

21st Century Engagement

Investor Strategies for Incorporating ESG Considerations into Corporate Interactions



BLACKROCK®





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“These businesses need us—their investors—to speak up and encourage a culture of long-term investment and growth. And well-run businesses will respond.”

THE VALUE OF OUR VOICE

Larry Fink, *Chairman and Chief Executive Officer, BlackRock*

What responsibilities do we have as investors? One of the most important is to use our voice to help companies focus on the long term. Financial sustainability is something all investors and companies should be focused on, but in today's demanding market environment and short-term culture, it's something that we too frequently overlook. As investors, we need to use our voice, through direct engagement and voting, to ensure that companies are being run to deliver sustainable growth and returns over the long term.

We do have to acknowledge that, for many companies, this is a challenge. The business environment is changing at an ever-faster pace. The “topple” rate, a measure of how rapidly market-leading companies lose that leadership position, increased almost 40 percent between 1965 and 2010. Competition has intensified, driven in large part by technology, rapidly changing consumer preferences, and an increasingly level global playing field. Many investors demand tremendous growth every quarter, with earnings hysteria compounded by a media culture addicted to tangible, short-term performance. It is not surprising, therefore, that companies feel enormous pressure to deliver in the short term.

Yet many of the factors that foster business resilience and sustainability play out over years and, in some industries, decades. Investing in innovation and future production, developing talent and ensuring robust supply chains are among the many environmental, social and governance (ESG)-related management actions that enhance a company's ability to generate long-term financial returns. Businesses that fail to make sufficient investments in the future can doom themselves to irrelevance.

These businesses need us—their investors—to speak up and encourage a culture of long-term investment and growth. And well-run businesses will respond. The best businesses strategically manage all aspects of the business and ensure that their investors, as well as other constituents of the

company, have enough information to understand the drivers of, and risks to, sustainable financial performance. They recognize that they are accountable to shareholders for the prudent use of the capital entrusted to them.

Constructive dialogue between investors and companies helps business leaders be the best they can be. Understanding investor views and concerns helps boards and management make better informed decisions. They are still free to make an apparently contrary decision when they believe that the outcome would best serve the interests of the company. And, more often than not, clearly articulated investors' views and questions will influence company leaders' thinking, particularly if they reflect a growing consensus.

As investors, we have responsibilities, too. Those who depend on us for their retirement income, or for other long-term financial needs, trust us to invest wisely and to both protect and increase the value of their capital. Using our voice through engagement with companies is an effective way to enhance our understanding of management's objectives and to hold company leadership to account. It helps ensure that well-managed companies receive credit for their efforts and can be a catalyst for change at those that are lagging their peers. Perhaps most important, engagement builds relationships over time that engender trust and, in turn, more effective dialogue. We have a valuable asset in our voice—and we should use it.

“More than ever, investors are actively engaging with their portfolio companies on ESG issues as part of their fiduciary duty and also to protect the long-term value of their assets.”

HOW ESG MEGATRENDS ARE SHAPING VALUATION

Mindy Lubber, *President, Ceres*



21st century companies and their shareholders are facing an increasing array of ESG challenges that can affect business and investment results. Climate change, water scarcity, community conflicts, resource depletion, supply chain breakdowns, worker well-being and economic inequality, coupled with instantaneous communication, can all present material risks and opportunities to businesses. Sustainability has become an imperative for successful corporations, and a variety of studies have shown that companies with strong sustainability cultures outperform their laggard peers. The business case for integrating ESG issues into mainstream investment practices has never been stronger.

More than ever, investors are actively engaging with their portfolio companies on ESG issues as part of their fiduciary duty and also to protect the long-term value of their assets. The evidence is everywhere, from the strong launch of the Shareholder-Director Exchange in 2013 to Glass Lewis & Co.'s purchase of Meetyl in late 2014—a technology platform that makes it easier for investors to research and schedule engagements with companies.

As a leader on corporate sustainability issues for 25 years, Ceres has seen remarkable growth in investor engagement on ESG issues—the focus of this guide—and we fully anticipate this trend to continue. More than 450 environmental and social shareholder resolutions were filed with US companies in 2014 alone, according to the Sustainable Investments Institute. And that number does not include the countless letters, meetings, conference calls and other types of engagement that shareholders had with listed companies last year.

We are witnessing a profound shift in communication between companies and shareholders—a shift to more regular, candid, behind-the-scenes conversations. We are also seeing investors exert more pressure to meet directly with board members on sustainability topics of mutual concern.

The pressures on investors to increase their levels of engagement with companies (and also with regulators and other market standard-setters, for that matter) have coincided with an uptick in beneficiaries and clients understanding that their investment portfolios have impact in the real world and that ESG issues are creating risk as well as opportunity for their investments.

We hope the collected wisdom in this *21st Century Engagement* guide will empower even more investors to ask the right questions, and to demand thoughtful answers. Sustainable and responsible investment demands no less.



ENGAGEMENT STRATEGIES

The consideration of environmental, social and governance (ESG) matters in investment decision making and post-investment engagement has many names. References to responsible investment, impact investing, ESG engagement, stewardship, socially responsible investment (SRI) and sustainability investment will imply different activities for different parties. And, confusingly, sometimes the same term is used to mean different things by different commentators. However, the common thread is that, in addition to financial or economic performance, the way in which companies manage the ESG aspects of their business is vital to the investor.

The Significance of ESG Engagement

Michelle Edkins, BlackRock

Engagement—direct communication between investors and companies—on environmental, social and governance matters is on the rise in the United States. A number of factors seem to be driving this change. First, companies seem more interested in understanding their shareholders' views. Many are engaging with the ESG specialists at their long-term investors as part of their broader investor relations programs, which have historically focused solely on Wall Street. Second, investors are developing specialist teams to conduct those conversations, in recognition of the connection between sound ESG management and corporate resilience. And third, there is today much greater public scrutiny of companies and investors and the role they play in the economy and society more generally.

“The key is to make conscious decisions about whether, and where, engagement fits into the investment strategy.”

It's difficult to precisely quantify the value created by shareholder engagement. But it is easy to see the problems created in its absence—evidence of value destroyed or unattained—arguably by disengaged shareholders enabling companies' poor management of ESG matters. Even so, the value proposition for shareholders will depend on the investment mandate and consequent investment strategy. There will always be investors who determine that selling is their best option when signs of poor management emerge, just as there will be investors who see a path to long-term growth driven in part by their engagement and influence. The key is to make conscious decisions about whether, and where, engagement fits into the investment strategy.

For those inclined to engage, active investors—those analyzing companies individually to identify the better investment alternative—can use engagement to their benefit, both before and after investing. Understanding ESG business drivers at a company helps investment decision-making by enabling portfolio managers to identify the full range of potentially unrewarded risks and otherwise unidentified opportunities.

Once an investment is made, engagement is often the preferred option to selling shares in underperforming companies, particularly for those with large stakes or a long investment horizon. For investors in indexed strategies, engagement (including proxy voting) is the only option for signaling concern to companies and is often seen as a fundamental part of fiduciary responsibilities. For some, the concept of stewardship responsibilities is intertwined with investment style, requiring engagement over passivity regardless of how the investment is made.

While engagement is fundamentally about communication, it can take a variety of forms. The approach taken by an investor will be influenced by the way they invest, by their investment time frame, by their philosophy around shareholder responsibilities and, often, by the level of interest from clients or others to whom they are accountable. When there is engagement, the technique used will also be influenced by the urgency of the situation and by the responsiveness of the company.

Some investors define “engagement” as any communication with a company that enhances mutual understanding. Others believe engagement, by definition, is intended to bring about a change of approach or behavior at a company. Many see it as a continuum covering all this and more, including full-blown activism. The point is to express views and concerns to those who can do something to address them—a company's board and management.

This variety of perspectives and techniques is expertly covered in the pages that follow. They reflect not only the influences mentioned above, but also the nuanced interaction that engagement tends to be. Underpinning them all is a framework of well-thought-through policies, specific to each investor's circumstances, and the objective of protecting long-term shareholder value. Nonetheless, it is clear that ESG engagement is more an art than a science. We hope this collection of experiences provides some guidance and helps inform your own approach.

REASONS TO ENGAGE ISSUERS ON ESG TOPICS

- ▶ *Inform your proxy voting and voting guidelines*
- ▶ *Augment your research*
- ▶ *Clarify public information*
- ▶ *Identify quality of management indicators*
- ▶ *Gauge sophistication of a company's strategy*
- ▶ *Understand peer performance indicators*
- ▶ *Identify potential vulnerabilities*
- ▶ *Develop insights into investment and growth opportunities*
- ▶ *Understand potential regulatory impacts and threats*
- ▶ *Identify how companies are positioned to mitigate risks or leverage opportunities*
- ▶ *Improve your reputation as an active and engaged owner*

Laying the Foundation for Successful Engagement

Anne Sheehan and Brian Rice, California State Teachers Retirement System (CalSTRS)

Step One: “The Plan”

The first step in deciding whether an engagement program is right for you and your firm is to solicit buy-in from key decision makers, and then to memorialize your engagement approach in documentation that can be shared with the companies with which you will be engaging. For example, at the California State Teachers Retirement System (CalSTRS), we lay the foundation for our engagement program through our Investment Management Plan (Plan). This Plan is the foundation for all our investment efforts at CalSTRS, and it identifies at a high level that we will “engage corporate management to seek information and understanding of the corporate decision and its ramifications on ESG issues.” Our Environmental-Social-Governance (ESG) policy serves as an overlay to the Plan, and is applied across all asset classes. The Plan is updated through internal staff analysis and recommendations to our Board. Our Board then uses independent fiduciary counsel and fiduciary consultants to fully review all investment considerations and to ensure alignment of the Plan with our fiduciary duty to beneficiaries.

Our Plan is publicly available at: www.calstrs.com/sites/main/files/file-attachments/a_-_investment_policy_and_management_plan_9-2013.pdf

“The first step in deciding whether an engagement program is right for you and your firm is to solicit buy-in from key decision makers...”

Each asset class integrates the CalSTRS ESG policy into its investment implementation. We have formed high-level, cross-asset teams consistent with our total portfolio approach. These teams consist of directors, portfolio managers and investment officers from each asset class within the total CalSTRS portfolio. Each representative must consider ESG opportunities and risks not only for their own asset class but also for the total fund. These teams do not rely entirely on internally generated data, but are also responsible for working collaboratively with other members of the global investment community to further the Board’s goals. Notably, we’ve successfully engaged with companies on issues of diversity, climate change, stranded assets, energy efficiency and sustainable business practices, all intended to produce economic growth, profits and positive cash flows across all asset classes and fully consistent with our Plan.

Step Two: Practical Implementation

Many forms of engagement can be used to potentially increase the value of your assets and to mitigate risk, including:

1. Holding **direct conversations** with portfolio companies, regulators and issue experts
2. Doing **educational outreach** with the marketplace
3. **Collaborating** with other investors, companies and advocates
4. **Convening summits** to identify and reach tipping points
5. **Soliciting** shareholder proposals
6. **Sponsoring** academic and other intellectual **analysis** on the issues, to increase market participant awareness

You will need to decide for your organization which of these forms of engagement is most appropriate for you and your beneficiaries or clients. However, it’s important to note that these forms of engagement can be used for all types of investment funds and products, and may also be leveraged within specific investment allocations, or with funds intending either to capture positive impact or to explicitly mitigate risk from ESG factors, in what might be called SRI funds or products.

“Notably, we’ve successfully engaged with companies on issues of diversity, climate change, stranded assets, energy efficiency and sustainable business practices, all intended to produce economic growth, profits and positive cash flows...”

Step Three: Develop a Focus List

Some public pension funds may have their list of ESG engagement efforts developed externally, as when they are mandated by state legislatures through prohibited or restricted investments. Other funds may have their ESG efforts developed by a fund board of directors working to establish ESG priorities that address portfolio risk issues or respond to concerns raised by beneficiaries. Finally, some funds may develop their engagement candidate lists through internal staff analysis.

Formulating a focus list can be done in several ways. A common way is to review the financial return of identified companies and then look at the worst performers over a specific period, generally one, three and five-year periods for long-term investors. CalSTRS uses a blend of both the bottom-up (or specific company) approach, and the top-down (or systemic issues) method, in designing its annual engagement plan. It is important to note that some companies do remain on engagement lists for a number of years.

