

Novartis

Novartis has increased its board gender diversity, appointed its first new auditor since 1940 and shown leadership on artificial intelligence. With over a decade of engagement history with the company, EOS continues its dialogue for change on ESG, on behalf of long-term investors.

Background

Considerable evidence suggests performance of the board is vital to the long-term success of a company, with a range of factors contributing to this. Therefore, board effectiveness, through a diverse composition aligned to the strategic needs of the company including gender diversity, is a key focus for our engagement. EOS at Federated Hermes has engaged with Novartis on a range of ESG topics since 2009. By 2018, we decided to escalate our engagement on gender diversity at the board level, given insufficient progress.

Novartis (and its predecessor companies) had been commissioning the same audit firm since 1940. Given that audit quality and integrity is at risk when the same assurance provider is maintained for long periods, we also engaged on auditor rotation. Supporting this is EU regulation which now requires that this period be an absolute maximum of 20 years (although this does not strictly apply to Novartis, domiciled in Switzerland). In addition, we engaged on artificial intelligence (AI), considering the firm's strategy on 'go big on data and digital'.

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Engagement with EOS has allowed us to further our understanding of priority long-term investor concerns and tackle these challenges effectively, when developing solutions to enhance the long-term value of the company.”

– Mavic Cuevas, Investor Relations ESG Director, Novartis

Engagement objectives:



Governance:

- Gender diversity
- Board effectiveness
- Remuneration



Risk management:

- Auditor rotation
- AI

Sustainable Development Goal:



Company overview

Novartis is a global healthcare company with a purpose to reimagine medicine to improve and extend people's lives. Its strategy is based on five priorities: unleash the power of Novartis people, deliver transformative innovation, embrace operational excellence, go big on data and digital, and build trust with society.

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Our engagement

Ahead of the 2018 annual shareholder meeting, our concerns about the insufficient progress made on gender diversity at board level, despite engagement on this issue, had risen. In Switzerland, we expect at least 30% of the board to be women but Novartis had achieved just 25%. We therefore informed the company of our intention to recommend a vote against the re-election of the nominations committee chair, maintaining our vote recommendation at the 2019 shareholder meeting as no further progress had been made.

During a call with the investor relations team in September 2019, we again pressed for greater gender diversity on the board and explained that we would continue to recommend a vote against the re-election of the nominations committee chair in the absence of improvements. We also raised concerns regarding the tenure of the audit firm. We reiterated these concerns during a call with the vice chair in October 2019, and he indicated that gender diversity was also viewed as unsatisfactory by the board. We asked for greater disclosure around the results of board evaluations. Since the vice chair also chairs the remuneration committee, we suggested extending the horizon of the long-term incentive plan to be more aligned with the business cycle of a pharmaceutical company. We followed up in November 2019 reiterating these concerns.

Prior to the 2020 shareholder meeting, we informed the company of our recommendation to vote against the re-election of the auditor and the re-election of the audit committee chair due to excessive tenure of the auditor. We attended the meeting in Basel, speaking out to ask the board to start planning for a rotation of the audit firm, with the aim of having a new auditor in place for the 2022 reporting. The chair of the board responded that this had been discussed by the board for several years and it would be on the agenda again in 2020. At the end of the meeting we had a brief discussion with the audit committee chair who thanked us for our question and confirmed that this would be high on the agenda in 2020.

In March 2020, we had a call with the head of data science and AI and with the global head of ethics, risk and compliance to discuss our paper¹ which sets out investor expectations on AI and data governance. We noted the importance for the company to demonstrate the existence of robust governance processes. Novartis believes that behind the methodology and the application of machine learning there are people. Having the right governance and risk-management processes in place is therefore fundamental, with cross-functional teams overseeing it. The compliance function had been working on improving the culture and awareness of ethical risks associated with AI, with a principle-based approach to drive daily decision making. We encouraged Novartis to leverage its leadership position by educating the wider public on its approach and the challenges it faces, for example by publishing a white paper.

Changes at the company

During a call with the investor team prior to the 2020 shareholder meeting, we noted the company's announcement of an aspiration to find female candidates for two of the next three board nominations. One woman had already been nominated for election to the board which would therefore comprise four out of 14, bringing the proportion to 29%. In December 2020, we had a video call with the vice chair who assured us that a smooth and orderly transition will ensure there is appropriate gender diversity on the board. The latest annual report indicates that Novartis is focused on achieving even greater diversity when identifying new board member candidates and gives us confidence on its aims to further increase the number of women on the board, in line with our engagement. On remuneration, we welcomed the introduction of a post-vesting holding period for the long-term incentives.

In May 2020, the company informed us that the audit and compliance committee had decided to launch a re-tender process. We engaged the vice chair via video in December 2020 and were pleased to hear that a new audit firm would be proposed for election at the 2022 shareholder meeting, commencing its audit work for the 2022 financial year, meeting our request.

In February 2021, in line with our suggestion to leverage its leadership position on AI, the company sent us a copy of its new paper² on the ethical and responsible use of AI. To develop this paper, Novartis developed an inventory of its current practices in AI and designed a set of eight principles in line with its wider code of ethics. This was reviewed by the independent bioethics advisory committee and approved by the trust and reputation committee, which is chaired by the CEO.

Next steps

One big lesson from Covid-19 is that human health is dependent on protecting the health of the planet. However, biodiversity loss is happening at unprecedented rates and in 2020 the World Economic Forum identified biodiversity loss as a top-five risk for the first time. The success of pharmaceutical companies is highly dependent on nature.

For these reasons, we wish to see Novartis joining global efforts to reverse nature loss by 2030. At the 2021 shareholder meeting, we asked the board for an assessment of the company's impacts and dependencies on nature, and for a commitment to a net-positive impact on biodiversity across the full value chain.



Pauline Lecoursonnois
Engagement
EOS



This case study has been fact-checked by Novartis to ensure a fair representation of EOS work carried out and changes made at the company.

¹ <https://www.hermes-investment.com/ukw/eos-insight/eos/investors-expectations-on-responsible-artificial-intelligence-and-data-governance/>

² <https://www.novartis.com/sites/www.novartis.com/files/novartis-responsible-use-of-ai-systems.pdf>

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