commitment, adopted by many growers, traders and downstream companies, helps reduce deforestation, preserve natural resources and protect workers' and local communities' rights.[6]
- **Government Support:** The Malaysian government supports the sustainable transition through initiatives such as the Malaysia Sustainable Palm Oil (MSPO) Board and mandating the MSPO certification. In addition, the government established legislation, such as a plantation area cap in 2019 (effective through 2023) and the 2022 National Forestry Act enacted to conserve forests from illegal loggers.[7]

Challenges: Traceability and Smallholder Management

- **Traceability Issues:** Achieving 100% traceability to the mill and plantation level remains challenging, especially for smallholders. During an in-person meeting, one company mentioned that if smallholder farmers are to be a part of the supply chain, it did not believe that 100% traceability at the plantation level could be achieved. The EU Deforestation Regulation (EUDR) requires this level of traceability, but many smallholders lack the resources to comply.
- **Smallholder Inclusion:** Although efforts are being made to include and certify smallholder farmers, progress is slow. From our meeting with the RSPO, smallholders' production currently accounts for 40% of total palm oil production in Malaysia; however, only 0.3% of smallholders in Malaysia are RSPO-certified as of the end of 2023. This may expose downstream buyers and financiers to higher risks of deforestation and other unsustainable practices within supply chains. Although some smallholders might follow sustainable production practices, it is challenging to meet the EUDR requirements due to resource constraints, such as lack of documentation and substantial due diligence.

Opportunities: Nature-Related Risk Management

- **High Conservation Value (HCV) and High Carbon Stock (HCS) Assessments:** With the growing attention on nature conservation, other high-risk commodities (e.g. soy, cattle) and industries (e.g. forestry, mining) can learn from the practices of the palm oil industry, such as the implementation of HCV and HCS assessments before land development.
- **Wildlife Conservation:** Palm oil companies are also familiar with the concept of wildlife conservation and the management of human-wildlife conflict. We observed some good practices from companies to conserve and support wildlife protection efforts, such as funding wildlife rescue centers. Also, we noticed that companies are setting standard operating procedures (SOPs) for plantation workers to raise awareness and achieve coexistence. Amid increasing demands for companies to assess their nature-related impacts and dependencies and establish strategies to address them, the palm oil industry has abundant experience and practices to share with other industries starting this work.

Key Messages for Responsible Investors

The palm oil sector, with its versatile properties, high yield, and ubiquitous usage, presents an intriguing investment opportunity. Two insights we can learn from its transition process:

1. **Collaborative Efforts Accelerate the Sustainable Transition**
   The sustainable transition in the palm oil industry results from collaborative efforts among investors, companies, governments, NGOs, certifiers (like the RSPO) and consumers. Despite ongoing challenges, multi-dimensional collaborations and communication are essential in navigating these challenges and accelerating the process to find win-win solutions.

2. **In-Person Interaction as a Tool for Responsible Ownership**
   Direct interaction with companies allows investors to verify corporate sustainability commitments, understand current challenges, and better assess potential risks and outcomes. In-person engagement not only builds trust with companies but also demonstrates that investors are genuinely concerned about the issues, further accelerating company actions to address them. In-person engagement also helps mitigate greenwashing claims by ensuring corporate disclosures align with on the ground practices.

Morningstar Sustainalytics' Biodiversity and Natural Capital Stewardship Programme will continue to gather valuable biodiversity insights from companies and support the sustainable transition across the agricultural value chain through active engagement dialogues with key stakeholders. Ultimately, we aim to achieve the targets of the Global Biodiversity Framework and halt biodiversity loss across the globe.

The Climate Accountability Crisis: Weakened Targets and Declining Investor Support in the Oil Industry

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In recent years, the commitment of major oil and gas companies to climate targets has come under increasing scrutiny. Despite their public announcements of support for the Paris Agreement, many of these companies have been found to be falling short of their emission reduction goals, while shareholder support for climate resolutions has also been waning.

Weakened Emission Reduction Targets

The *Paris Maligned II* report by Carbon Tracker Initiative, which focused on the analysis of major oil and gas companies, reveals a troubling pattern: these companies are not only failing to align their targets with the Paris Agreement, but some are also actively weakening their existing climate commitments.[8] For instance, **BP**, which had initially set ambitious targets to cut its emissions by 35-40% by 2030, revised its goals down to a 20-30% reduction.[9] This lowered target raises concerns among investors and climate activists alike, highlighting a broader trend of weakened ambitions within the industry. **TotalEnergies** also faces criticism for its insufficient response to climate change, with only 79.7% of its shareholders supporting its sustainability and climate goals for 2030, down from 88.8% the previous year.[10]

The Erosion of Climate Targets

In March 2024, **Shell** announced a revision of its 2030 carbon-reduction goal, reducing the target from a 20% cut to a range of 15-20% compared to 2016 levels. This adjustment, justified by the company through anticipated strong gas demand and uncertainties in the energy transition, marks a significant step back in their climate ambition. Furthermore, Shell scrapped its 2035 emissions reduction objective while maintaining a long-term goal of net zero emissions by 2050. These changes underscore a prioritization of short-term profitability over long-term environmental responsibility.

