Director Notes

The Role of the Board in Accelerating the Adoption of Integrated Reporting

by Robert G. Eccles and George Serafeim

This report examines the concept of integrated reporting and its current state of adoption around the globe. It also discusses the benefits to both companies and society and recommends ways boards can help their organizations accelerate the implementation of integrated reporting.

Interest in and adoption of integrated reporting regarding a company's financial and environmental, social, and governance (ESG) performance is growing rapidly. Although still largely a voluntary practice in most countries, it already is (South Africa) or soon will be (France) required of all listed companies. The European Union is poised to mandate ESG (environmental, social, and governance) reporting within the next year, a significant step toward mandated integrated reporting. The first company to issue an integrated report, nearly 10 years ago, was the Danish bio-industrial products company, Novozymes. Natura Cosméticos, a Brazilian cosmetics and fragrances company, issued its first integrated report in 2003. The Danish diabetes care company Novo Nordisk did so the next year.

Today, a number of European companies are producing integrated reports and creating more integrated websites. Even a few U.S. companies, which historically have been notoriously risk averse to voluntary disclosures given heavy financial reporting requirements and fears of litigation, have started to practice integrated reporting. During the past few years, some U.S. companies, such as American Electric Power, Pfizer, Southwest Airlines, and United Technologies Corporation, have issued integrated reports.*

A sustainable society requires the vast majority of its companies to have sustainable strategies—defined as those that create value for shareholders over the long term while meeting the needs of other stakeholders and not taking excessive or uninformed risks. Integrated reporting is both the most effective way to communicate a company's performance in implementing a sustainable strategy and a form of discipline to ensure that it has a sustainable

* This *Director Notes* is adapted from the book chapter, "Accelerating the Adoption of Integrated Reporting," in Francesco de Leo and Matthias Vollbracht (Eds.), *CSR Index* (Zurich, InnoVatio Publishing Limited, 2011), pp. 70–92.

No. DN-V3N23
NOVEMBER 2011

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strategy in the first place. The benefits to companies of integrated reporting include:[1]

- A better understanding of the relationship between financial and nonfinancial performance
- Improved internal measurement and control systems for producing reliable and timely nonfinancial information
- Lower reputational risk
- Greater employee engagement
- More committed customers who care about sustainability
- More long-term investors who value sustainable strategies
- Improved relationships with other stakeholders

This report argues that the rapid and broad adoption of high-quality integrated reporting is an imperative for capital markets and society at large. For this reason, all listed companies should be encouraged to adopt integrated reporting practices within the next five years. A combination of market and regulatory forces will be required to make this happen, with the balance varying across countries.

Board directors can play an important role in spreading the adoption of integrated reporting. This report suggests that it is in their interest to do so, since integrated reporting will enable them to better fulfill their fiduciary responsibility to represent shareholders and other stakeholders. Increasingly, shareholders' interests are affected by the interests and objectives of other stakeholders, so the board must take into account both sets of interests.

The Concept of Integrated Reporting

Integrated reporting involves reporting both financial and nonfinancial (ESG) information in a single document, ideally showing the relationship between the two—good performance on ESG issues contributes to good financial performance and vice versa—and the potential tradeoffs that a company might face across financial and nonfinancial performance. Today, all listed companies are required to report their financial performance at least annually, but reporting on nonfinancial performance is a voluntary exercise in most countries. However, empirical research has shown the benefits of mandated ESG reporting to both companies and society.[2] The same will be true of integrated reporting and even more so.

The fundamental premise behind integrated reporting is that a *sustainable society*, defined as one that can meet the needs of both present and future generations, requires most (if not all) of its companies to have *sustainable strategies*, which can create value for shareholders and other stakeholders in both the short and long term. This may involve sacrificing the former for the latter.[3] Four factors account for the current sense of urgency to ensure a sustainable society:

- Recurring global financial crises
- An increasing awareness of the effects of climate change and natural resource limitations, such as water and certain minerals
- The growing importance of human capital to value creation in developed economies and of human rights in developing countries
- The recognition of the essential role of good corporate governance and risk management to prevent major corporate disasters, such as through fraud, corruption, and major operating blunders

