REWARD VALUE

RESPONSE TO THE DUTCH CORPORATE GOVERNANCE CODE PROPOSAL FOR UPDATE

CONSULTATION DOCUMENT

14th April 2022

Reward Value Foundation's mission is to support the development of remuneration policies that contribute to long-term sustainable and inclusive value creation. The Foundation seeks to further the debate on executive remuneration with investors, business schools, and the business community at large to develop evidence-based, long-term, sustainable, and stakeholder-inclusive executive remuneration policies.

Reward Value is a not-for-profit research initiative. Reward Value can be reached by email (contact@rewardvalue.org). For more information on Reward Value please visit our website www.rewardvalue.org.

Reward Value Foundation welcomes the Corporate Governance Code Monitoring Committee (the Committee)'s ambitions to update the Dutch Corporate Governance Code (the Code) and strengthen its alignment with sustainable corporate governance and stakeholder-value creation. We appreciate the Committee's recognition of diversity and shareholder rights as important areas to be addressed and improved upon and, in particular, we strongly support the Committee's efforts to further define the concept of long-term-value creation within the Code with the introduction of the ESG strategy.

Much like the Committee highlights in the introduction to the consultation document, we believe that such amendments should align with trends and developments in the international social context, as well as in the national, transnational, and international legal frameworks, and that the Code should adequately consider the recommendations and wishes of its stakeholders. In this regard, we believe the proposed amendments to be a valuable addition to the Code's text. With this response, we wish to present our insights to the proposed updates, as well as advise on particular points of interest that we believe should be highlighted and elaborated on in the Code.

The role of management is to ensure the sustainable success of the company, which is expressed through long-term value creation. We believe that value creation should be based upon – and compatible with – the interests of the broader group of the company's stakeholders, including its shareholders.

PURPOSE

Before addressing our specific proposals and comments on the amendments, we wish to highlight our view of 'corporate purpose' and emphasise how it contextualises our approach to long-term value creation, as well as all different facets of the corporate governance strategy. We welcome the Committee's efforts to include and reference corporate purpose in the explanatory notes to the code, particularly with reference to Chapter 1 and the ESG strategy. Building on the Committee's nods to purpose-driven governance in this regard, we wish to go one step further, and put forward the idea of purpose as the foundational element of the company's strategy. We believe that to truly thrive and achieve meaningful long-term value creation, companies should align themselves with the social and environmental context they operate in and consider the interests of all its stakeholders. Defining a corporate purpose can help companies identify and implement a frame of reference based on fundamental values and concrete aspirations, which can then be reflected in different aspects of the corporate governance strategy. We view purpose not only as an additional element of the overall strategy, but as a foundation that can enhance the company's ability to operate cohesively both internally and externally. Once a company has a strongly defined corporate purpose, the delineation of a strategy for long-term value creation, the remuneration policy, the diversity and inclusion policy, and all other facets of strategy can be formulated according to the direction and structure given by said purpose.

It is our understanding that leading companies already recognise the strength of this concept, and that defining corporate purpose is a best practice in the market. As we also understand the role of the Code to provide an ambitious example of best practices for companies to aspire to, we highlight the potential of the strengthening of the role of corporate purpose in Chapter 1, and its positioning as a foundational element for companies to build their strategy on, which in turn serves as the basis for the remuneration policy.

As Reward Value Foundation, our response is formulated according to our expertise on sustainable executive remuneration and understanding of its role in the pursuit of sustainable, long-term value creation within companies. Additionally, our recommendations are grounded in the notion that much on this topic is already anchored in legislation and the Code serves a supplementary role, providing guidelines for the implementation of best practices and 'good governance'.

Our more substantial contribution to this consultation addresses the topics of long-term value creation and executive remuneration, as we believe these two subjects to be closely linked together.

The following proposals have been formulated following this general line of thought: the remuneration policy should match corporate strategies and support long-term value creation. There should be a clear link made to the materially relevant non-financial performance indicators, which make long-term value creation possible.

LONG-TERM VALUE CREATION

Long-term value creation (LTVC) is one of the central themes the Committee has highlighted with this proposed revision of the Code. Although already emphasised by the Revised Code of 2016 as one of the main objectives of a long-term corporate strategy, the new proposed amendments highlight the importance of ESG and their key role in LTVC. The 2022 revision provides the opportunity to strengthen this concept, and, in this sense, we stress the need to define it more clearly and explicitly. In particular, Reward Value Foundation would like to highlight the close relationship between long-term value creation and sustainable executive remuneration.

We believe that, by following certain parameters, companies should be able to provide a concrete interpretation of long-term value creation (best practice provision 1.1.1) and translate it into their remuneration policy (provision 3.1.2), as well as their remuneration report (provision 3.4.1)

On the basis of our understanding of LTVC and sustainable executive remuneration, we put forward two proposals which the Committee might take into consideration when addressing the proposed amendments in these regards:

Proposal 1 foresees that the Code provides companies with a certain set of tools in order to demonstrate how LTVC is produced, and how this information can be meaningfully reported.