The *Big Oil Reality Check* report reveals that major oil companies, including **Chevron**, **ExxonMobil**, Shell, TotalEnergies, **ConocoPhillips**, **Equinor**, BP, and **Eni**, are failing to set ambitious targets to align with the Paris Agreement's goal of limiting global temperature rise to below two degrees Celcius.[11] The same document underscores that none of these companies have set comprehensive targets to ensure rapid and consistent emission reductions. Instead, many are increasing oil and gas production, leveraging carbon capture and storage (CCS) technologies, and selling off polluting assets to appear compliant while continuing to contribute to climate pollution.

Declining Shareholder Support

The weakening of climate commitments has coincided with a decline in shareholder support for climate resolutions. In 2023, voting records for major US and European asset managers showed increasing divergence, a trend continuing into 2024.[12] Independent shareholder support for key ESG resolutions at US companies fell below 50% for the first time in over three years. Morningstar Sustainalytics' analysis indicates that European managers maintained high support levels averaging 98%, compared to 50% for US managers.

Ten of the twenty US equity fund managers exhibited low or very low support for key ESG resolutions in 2023, a significant increase from the past three years. Support trends declined for 12 of the 20 US managers, with **American Century**, **BlackRock**, **Capital Group**, **Goldman Sachs**, and **Janus Henderson** showing the strongest negative trends. In contrast, all 15 European managers assessed consistently demonstrated high support for key ESG resolutions, reflecting their stronger sustainability commitments.

Notably, at Shell's 2024 Annual General Meeting (AGM), only 18.6% of shareholders backed a resolution urging the company to set more stringent climate targets, down from over 20% the previous year. This resolution, proposed by the activist group Follow This and supported by a coalition of 27 investors managing around USD 4 trillion, sought to align Shell's medium-term carbon reduction targets with the Paris Climate Agreement.[13] The reduced support reflects a broader trend of dwindling investor enthusiasm for ambitious climate action. Similarly, at TotalEnergies' recent AGM, more than 20% of shareholders voted against the company's climate strategy. This significant minority vote reflects growing dissatisfaction with the pace and scope of the company's climate actions.[14]

At BP's AGM, investor frustration over the company's revised emissions reduction targets for 2030—from 35-40% to 20-30%—was evident during the 2023 Annual General Meeting. Nearly 10% of shareholders voted against the re-election of chair Helge Lund, compared to just 3% the previous year.[15] Despite this, support for BP's board remained relatively strong, indicating a complex interplay between shareholder priorities and corporate governance.

ExxonMobil's approach to climate resolutions has been equally contentious but with a legal twist. In an unprecedented move by a major corporation, ExxonMobil sued two activist investor groups, Follow This and Arjuna Capital, who had filed a proposal urging the company to set more ambitious climate targets. The lawsuit argued that the proposals breached Securities and Exchange Commission (SEC) guidelines and sought to exclude them from the AGM agenda. Although the proposals were withdrawn following the lawsuit, ExxonMobil's decision to continue legal proceedings underscored its aggressive stance against shareholder activism.[16] Even though Exxon's actions are completely legal, this approach will certainly discourage future shareholder proposals.

The Path Forward

The current trajectory of major oil and gas companies poses significant risks to achieving global climate goals. To align with the Paris Agreement, these companies must set and adhere to more ambitious emission reduction targets, halt new fossil fuel projects, and transparently report their progress. Furthermore, shareholders and investors must continue to hold these companies accountable, leveraging their influence to drive meaningful change.

Conclusion

The weakening of emission reduction targets by major oil and gas companies, coupled with declining shareholder support for climate resolutions, paints a bleak picture for the global effort to combat climate change. As these companies continue to prioritize short-term profitability over long-term sustainability, the gap between their public commitments and actual practices grows wider. Investors, activists, and policymakers must intensify their efforts to hold these companies to account and push for more ambitious and actionable climate strategies. The future of our planet depends on it.

Freedom of Association and Labour Controversies

Why Investors Should Consider Using Their Voice to Support the Voice of Workers

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While it is 2024, and life has assumed a version of normal, it would be incorrect to suggest that the experience of the Covid-19 pandemic is behind us. In particular, the sharp inflection point it provided for our collective conversation on labour rights and human capital is a conversation that is going strong today. It highlighted questions around provision of basic labour rights, created deep discussions about topics like health and safety, sick pay, and living wages, and gave us the terms "essential workers" and "hybrid work environments."

It also inspired unionization movements around the globe as workforces and corporate management recalibrated how to collaborate on these topics. Starbucks, Amazon, and Teleperformance were prominent examples of companies making this list as Morningstar Sustainalytics launched new Global Standards/Incidents Engagement cases in either 2021 or 2022 focused specifically on freedom of association issues, without mentioning other cases opened in that period dealing with other labour rights concerns.