Long-term sustainable value creation requires the company to take a holistic view of its decisions and the consequences of these decisions regarding financial, natural, and human resources in terms of how decisions about each type of resource affects the others. It also requires good governance and risk management to ensure that decisions producing short-term performance do not threaten the company's long-term performance (or even existence). As expressed by the International Integrated Reporting Committee (IIRC), through integrated reporting, a company is able "to demonstrate the linkages between an organization's strategy, governance and financial performance and the social, environmental and economic context within which it operates. The IIRC's Framework will support an organization in addressing, in a clear and concise manner, the material issues affecting its ability to create and sustain value in the short, medium and longer term."[4]

1 Robert G. Eccles and Michael P. Krzus, "United Technologies Corporation," *One Report: Integrated Reporting for a Sustainable Strategy*, (New York: John Wiley & Sons, Inc., 2010) and Robert G. Eccles and Kyle Armbrester, "Two Disruptive Ideas Combined: Integrated Reporting in the Cloud," *IESE Insight*, no. 8, 2011.

2 Ioannis Ioannou and George Serafeim, *The Consequences of Mandatory Corporate Sustainability Reporting,* Harvard Business School, Working Paper 11-100, 2011.

3 Robert G. Eccles and Michael P. Krzus, "Sustainable Strategies for a Sustainable Society," *One Report: Integrated Reporting for a Sustainable Strategy* (New York: John Wiley & Sons, Inc., 2010).

4 IIRC Integrated Reporting Pilot Programme (www.theiirc.org/wp-content/uploads/2011/06/BriefingIntegratedReportingPilotProgramme.pdf) accessed July 2011.

The State of Integrated Reporting Today

Since no universally accepted framework for integrated reporting exists and it is still largely a voluntary practice, an "integrated report" is not well defined. Still, it is possible to get a sense of the degree to which companies are attempting to integrate reporting of their financial and nonfinancial performance and how this varies across countries. For example, of those 1,861 companies using the G3 Guidelines published by the Global Reporting Initiative, 237 are self-declared integrated reports.[5]

Another way to assess the degree to which companies are attempting to put the concept of integrated reporting into practice is through a proprietary database of 2,255 companies from Sustainable Asset Management (SAM).[6] The analysis conducted for the purpose of this report used data from 2009 in which SAM analysts coded whether a company was integrating ESG and financial information. This integration could be in terms of either narrative information or quantitative key performance indicators (KPIs) or both.

The SAM database makes it possible to examine variations across countries. For ESG information, it was possible to develop an index for each country based on the percentage of companies integrating both narrative and KPI information minus the percentage of companies integrating neither. The larger the number, the greater the degree of integration. (Table 1)

For environmental information, 14 countries have a positive score, meaning that more companies are integrating both narrative and KPI information than those that are doing neither, and the remaining 15 have a negative score. The United Kingdom ranks first—followed by France, Denmark, Sweden, Finland, Portugal, and Brazil—and the United States ranks last. Joining the United States at the bottom of the rankings are South Korea, China, Canada, Hong Kong, and India. For social information, 13 countries have a positive score, and 16 have a zero or negative one. Here, too, the United Kingdom ranks first—followed by Brazil, Germany, Sweden, and France—and the United States ranks last. Also at the bottom of the rankings are South Korea, Colombia, Canada, Greece, and Japan.

Table 1

Integration of Environmental and Social Information by Country

Rank	*Country*	*Environmental score*	*Country*	*Social score*
1	United Kingdom	54.5	United Kingdom	48.2
2	France	54.3	Brazil	48.0
3	Denmark	46.2	Germany	46.8
4	Sweden	45.5	Sweden	45.5
5	Finland	44.4	France	42.9
6	Portugal	44.4	Finland	33.3
7	Brazil	40.0	South Africa	30.8
8	Russian Federation	33.3	Italy	29.2
9	Germany	29.8	Denmark	23.1
10	Luxembourg	25.0	Belgium	16.7
11	South Africa	23.1	Ireland	11.1
12	Netherlands	9.1	Spain	6.7
13	Switzerland	8.1	Netherlands	6.1
14	Spain	6.7	Luxembourg	0.0
15	Belgium	-5.6	Malaysia	0.0
16	Italy	-8.3	Singapore	-4.3
17	Ireland	-11.1	Switzerland	-5.4
18	Mexico	-12.5	Mexico	-12.5
19	Greece	-18.2	Hong Kong	-17.1
20	Australia	-19.7	Austria	-22.2
21	Japan	-20.0	India	-26.3
22	Singapore	-21.7	China	-26.7
23	Austria	-22.2	Australia	-33.3
24	India	-31.6	Japan	-39.0
25	Hong Kong	-31.7	Greece	-45.5
26	Canada	-46.2	Canada	-49.5
27	China	-53.3	Colombia	-50.0
28	Korea (South)	-59.0	Korea (South)	-64.6
29	United States	-79.0	United States	-81.1