Value creation

In this regard, value creation would be understood as a broader concept, comprising both financial and non-financial dimensions.[1] Thus, in order to adequately consider the non-financial aspects, the overall value of the company would be established on the basis of different types of 'capital', which would be measured individually; these are:

- Financial capital
- Natural capital
- Social capital

[1] Dirk Schoenmaker & Willem Schramade – Principles of Sustainable Finance – Oxford University Press - 2019

After having set parameters to adequately identify and measure these capitals, companies would be required to formulate and disclose their yields on these different capitals in a transparent and straightforward way. The same formulation should then also feature in the company's strategic plan, as well as form the basis of the remuneration policy.

The key to this approach would be that the multiplicity of factors making up the 'social' and 'natural' capitals are identified and defined in a way that puts the *items of material importance* on centerstage.

This proposal is based on the understanding that LTVC is principally influenced by the material aspects of natural and social factors, rather than 'sustainability', in general.[2] In addition, companies should be helped in the determination of *items of material importance*, by the fact that 'materiality' as a concept has already been described by standard-setters such as the SASB,[3] (now VRF and part of ISSB) who provide an investors' perspective, and by GRI,[4] who provide a broader stakeholders' perspective.

The concept of return of investment for the three different 'capitals' should be understood along these lines:

1. ***Financial capital:*** *Many factors can be cited as criteria of financial capital. Often, this involves providing insight into returns for shareholders and other providers of capital. This can be calculated with return-on-capital methods, a profit target, or on returns to shareholders. It is not for the Code to prescribe a tool for this purpose. What is, however, important, is that the company makes clear which instrument is chosen and for which reasons. Furthermore, insight on performance objectives and achievements should be provided.*

2. *Similarly,* ***natural and social capital*** *can also be calculated with 'return'-measures, whether projected or realised. Following the consultation text,[5] it is interesting to use monetised values where possible. Furthermore, focusing on the items of material importance, it is once more recommendable, where possible, to indicate which standard setter is followed with the publication of the objectives and achievements, as well as how these objectives contribute to the achievement of the Sustainable Development Goals (SDG), as defined by the UN Global Compact. With regards to climate-related targets, it is preferable to make use of the 2015 Paris Agreement. Comparisons with peers is also insightful, where possible.*

Long-term

Since ESG is in and of itself a long-term concept, companies should adopt a long-term perspective and translate this time-horizon element in their approach to value creation, in relation to the broader economic, environmental and social context in which the company operates. This approach should be prioritised over the pursuit of short-term financial profit.

[2] https://dash.harvard.edu/bitstream/handle/1/14369106/15-073.pdf
[3] https://www.sasb.org/blog/materiality-the-word-that-launched-a-thousand-debates/
[4] The GRI Perspective – The Materiality Madness: why definitions matter – February 2022
[5] See consultation text page 14 item 1.1.4. Reporting by the management board

REMUNERATION

Proposal 2 foresees that the Code provides companies with a certain set of tools to indicate how its remuneration policy is in line with and contributes to LTVC. In this case, the element of 'value creation' is as important as that of 'long-term'.

The remuneration policy should be formulated in accordance with the purpose and strategy. This should be reflected in both the long-term and short-term incentive structures, particularly in relation to the yield objectives set out in the strategy, as well as the corresponding strategic and operational targets.

The performance criteria should be established in terms of their materiality to the company and its stakeholders, and these are, where possible, related to existing standards.

Long-term sustainable value creation should be prioritised over the pursuit of short-term financial profit. The alignment with international standards and the determination of long-term sustainability objectives may not be intuitive or easily manageable within the timeframe of remuneration policies. For example, global climate objectives are defined on the basis of timelines that range from 2030 to 2050. Obviously, such timelines are not easily manageable within the context of remuneration policies, but broadening the existing timeline is justifiable, and stimulates focus on LTVC. Here, a reframing of the currently existing practice (vesting period of a minimum of 3 years) is recommendable. The company can take the following elements into consideration:

- The term within which costs and benefits of business activities materialise, keeping in mind the predominantly long(er) term character of non-financial / ESG objectives;
- The appointment term of management board members;
- The pre-existing 5-year holding period.

It is not for the Code to provide which remuneration policy, performance criteria and time horizon should be used. The Code should rather require companies to clearly show the way in which the remuneration policy contributes to the LTVC of the company, in alignment with the interests of its stakeholders and broader society.

In order to demonstrate how the remuneration policy contributes to and supports the LTVC, when determining the policy, the performance criteria and time horizon to which the remuneration is linked, the company should apply a number of materiality requirements, as indicated below.

To this effect, the following principles provide a roadmap for companies for the determination and disclosure of the remuneration policy:

1. *The remuneration policy is aligned with the business strategy*

> The company explains its vision for their LTVC and the strategy to realise this value creation. The company implements an integrated policy in terms of long-term value creation, including internal and external, financial and non-financial interests, addressing sustainable value creation on financial, natural and social capital.
> The objectives of the ***remuneration policy*** are in line with this business strategy and there is an aligned and meaningful balance between financial and non-financial objectives.