The Universal Declaration of Human Rights protects individuals' right to associate freely. The International Labour Organization (ILO) considers freedom of association and collective bargaining as fundamental rights. They are addressed directly by ILO conventions 87 and 98, respectively Freedom of Association and Protection of the Right to Organise Convention and the Right to Organise and Collective Bargaining Convention.

A key reason that freedom of association is considered fundamental is that it provides a foundation for protecting and promoting other labour rights—health and safety, discrimination, working conditions, wages, etc. The protections provided by trade unions can enable a sense of safety for employees to raise concerns in a legitimate forum. In this way, issues that may not otherwise have been disclosed for fear of retaliation from the business can be heard and, ideally, remediated. Establishing genuine dialogue with freely chosen workers' representatives enables both workers and employers to understand each other's problems better and find ways to resolve them.

It is not only the experience of the pandemic that is leading workers to push for a stronger voice in their companies. We are also entering a time of generative AI, managing workplaces with four generations of people, such as Baby Boomers, Gen Xers, Millennials, and Gen Zers, and all of the diverse ethnicities, values, and expectations held by those generations, and balancing societal concerns as broad as climate change impact and a cost-of-living crisis. People want to feel safe at work, secure in their livelihoods, included in the work community, able to support themselves and their families, and to be able to express their values. Freedom of association and collective bargaining can support that objective.

Investors also need to be mindful of this reality as they look for companies that competently manage their ESG risks. Well managed companies—and particularly those for which human capital is a material aspect—must consider their ability to attract, retain, and develop talent to remain competitive in the future. Companies will often state their objective is to be an employer of choice, but if there are perceived gaps in their capacity to respect fundamental labour standards, their human capital management practices may falter. Investor support and advocacy for strong worker representation is also a contribution to good people management.

Over the past year, a great example of investors using their own voice to support the voice of workers has played out at Starbucks. Unionization efforts began at Starbucks during 2021 and were met with strong resistance from company management. The relationship between management and those employees pursuing unionization remained tense, resulting in multiple US National Labor Relations Board complaints and allegations of anti-union activity.

The stalemate began to loosen at the company's 2023 annual general meeting when shareholders were able to push through a resolution demanding that Starbucks conduct an independent third-party workers' rights assessment. Then, in the lead-up to the 2024 AGM, a proxy challenge was launched by shareholders to elect three independent directors to the Starbucks board specifically to address the labour relations issues. This resolution was withdrawn when the company agreed to collaborate with Workers United—the union representing Starbucks employees—on a framework agreement for unionizing stores. The Starbucks example is still in progress, but we think it can be looked at as a success story of the value of investors supporting workers goals. Investors of Starbucks expressed concern regarding the company's reputation as an employer and whether it had the focus to continue attracting and retaining employees and took steps to protect their investment.

Investor engagement on ESG issues remains a powerful tool to leverage positive change. Investors looking to engage companies in their portfolios—or that they would like to be eligible for their portfolios—on issues of freedom of association and collective bargaining would do well to consider how well investee companies' policies align with international norms and ILO conventions and whether there is visibility on how those commitments are being implemented. Ensuring due diligence and enhanced stakeholder engagement are two very positive signs that labour rights are respected and should be an enabler for more detailed discussions. The pandemic was a disruptive element in all our lives but the conversation around labour rights has become more focused and responsive, a positive for the delivery of improved ESG performance, and reduced investor risk.

Empowering the Future Workforce: AI Integration With a Human-Centric Approach

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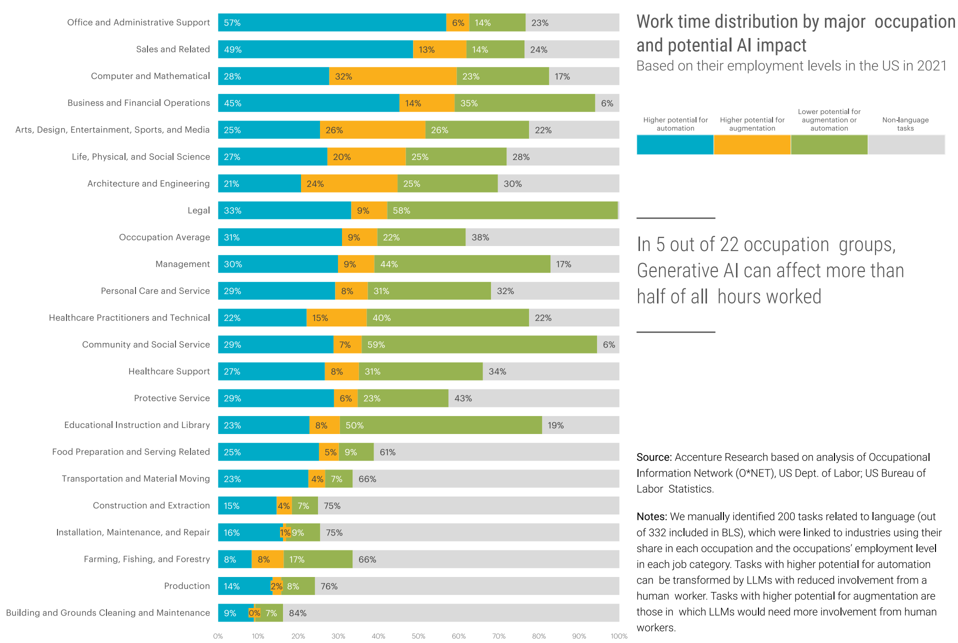
Integrating artificial intelligence (AI) into business operations is a critical focus for institutional investors. This transformation brings opportunities and challenges, particularly regarding its impact on customers, employees, and communities. For companies, it is essential to adopt a holistic approach that centers on people, ensuring AI enhances work and wellbeing rather than merely boosting productivity and innovation.[17]