Source: Sustainable Asset Management (SAM) database

5 GRI Reports List (www.globalreporting.org/ReportServices/GRIReportsList/) accessed July 2011.

6 Sustainable Asset Management (SAM) is an international investment company with a specific focus on sustainability investments. The company is based in Zurich, Switzerland, and considers economic, environmental and social criteria in its investment strategies. In addition to asset management, the company constructs stock market indexes and is active in private equity.

It is worth cautioning against over-interpreting the strict rank order given data and methodological limitations. However, the general pattern is clear and consistent with expectations. The highly ranked countries for both environmental and social information are in Europe and Brazil. This is consistent with the fact that 45 percent of companies practicing integrated reporting, according to the GRI list, are in Europe. Outside of the United States and Canada, most of the low-ranked countries are in Asia. Companies in the United States and Canada remain skeptical about the important of sustainability in their strategies, which is exacerbated somewhat by the short-term nature of their capital markets. Companies in the developing economies of China, India, and South Korea are more focused on pursuing the substantial short-term growth opportunities they are facing and thus less concerned about long-term sustainability.

A common complaint of companies practicing integrated, or even separate, sustainability reporting is general investor indifference. What is the point, companies ask, of pursuing strategies for sustainable long-term value creation if investors do not care? Furthermore, why prepare an integrated report if this will have no impact on investors? While some in the investment community, particularly the Socially Responsible Investment (SRI) funds, have expressed vocal support for integrated reporting, this topic is not yet at the top of the agenda of most "mainstream" investors. Using Bloomberg data, it was possible to evaluate the degree to which investor interest in ESG information varies across countries. In particular, Bloomberg supplied data showing the number of times investors in 23 countries accessed a long list of ESG metrics. While two quarters may seem like a short period of time, there were a total number of hits of around 34 million—a substantial amount of data. Controlling for total country market cap, it was possible to then produce the rank order (Table 2).

Investors in Switzerland, the United Kingdom, Canada, and Spain are the most interested in environmental information. In contrast, investors in Netherlands, Hong Kong, China, Belgium, and Finland are the least interested. Investors in Switzerland, the United Kingdom, Canada, and Spain are also the most interested in social metrics. In contrast, investors in Netherlands, Denmark, China, Belgium, and Finland are the least interested. Investors in the United States rank in the middle in terms of relative investor interest in environmental and social information. It is interesting to note that the integration of company information and investor interest in social and environmental information is not perfectly aligned. For example, Canadian companies tend not to integrate ESG information, but investors seem to care about this information relative to investors in other countries.

Table 2

Investor Interest in Environmental and Social Information by Country, Controlling for Market Cap

Rank	*Country*	*Environmental interest*	*Country*	*Social interest*
1	Switzerland	1.778	Canada	0.314
2	United Kingdom	1.063	United Kingdom	0.253
3	Canada	0.824	Switzerland	0.210
4	Spain	0.502	Spain	0.144
5	Denmark	0.320	Singapore	0.116
6	Singapore	0.303	Japan	0.104
7	Japan	0.289	Germany	0.086
8	India	0.219	India	0.065
9	United States	0.156	United States	0.058
10	Germany	0.131	Greece	0.046
11	Greece	0.114	Italy	0.039
12	Brazil	0.090	Brazil	0.036
13	France	0.083	Hong Kong	0.029
14	Italy	0.075	France	0.027
15	Australia	0.073	Australia	0.026
16	Sweden	0.066	South Korea	0.025
17	South Africa	0.047	South Africa	0.017
18	South Korea	0.047	Sweden	0.017
19	Netherlands	0.036	Netherlands	0.013
20	Hong Kong	0.035	Denmark	0.013
21	China	0.019	China	0.011
22	Belgium	0.016	Finland	0.008
23	Finland	0.012	Belgium	0.007