For additional information on the CalSTRS approach on ESG issues, please visit: www.calstrs.com/corporate-governance-overview

METHODS FOR SELECTING COMPANIES FOR ENGAGEMENT

- ▶ Select a consistent review period each year for the portfolio to identify outliers in terms of financial/ESG performance where it is possible to influence change.
- ▶ Review these factors at the companies:
 1. **Financial performance**—Are they a financial outlier?
 2. **ESG ratings**—How do they measure compared to their industry?
 3. **Ownership structure**—How much do you own? Is it a controlled company, or how much is owned by insiders or your peers? (i.e., to determine your ability to affect change)
 4. Which ESG practices are of concern at the companies, and of those, which are most important to your organization or your clients or beneficiaries?
 5. Has there been a controversial proxy vote or a controversy in general?
 6. Has the company been unresponsive to majority votes on shareholder proposals?
 7. Has the company worked against shareholder rights (e.g., through bylaw amendments) without shareholder approval?

Determining the Initial Approach to a Company

Anne Simpson, California Public Employees Retirement System (CalPERS)

Communication is the simple key to enable shareowners to effectively engage with companies. Yet the question of with whom, when and how to engage is not so simple. Here are some thoughts on terms of engagement for owners—how to navigate the dialogue on sustainability.

Who

When investors are concerned with sustainability issues, with whom should they engage? It is important to consider where it is appropriate to direct the issue. Is it a matter for the board of directors in its entirety? The chair or the lead director? Or a particular committee that may be responsible for the issues of concern, such as risk or audit? Is it better to address concerns to the company's staff, such as its General Counsel or Corporate Secretary? Should the matter be channeled through an Investor Relations Chief or the Sustainability Officer? Is it an issue for Public Affairs or Stakeholder Relations? Circumstances will vary according to company size, policy and circumstance.

Investors need to engage the company board, for a straightforward reason: The board of directors is appointed by and should be accountable to the company's owners. The board's chief is its chair or lead independent director, who has the role of ensuring that the board fulfills its critical role of overseeing management. One of the most important tasks for the chair or the lead independent director is setting the agenda for board meetings. If a sustainability issue seems of strategic importance, then it is entirely appropriate that the investor ask that the matter be discussed by the board and a full response be provided.

“Investors need to engage the company board, for a straightforward reason: The board of directors is appointed by and should be accountable to the company's owners.”

An example is climate change risk and opportunity. The Ceres-led Carbon Asset Risk Initiative is posing tough questions to fossil fuel-based energy majors about their risk scenarios, and plans to devote new capital to further the development of carbon intensive fuels, which may pose hazards to their balance sheets. These are not questions for staff, however well-intentioned. Rather, they are fundamental, strategic questions about the companies' long-term future success and critical issues in both risk management and scenario planning. As such, they are properly matters for the board.

Other issues of concern to investors may arise that are equally valuable for the board to be aware of. An example is seen in Duke Energy, which saw a massive coal ash spill at a time when precious few of its board members had any coal industry experience. Questions were raised primarily by just two investors—the New York City Comptroller and CalPERS. An investor protest can signal serious issues that a board needs to address. Massey Energy is another example, where the state of North Carolina, CalPERS and other funds engaged around the company's poor governance. This was an early cause of investor protest. When these and other health and safety disasters strike, it often becomes clear that poor governance allowed lax standards, and human tragedy followed.

(See page 28 for the case study Lessons Learned from the Massey Energy Engagement.)

An investor may have questions that can be answered by an explanation of current operations—for example, the company's record of compliance with particular environmental regulations. In this case, the company staff will be ready to provide information. As such, that information should be made public; which is why CalPERS supports integrated reporting in order that the ESG factors which drive value and risk are fully presented to investors, and we support initiatives like the Global Reporting Initiative and the Sustainability Accounting Standards Board which provide useful guidance. In turn, CalPERS publishes its own sustainability report¹ and our engagement guidelines in our Global Governance Principles.

Investor inquiries can be a tremendous advantage to companies. They serve as a vital early warning on issues. BP saw such an earthquake in its share price after the Gulf oil spill disaster prompted engaged investors to use their voting rights to call for the removal of the chair of the board's risk committee.

[7] ¹ CalPERS Towards Sustainable Investment & Operations: Making Progress

“Investor inquiries can be a tremendous advantage to companies. They serve as a vital early warning on issues.”

When

Companies' own flow of announcements is in part governed by the regulatory regime, which quite properly means that certain times are not conducive to conversation. Investors should take advantage of the period after companies' annual general meetings (AGMs) to have conversations about the longer term, which cannot always be addressed in the intensely busy period in the run up to the AGM. Or they should have the conversations before announcements when companies are in a closed period. It is also important to note announcements concerning retirements and appointments. In making contact with a board, check first with the Corporate Secretary whether board meetings are held monthly, quarterly or otherwise. It will be important to know when the board might discuss your issue of concern and whether it will do so before filing of the company's annual proxy statement.

How

It is always helpful to companies to have advance warning of concerns. A call is usually appreciated, be it to the General Counsel, the Corporate Secretary or the Investor Relations Chief. Better still, a letter of concern to the board can be delivered via the General Counsel or the Corporate Secretary, although addressed to the board chair or lead independent director. CalPERS usually sends hard-copy letters to board members through registered mail, and does not rely solely on email, to ensure that concerns are seen. As needed, we translate letters into local languages to facilitate communication.

Some investors use this moment to inform the press. A company's board may well be reading about the issue in the media before it has had a chance to respond to the investors' letters. CalPERS prefers to raise the issue with companies first so that boards have an opportunity to respond.

Another issue is discretion. Once discussions have begun, it is important that investors exercise discretion and, at minimum, clearly state their intentions. On occasion, investors have spoken to the media during discussions, thereby losing trust. If an investor intends to speak to the media, they should tell the company that is their plan before discussions begin.

It is important the investors set out their views clearly in advance. CalPERS has a framework of Investment Beliefs² which explains where ESG issues factor into our fiduciary duty to foster long-term, sustainable, risk-adjusted returns. We state that value is created from the effective management of three forms of capital: financial, human, and physical, hence our concern with integrated reporting. We also state that risk is multifaceted, and that our long-term investment horizon is both an advantage and a responsibility. Engaging with companies, intermediaries and policy makers is part of that responsibility.

If diplomacy breaks down and an agreement cannot be reached, investors will often turn to more formal methods, such as shareholder proposals. They will argue that filing a proposal is a clear way to get management's attention, if not the board's, and once investors have that attention, progress can likely be made.

The situation can vary both at the company and with the shareowner. If both sides navigate with care, then engagement can be fruitful. Shareholder votes on sustainability resolutions are rising, year after year, so there is good reason to engage with companies before the voting season begins.

Tailoring Your Engagement Plan

Tracey C. Rembert, Ceres

No matter the level of resources you can devote to engaging with companies, there are situations where certain strategies are more appropriate to use than others. Engagement strategies range from sending letters and making phone calls to informed proxy voting, filing a shareholder proposal or attending an annual meeting and making remarks. They can also include dialogue with a company or with a large group of shareholders, having private communication with company experts or targeting directors through “vote no” campaigns and other board-focused strategies. Whichever strategy is used, research, follow-through and setting clear expectations are a must for successful engagement.

Fitting the right engagement strategy to the relevant corporate context can be tricky, but a few questions can help guide you in selecting the strategy that might be most effective:

- 1. Has the company or its board ignored repeated attempts by yourself (or other shareholders) to discuss needed improvements, increased disclosure or greater risk oversight?** Then perhaps shareholder collaboration or public strategies are actually what are needed.
- 2. Has the C-suite become so entrenched and recalcitrant that private measures no longer have traction?** If so, the board may be a better target for communication.
- 3. Do you know if other shareholders share your concerns?** If so, collaboration with other investors will be easier and more effective.
- 4. Are investors already engaging on the company or industry and topic?** Do your homework to make sure you are not duplicating effort, or that companies are not approaching an issue with a divide-and-conquer strategy.
- 5. Is your engagement focused on multiple asset classes?** If so, you will need different tools for them and must set different expectations for outcomes.
- 6. Are you worried that public knowledge of your engagement might harm the company’s reputation or impact the share price?** Then keeping dialogue confidential might be your best option.
- 7. Do you prioritize deep and long-term relationships with some of your core holdings?** Then holding an in-person meeting with the Chief Executive or board members might get you further than meeting merely with a company expert.
- 8. Do you have access to a company’s board or the CEO?** It might be more effective, and use fewer resources, to start at the top.
- 9. Does the company have a respected internal advocate on the topic of concern?** If so, meeting with junior staff might produce more lasting results if that person can help build buy-in internally.
- 10. Have you held the company for a number of years, and do you plan to continue holding for years more?** Again, this might prioritize more direct and high-level contact with a company, even if you are a smaller shareholder.



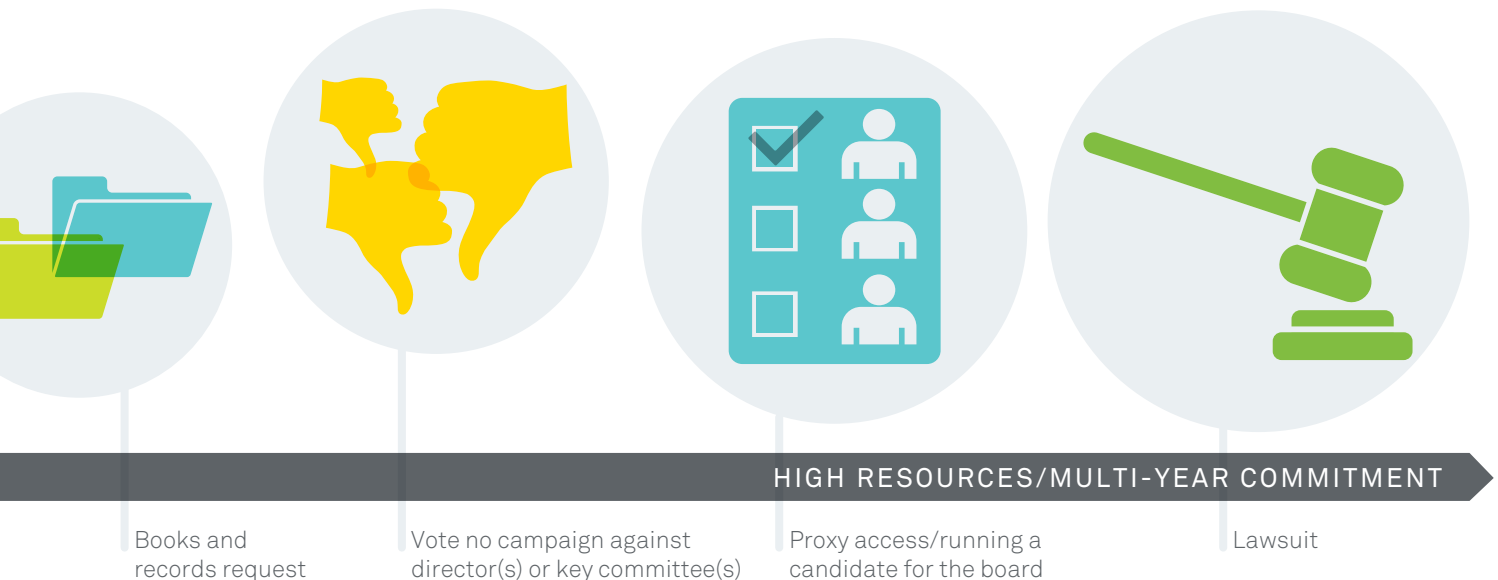
“Whichever strategy is used, research, follow-through and setting clear expectations are a must for successful engagement.”

Once you have figured out which companies you'd like to focus on, you've lined up support internally to engage them, and you've determined how you want to initially approach a company, then it's time to jump in and test the waters. The strategies on the following pages, shared by leading experts in governance and ESG engagement, are only a few of many well-tested methods for communicating your concerns to corporate leaders.