Companies often claim that "people are our greatest asset;" hence, investors should require companies to provide evidence of how they support this statement through data and progress. Mercer reports that 89% of asset managers consider people a key asset driving business value.[18] Thus, institutional investors play a pivotal role in guiding companies toward balanced and responsible AI integration. This article explores how companies can achieve this balance, focusing on the dual goals of leveraging AI for productivity and innovation while simultaneously enhancing employee well-being, driving cultural transformation and preparing the future workforce.

Enhancing Productivity and Innovation

A Mercer report highlights that tasks which add no value are major drains on employee productivity.[19] By automating routine tasks, AI can significantly boost productivity, allowing employees to dedicate their time to more valuable and complex work. AI tools can process data faster and more accurately, improving decision-making and operational efficiency. To effectively address the challenge of non-value-adding tasks—such as repetitive data entry, manual processing and routine administrative work—organizations need to focus on capacity planning, work redesign in collaboration with employees and better skills/task matching using AI tools.[20] Generative AI, for example, could impact 40% of working hours across all industries by automating or augmenting tasks, as illustrated by Accenture's report on work time distribution (see **Figure 3**).[21] However, this transformation will not happen overnight.

Figure 3. Impacts of Generative AI Across Job Categories.[22]



Note: Articles will not be adjusted to client portfolio.

Organizations must prepare their workforce and adapt to these changes, especially since 75% of global knowledge workers already use AI with or without employer support, according to Microsoft and LinkedIn.[23] Moving from experimentation to business transformation requires proactive measures. Institutional investors play a critical role in engaging organizations to understand how they deploy AI tools to enhance worker experiences and support this transition. Freeing up time for more meaningful tasks can boost creativity, innovation, and business value while enhancing employees' sense of purpose and well-being.

Cultural Transformation and Change Management

Implementing AI systems involves significant cultural and structural changes. To transition from experimentation to business transformation, effective change management strategies are essential. This includes clear communication, employee involvement, and addressing resistance to change. Fostering a culture that embraces innovation and continuous learning can create a positive attitude toward technological advancements. Mercer notes that 67% of organizations adopt new technology without transforming their work processes.[24] Investors need to understand how companies embrace change and foster a culture of innovation, creativity, and lifelong learning to ensure that companies are implementing effective change management strategies in order to decrease risk and remain competitive.

Supporting employees during this transition is crucial. Data-driven approach and people analytics can help organizations understand the impact of technologies on roles and proactively address potential negative consequences. The challenge is that companies often do not disclose how they do this or assess technology's impact across job categories. Investors must engage with companies to discuss the potential impact of technology on jobs and how they address it proactively. Understanding a company's culture and its role in achieving strategic goals is key to adaptability.

Enhancing Employee Well-Being

A Microsoft and LinkedIn Work Trend Index Survey of 31,000 employees reveals that 68% of respondents struggle with the pace and volume of work, and 46% feel burned out.[25] The World Health Organization classifies burnout as an organizational phenomenon that leads to exhaustion, negativity, and disengagement, resulting in low productivity.[26] These statistics are concerning given their negative impact on employee mental health, well-being and overall business performance.

High workloads and inflexible work conditions are key factors contributing to burnout.[27] Redesigning work with employee input is critical. By understanding workload levels and identifying stress sources, organizations can deploy AI tools to automate or augment tasks effectively. AI can handle repetitive and time-consuming tasks, allowing employees to focus on more meaningful work. Additionally, AI-driven analytics can provide insights into employee well-being, identifying trends and potential issues before they escalate.

Improving employee health and well-being should be a priority to reduce workforce risks and boost agility and innovation.[28] Mercer's Global Talent Trends 2024 reports that 46% of employees would forgo a pay increase for additional well-being benefits, highlighting the growing importance of well-being in the workplace.[29] The “Great Exhaustion,” a new term used to describe wide spread burnout across the workforce describes the situation we find ourselves in today.[30] Adopting a multidimensional view on flexibility—considering where, when, who, how, and why work is done—can enhance agility and productivity.[31] This approach may allow organizations to redesign work collaboratively with employees, ultimately increasing employee well-being, reducing burnout, and strengthening long-term business value.