Source: Bloomberg

A Strategy for Change

Ensuring the universal adoption of integrated reporting by all listed companies within the next five years will require a combination of market and regulatory forces. One important market force is voluntary adoption by companies. Because no global framework for integrated reporting currently exists, voluntary adoption by companies will play an important role in helping to create one. Experimentation and innovation by companies, which, after all, bear the ultimate responsibility for integrated reporting, are essential to giving meaning to the very concept of integrated reporting. The efforts of early adopters will help build knowledge regarding the essential elements of an integrated report, the barriers and challenges to producing one, and how those hurdles can be overcome. Pressure from large institutional investors active in both the public and private equity markets is another market force that can encourage voluntary adoption of integrated reporting.

In the public markets, investors who own a significant proportion of a company's stock can put pressure on the company to implement integrated reporting in various ways, such as raising the issue at the annual general meeting or getting a proposal on the topic in the company's annual proxy statement. Large institutional investors in their role as limited partners (LPs) in private equity funds can encourage these funds to provide them with short integrated reports at the portfolio company level. On their own initiative, the general partners of these funds can also implement integrated reporting for their portfolio companies, laying the groundwork for an integrated report when the exit is an initial public offering, or spreading the practice when the exit is to a strategic buyer. The knowledge they gain about the relationships between financial and nonfinancial performance can be shared with their LPs, which can then apply this knowledge in their public equity portfolios.

Two other market forces can play an important role: individual consumers and corporate consumers. Individual consumers who buy from companies with more sustainable strategies and more sustainable products both contribute to their success and put pressure on companies that have less sustainable business practices. Corporate customers can encourage integrated reporting in their supply chain and even make it a requirement in requests for proposal (RFPs).

A third force that can speed the adoption of integrated reporting is the voice of civil society, such as represented by nongovernmental organizations (NGOs). NGOs can add momentum to both market forces, through what Waygood calls "capital market campaigning" to exert influence on both investors and companies.[7] NGOs can also exert pressure on governments, stock exchanges, and securities and other regulators to encourage them to support the integrated reporting movement.

7 Steven Waygood, "Civil Society and Capital Markets," *Sustainable Investing: The Art of Long-Term Performance*, Cary Krosinsky and Nick Robins (eds.) (London: Earthscan, 2008) p. 178.

There are significant challenges to accomplishing these objectives, particularly on a global basis. The IIRC has taken upon itself the responsibility for producing a draft framework for integrated reporting that will be subject to public exposure and debate. But there are reasons to be optimistic that this process will ultimately yield a principles-based framework that companies, investors, and others will find useful. Accomplishing this will require active participation and engagement by both companies and institutional investors. While some may argue that, in doing so, they will incur private costs to create a public good, those who participate will benefit by shaping the framework and positioning themselves to reap the benefits of adopting it ahead of their peers.

A more difficult problem is determining the standards for nonfinancial information. Various groups have made substantial contributions, such as the Global Reporting Initiative (GRI), the Carbon Disclosure Project (in its role as Secretariat of the Climate Disclosure Standards Board), and The Society for Investment Professionals in Germany through the European Federation of Financial Analyst Societies. Organizations seeking to establish standards for nonfinancial information, typically NGOs or professional associations, both cooperate and compete with each other. Competition can spur innovation and produce alternatives so that the best choice becomes clear, but it can also result in repeating history, as happened when accounting standards were set by each country, resulting in multiple versions of Generally Accepted Accounting Principles (GAAP).[8] Currently no country has a government agency, such as an accounting standards board or securities regulator, charged with responsibility for specifying the standards for nonfinancial information. Establishing and enforcing reporting standards is a difficult and contentious terrain, especially at a global level. For this reason, this problem must be put on the agenda of the IIRC to eventually make a recommendation regarding which body or bodies should be responsible for nonfinancial reporting standards, as well as the standards for providing assurance on them.