We have chosen not to focus on three strategies in this guide—lawsuits, books and records requests, and proxy access—because these have, to date, either been used largely for financial or corporate governance matters, or regarding proxy access, do not have a multi-year track record of use on ESG matters (as a substantial proxy access campaign tied to diversity and carbon asset risk was just launched in late 2014 by the New York City Comptroller).

ENGAGEMENT CHECKLIST

- ▶ *Develop your institutional plan and garner internal buy-in.*
- ▶ *Do your research—both internal and hiring external—to prepare you for the engagement to come.*
- ▶ *Fine tune your issues focus and any pertinent sectors involved.*
- ▶ *Develop a focus list.*
- ▶ *Establish which types of engagement you are likely to employ as well as your level of resources to achieve your goals.*
- ▶ *Determine how you will initiate communications with the company or entity.*
- ▶ *Give the company clear guidance on what to respond to, and by what date.*
- ▶ *Be explicit about why you need the information you seek, or why you are suggesting specific management or performance changes.*
- ▶ *Prepare to measure outcomes or impacts, and plan early for needed follow-through and staff time and resources.*



A Spectrum of Engagement Intensity

Donna Anderson, T. Rowe Price

At T. Rowe Price, engagement, proxy voting activities and assessment of a broad range of investment considerations (including environmental and social issues) are integrated into our equity investment process. In our view, the following questions are, at their core, investment issues:

- ▶ *Who represents shareholders on a company's board?*
- ▶ *What drives the executive incentive program?*
- ▶ *How robust are shareholders' rights at the company?*
- ▶ *How is the company managing its environmental risks, human resources, facilities, stakeholder relations and long-term access to critical resources?*

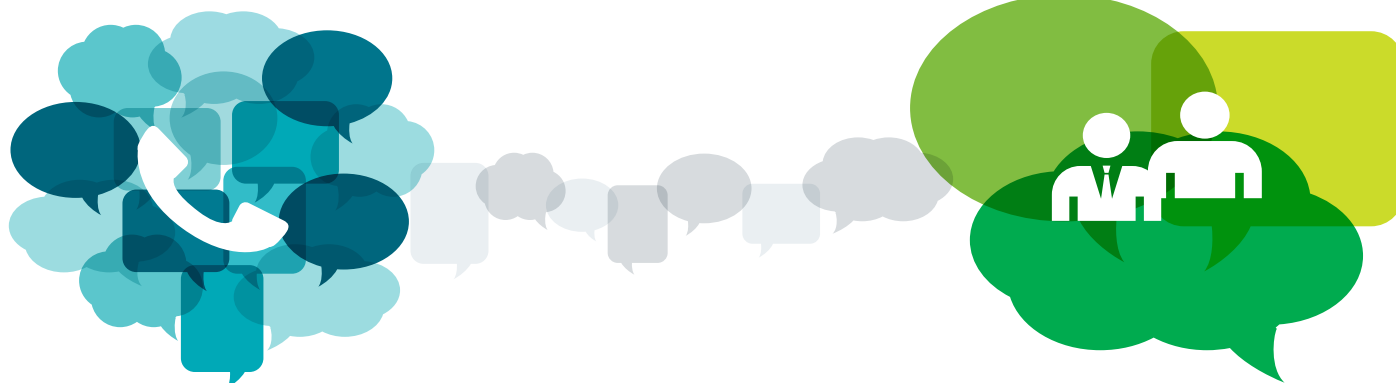
Based on this view, our engagement program is driven by portfolio management and is supported by the expertise of our industry-focused analysts and our in-house specialists in corporate governance and sustainability. Because our engagement priorities are so tightly connected to our investment views on a company, we conduct privately our company-level engagement activities. (By contrast, we tend to work collaboratively with other shareholders on a policy level, such as advocating with regulators for better disclosure or stronger shareholder rights.)

After many years of dialogue with managements and board members of the companies in our clients' portfolios, T. Rowe Price's program has taken on a distinct barbell-shaped pattern.

Light Engagement

On one side of the barbell, we hold hundreds of short, direct conversations with companies over the course of each year, focused on issues that may fall outside the scope of our analysts' normal, ongoing due diligence meetings with companies. More than 80 percent of these engagements are conducted via conference call and do not involve board members. Typically, the parties involved are the company's General Counsel and subject-matter expert, our industry analyst, and our governance or sustainability specialists. The purpose of these conversations is for us to gather information about a specific topic of an environmental, social or governance nature. It may be a general exchange of views on the topic, or it may be a conversation centered on an upcoming vote.

Over time, we have found that these brief exchanges add to our overall mosaic of information about the company. We develop relationships with our counterparts within these companies, which leads to more opportunities to discuss the



LIGHT ENGAGEMENT

- ↑ High number of brief engagements
- ↓ Fewer resources devoted to each engagement

MODERATE ENGAGEMENT

- Modest number of engagements
- Moderate resources devoted to each engagement

HEAVY ENGAGEMENT

- ↓ Low number of intensive, often multi-year engagements
- ↑ More resources devoted to each engagement

“Over time, we have found that these brief exchanges add to our overall mosaic of information about the company.”

issues we see as most important. The frequency of contact—generally once or twice a year—gives us a good sense of the pace of change with which the company is addressing any concerns we’ve raised.

For example, we frequently initiate short-term engagements with companies when we discover that they are poorly rated by our external research providers who specialize in environmental or social risks. Often, we learn that a poor relative ranking by these third-party services is driven more by spotty disclosure than by poor risk management. We find that small- and mid-cap companies rarely receive feedback from their investors about their disclosure on corporate responsibility issues, so they devote few resources to reporting or engagement on those issues. As a consequence, they are poorly rated by external research providers. In our experience, this problem is often easily addressed.

Heavy Engagement

The other side of the barbell, for us, is characterized by a deep investment of time and resources. These engagements are intense, in-depth exchanges with a company’s management or board, often extending over more than a year. Typically, they are initiated with a formal letter to the board, followed by multiple in-person meetings.

The purpose of this type of engagement is to share our perspective with the board about what we view as a significant impediment to our ability to meet our investment goals, and to explore ways to work constructively with the company to remove the impediment.

A recent example of this type of engagement had to do with the mix of skill sets on a pharmaceutical company’s board. Several years before, this company experienced a period of financial distress, and as a result the board became populated with turn-around experts, bankers and directors with distressed-debt experience. This group of directors successfully executed a turn-around, and the company was able to invest in its drug pipeline again. However, it had entered a stage when it was failing to reach critical

milestones, experiencing serious patient-safety issues and reporting consistently disappointing financial results. In our view, the board’s lack of medically trained experts and practitioners was one reason for the persistent problems. Over two years, we advocated for a renewed focus on director skills and qualifications, given the changing nature of the company’s challenges.

Moderate Engagement

There are, in fact, engagement activities in the middle of the barbell where we tend to be less involved. We do not generally employ issue-specific screens to identify engagement targets, or write large numbers of letters to our portfolio companies expressing a view on a general sustainability topic. For some investors, these seem to be effective mechanisms to initiate dialogue, but we believe our barbell approach is best suited to our firm’s resources and investment strategies.

CRITERIA FOR “HEAVY ENGAGEMENT”

Before embarking on any engagement of this variety, consider the following questions:

- ▶ *Are we significant shareholders?*
- ▶ *Do we expect to remain long-term shareholders of the company? Do we understand the company well? Are we prepared to devote significant resources toward resolving this situation? In short, do we have standing to engage with this board?*
- ▶ *To the extent there are multiple portfolio managers who own the security, do they all agree on the nature and extent of the problem?*
- ▶ *Do our firm’s clients own other securities of this company (for example, its debt instruments)? If so, have we communicated effectively on an internal level before requesting dialogue with the company?*
- ▶ *Do we have both a concrete understanding of the problem and a constructive solution to offer?*

Effective Letter-Writing

Anita Green, Wespath Investment Management

“Let us never underestimate the power of a well-written letter.” – Jane Austen

Well-written letters are an absolute necessity for engagement. Your organization is represented by what lies on the page, and first impressions are critical. Every word choice and nuance can either make a compelling case for action or destroy it.

You may choose to write a letter from your own organization or may support a “collaborative” letter. Collaborative letters are usually written by one or more lead investors and endorsed by others—in some cases, signatories extend beyond investors, to include a variety of stakeholders. Weighing the merits of each strategy will help determine your course of action. Individual letters are usually the most effective; however, it can be a time-consuming endeavor and many organizations are reluctant to devote significant resources to letter-writing.

Individual Letters

Individual letters are preferred in certain circumstances, including:

- ▶ *The issue is closely aligned with your organizational priorities or where your shareholding is particularly significant.*
- ▶ *You are seeking to establish a relationship with the company.*
- ▶ *The issue is high-profile among your clients or participants.*
- ▶ *Organizational policies preclude endorsing collaborative letters, or lengthy internal review processes (legal, communications, etc.) may interfere with the ability to meet a quick deadline.*

Collaborative Letters

Collaborative letters are beneficial in other circumstances, such as:

- ▶ *When you wish to convey a message of significance and coordination—in other words, a substantial number of investors are interested in the subject and they are communicating with each other.*
- ▶ *When you think the issue carries financial risk but you are uncomfortable with individual engagement.*
- ▶ *When an investor has a small number of shares, or is resource-constrained.*

A cautionary note about collaborative letters: Collaborative letters can send a powerful signal to management; however, corporate recipients may categorize the signatories as a special interest group to be dealt with in a specific way, possibly even dismissed. Also, ask if the author intends to keep the engagement private or if a public release is under consideration, as this may affect your ability to sign on.*

Regardless of the strategy chosen, the following are essential elements of any effective engagement letter:

1. **Demonstrate your knowledge of the company.** Show that you have done your homework and understand the company’s business model and how a particular risk or issue relates to the company’s operations. Use language that will resonate with the company, avoiding jargon or acronyms.
2. **Be clear.** Early in the letter, communicate the action you are requesting. Many letters build the case first, which pushes the “ask” to near the end where it may be overlooked. Executives are busy people. Say what you want up front, followed by your supporting arguments.
3. **Be brief.** Shareholders tend to lay out the full business case and all supporting details in every letter, resulting in

a document that is so long it loses impact. Collaborative letters are particularly challenging because signatories want their individual perspectives to be represented. Compromises may be required to achieve the shared end-goal. Use the body of the letter to introduce your points, and use footnotes, web links and appendices to elaborate.

4. Write to the highest professional standards. Unfortunately, an alarming number of poorly written letters are circulated for sign-on. A clear, concise, high-quality letter establishes the credibility of both the argument and the author(s). Key tips for professional business writing include:

- ▶ *Use an active voice (not passive).*
- ▶ *Make the business case.*
- ▶ *Strive for balance—search for words that indicate obvious bias or hyperbole (e.g., “fail,” “lag,” “applaud”) and replace them.*
- ▶ *Research your sources to ensure that they are reputable.*
- ▶ *Always ask someone else to review and edit.*
- ▶ *Read it aloud, sleep on it, and read it again.*

Shareholder Proposals

Shareholder proposals (also called shareholder resolutions) can also benefit from the same attention to quality. Poorly written proposals receive fewer votes and reflect negatively on

the credibility of the sponsor. Remember, your organization’s reputation is at stake with every letter you send and every engagement action you pursue. Following these simple steps will send the message that you are a serious, thoughtful investor who deserves to be listened to.

**In the interest of transparency, letters to public officials should be disclosed on your website.*

“...first impressions are critical. Every word choice and nuance can either make a compelling case for action or destroy it.”

Shareholder Proposals: The Basics

Matthew Frakes, Council of Institutional Investors (CII)

Shareholders interested in filing resolutions with US listed companies must comply with rules detailed in Securities and Exchange Commission's (SEC) Rule 14a-8(a)(1)³, which covers a range of issues. The Council of Institutional Investors' primer *Filing a Shareowner Proposal: Everything You Ever Wanted to Know But Were Afraid to Ask* details the basics, including the following:

Ownership requirements: Shareowner proposals may be filed only by an investor that has held at least \$2,000 worth of the company's stock (or 1 percent of the shares eligible to vote, whichever figure is smaller) continuously for at least one year before the date the proposal is submitted to the company. The shareholder must continue to own those shares through the annual meeting.