Future Outlook and Expectations

Looking ahead, AI is set to further transform the workforce landscape. Investors should expect companies to continuously adapt and innovate, leveraging and learning about AI to stay competitive. This includes anticipating future trends and challenges. Encouraging companies to adopt a mindset of continuous improvement and regularly update their AI strategies to reflect technological advancements and market changes is essential. Supporting initiatives that build organizational resilience enables companies to adapt quickly to disruptions and capitalize on new opportunities.

However, as companies navigate this transformation, it is crucial that they do not lose sight of the human element. Ensuring that AI integration enhances worker well-being and maintains a human-centric approach is vital. Investors should monitor the long-term impact of AI on workforce dynamics, ensuring ethical considerations and human-centric approaches remain at the forefront.

The State of Circular Economy Reporting in the Automotive Value Chain

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Among the companies targeted thus far, it is already common for 'circular economy' to be recognized as a priority topic in the ESG materiality assessment and for reporting to include a section that is dedicated to this topic. One year before companies are required to comply with the more comprehensive requirements imposed by the EU's Corporate Sustainability Reporting Directive (CSRD), it is still exceptional among the targeted companies to publish multiple quantitative targets and report on progress on the transition to a circular economy in a comprehensive manner. In most company reports, circular economy reporting seems to be at an early stage. Many environmental compliance management topics have already been covered for many years, typically accounting for waste, water, pollutants, and emissions. The circular economy lens, however, requires companies to extend the scope of their strategy and accountability to cover the entire value chain and go beyond efficient production by closing resource loops as much as possible.

As a material ESG topic, the transition to a circular economy has not been getting the same level of attention as the transition to a net zero economy. One of the engaged companies offered a possible explanation: Circular economy efforts often need to serve the net zero transition agenda. At least for car manufacturing companies (OEMs), the net zero transition has needed to be their top environmental priority, considering how tailpipe emissions of internal combustion engine vehicles still dwarf all the other emissions sources in the industry's value chain. Upstream companies in the automotive industry tend to have little to no leverage over tailpipe emissions. This makes it easier for them to focus on improving resource efficiencies in the OEMs' supply chain, involving parts, EV batteries and tires. We have started engaging tire manufacturing companies on their priority circularity topics, such as the share of recycled and renewable resource content, tire and road wear particles pollution, and end-of-life product management. Since tires can easily be removed from cars, the tire value chain appears to be less integrated with the rest of the automotive value chain.

In contrast to general sustainability management, climate action and environmental compliance, it is currently still uncommon among the targeted companies to dedicate board oversight and executive mandate specifically to the transition to a circular economy. In terms of practical leverage, it may also be an effective strategy to ensure that companies and their boards are environmentally competent more broadly and to promote financial incentives for companies, such as a performance-based remuneration component or a sustainable finance instrument, to support the transition to a circular economy.

Exxon vs. Shareholder Resolution Proponents: The Case that Could Muffle the Proxy Process

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Generally, proxy season is seen to begin with Apple's annual general meeting in February, and end with Alphabet's annual general meeting in early June. This year, Exxon Mobil book-ended proxy season all on its own.

In January, Exxon sued two shareholders—Arjuna Capital and Follow This—to stop their proposal from appearing on the agenda of the company's annual general meeting (AGM) at the end of May. The proposal asked Exxon to do more to cut its greenhouse gas (GHG) emissions. Exxon has faced numerous climate-related shareholder proposals over the years but has taken issue with these proponents because Exxon believes that "neither organization wants to improve Exxon's business performance or increase shareholder value." Rather, Exxon states that the proponents share a different goal of "disrupting Exxon's investments and development of fossil fuel assets and causing Exxon to change its business model, regardless of the benefits, costs, or the world's needs."[32]

This was an unusual move by the company, given that the standard approach is to follow the Securities and Exchange Commission (SEC) no action process, whereby companies seek assurance from the SEC that they can exclude a shareholder proposal from their AGM ballot. However, Exxon's lawsuit makes its position quite clear on this and clearly indicates why the company took such an unconventional route. Exxon describes the current shareholder proposal and proxy voting process as "flawed," stating that it "does not serve investors' interests and has become ripe for abuse by activists with minimal shares and no interest in growing long-term shareholder value."[33] Exxon was clearly concerned that the SEC no action process would not work in the company's favor, and after years of facing numerous climate-related shareholder proposals, the company took what some are seeing as the nuclear route.

The threat of legal action from a USD 500 billion company and all of its resources against two shareholders with a likely shareholding that is worth a few thousand dollars was enough to stop the shareholders in their tracks. A statement was soon released confirming that the shareholder proposal had been withdrawn, and that it would never be filed again.

However, despite seemingly achieving the objective of stopping the proposal from appearing on Exxon's AGM agenda, the company maintained the suit: a judge dismissed the case against Follow This on jurisdiction grounds, but the case against Arjuna Capital was allowed to proceed. Exxon stated its belief that the proponents' withdrawal did not provide the company with sufficient relief this year, because the proponents could table slightly modified proposals that address substantially the same subject matter in future years.