There are three ways that regulation can speed the adoption of integrated reporting. First, there is legislation, such as the anticipated EU legislation regarding mandatory ESG

8 Today the two main forms of GAAP are U.S. Generally Accepted Accounting Principles, established by the Financial Accounting Standards Board, and International Financial Reporting Standards established by the International Accounting Standards Board. Both groups are working together on a "convergence project" to produce a single global set of accounting standards For a discussion of "Global GAAP," see Robert G. Eccles and Samuel A. DiPiazza, Jr. *Building Public Trust: The Future of Corporate Reporting* (New York: John Wiley & Sons, Inc., 2002).

reporting referred to above. Multilateral organizations, such as the Group of Twenty Finance Ministers and Central Bank Governors (G20), can help coordinate this at a global level so that country-based legislation is largely similar. Second, there is regulatory action by a national securities regulator, such as the U.S. Securities and Exchange Commission or the Chinese Securities Regulatory Commission, with a coordination and homogenization function played by the International Organization of Securities Commission (IOSCO). Third, there are stock exchange listing requirements, such as in South Africa. As a first step, a stock exchange might want to start with a "voluntary filing program" for companies that wish to file integrated reports; in doing so, the exchange can gather useful knowledge about "best practices" and develop the procedures and systems necessary to eventually make it mandatory.[9] In the stock exchange world, the World Federation of Exchanges could play a role similar to that of the G20 and IOSCO.

Finally, market intermediaries, such as accounting firms, sell-side analyst firms, rating agencies, and boards of directors, also have an important role to play to enable companies to implement integrated reporting and investors to use the information. Accounting firms can contribute to the development of measurement and reporting standards, as well as the development of methodologies for providing assurance on them. Integrated reports will be most credible when accompanied by an integrated assurance statement. Sell-side analysts can incorporate ESG information into their analysis and recommendations. Rating agencies should also take ESG factors into account in their ratings since they are an increasingly important risk component. Finally, boards of directors, who have a fiduciary duty to shareholders and other stakeholders, need integrated reports to properly fulfill their duties. They can also encourage or even require management to make them available externally.

The most effective mix of market and regulatory forces will vary according to a country's particular circumstance. By combining data from SAM and Bloomberg, countries could be classified into one of four categories for environmental and social performance, as shown in Figures 1 and 2. Based on this classification scheme and for each category, it is possible to suggest the appropriate balance between market and regulatory forces.

9 Robert G. Eccles and Mervyn E. King, "Integrated reports voluntary filing," *Focus*, June 2010: 3-6, http://www.world-exchanges.org/news-views/views/integrated-reports-voluntary-filing, accessed July 2011.

In *Sustainable* countries—such as Germany and the United Kingdom—there is a high degree of integrated reporting by companies and a high level of investor interest in nonfinancial performance metrics. Companies and investors in these countries are on the vanguard of integrated reporting and should continue to exercise leadership to help create a more

Figure 1

Integrated Reporting of and Investor Interest in Environmental Information

Integrated Reporting by Companies

Investor Interest	LOW	HIGH
HIGH	SUSTAINABLE INVESTORS COUNTRIES Canada Greece India Japan Singapore United States	SUSTAINABLE COUNTRIES Denmark UK Germany Spain Switzerland
LOW	UNSUSTAINABLE COUNTRIES Australia Belgium China Hong Kong Italy South Korea	SUSTAINABLE COMPANIES COUNTRIES Brazil Finland France Netherlands South Africa Sweden

Source: Bloomberg and Sustainable Asset Management (SAM)

Figure 2

Integrated Reporting of and Investor Interest in Social Information

Integrated Reporting by Companies

Investor Interest	LOW	HIGH
HIGH	SUSTAINABLE INVESTORS COUNTRIES Canada Greece India Japan Singapore Switzerland United States	SUSTAINABLE COUNTRIES UK Germany Italy Spain
LOW	UNSUSTAINABLE COUNTRIES Australia China Hong Kong Netherlands South Korea	SUSTAINABLE COMPANIES COUNTRIES Belgium Brazil Denmark Finland France South Africa Sweden

Source: Bloomberg and Sustainable Asset Management (SAM) sustainable global society. In these countries, market forces play a dominant role. The view endorsed in this report is that the implicit market support for integrated reporting suggests that the best way to mandate integrated reporting is through regulatory actions supporting investor interest and stock exchange listing requirements supporting the leading companies and encouraging others to do better.