Proposal length: A proposal cannot exceed 500 words and must be submitted by a deadline set by the company and usually disclosed in the prior year's proxy statement.

Permissible topics: Topics covered by shareholder proposals vary from year to year but tend to fall into three general categories: shareholder rights, a company's governance (including executive compensation), or environmental or social topics. The number of proposals addressing environmental and social issues has climbed steadily in recent years. The SEC acknowledged the increasing importance of environmental issues when, in January 2010, it issued an interpretive release providing guidance on existing rules that could require a company to disclose the impact that business or legal developments related to climate change may have on its operations.

“The number of proposals addressing environmental and social issues has climbed steadily in recent years.”

“The idea is to respect the proper boundary between issues best left to management and the board, on the one hand, and policy issues on which shareowners have a right to be heard.”

Grounds for exclusion: Rule 14a-8(i) spells out the criteria limiting the types of resolutions that can be submitted for inclusion in companies' proxy materials and detailing what a shareowner must do from a procedural standpoint. Companies frequently argue that resolutions—particularly ones addressing social and environmental issues—relate to the “ordinary business” of the company. The idea is to respect the proper boundary between issues best left to management and the board, on the one hand, and policy issues on which shareowners have a right to be heard. Where the line is drawn is not always clear and is debated widely every year.

It may be useful for shareholders interested in filing resolutions to consult with an attorney who has experience in this area. In addition, the SEC's website contains a page where the Division of Corporation Finance staff explains how the staff interprets these exclusions in specific cases. These interpretations are also available on legal databases such as Westlaw. Also, there are some, but not many, court decisions construing Rule 14a-8. Disputes over shareowner resolutions rarely go to court.

Request for action: A proposal must recommend that a company take some sort of action (be it preparing a report, assessing a specific risk and making a recommendation, updating or developing a policy, or requesting that the board amend its bylaws, for example). A proposal typically has a “Resolved Clause” (i.e., “Resolved: Shareholders hereby request that the board of directors does X.”). This clause is often accompanied by a supporting statement and “whereas” clauses, explaining why shareholders favor a recommended action.

[15] ³ For a full list of rules on filing shareholder proposals, see [SEC Rule 14a-8](#)

Shareholder Resolutions and Constructive Dialogue

Gianna McCarthy and Eric Shostal, New York State Common Retirement Fund

We'd like to question the premise that filing a shareholder proposal is an inefficient and potentially combative approach to dialogue with a portfolio company. Many institutional investors prefer more informal outreach and dialogue among governance staff, portfolio managers and management and directors. It has also been suggested that shareholder proposals limit the scope of such traditional engagement or are too costly and burdensome. Let's examine these perceptions.

Our experience in filing shareholder resolutions on behalf of the New York State Common Retirement Fund does not bear out the claim that filing proposals is, in fact, inefficient. In the last five years alone, the Fund's shareholder resolutions have resulted in constructive and substantive agreements to improve ESG policies and practices in partnership with more than 100 portfolio companies—over 40 percent of the 250+ companies receiving initial letters or shareholder proposal engagements. These agreements stem from the fact that many companies receiving shareholder resolutions are not surprised by the request. For example, a company may have garnered low shareholder support in prior years on a governance issue, or an investor coalition may have made earlier outreach efforts encouraging best practices.

Further dispelling the characterization of shareholder proposals as potentially combative engagement, proposals are always delivered with an invitation to discuss implementation. There have been instances where we have heard from company management that the filing of a shareholder resolution helped put the issue on the board's agenda. While a risk or an issue may have been recognized internally, in the absence of a shareholder resolution, it may not have been likely to get the board's attention in the near future. For instance, we recently participated in a collaborative, structured working group consisting of 13 institutional investors aiming to persuade large-cap pharmaceutical companies to develop a set of internal executive compensation policies to "claw back" pay in the event of fraudulent activities or misconduct resulting in a material violation of a company policy. In light of substantial government recoveries against several companies in the industry where such conduct was alleged, the companies were presumably aware of the risk of similar investigations and recoveries. When faced with the submission of shareholder resolutions, following initial engagement letters and in light of various recoupment policy agreements we obtained with peer companies, other boards adopted similar best practices.

We also have substantial evidence that engagement by means of shareholder resolution can fast-track dialogue for the simple reason that the clock is set for directors to respond with specificity prior to a company's annual meeting. Negotiations

can have a laser-like focus—starting with a resolution's "Resolved Clause"—since our request speaks directly to what we would like to see improved at the portfolio company. As such, dialogue rarely drags on for years, or even months, enabling us to allocate staff resources to pursue other equally important governance activities, such as effecting policy change, enhancing proxy voting functions and incorporating ESG into our investment processes. It is the sum of these activities, in concert with a comprehensive shareholder engagement program, that we believe will improve the investment landscape for our beneficiaries and for shareowners generally.

“Negotiations can have a laser-like focus—starting with a resolution’s ‘Resolved Clause’—since our request speaks directly to what we would like to see improved at the portfolio company.”

It is worth noting, too, that shareholder resolutions do not necessarily limit the scope of the engagement. To begin with, the shareholder resolution may give you a seat at the table. You should use this time with management or the board (or both) wisely, for it can provide an avenue to discuss other governance matters. For instance, when we file a shareholder resolution seeking enhanced board diversity, we will come to the table ready to discuss other issues that may be relevant, such as board entrenchment or strengthening shareholder rights.

Further, filing a shareholder proposal does not have to be a costly endeavor. Investors should be aware of the many organizations around the country that can help them streamline the shareholder filing process. If climate change and related sustainability issues are on your engagement radar, organizations such as Ceres' Investor Network on Climate Risk may provide useful ESG research that can facilitate filing a shareholder proposal with companies in your portfolio. The Council of Institutional Investors has also contributed to this very guide, with pointers on how to file a proposal, and is a good forum for collaboration on engagements focused on corporate governance issues.

So, rather than shelving the shareholder resolution tool in the proverbial engagement toolbox, consider its benefits: It can yield significant results, and has yielded them, in less time and with fewer resources than may have been previously thought.

Building Trust Is Critical for Effective Engagement

Bess Joffe, TIAA-CREF, and Francis Byrd (formerly with TIAA-CREF)

As a long-term institutional investor, TIAA-CREF seeks to ensure that our portfolio companies focus on building long-term shareholder value. We want our companies to do well for our participants and clients over the long run, and, as such, when we engage with companies, we strive to create constructive, long-term relationships in an effort to be effective stewards. We believe that good corporate governance and effective risk management of environmental and social issues not only adds value to the portfolio on behalf of our participants but also can help the broader market over the long term.

Our approach for developing relationships with portfolio companies is to privately engage when we sense potential shortcomings in their environmental, social or governance policies and practices that we believe could affect their financial performance. Establishing trust is a critical element of our engagement program. We call this approach “quiet diplomacy.”

“Establishing trust is a critical element of our engagement program. We call this approach ‘quiet diplomacy.’ ”

We communicate with hundreds of companies each year through written correspondence, in-person meetings and discussions with independent directors and senior corporate management. As a practice, “quiet diplomacy” reflects our deeply held belief that informed dialogue—rather than public confrontation—is more likely to build trust and lead to mutually productive outcomes. In cases where we have more significant concerns about company behavior, we may establish dialogues that extend for multiple meetings over an extended period of time. In some instances, we may also

“...our deeply held belief that informed dialogue—rather than public confrontation—is more likely to build trust and lead to mutually productive outcomes.”

initiate broader engagements focused on a specific issue, with the goal of influencing the practices of an industry or a select group of portfolio companies.

Even in those instances where a company may not be responsive to our outreach, we try to find other ways to engage, still behind closed doors if at all possible. For example, between 2007 and 2011, we filed 31 shareholder proposals on issues including corporate social responsibility reporting and majority voting but, importantly, did not publicly disclose these filings. Ultimately, 25 of those proposals were withdrawn as we were able to reach mutually agreed on outcomes with those companies and, as a result, those engagements remained private.

Unlike public pension funds, which can be required to report publicly on their activities, we are not obligated to publicize our discussions or the outcomes from our engagements. We believe this helps us build long-term relationships with companies that contribute to constructive dialogue. Furthermore, ensuring that a company’s board and management take credit for any resulting change of policy or behavior furthers our goals of building trust and enhancing shareholder value over the long term.

Reaching Out to the Board of Directors

Brandon Rees, American Federation of Labor and Congress of Industrial Organizations (AFL-CIO)

Shareowner engagement with boards of directors is one of the best ways to advocate for attention to material ESG issues. Here are some tips and ideas for engaging with directors effectively:

- 1. Identify the best director to engage.** Research your company's board of directors and evaluate each director's background and professional experience. Generally, the best director to engage with is an independent director who is in a leadership position on the board (e.g., the lead director or a committee chair).
- 2. Write a letter.** Send a letter addressed to the director articulating your concerns. Explain why your ESG issue is a concern for shareowners more broadly. Do not assume that the director is aware of the issue you are raising. Let the facts speak for themselves, and try to write persuasively, rather than argumentatively.
- 3. Send the letter.** You should refer to the company's proxy statement for instructions on how to communicate with the board. You may wish to copy the entire board. In addition to sending the letter via the company, send your letter to the director's primary place of business or hand deliver the letter at the annual general meeting (AGM). Registered mail works well.
- 4. Follow up.** If a satisfactory response is not received after a reasonable time, contact the director by telephone, or engage a director privately at a public forum, such as an investor conference. Or try an annual meeting of another company where the director serves on the board.
- 5. Meet with the director.** If the director responds to your letter, offer to meet in person or arrange a telephone call. Consider including other shareowners in the conversation (but make that transparent to the director). Usually, a representative of company management (e.g., a Corporate Secretary or General Counsel) will also want to participate.

“Shareowner engagement with boards of directors is one of the best ways to advocate for attention to material ESG issues.”

In some cases, shareowner engagement with directors may not be successful. In these cases, you may decide to run a “vote no” campaign to urge shareowners to withhold their vote from the director's re-election. Alternatively, consider nominating a new director to the board by suggesting names to the nominating committee or conducting a proxy solicitation.

Here are some key steps for running a successful “vote no” campaign:

- 1. Identify your fellow shareowners.** Research the proxy voting policies and contact information for key decision-makers at the company's major shareowners.
- 2. Send shareowners a “fight letter.”** Circulate your campaign materials as soon as practical after the company publishes its proxy statement. Consider using Broadridge Financial Solutions to forward your materials to beneficial owners who are bank and broker clients.
- 3. Comply with the SEC's solicitation rules.** Under Rule 14a-2(b)(1), “vote no” campaigns are generally exempt from certain SEC proxy rules so long as you do not seek to act as a proxy for other stockholders. However, if you own more than \$5 million in shares, you must file your materials and a “notice of exempt solicitation” with the SEC under Rule 14a-6(g).
- 4. Educate proxy voting advisors.** Share your campaign materials with key proxy voting advisors, such as Institutional Shareholder Services and Glass, Lewis.
- 5. Contact the proxy voters.** Although many institutional investors will not disclose how they plan to vote, call their proxy voting staff to explain your concerns.
- 6. Publicize your campaign.** Talk to reporters who follow the company, industry, or issue area, and use social media, like blogs and networking sites.
- 7. Attend the annual general meeting.** Speak from the floor at the company's AGM to voice the concerns of shareowners that supported your campaign.

Engagement Through the Proxy Vote

Michael McCauley, State Board of Administration (SBA) of Florida

The State Board of Administration (SBA) of Florida frequently attempts to influence and make improvements in the corporate governance structures and ESG practices of individual companies we own. We achieve these objectives through a number of different, but integrated, strategies. One element of these efforts includes the development of comprehensive corporate governance principles and proxy voting guidelines. Managing stock ownership rights and the proxy vote includes the establishment of written proxy voting guidelines, which must include voting policies on issues likely to be presented, procedures for determining votes that are not covered or that present conflicts of interest for plan sponsor fiduciaries, procedures for ensuring that all shares held on the record date are voted, and procedures for documentation of voting records and making them transparent. The SBA's proxy voting guidelines reflect internationally recognized governance practices for well-managed public companies, covering the independence of boards of directors, performance-based executive compensation vehicles, high-quality accounting and audit practices, and emerging ESG issues of concern, as well as transparent board procedures.