This became the thread that weaved its way through proxy season, culminating in the Exxon AGM on 29 May.

Many condemned Exxon for what appeared to be a case of overkill to the highest degree, but this transcends Exxon, its AGM, and even this year's proxy season. This is being seen as a gratuitous and calculated wielding of power to silence investors, prevent shareholder proposals in future, and ultimately attack shareholder democracy. Despite Exxon's actions being entirely legal, this approach will undoubtedly have a chilling effect on shareholder proposals in future. Many other companies may now see this approach as a way to limit the numerous troublesome shareholder proposals that they face annually.

Many Exxon shareholders publicly stated their opposition to the company's approach and declared an intention to vote against the company's Chair and CEO, Darren Woods, and the board's Lead Independent Director, Joseph Hooley. Glass Lewis—one of the big two proxy voting advisors—recommended a vote against Hooley, holding him accountable for the company's aggressive tactics.

A key question in all of this: was the board fully behind the company's approach? It seems unlikely that the body that is nominated by shareholders to oversee management and look after their best interests would support such aggressive tactics, particularly after the withdrawal of the proposal. And yet, despite Exxon's board including three nominees from Engine No. 1—the small climate activist whose proxy fight defeated Exxon in 2021 and installed its more climate-sympathetic nominees to the energy behemoth's board—Exxon has continued down this unwavering path.

Despite the outcry over Exxon's approach and the declarations to vote against the entire board in some cases, the company's AGM did not prove to be as explosive as the buildup throughout proxy season had suggested. The company reported soon after the AGM that Chair and CEO, Darren Woods, had received 91.6% support and Lead Independent Director, Joseph Hooley, had received 87.1% support. Generally, director support averages around 93-94% in the US, and while both results are lower than the average, the numbers still indicate strong support among shareholders.

While the Exxon AGM vote has now come and gone, and the case against Arjuna dismissed on 17 June (with Arjuna promising never to file another climate resolution at Exxon ever again),[34] the broader impact of Exxon's actions on future resolution filing at US companies is yet to be seen.

Our view is that shareholders can complement resolution filing with other activities available in the stewardship portfolio. For example, continuous engagement with issuers, especially when done together with other like-minded investors, can help to create effective communication channels with issuers, allowing a greater understanding of perspectives and an increased likelihood of successful outcomes.

Insights from the 2024 Proxy Season in the US and Canada

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The majority of issuers in US and Canada have already concluded their annual general meetings. Based on the voting activity publicly available between 1 January 2024 and 17 June 2024, we want to share some highlights of the 2024 proxy season related to sustainability and good governance topics. The selected data points and insights presented below can help to better understand current trends and provide useful background.

Total Shareholder Resolutions

During the 2024 proxy season, around 600 shareholder proposals were voted across the US and Canadian markets, 261 of these focusing on governance-related topics. At the highest level, most governance-related resolutions can be grouped into three broad categories: shareholder voting rights, board accountability and executive compensation. Two topics with ten or more resolutions receiving strong average support include shareholder voting rights and racial/gender pay equity. Board diversity resolutions, while numbering only two resolutions this year, also received strong support, showing shareholders' continued conviction about the importance of this governance metric. Proposals focusing on board accountability and workplace/senior management diversity also received significant support.

By further aggregating the data, one may conclude that shareholder priorities during the 2024 proxy season can be grouped into two broader categories: seeking greater influence over their investees and promoting equity and diversity throughout their portfolios.

Table 2. Shareholder Resolutions Addressing Governance Topics Voted at US and Canadian Companies in the 2024 Proxy Season.

Governance-Related Topics	Number of Proposals	Average Support from Independent Shareholders
Shareholder Voting Rights	103	42%
Board Accountability	65	27%
Executive Compensation	58	12%
Workplace/Senior Management Diversity	16	27%
Racial/Gender Pay Equity	13	30%
Board Diversity	2	42%
Tax Accountability/Fair Taxation	2	19%
Employee Governance Representation	1	6%
Corporate Purpose/Corporate Form	1	2%
Total	**261**	

Shareholder Resolutions Receiving Majority Support

During the 2024 proxy season, 45 governance-related shareholder proposals received majority support across the US and Canadian markets. The adoption of a simple majority vote rule stands out as the main priority for investors being covered by more than half of the successful resolutions. In addition, the declassification of board of directors, allowing shareholders to call special meetings, and offer in-person participation to annual meetings at Canadian issuers are three other topics that have been supported by majorities of shareholders at various issuers.

Beyond voting at proxy seasons, investors can rely on continuous engagement with issuers to establish and maintain open communication channels that advance shareholder democracy. This approach can lead to better outcomes for shareholders by building trust, enabling proactive issue resolution, developing a deeper understanding of long-term strategy, and promoting transparency and accountability in corporate governance.