2. *The performance criteria are materially relevant*

Performance metrics focus on materially relevant items for financial, natural and social capital.
Where possible, connections with universal and sector-specific non-financial performance indicators (standards) are also sought out. If the company makes use of performance indicators that are specific to the company only, complementing those of the sector-specific, the company also indicates why these indicators are relevant in view of the value creation process and strategy, as well as how they are measured. Furthermore, the company takes stock of the SDGs on which they have the greatest impact (positive as well as negative) and in which way the strategy, and the strategy-aligned remuneration policy, contribute to the achievement of the SDGs.
The performance criteria are measurable and auditable. They are put forward in the most detailed way possible, to meet the needs of transparency.

3. *Meaningful weight is allocated to financial and non-financial performance criteria*

There is a meaningful weight allocated to relevant financial and non-financial performance criteria (social and natural capital) in the total reward, so that the set criteria also invite follow-up.

4. *The remuneration policy has a long-term perspective*

Aligned with the company's vision for LTVC and the strategy to realise this value creation, the remuneration policy design starts from the long-term perspective. Companies formulate the time horizon needed for the realisation of objectives and explain how this is embedded in the remuneration policy.
The remuneration policy strikes a meaningful balance between fixed and variable pay, short and long-term, aligned with the LTVC. It addresses the time horizon and the split in strategic -(long-term) and operational-goals (short term).

5. *Performance targets are sufficiently ambitious ("aimed to win" as opposed to "aimed not to lose")*

The objectives are clear and ambitious (as well as quantified, and where possible, monetised). In order to contribute to the realisation of a sustainable economy and long-term value creation, the performance criteria should be ambitious (yet realistic), – failing which, the strategy is negatively impacted. The company indicates to what extent objectives are formulated to be absolute (internal) or relative (in terms of market, sector or specific company), as well as provides an explanation hereof.

The abovementioned five facets of materiality can serve as supplementary to the Code's Remuneration Policy provision 3.1.2.

Remuneration report

Transparent reporting of performance criteria and realised achievements are, where possible, in line with existing and generally accepted standards, making clear the ways in which the policy and its performance criteria contained therein, contribute to the LTVC. The company uses remuneration reporting that is as consistent as possible; in order to maintain internal consistency of strategic-, sustainability- and remuneration reporting, as well as in view of external comparability.

The principles formulated under provision 3.1.2 (Remuneration Policy) also translate over to provision 3.4.1 (Remuneration report) and provide a more specific interpretation of "the remuneration report explains how the *implementation* of the remuneration policy contributes to long-term value creation" and "… how ESG-objectives have been taken into account and how this contributes to the creation of value on a long-term basis".

Note: in our view, it is *the policy itself* that principally contributes to LTVC, rather than the *implementation*. The implementation is a consequence of that policy. However, any discretionary deviations in the implementation should also be commented on in order to substantiate their contribution to the LTVC.

A clear explanation in the remuneration report of how objectives are set, contributes to better insight on a clear and unambiguous basis for variable remuneration related to the achievement of LVTC.

To this effect, the following principle provides a roadmap for companies for the disclosure of the remuneration policy and the implementation thereof.

The companies ensure transparent reporting on the policy, the performance criteria, the objectives (targets and intervals) and the actual achievements.

> Companies thoroughly explain how the remuneration policy is in line with the creation of long-term value. Included herein is the transparent reporting detailing the choices of remuneration criteria (policy) as well as the objectives.
>
> The disclosure helps stakeholders assess linkage to strategy, materiality and pay for performance.
> It also provides a consistent narrative that bridges strategic, sustainability and remuneration reporting.
> It provides transparent disclosures, as much as possible linked to (sustainability) standards to ensure consistency and comparability.

The abovementioned point can be complementary to provision 3.4.1 (Remuneration Report).

CULTURE, DIVERSITY AND INCLUSION, AND PURPOSE

Finally, we want to take note of the link the Committee has made between company culture and long-term value creation in Chapter 2. We particularly appreciate the additions to best practice 2.5.1 and 2.5.4 on 'reporting on culture'. As elaborated upon in the first part of this contribution, we believe that corporate purpose can serve as a guiding, foundational element in the delineation of a company's strategy. Accordingly, we believe that an underlying purpose can also be instrumental to the company's approach to culture and its diversity and inclusion strategy.

In light of these considerations, we wish to comment on the fact that the role of purpose could be certainly strengthened in these sections of the Code as well.

CONCLUSION

In conclusion, we would like to remark that, ideally, companies should prioritise developing an integrated vision for long-term value creation and express it in terms of material financial and non-financial indicators and with an understanding of the time horizon relevant to each one. The right design of the remuneration policy can contribute to long-term sustainable and inclusive value creation.

We also believe that the delineation of a corporate purpose can provide direction in the form of a guiding light and a frame of reference for the creation of the company's strategy in general, and its specific policies in particular, especially in relation to LTVC, remuneration, culture and diversity and inclusion. We believe that the Committee could raise its ambitions in building up this best practice behaviour and take a stronger stance in this regard as well.