“We achieve these objectives through a number of different, but integrated, strategies. One element of these efforts includes the development of comprehensive corporate governance principles and proxy voting guidelines.”

Through the development and implementation of comprehensive principles and proxy voting guidelines, the SBA ensures that our proxies are voted consistently across all portfolios and market structures. We are reliant on our Corporate Governance Principles to direct our activities related to ESG engagement and proxy voting. These principles, in conjunction with other relevant

policies, set the parameters for company engagement and provide a framework for our initiatives. The SBA's Proxy Voting Guidelines are formulated and revised in accordance with these principles, on at least an annual basis.

Our voting guidelines are based on rigorous empirical research, industry studies, investment surveys, and other general corporate finance literature. SBA proxy voting policies are based on both market experience and balanced academic and industry studies, which aid in the application of specific policy criteria, quantitative thresholds, and other qualitative metrics. Empirical citations provide evaluation of specific items over long time frames, in excess of three years—and also are applied extensively, analyzing companies of various sizes and geographic locations.

Although we believe that it is essential to confront corporate boards with poor oversight practices, we also recognize the necessity of allowing boards to direct the businesses that they have been entrusted to oversee without excessive interference; therefore, we do not attempt to impose highly prescriptive procedures upon the companies we own. However, to balance our position, we vote “against” any proposal that limits shareowner rights or makes it more difficult for shareowners to have a voice in company practices, as well as certain board structures, super-majority requirements, and others.

Frequently, the SBA discusses proxy voting issues and specific ESG topics directly with owned companies. For example, we may write letters to members of a board to communicate our general or specific concerns. Less frequently, we may seek opportunities to meet with individual directors or committees of the board to express similar views or submit shareowner proposals for approval on a company's proxy statement. Incorporating the information achieved through direct engagement helps the SBA to make better voting decisions, with an opportunity to apply timely and nuanced factors within our decision-making process.

The SBA discloses all proxy voting decisions once they have been made, several days before the date of the shareowner

“*Although we believe that it is essential to confront corporate boards with poor oversight practices, we also recognize the necessity of allowing boards to direct the businesses that they have been entrusted to oversee...*”

Our votes across all primary ballot items and topics of focus are compared to other major investors’ voting decisions (generally the largest or top five shareowners) as well as to the entire voting market. In addition to benchmarking voting against other market participants, the SBA regularly evaluates the policy frameworks implemented by our external proxy advisors. Vote benchmarking helps shareowners identify new topics requiring policy treatment within their own guidelines. Finally, a comprehensive report is published for our stakeholders annually, providing a detailed summary of voting results across a variety of topics and highlighting significant trends in company engagement and regulatory changes.

meeting. Disclosing proxy votes prior to the meeting date improves the transparency of our voting. Disclosing votes in advance of their effective dates emphasizes the SBA’s position on corporate governance and ESG practices.

VOTING: IT’S ALL ABOUT COMMUNICATION

Vicki Bakhshi, F&C Investments (Part of BMO Financial Group)

Proxy voting is one of the main levers investors have to promote high standards of governance at the companies they own. Yet too often, as long as their resolutions are passed, company attention to shareholder views fades the day the AGM ends. At F&C Investments, we believe there is great value in engaging with companies not only ahead of the ballot, but also afterward, by highlighting to companies when we have voted against management, and telling them the reasons why.

When we cast a vote, we record comments, summarizing the rationale behind our voting decisions. These comments are entered into our service provider’s platform when the vote is executed, and are published the day after the meeting.

In principle our commitment could end there. Some particularly diligent companies might then go to F&C’s website and look up the reasons for our voting decision; but realistically this will be a small minority. We believe we have a duty to go further, and that it is part of our responsibility as shareholders to actively alert companies to the decisions we have taken.

We therefore write to all companies where we have opposed at least one resolution or board nomination to alert them to this, and to direct them to our online vote reporting where they can find out the reasons why. In 2014, this meant contacting over 3,500 companies, by email and letter. We receive responses from companies keen to secure our support in future years—some reassuring us about their commitment to good governance and sound ESG practices, and others asking for further dialogue about our voting decision and the standards we apply.

Where our vote was accompanied by active engagement, we will often write a more personalized letter directly to the Chairman, summarizing the reasons for our final decision. This helps to put our engagement definitively on the record and serves as a point of reference for the next year’s vote. Such letters can also help to provide internal leverage for those within companies pressing for improved standards, by giving them evidence of investor support.



ENGAGEMENT IN OTHER ASSET CLASSES

“We believe that every financial analyst conducting investment analysis should have knowledge of the risks and opportunities of environmental, social, and governance (ESG) issues in investing.”

—CFA INSTITUTE

Private Equity Engagement: Post-Investment Monitoring Is Critical

David Russell, USS Investment Management

Increasing numbers of pension funds globally are allocating capital to private equity. Responsible investment policies should apply to all asset classes, with private equity being no exception, and therefore private equity managers should expect engagement from pension funds on their integration of ESG factors into investment processes and activities.

“Responsible investment policies should apply to all asset classes, with private equity being no exception... private equity managers should expect engagement...”

From an asset owner’s perspective, engagement with private equity (PE) is different from engagement with companies, in that most PE investments are via a limited partner arrangement. This means that the asset owner or pension fund has limited influence over the management of the final investment. This is a key difference from traditional corporate engagements.

As a result, it is critical that prior to investment, the pension fund undertakes comprehensive due diligence of the potential private equity manager’s processes and approach to integration of ESG issues. Private equity fund managers should expect this due diligence to cover, at a minimum, the following three areas of manager activity:

- ▶ **Due diligence: How does the private equity manager integrate ESG issues into its analysis of potential investments?** *In any investment, it is important to understand what you are buying. As private equity tends to be illiquid and long-term investments, this understanding is vitally important, as it is not possible to sell out of the investment easily. As a result, the manager should be able to demonstrate that it has processes to identify any ESG risks with any potential investment.*
- ▶ **Asset management post-investment: How does the fund manage ESG issues in the asset post-investment?** *Once an investment has been made, private equity frequently takes a controlling stake in companies, and is therefore in a position to influence directly how the assets in the portfolio are*

managing ESG risks. The manager should be able to provide details of how ESG issues will be managed within portfolio companies, the resources that could be used, and other similar issues.

- ▶ **Transparency with investors and other stakeholders: How does the fund communicate its management of ESG issues?** *Private equity has been rightly accused of being poor at communicating its management of ESG issues to both investors and society in general. Pension funds should request both improved information on the management of ESG issues in the portfolio and better transparency in general.*

The outcomes of this due diligence would then be fed into the investment decision-making process and ongoing monitoring of the private equity manager. This ongoing monitoring is important: As PE investments tend to be illiquid and for a defined period (often 10 years), it is very difficult to get out of an investment if it fails to achieve the ESG standards expected. Ongoing engagement and discussion with managers, to monitor and encourage ESG performance, is therefore important and should be expected. It is worth noting that while collaborative engagement to discuss ESG issues between pension funds with a shared PE manager is unusual, it does occasionally occur and can be useful.

“Ongoing engagement and discussion with managers, to monitor and encourage ESG performance, is therefore important and should be expected.”

Finally, guidance is available for both investors and PE fund managers on ESG engagement and oversight, including that produced by the UN-supported Principles for Responsible Investment (PRI)⁴, the British Private Equity & Venture Capital Association⁵ and the Private Equity Growth Capital Council.⁶

⁴ PRI’s *Integrating ESG In Private Equity*

⁵ *British Private Equity & Venture Capital Association’s Responsible Investment Guide*

⁶ *Private Equity Growth Capital Council—Guidelines for Responsible Investment*

Enhancing Credit Analysis Through Engagement

Robert Fernandez and Nicholas Elfner, Breckinridge Capital Advisors

At Breckinridge Capital Advisors, we strive to provide the highest caliber of fixed-income management, facilitating a sustainable flow of capital from long-term investors to responsible municipal and corporate borrowers. We assess the reliability of future cash flows and identify future risks by maintaining a long-term focus on our investment commitments. While we are active managers, we often hold our medium- to long-term commitments to maturity.

To fulfill this mission, we seek to invest in enterprises and local governments that are operating in a sustainable manner today, with an eye on material issues that may affect their performance in the future. We select these debt issuers after a rigorous credit research process that includes an assessment of both traditional financial, as well as nonfinancial, ESG performance. We have found that this integrated approach provides a more comprehensive and forward-looking evaluation of a borrower's ability to repay. It is also a factor in investment valuation, as ESG integration helps us to identify and price risk.

“We have found that this integrated approach provides a more comprehensive and forward-looking evaluation of a borrower's ability to repay. It is also a factor in investment valuation, as ESG integration helps us to identify and price risk.”

We supplement our credit research by engaging with our borrowers. As a signatory to the Principles for Responsible Investment, Breckinridge believes that engagement is about leveraging our voice to bring greater focus on management's stewardship of long-term capital. Bondholders play a key role in the capital structure but, unlike shareowners, have

no formal venue such as proxy voting where their voice can be heard systematically. Therefore, we direct our engagement efforts toward private dialogue with management. We enter the discussions with two objectives in mind:

1. To gain a better understanding of the ESG policies and performance of the borrowers in our portfolios, as well as the material issues, opportunities and risks they face.
2. To encourage additional reporting on material ESG issues and the management of those risks, especially when disclosure falls below best practices.

Our engagement efforts to date have taught us the following:

- ▶ *Municipal and corporate management teams are usually eager to share their sustainability initiatives, when provided the opportunity. In our conversations, we have been told that “this is the first time a bond investor has asked about sustainability,” or, during a recent call with a large US corporation, “you are the only investor to inquire about sustainability this year.”*
- ▶ *Conversations with management teams, in some cases, confirm our internal ESG assessments of the related borrowers. For example, calls with representatives of companies or municipalities that we rate highly for their ESG risk management were generally productive and rich with information about sustainability targets, plans and strategies.*
- ▶ *ESG-related inquiries serve as an effective evaluation of the quality of management, which allows us to know our borrowers better. Answers we receive to questions we pose across the spectrum of ESG issues (such as waste from operations, supply chain management practices, and bribery and corruption policies) provide us with a clearer picture of a corporation's priorities, culture and commitment to sustainability.*

Our engagement work is composed of three phases: the pre-call, the engagement call, and the post-call. The steps involve the following chart:



We believe bond investors, with their often multiyear perspective, are well-positioned to engage collaboratively with management to endorse and promote sound ESG practices. In the end, we feel that such engagement enhances our credit analysis, by providing us with more comprehensive credit profiles of our borrowers.

“ESG-related inquiries serve as an effective evaluation of the quality of management, which allows us to know our borrowers better.”

COLLABORATIVE ENGAGEMENT

“Principle 5: We will work together to enhance our effectiveness in implementing the Principles.”

—PRINCIPLES FOR RESPONSIBLE INVESTMENT

Effective Collaboration

Meredith Miller, UAW Retiree Medical Benefits Trust

Over the past few years, investors have increasingly chosen to participate in large shareholder coalitions as a more effective way to engage companies on environmental, social and corporate governance issues. By bringing more capital to the table, collaborative work can elevate an issue or a strategy far beyond what funds generally could achieve working alone or in very small groups. Companies also typically support a coalitional model of engagement, which can be far more efficient than separate engagements with multiple investors on the same issues.

“By bringing more capital to the table, collaborative work can elevate an issue or a strategy far beyond what funds generally could achieve working alone or in very small groups.”

At the UAW Retiree Medical Benefits Trust, coalitions have been an integral part of our work plan since our 2010 inception. We have found that working in diverse coalitions that capture a wide range of institutions—including public sector, Taft-Hartley, faith-based and sustainable investment funds, asset managers, other health care trusts, and funds domiciled abroad—allows us to leverage various perspectives and approaches to corporate engagements to our advantage.

In the 2013–2014 proxy season, the Trust led five coalitions covering a variety of strategies across the engagement spectrum. Some coalitions favored dialogue only as a way to learn more about an issue, while others were designed to follow the shareholder resolution process, including filing. The total assets of the coalition members ranged from smaller groups of funds with \$219 billion in assets under management (AUM) to larger groups, such as the Human Capital Management Coalition with 23 funds and \$1.6 trillion AUM.