Table 3. Majority Supported Governance Requests Voted at US and Canadian Companies in the 2024 Proxy Season.

Shareholder Resolutions Filed in the US and Canada	Number of Shareholder Resolutions Receiving Majority Support
Adopt Simple Majority Vote	23
Collapse Dual Class Share Structure	1
Declassify the Board of Directors	6
Separate CEO and Chair Roles	2
Extend Proxy Access	1
Shareholder Approval of Poison Pill Provisions	1
Shareholder Ratification of Termination Pay	1
Shareholder Right to Call Special Meetings	5
Extend In-Person AGM Participation (Canadian Companies)	5
Total	**45**

Scaling Regenerative Agriculture: Insights from a Corporate and Investor Roundtable

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In an article for the *Q1 Quarterly Report*, we explored the connection between regenerative agriculture and biodiversity protection.[35] We considered the definition of regenerative agriculture, its benefits, and the attitudes and approaches of companies and financial institutions towards it. We also looked at how various stakeholders might overcome the barriers to scaling regenerative agriculture, a topic which we revisited during a virtual roundtable with companies and investors on 14 May 2024.

The purpose of the roundtable was to exchange insights and perspectives on opportunities and challenges associated with the promotion of regenerative agriculture. Seven companies participated from sectors involved in the food system—agricultural chemicals, packaged food and food retail—along with 11 institutional investors. The discussion took place under Chatham House rules to encourage an open exchange of views.

Participants from various points on the value chain observed that agriculture accounts for a huge volume of carbon emissions. It also has other significant environmental impacts globally, as the primary driver of biodiversity loss[36] while accounting for 70% of water use,[37] as well as social impacts. Regenerative agriculture can drive progress by simultaneously addressing interconnected issues such as biodiversity, water, climate and human rights. Its benefits can include sequestering carbon, increasing soil biomass, decreasing fertilizer use and increasing production. Although these benefits can take years to materialize, some farmers may be willing to reduce yields in the short term for better outcomes in the long term.

The discussion also illustrated that some companies have commitments to source key commodities sustainably, which may be aligned with initiatives to promote regenerative agriculture. However, one participant noted the challenge of companies working in silos with individual goals and claiming impact. They argued that all stakeholders should focus on meeting global goals related to nature, climate and people, meaning that a systemic approach is needed to deliver successful outcomes.

Participants placed particular emphasis on the importance of collaboration between companies and farmers. Company participants underlined the necessity of centring the farmer and the local community in promoting regenerative agriculture, partly because farmer success is essential to implementing regenerative practices. Companies should work together to define standards for regenerative agriculture and train producers, given that lack of knowledge is a significant barrier to entry for farmers who have varying levels of resources and toolkits. At the same time, companies can learn from the experience of suppliers and producers and share this knowledge across their own supply chain.

Another challenge is that farmers are expected to deliver targets on behalf of companies. It would be more effective if farmers see the benefits of regenerative agriculture, though a resilient and thriving ecosystem that enhances their own productivity and economics. Simple and financially motivated practices will be adopted quickly, especially as many farmers are working on rented land, making it difficult for them to take a long-term view. However, each supply chain and farmer may require different incentives and solutions. For example, there are 127 types of cover crop, so the choice needs to be tailored to local conditions to avoid decreasing the main crop yield.

While some elements of the discussion focused on disseminating regenerative practices, others stressed the endeavour of measuring outcomes. Regenerative agriculture is not just about implementing specific practices but building a more sustainable and resilient system over time. Companies reflected that carbon is a key metric in promoting regenerative agriculture, in part because it is linked to specific, tangible outcomes. Regenerative agriculture can be a key lever for reducing carbon emissions embedded in food products, for example, by reducing pesticide use. However, Morningstar Sustainalytics' earlier dialogue with companies has illustrated that there remains a lack of standardized and widely adopted measurement of outcomes of regenerative agriculture, beyond carbon emissions. At the same time, some companies are partnering with scientific institutions to conduct research on assessment of outcomes, and we look forward to seeing how this body of work develops.

A further challenge is that of building on encouraging pilot projects and achieving scale. As the discussion concluded, participants traced out some core elements of a corporate scaling strategy:

- derive practical recommendations from pilot projects, including on measurement of outcomes;
- collaborate with other companies, including on common goals;
- acknowledge the important role of public sector partnership, and combining investment with government funding in a targeted jurisdiction;
- collaborate with civil society groups.

In addition, stakeholders should not only back companies who have voluntarily committed to investment in regenerative agriculture, but also 'call in' (rather than 'call out') industry laggards to ensure they can also scale investment and impact.

Roundtables can be an effective way of enhancing communication between investors, sectors and peer companies. In this case, the sharing of solution frameworks and successful programmes can help advance regenerative agriculture within the food value chain.

We also promote such interactions more broadly on the basis that collective solutions are needed to address complex issues associated with biodiversity and natural capital. We will seek further opportunities to convene such meetings as this as the Thematic Stewardship Programme evolves.