In *Sustainable Companies* countries—such as Brazil, South Africa, and Sweden—there is a high degree of integrated reporting by companies, but very little interest by investors in nonfinancial performance metrics, so the dominant market force lies with companies. Companies in these countries need to educate investors on the importance of nonfinancial metrics in evaluating company performance and making investment decisions. Investors can leverage experiences from investors in other countries and learn emerging practices on ESG integration and engagement. In these countries, it seems reasonable to believe that market forces on the company side are providing substantial momentum that needs to be supplemented by greater market forces on the part of investors. Stock exchange listing requirements mandating integrated reporting will award those already doing so and put pressure on those who are not.

In *Sustainable Investors* countries—such as India, Japan, and the United States—there is very little integrated reporting by companies, but a high level of interest by investors in nonfinancial performance metrics, so the dominant market force lies with investors. Investors in these countries need to demand more integrated reporting from the companies they own. In these countries, market forces on the company side are providing substantial momentum that needs to be supplemented by greater market forces on the part of investors. This report argues that regulatory actions mandating integrated reporting, such as by the securities commission, can support this investor activism.

In *Unsustainable* countries—including China, Hong Kong SAR, and South Korea—there is very little integrated reporting by companies and very little interest by investors in nonfinancial performance metrics. For this reason, these countries may need some type of intervention at the legislative or regulatory level: in fact, since neither investors nor companies are paying much attention to ESG issues, it is unlikely that market forces will be sufficient to generate a change in behavior.[10]

10 Classification system taken from Robert G. Eccles and George Serafeim, "Leading and Lagging Countries in Contributing to a Sustainable Society," *Working Knowledge*, May 23, 2011, http://hbswk.hbs.edu/item/6716.html, accessed July 2011.

An appropriate strategy for institutional change to make integrated reporting a universal practice in five years could be summarized as follows:

- In the short term, companies must take the lead, especially those in *Sustainable* and *Sustainable Companies* countries. Through their efforts of experimentation and innovation, the concept of integrated reporting will obtain greater clarity and rigor.
- Investors, especially those in *Sustainable* and *Sustainable Investors* countries, need to actively support companies already practicing integrated reporting, and encourage companies that are not doing so to make it a priority. In addition, investors need to provide input into efforts to develop frameworks for integrated reporting and standards for nonfinancial information.
- Market intermediaries can facilitate the efforts of both companies and investors.
- When the time is right (this will vary by country), the appropriate legislation, regulatory action, or stock exchange listing requirements need to be put in place to mandate integrated reporting. These mandates must be principles-based and informed by market forces.
- Through effective engagement, NGOs can contribute to the momentum of both market and regulatory forces.

The Role of the Board

To date, at most companies that have started down the path of integrated reporting, it has been initiated by the CEO with the board giving approval when necessary or desired. But the board can do more by serving as the motivating force for a company to start practicing integrated reporting, recognizing that it is a journey that will evolve over many years. The board can start by asking management to produce an integrated report for internal purposes, including board meetings. This will instill the internal discipline for executives to identify material ESG metrics that create value for shareholders and to better understand the ways in which they do so. In those instances when accomplishing ESG objectives actually detracts from profits, at least in the short term, it is important to know that and to be explicit about it. Having integrated performance information will enable the board to better understand the balance that must be struck in both the short and long term in addressing the needs and expectations of shareholders and other stakeholders.

Once management and the board are comfortable with the quality of the internal integrated report, the company can start to produce an external one, although perhaps not at the same level of detail. It is the board's responsibility to balance the benefits of greater transparency to shareholders and other stakeholders with the costs of producing and disseminating this information and the competitive and legal risks in doing so. In most circumstances, management will be inclined toward less disclosure, while external users will want more. The board should always remember that it is representing the interests of the latter, but do so in a way that enables it to support the efforts of the former to create value for shareholders and other stakeholders.

Mobilizing a board to initiate an action is always challenging. Ultimately, action by the board depends upon the impetus of an individual board member. Those in the best position to serve that role are the chairman and/or the audit committee chairman. For this reason, individuals performing in those capacities should be urged to learn more about integrated reporting and to raise this issue with their fellow board members and the management team. Practicing integrated reporting will make both groups more effective, leading to a more sustainable company for a more sustainable society.

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Acknowledgments

The authors would like to thank Cecile Churet and Iordanis Chatziprodromou at Sustainable Asset Management, and Curtis Ravenel, Global Head of Bloomberg’s Sustainability Group, for their assistance.

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