Coalitions can vary significantly in composition. The Trust has coordinated coalitions that consist only of investors (including asset managers), as well as launched collaborative efforts with a wide range of stakeholders. For example, the Trust spearheaded a multi-stakeholder initiative in 2012 that sought to develop a sector-wide set of principles on executive compensation

clawbacks for misconduct in the pharmaceutical sector. Six pharmaceutical companies and 12 investors, led by facilitators and supported by several content-matter experts, met for 18 months to develop the policies. These policies were ultimately adopted by each company’s board and have become a new corporate governance standard that investors have used in engagements with other companies in the healthcare, finance and defense sectors. By working collaboratively, the group was able to effectuate change without having resolutions go to a vote, while setting the stage for an industry-wide standard.

The Trust has also led coalitions on corporate political spending, human capital and board diversity. As well, the Trust participates as a member in other investor coalitions on supplier safety and reporting, global health company practices and lobbying disclosure. There is no one formula for how investor coalitions work. As with other coalitions, some funds within a coalition take on the administrative and coordinating role, developing the initiative, the research, the corporate and press communications, and then setting meetings. Coalitions may choose to share both leadership and supporting functions.

INSTITUTIONS THAT SUPPORT INVESTORS IN COLLABORATIVE ENGAGEMENTS

- ▶ *Council of Institutional Investors*
- ▶ *Ceres’ Investor Network on Climate Risk*
- ▶ *Principles for Responsible Investment*
- ▶ *30% Coalition*
- ▶ *Center for Public Accountability*
- ▶ *Interfaith Center on Corporate Responsibility*
- ▶ *International Corporate Governance Network*
- ▶ *CDP*

Group Dialogue Clarifies the “Investor Voice”

Michael McCauley, *State Board of Administration (SBA) of Florida*

Regular interaction with other shareowners of commonly owned firms often has a material impact on the quality and scope of company engagement. When a group of investors shares information and expertise (on management quality, ESG risks, board member independence or other significant topics), a common ground of understanding can be achieved, advancing the analysis of corporate performance among a large portion of the company’s investor base. Even small groups of investors can be highly effective, especially when including one or more members of a company’s top owners—usually defined as an investor owning more than 5 percent of the firm’s equity shares, or designated within the largest five

individual shareowners. Being open and receptive to the views and analysis of other investors helps Florida’s State Board of Administration stay abreast of issues involving specific companies, as well as of emerging ESG issues, including legal and regulatory changes. Group dialogue also serves to clarify and focus the “investor voice,” which at times may be perceived as disparate and unrelated within a company’s investor base. These dual advantages of group dialogue can translate into more effective engagement, with stronger effects on the ESG issues you are attempting to address.

CONSIDERATIONS WHEN LEADING OR JOINING A COLLABORATIVE ENGAGEMENT

Meredith Miller, *UAW Retiree Medical Benefits Trust*

Model: Is the coalition model event-driven, built for long-lasting use, or just a proxy season?

Governance: How are decisions in the coalition made?

History of Issue: Is the coalition sensitive to achievements, momentum and existing efforts of other coalitions or investors?

Different Strategies: Does the group understand and honor the differences in corporate strategies of the participants?

Signatories: Do participants need to be invested in every company, or does the group represent investors broadly without ownership requirements?

Press: Is there an expectation that the initiative will be public? If so, will the individual participants have an opportunity to review press releases, including offering quotes?

Leadership: Are there opportunities for individual coalition members to take on leadership roles?

Drafting: Does the coalition offer opportunities to edit or provide feedback on communications?

Momentum for Success: Has the coalition agreed on the definition of success or progress?

Lessons Learned from the Massey Energy Engagement

Jay Chaudhuri and Melissa Waller, North Carolina Department of State Treasurer

When an explosion in April 2010 killed 29 workers at the Upper Big Branch mine owned by Massey Energy Company in West Virginia, institutional investors quickly formed a coalition to remove three directors from the company's board and change Massey's corporate culture. In the end, this shareholder coalition removed an unresponsive board member and the CEO. That collaboration involved several state treasurers and public pension funds. Together, the coalition held more than 1.3 million Massey shares valued at more than \$64 million. The Massey experience offers key lessons on collaboration for institutional investors, namely:

- ▶ **Agree on goals:** Collaboration requires understanding why the coalition exists. Each member of the coalition may have a different strategy. However, by discussing and respecting all strategies, the coalition agreed on concrete goals to maximize outcomes.

“Agree on goals: Collaboration requires understanding why the coalition exists. Each member of the coalition may have a different strategy.”

- ▶ **Form strategy by exchanging information and research:** Collaboration translates into increased resources. To reform Massey, the coalition needed to collect, review and distribute information quickly and accurately. Each partner brought different strengths on reviewing and interpreting data. For example, the California Public Employees' Retirement System constructed a grid of the board's skill set that it shared with all members. Our North Carolina State Treasurer's Office provided information about the federal investigation of the mining accident.

- ▶ **Establish a coordinated communication strategy:** Collaboration also requires different levels of communications management. The coalition needed to communicate with each other, shareholders and the media. In the end, the coalition centralized its voice through one office. The North Carolina State Treasurer's Office coordinated all communications; as a result, when any coalition partner spoke, the messages were consistent and greater impacts were achieved.
- ▶ **Know when and how to use the media:** The coalition immediately recognized that publicity came with positives and negatives—a double-edged sword. The coalition agreed on what to say and what not to say. Shareholders inside and outside of the coalition needed to know that conversations would remain private. Yet the coalition also wanted to publicize efforts to put pressure on Massey and all its shareholders to take action. In the end, the coalition publicized efforts sparingly, keeping its efforts uniform. The coalition coordinated which messages were targeted for public consumption and which messages were more strategically held and in confidence with the company.

Tackling Fracking: Collaboration with Company Experts Brings New Understanding to Risks

Steven Heim, Boston Common Asset Management, LLC

Profound change can result from intense, structured discussions between shareowners and their companies that build common understanding of complex issues. In the end, “money talks,” but only if the shareholder perspective is well reasoned and effectively presented, with the end result of driving best practices.

Since July 2010, Boston Common Asset Management and Apache Corporation (a major US oil and gas independent) have co-convened a dozen invitation-only, Chatham House–rule investor meetings, largely on the topic of hydraulic fracturing operations for shale energy. Some meetings also covered offshore oil safety and human rights, corruption and compliance. Our initial 18-month dialogue provided a venue for extended conversations on risks, management practices and disclosure, and review by industry experts of draft practices and indicators. This led to the publication of the investor guide *Extracting the Facts* by the Investor Environmental Health Network and the Interfaith Center on Corporate Responsibility in December 2011 (which later became the basis for the *Disclosing the Facts* reports).

“In the end, ‘money talks,’ but only if the shareholder perspective is well reasoned and effectively presented, with the end result of driving best practices.”

Throughout, our goal has been to elevate investors’ understanding of complex issues so they can ask harder questions of companies and drive wider adoption of best practices. We have experimented with meeting formats, from workshop lectures to mainly question-and-answer sessions that discourage PowerPoint presentations. Meetings range between a half-day to two hours, with 35 to 60+ participants. We ask engineers and executives to give frank answers to hard questions from investors, from which common understanding grows for both investors and companies.

“...our goal has been to elevate investors’ understanding of complex issues so they can ask harder questions of companies and drive wider adoption of best practices.”

In recent meetings, in response to participant demand, we have covered hydraulic fracturing issues in depth—chemical use in oil and gas production operations, water management and use, best practices for regional operations, and air emissions and controls. Issue experts helped frame the discussions for investors and the company had its own internal champion, who invited other companies to participate. Beyond improving disclosure, Boston Common’s engagement prompted new ideas that resulted in Apache lowering costs with innovative, “green” practices that use less chemicals, water and diesel fuel.

A mix of companies, investors and NGOs has participated in these meetings. Investor participants ranged from public pension funds and large asset managers to small but passionate faith-based investors. Academics have also joined specific meetings as issue experts.

Support at the top by Apache’s CEO has been integral to the success of these interactions. Boston Common has held parallel, annual ESG-oriented meetings with the company’s CEO since 2005, featuring a broad spectrum of investors, as well as one-on-one annual meetings at his office since 2009. Over time, the engagements, which started initially on climate change, expanded to other issues, including environmental practices, human rights, corporate governance and health and safety. Our 2009 meeting showed that we needed to bridge the fact gap of the industry and NGO activists fighting fracking in the US. This led to our first joint meeting in July 2010 that had over 50 participants. The first joint discussion went so well that we continued with the model through the present. In fact, this sustained engagement model is being shared in circles like the World Bank and the International Finance Corporation (IFC). In January 2015, the IFC invited Boston Common to share the model’s success at an IFC roundtable for financial institutions and corporates in India.

Escalation Strategies: The Council of Institutional Investors' Ignored Majority Votes Initiative

Matthew Frakes, Council of Institutional Investors (CII)

The Council of Institutional Investors (CII) has long held that if a majority of investors support a shareholder proposal, the board should adopt the recommended action. Similarly, CII's policies call for directors who fail to win majority support to step down from the board. In short, CII believes that boards should take shareholder votes seriously—and act on them.

To advocate for these long-held policies and to hold boards accountable, CII has written since 1996 to all Russell 3000 companies reporting majority votes on shareholder proposals. The letters ask them to adopt the majority-recommended action and report back to CII. In 2010, CII expanded its letter campaign to call on any Russell 3000 director who failed to win majority support—a so-called “zombie director”—to step down from the board. Both efforts were launched following concerns that boards were simply disregarding these majority votes.

Company responsiveness to CII's outreach has markedly improved over the years. In the earliest days, a 10 percent response rate was considered high, and the tone of at least some responses was less than cordial. However, times have changed. By 2014, when CII sent letters to 65 companies with 78 majority votes, the company response rate had climbed to 43 percent—the same rate as in 2012 and 2013, when the majority votes included a sustainability reporting proposal that received 67 percent support at CF Industries Holdings.

“By 2014, when CII sent letters to 65 companies with 78 majority votes, the company response rate had climbed to 43 percent..”

Real results have followed these increasingly robust response rates. By the start of the 2015 proxy season, companies had taken substantive action to implement 75 percent of the majority-supported shareholder proposals from 2012, 74 percent of the 2013 majority-vote-winning proposals, and 31 percent of the majority votes from 2014.

“By the start of the 2015 proxy season, companies had taken substantive action to implement 75 percent of the majority-supported shareholder proposals from 2012...”

Still, more than half of the contacted companies do not respond to CII or fail to adopt the majority-recommended action. To spotlight these non-responders, CII tracks all letters sent—including the reason for the letter and the number of consecutive years similar letters have been sent to the company—and makes all responses and follow-up actions available to CII members, who frequently use this data to identify companies for special attention in the following year.

CII plans to continue this program, which it believes has been highly successful in holding boards accountable for their actions and keeping shareholders informed of company responsiveness.



BEYOND COMPANY ENGAGEMENT

“Institutional investors should engage as appropriate in the development of relevant public policy and good practice standards and be willing to encourage change where this is deemed helpful by beneficiaries or clients to the delivery of value over appropriate time horizons.”

—ICGN GLOBAL GOVERNANCE PRINCIPLES (2014)

Engaging on Public Policy

Michael Garland, Office of New York City Comptroller Scott M. Stringer

Investors engage with policymakers and regulators for the same reason they engage with companies: to protect and advance their long-term financial interests. Many of the underlying reforms sought are also similar, including those that: promote responsible and transparent business practices; enhance corporate governance and disclosure, including with respect to material ESG risks; and strengthen shareholder rights.

Unlike company-specific engagement, however, public policy engagement has the potential to extend company best practices to an entire industry or market, and to establish uniform standards. It also enables investors to address market structure, practices and transparency issues that can create systemic risks for financial markets and the economy overall, such as those exposed by the global financial crisis or posed by climate change.

“Unlike company-specific engagement, however, public policy engagement has the potential to extend company best practices to an entire industry or market, and to establish uniform standards.”