Engagement Events and Industry Initiatives

OECD Forum on Sustainable Mineral Supply Chains in Paris

The year's Forum in Paris was attended by various stakeholders such as governments, businesses and civil society organizations. While the Forum addressed a wide range of issues and it offered a great opportunity to meet with stakeholders in the field, we identified three key takeaways for investors in terms of engaging with mining companies.

Firstly, the goal of engagement should focus on outcomes rather than merely counting the number of meetings. Secondly, quantitative data should be complemented by qualitative data. Thirdly, data triangulation should become mainstream when assessing corporate performance.

This is especially important when engaging with mining companies, as they encounter complex issues and interact with a wide range of stakeholders. Not only might the companies have competing perspectives from those of the communities, but the various communities themselves may also have differing views. Investors need to overcome the challenge by accessing appropriate information sources, ensuring data quality, and balancing stakeholder views to make decisions.

Highlights of the Latest Developments for the Incoming GRI Banking Sector Standard

GRI Banking Sector Standard Technical Committee In-person Meeting in Amsterdam

In April 2024, Angela Flaemrich, an Engagement Manager on the Stewardship Services team at Morningstar Sustainalytics and a member of the Banking Technical Committee, participated in the GRI (Global Reporting Initiative) in-person meeting in Amsterdam, aimed at making progress on focal topics for drafting the new GRI Banking Sector Standard.

Since September 2023, members of the GRI Banking, Insurance, and Capital Markets Technical Committees have been collaborating to advise the GRI on developing the three respective sustainability reporting Sector Standards, which are expected to be released in late 2025. These Standards are designed to help identify a sector's most significant impacts and provide sector-specific disclosures to complement the existing GRI Standards and will enhance the global comparability and quality of information within the banking sector, as needed to support informed decision-making by a variety stakeholders.

Angela is pleased to share a few highlights for the Banking Sector Standard thus far:

The Banking Technical Committee has identified an initial list of likely material topics for the banking sector. These proposed topics cover issues including climate change, biodiversity, financial health and inclusion, customer privacy, forced or compulsory labour, non-discrimination and equal opportunity, anti-corruption and prevention of financial crime, anti-competitive behavior, employment, remuneration and working time, local communities and rights of indigenous peoples, and marketing and labelling.

The likely material topics outlined in the new Banking Sector Standard will provide banking organizations with a helpful tool when conducting their materiality assessment and additional sector specific reporting as needed. While banks can continue to report on any material topic, banks reporting in accordance with GRI in the future will need to refer to the Banking Sector Standard and provide an explanation if any of the identified topics are not material to them.

Considerable attention has been given to developing sector-specific reporting to supplement the revised drafted GRI Climate Change Topic Standard (particularly to new disclosures on just transition principles, transition plans for climate change mitigation and climate change adaptation plans) and the new GRI Biodiversity Topic Standard.[38] The technical committee's discussions focused on Scope 3 GHG emissions and expectations for separately reporting financed GHG emissions, insured GHG emissions, and off-balance sheet GHG emissions (with breakdowns by sector), and reporting on exclusions, the rationales for the exclusions, any limitations on the data and plans to improve the data. Regarding biodiversity, Angela raised the issues of limitations in data and reporting expectations around impact assessment and client due diligence.

There have been extensive discussions regarding how to structure banking disclosures for the many types of business ethics-related topics, which represent most of the industry's controversies. While at Morningstar Sustainalytics business ethics disclosures are grouped together under one material issue, for the GRI, certain aspects of business ethics are already covered under GRI 2 (Universal Standards) and different Topic Standards.

The technical committee discussed potential reporting expectations for the banking sector around the prevention of financial crime (anti-competitive behavior, public policy and tax). Sustainability integration (how organizations define and manage sustainability impacts through investment practices, organizational approach, alignment with core business strategies, and implementation through policies, processes, and investment decisions) is another challenging area that is still being discussed and is recognized as very important.

Angela has been advocating for improved disclosures on the approach, means and actions of stewardship and engagement activities by banks on material topics, and is pleased that this type of disclosure is being developed as part of this project.

The GRI Banking, Capital Markets and Insurance Sector Standards drafts will undergo a significant feedback and comment period from technical committee members and peer reviewers between now and July 2024, and will enter a public comment period early 2025, for release late next year.

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About Morningstar Sustainalytics and Contacts

Morningstar Sustainalytics is a leading ESG data, research, and ratings firm that supports investors around the world with the development and implementation of responsible investment strategies. For more than 30 years, the firm has been at the forefront of developing high-quality, innovative solutions to meet the evolving needs of global investors. Today, Morningstar Sustainalytics works with hundreds of the world's leading asset managers and pension funds who incorporate ESG information and assessments into their investment processes. The firm also works with hundreds of companies and their financial intermediaries to help them consider material sustainability factors in policies, practices, and capital projects. Morningstar Sustainalytics has analysts around the world with varied multidisciplinary expertise across more than 40 industry groups. For more information, visit www.sustainalytics.com.

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