Investor advocacy is responsible for many meaningful regulatory and policy actions. In 2010, for example, the SEC issued guidance requiring corporate disclosure of material climate change risks in response to a rule-making petition from leading pension funds, elected officials with fiscal management responsibilities, and Ceres, among others. Similarly, a rule-making petition from the AFL-CIO’s Office of Investment led to the SEC’s 2003 rule requiring mutual funds to disclose their proxy votes, which increased fund transparency and voting support for shareholder proposals on a wide range of ESG issues, and ushered in a wave of fund companies beginning to really engage with the companies they (largely passively) owned.

Many more existing laws and regulations originated out of company-specific advocacy by investors, and in many cases investors actively supported and helped to shape subsequent implementation. Recent examples include the Dodd-Frank provisions mandating an advisory vote on executive compensation (“Say on Pay”) and the disclosure of conflict minerals, as well as a pending SEC rule-making petition on the disclosure of corporate political spending. That August 2011 petition generated over one million supportive comment letters from individual and institutional investors as of September 2014, a record.

The “investor voice” is especially important in policy debates in which investors believe companies or their trade associations have taken a position that conflicts with the best long-term interests of the corporations and their shareholders. Such differences can arise when management and shareowners have differing time horizons or risk appetites, or when management’s own interests conflict with those of the corporation and its shareholders, as is often the case with reforms focused on executive compensation (e.g., mandatory stock option expensing).

At a minimum, therefore, investors should consider actively supporting proposed reforms that they believe are in their best interests and opposing those that are not. Because the devil is often in the details, it is important for investors to offer specific comments and recommendations when they have particular concerns with proposed policies or regulations. Form letters from institutional investors are not very valuable or persuasive in the current regulatory environment.

Investors can express their views by meeting with regulators and key policymakers, providing testimony or submitting comment letters. They can also submit formal petitions seeking new rules or regulations. Similar to company engagement, investors can engage individually as well as through coalitions and more formal organizations with particular expertise, such as the Council of Institutional Investors (CII) and the Investor Network on Climate Risk (INCR). CII facilitates member engagement with key decision makers, including annual meetings on Capitol Hill. The INCR, as part of its effort to promote climate and sustainability policies and greater ESG disclosure, has established separate working groups focused on (1) federal and state policy makers, (2) the SEC and (3) stock exchanges.

COMMON TYPES OF PUBLIC POLICY ADVOCACY

- ▶ *Rule-making petitions*
- ▶ *Comment letters to the SEC and other regulatory agencies*
- ▶ *Letters to, meetings with or testifying before Congress*
- ▶ *Amicus briefs in key court cases that affect regulation*
- ▶ *Op-ed articles or public ads noting an investor position on key regulations or proposed reforms*

Engagement to Create Common Investment Standards

Chad Spitler, BlackRock

A significant problem in the market today is that when investors talk about ESG information or performance, they do not speak the same language. A CFO does not use the same vocabulary as a corporate governance officer, and a company might not use the same words as an institutional investor while discussing the same aspects of sustainability performance. Investors have an opportunity to help draft common language through engagement on sustainability standards—whether they be focused on what should be reported, how it should be reported, or bright lines for what is considered a “sustainable” investment or not.

As broadly diversified investors holding securities across markets, sectors and asset classes, we also need standards and more standardized language to be effective at communicating product and disclosure needs and to gather comparable disclosures for benchmarking, analysis and valuation purposes. Standards allow us to better facilitate the exchange of information and derive meaning from that information. Disclosure standards also drive efficiency and, ultimately, cost savings. As such, investors can derive direct value from participating up front in developing standards.

There are currently several market-based sustainability initiatives that BlackRock is focused on to clarify investment criteria for new product offerings and those related to reporting standards: the development of the green bonds market, the Sustainability Accounting Standards Board (SASB) and sustainability disclosure requirements as an exchange listing requirement.

Investors are paying much closer attention to the growing “green bond” market, but do we all share the same definition of “green”? Green bonds are just like any other bonds, the difference being that the proceeds raised from the bonds fund environmentally beneficial projects. But what does that mean over the maturation of the bond? For example, should a hydroelectric dam project that creates renewable power, but in the course of its construction displaces communities and threatens fisheries, be considered a green investment? These are value judgments regarding the use of proceeds that investment managers are challenged to make on behalf of clients, and, as such, green bond standards are being developed to help provide a common framework of understanding for assessment and comparison. Impact reporting standards are thus critical in the development of the green bond market, for investors to assess which projects are most aligned with their goals and objectives and how they

compare with other investment opportunities. Ultimately, if standards are not developed, it will hinder the growth of this market, increase concerns of “green washing” and undermine the market’s overall enthusiasm for these types of investment vehicles. As such, one way to help build an emerging asset class to create investment opportunities for your clients is to participate in the development of standards.

“Ultimately, if standards are not developed, it will hinder the growth of this market, increase concerns of “green washing” and undermine the market’s overall enthusiasm for these types of investment vehicles.”

Another way to promote the development of a sustainable economy is to engage in the market dialogue around sustainability listing standards. We hear from our portfolio companies time and again how challenging it is for them to respond to multiple reporting regimes asking for similar but slightly different information. “Survey fatigue” is a common term describing this dynamic. As shareholders, we too are concerned about the cost and resource implications of too many surveys and questionnaires on sustainability topics, and we want comparable data from all the companies we own. The Sustainability Accounting Standards Board is one initiative that we are involved with that will help companies and investors by identifying the sustainability factors, by sector, that are perhaps most likely to affect financial value. Furthermore, if we could align these factors with the sustainability reporting listing standards initiative that we are working on with Ceres, this could facilitate uniform disclosure of the most financially material sustainability factors across companies and sectors globally. Through exchange listing requirements, we also see benefits to our portfolio companies that are concerned about being put at a competitive disadvantage compared to their peers who may not disclose. As such, stock exchange listing rules on sustainability disclosure expectations not only reduce costs, but they also significantly level the playing field for the reporting companies and provide meaningful and comparable data for investors, leading to a win all-around.

The Rise of Stewardship Codes

Kerrie Waring, *International Corporate Governance Network (ICGN)*

Over 20 years have passed since the UK's Sir Adrian Cadbury first defined corporate governance as the system by which companies are directed and "controlled".⁷ It sparked generations of research focused around corporate "direction" and influenced ICGN's principles around how companies should be governed. This movement was echoed in the US when Robert A.G. Monks noted that it is imperative that "plan fiduciaries take an active role in corporate affairs in order to ensure safeguarding of plan assets."⁸ Seven years ago, the Lehman Brothers collapse fundamentally swung the pendulum in another direction—towards the effectiveness of shareholders in their ability to exert "control" or assert influence over corporate governance. Investors were lambasted by regulators and the media for failing to use their shareholder rights to sanction companies that were taking too much risk. By not doing so, it was claimed, investors failed to protect their beneficiaries from substantial losses suffered as a result of the financial crisis. The general sense was that shareholders had been passive, apathetic and short-termist.

Partly in response to this, the first Stewardship Code was published in 2010 by the UK's Financial Reporting Council. The modern Stewardship Code, however, traces its origins to principles published by the UK's Institutional Shareholders Committee in 2002 and later, the ICGN *Principles on Institutional Investor Responsibilities* in 2007. A stream of responsible investor codes have followed, including in Canada, Italy, Japan, Singapore, South Africa, Switzerland, the Netherlands, and most recently, Malaysia. A Stewardship Code for the US has been debated by some institutional investors, but none currently exists.

A common theme throughout these codes is the concept of stewardship, which Webster's defines as "the careful and responsible management of something entrusted to one's care." In this context, it is primarily focused around company monitoring, engagement and voting. Nearly all investor codes call for disclosure of policies around stewardship approaches, how conflicts of interest are managed, and reporting to beneficiaries.

To date there has been wide variation in the degree to which integrating environmental and social factors are considered a core stewardship responsibility. In several codes, the importance of environmental and social factors is specified. For example, *Eumedion's Best Practices for Engaged Share-Ownership* specifies that "participants

“A common theme throughout these codes is the concept of stewardship, which Webster's defines as 'the careful and responsible management of something entrusted to one's care.'”

(should) take aspects relating to environmental and social policy and to governance into account in their policies in the exercise of their shareholder rights....” The South African *Code for Responsible Investing* (CRISA) is clear in the first principle that “an institutional investor should incorporate sustainability considerations, including environmental, social and governance, into its investment analysis and investment activities as part of the delivery of superior risk-adjusted return to ultimate beneficiaries.”

In other jurisdictions, there is less-specific reference to environmental and social matters, which are often mentioned more generally through the importance of delivering sustainable value by promoting and safeguarding the interests of beneficiaries over appropriate time horizons. In the ICGN's *Global Governance Principles*, sustainability implies that the company must manage effectively its governance, and social and environmental aspects of its activities, as well as financial operations. In doing so, companies should aspire to meet the cost of capital invested and generate a return over and above such capital. This is achievable if the focus on economic returns and strategic planning includes the effective management of company relationships with stakeholders, such as employees, suppliers, customers, local communities and the environment as a whole.

The publication of the ICGN *Global Governance Principles* perhaps marks another era in global governance application and practice. Approved by ICGN members with assets under management in excess of \$18 trillion, the *Principles* consciously combine the governance responsibilities of boards and shareholders into a single document emphasizing a mutual interest in protecting and generating sustainable corporate value.

⁷ *Code on Corporate Governance*, 1992, The Cadbury Committee

⁸ *Remarks to Institutional Investors Annual Pensions Conference*, January 23, 1985

Fiduciary Duty and ESG Engagement

Keith L. Johnson, Reinhart Boerner Van Deuren s.c.

US institutional investors are governed by legal standards like those contained in the Employee Retirement and Income Security Act (ERISA) and similar laws that are relevant to their engagement with companies. However, these statutory fiduciary duties are also supplemented by a body of case law that governs trustees generally. The US Supreme Court has confirmed that Congress's intent was to incorporate trust law into ERISA when it was enacted. **“Rather than explicitly enumerating all of the powers and duties of trustees and other fiduciaries, Congress invoked the common law of trusts to define the general scope of their authority and responsibility.”** *Central States v. Central Transport*, 472 US 559 (1985)

The law of trusts contains several well-established concepts that are particularly relevant for today's fiduciaries as they seek to engage with issuers:

- ▶ **Duty of Impartiality:** *The duty of loyalty includes an obligation to identify and fairly balance conflicting interests of different beneficiary groups, including those of younger and older generations.⁹ This makes short-term earnings, long-term wealth creation and risk exposures over both time frames equally important for long-term investors. The US Supreme Court confirmed that the duty of impartiality applies to ERISA: “The common law of trusts recognizes the need to preserve assets to satisfy future, as well as present, claims and require a trustee to take impartial account of the interests of all beneficiaries.”* *Varity v. Howe*, 516 US 489 (1996)

“The duty of loyalty includes an obligation to identify and fairly balance conflicting interests of different beneficiary groups, including those of younger and older generations.”

- ▶ **Standards of Prudence Evolve:** *Understanding of fiduciary duty has been relatively stable for a generation. However, fiduciary principles are dynamic concepts that evolve over time in response to advances in knowledge and changes in circumstances. For example, a generation ago, pension fiduciaries were generally precluded from trading in stock because it was seen as an imprudent investment.¹⁰ Today, with the unprecedented growth of institutional investor assets and their collective economic impact, and the greater appreciation of shortcomings in prevailing investment theories that became evident during the recent financial crisis, understanding of fiduciary principles is once again in flux.¹¹ “Trust investment law should reflect and accommodate current knowledge and concepts. It should avoid repeating the mistake of freezing its rules against future learning and development.”* Restatement of Trusts (Third) §227, Introduction (1992)

These trust law principles present a challenge for 21st century fiduciaries. Investment practices that foster intergenerational transfers of risk and wealth raise duty of impartiality concerns for long-term investors. Changes in understanding of systemic risk, and related investment management practices among global peers, demonstrate an ongoing evolution in the prudence standards against which the conduct of fiduciaries is judged. **“As a long-term investor, CalPERS must consider risk factors, for example climate change and natural resource availability, that emerge slowly over long time periods, but could have a material impact on company or portfolio returns.”** *Investment Belief 9-B* of the California Public Employees' Retirement System (2013)

After a year-long study of fiduciary duty in the UK, a country with which the US shares the common law of trusts, the Law Commission concluded, **“There is general agreement that wider investment factors may be considered, but concern that pension trustees may continue to receive risk-averse legal advice on the issue. We hope we can finally remove any misconceptions on this issue: there**

⁹ www.reinhartlaw.com/Publications/Documents/art111020%20RIIS.pdf

¹⁰ www.law.harvard.edu/programs/olin_center/papers/pdf/Schanzenbach_Sitkoff_580.pdf

¹¹ www.cfapubs.org/doi/pdf/10.2469/faj.v70.n3.1

is no impediment to trustees taking account of environmental, social or governance factors where they are, or may be, financially material.” *UK Law Commission, Fiduciary Duties of Investment Intermediaries*, §6.28, 6.29 (June 2014)

“...there is no impediment to trustees taking account of environmental, social or governance factors where they are, or may be, financially material.”

Indeed, the duties of loyalty and impartiality require that “conduct in administering a trust cannot be influenced by a trustee’s personal favoritism...nor is it permissible for a trustee to ignore the interests of some beneficiaries merely as a result of oversight or neglect.” *Restatement of Trusts (Third)* §79, Comment (b) (1992)

Most trustees are tasked with balancing risk and return across generations in an impartial manner that reflects evolving standards of care. Those who proactively integrate consideration of the material, long-term effects of environmental, social and governance factors into their investment and risk management process will be in the best position to demonstrate future compliance with fiduciary obligations. “As a fiduciary that invests on behalf of its clients, we have a responsibility—and exercise our right—to monitor and engage with the boards and management of our portfolio companies on matters concerning shareholders’ long-term interests and the good of the market as a whole.” *Leadership in Responsible Investing*, TIAA-CREF (2013 Report)

PRIMARY LEGAL DUTIES FOR ERISA FIDUCIARIES INCLUDE:

1. The duty of loyalty, which requires the discharge of responsibilities:
 - a) solely in the interest of fund beneficiaries and
 - b) for the exclusive purpose of providing benefits
2. The duty of prudence, which expects adherence to the standard of care, skill, prudence and diligence that a prudent expert would exercise at a comparable entity under similar circumstances¹²

When Is Divestment More Appropriate Than Heightened Engagement?

Catherine Jackson and Pieter van Stijn, PGGM

PGGM is of the view that one of our functions and indeed, responsibilities, is to use our rights as shareholders to engage with companies we invest in when we see room for improvement in the way companies manage critical ESG risks and opportunities. Such engagement activities are intended to deliver a demonstrable change in the behavior or activities of a company with which dialogue is conducted. If companies are unwilling to enter sufficiently into a meaningful dialogue with PGGM or do not adjust their behavior or activities in the desired direction, PGGM can opt to discontinue its investments in these companies. As such, divestment is expressly seen as a last resort.

“If companies are unwilling to enter sufficiently into a meaningful dialogue with PGGM or do not adjust their behavior or activities in the desired direction, PGGM can opt to discontinue its investments in these companies.”

When divesting of companies, PGGM seeks to prevent PGGM-managed investments from contributing financially to practices incompatible with the standards and values of PGGM, its clients and their beneficiaries.

Divestment for PGGM can occur under two sets of circumstances: divestment after engagement, and immediate divestment.

Divestment After Engagement

When assessing the extent of divergence from our investment criteria, PGGM considers the scale and duration and the consequences for affected communities, society or the environment. If a case of mismanagement is considered to be serious and insufficient measures are taken to remedy the situation, PGGM will initiate a targeted engagement program with concrete timelines, decision times and objectives, with the aim of remedying the abuse and preventing it in the future. Should the engagement program fail to produce the necessary changes in corporate behavior, PGGM can opt to discontinue investments in that company.

Currently, PGGM bases its criteria for such divestment on the principles of the United Nations Global Compact, relating to human rights, labor rights, the environment and corruption. We will also consider other criteria on a case-by-case basis when other engagement avenues have failed. These criteria are linked to the other focus themes of our responsible engagement activities: corporate governance, climate change, water and food security and health.

We believe issues triggering divestment pose a serious risk to the reputation and ongoing business of the companies we invest in. If this risk is not reduced, divestment serves to protect our and our clients' reputations, as well as the economic impact to our investment.

An example of such a case is Wal-Mart, which PGGM divested of in 2013. This was because Wal-Mart failed to respond adequately to concerns about strained labor relations in the company's home market, despite repeated and long-term engagements by investors (including PGGM) for management to improve the situation. In this case, the policy pursued by Wal-Mart in the US limited the right of employees to organize themselves into trade unions. This contravened not only international labor guidelines (ILO) but also the codes that Wal-Mart had drawn up for its own suppliers. Moreover, the company's independent directors were not inclined to engage in constructive dialogue with shareholders on this matter.

Immediate Exclusion

Dialogue may not be possible or the most appropriate instrument in all cases—for example, if an investee is involved in the production of, or trading in, products that are incompatible with the identity of PGGM and its clients. PGGM will then carry out “immediate exclusion,” without seeking to bring about a change in the companies concerned. As part of this process, PGGM reaches out to such companies to ensure that we have all the facts and that they are correct. In circumstances where there are clear moral issues of deep concern to our clients and identified in our investment policies, economic considerations do not play a role. Categories for immediate exclusion include, but are not limited to: tobacco, controversial weapons, and government bonds of states that face sanctions by the international community.

For instance, in 2013, PGGM placed 79 companies that are tobacco producers on the exclusions list. We endorse the World Health Organization rules on smoking by underage people, and entered into discussions with several companies in the sector on this subject. The dialogue did not have the desired result. Around this same time, tobacco was increasingly being seen as an unsuitable investment because of its impact on society by a large proportion of PGGM's pension fund clients. This prompted PGGM and several of our clients to add all tobacco producers to our exclusions list.

Issuers involved in weapons that PGGM and its clients consider controversial, such as cluster bombs and nuclear weapons, have been excluded by PGGM for a long time. It is our assessment that engagement aimed at ending corporate involvement with such weapons makes little sense, as we would be asking for a breach of contract with a legitimate government to supply military equipment in most cases. We therefore opt for direct exclusion to prevent financial contributions to such activities. For cluster bombs, the Dutch legal ban on investment leaves us no other choice but divestment. This ban is enforced by the Dutch regulator (AFM), which has drafted a (non-public) list of companies which are considered producers of cluster bombs and as such should be banned from our investments.

ENGAGEMENTS MAY LEAD INVESTORS TO:

- ▶ Buy more shares
- ▶ Short a holding
- ▶ Maintain the status quo
- ▶ Completely divest

Divestment is appropriate when we or our clients decide it is necessary to meet our policies and standards. Appropriateness is determined via clear mandates from beneficiaries, who are monitored by surveys, and through following the policies and broader responsibilities of PGGM and our clients. We view divestment as an extension of our activities as a responsible investor: It is the *ultimate stick* we can use to strengthen our engagement activities.

TOP US LEGAL CONSIDERATIONS REGARDING SHAREHOLDER AND ISSUER ENGAGEMENTS

Damon A. Silvers, AFL-CIO

1. Engagement is a fiduciary act, and therefore fiduciary law is the basis on which you should conduct your engagement program.
2. Engagement should be for the economic benefit of the beneficiaries, but it may include collateral benefits as well for your beneficiaries, should those benefits not cause economic harm.
3. Be cautious that during your engagement you do not receive an unfair advantage that could put you at risk of violating Regulation FD (e.g., insider trading), and have a policy and procedure in place for how you will manage the situation should you inadvertently receive nonpublic material information. For example:
 - a. Wall off from trading those who engage.
 - b. Determine if the company should make the information public, and so forth.
4. For collective engagements, monitor your thresholds and determine if you have an agreement to act in concert or not; if you do, or if you hold over 5 percent collectively, you may have to publicly file.
5. As long as you are engaging in good faith with a genuine belief that the issues you are discussing are economically consequential, then engagement is relatively low risk in the legal sense.

The background of the entire page is a photograph of an industrial facility, likely a power plant or refinery, with several tall, striped smokestacks rising into the sky. The scene is bathed in a warm, golden-orange light, suggesting a sunset or sunrise. The sky is a gradient of orange and yellow. In the foreground, there are some trees and a fence. The overall aesthetic is professional and industrial.

DIFFERENCES IN INTERNATIONAL ENGAGEMENTS

Just as corporate governance principles and practices vary around the globe, so too do the approaches to engagement. The topics of focus and the most appropriate methods of communication with companies and with other shareholders will be influenced by many market-specific factors. These include the legal, regulatory and governance frameworks, as well as cultural norms and the level of client interest. For international investors seeking to engage companies outside their home market, understanding these differences and the implications for how they conduct their engagements is essential for success. It is worth considering partnering with local investors in a market, either simply to enhance knowledge and understanding or to engage a company collaboratively, to the extent that is allowed by local regulation. As the following experiences illustrate, even in markets with a common heritage, such as the UK and Australia, there can be subtle differences in how to engage effectively, and having an insight into these will make international investors seem less “foreign.”

Japan: Preparing the Market for a Culture of Engagement

Yoshikazu Maeda, *Governance for Owners Japan (GO Japan)*

Shareholders are equipped with strong legal rights in Japan, but domestic institutional investors have not so far utilized them as tools of engagement to improve companies' performance. Engagement is a new concept to investors and corporations in Japan as Prime Minister Abe's administration introduced the Japan Stewardship Code as part of the country's growth strategy in February 2014. As a result, a concrete set of common practices has yet to be developed. This section therefore concentrates on our experiences in Japan since GO Japan started engagement services in 2007.

Our seven-year track record shows we achieved full or partial success in nearly 60 percent of our planned engagement objectives. By far the most critical factor is to select an "engageable" company. Not all companies are prepared for investor engagements. According to Buchanan, Chai and Deakin (2014),¹³ "internal governance" substitutes for "the exercise of control rights by outside capital" in Japanese markets; they also write that "Japanese managers reject the idea that they should act primarily as the representatives of the shareholders."

“Our seven-year track record shows we achieved full or partial success in nearly 60 percent of our planned engagement objectives.”

We identify three different sorts of companies: open-minded companies that welcome investor engagements, those that are initially unhelpful but can be accessed by appropriate approaches and tactics, and, last, those skeptical of engagements that will not listen to investors. Engagement success therefore depends significantly on picking the first or second group of companies and introducing an agenda with convincing engagement objectives. Having chosen companies on this basis, we have found that successful engagements have the following characteristics that we think are unique to or of particular relevance in Japanese markets:

▶ **Bottom-up: A bottom-up approach to engagement works most effectively.** We normally start with Investor Relations staff and escalate the dialogue to a general manager, and eventually to a board member, ensuring that our engagement agenda is shared with and understood by each of them. The rationale for our approach is that the decision-making process at Japanese corporations is characterized as "bottom-up" and "consensus." The process of going up a corporate ladder works by convincing each member in the reporting line via face-to-face meetings. In doing so, we spend a large amount of time on listening to a company's explanations. We never argue with a

company in the early stages, but put extra effort into fostering a relationship of mutual understanding and trust. This resulted in the CEO of one of our engaging companies, having appreciated previous discussions with us, saying, "We always welcome this type of dialogue" after what became a heated discussion on their anti-takeover measure.

▶ **Constructive: An engagement in a constructive manner works much better than a confrontational one.** It is important how an investor delivers a message, especially when he or she is logically right. Japan is a society where seniority matters, and respect to the senior is expected culturally. In engaging company management, the investor will often be speaking to a senior person in his 50s or 60s. A behavior of outright confrontation with the current management and advocating strategic or financial changes, even if the investor is 100 percent right, will be just taken as an act of arrogance and will create friction. It is a famous past incident that the founder of one activist fund said at a public conference, "We need to educate the management of the Japanese companies we invest in"; there was a strong backlash to that from companies and even from some investors.

▶ **Private: Engaging publicly is unlikely to increase the chances of success, compared with staying private.** There is not sufficient empirical evidence to make a firm conclusion, as we engage only in a private manner. However, it appears that public engagements tend to be confrontational and make a company unnecessarily stubborn, as managements do not like to be seen as bowing to pressure from investors. Several companies have commented that they are annoyed that some activist managers publicly claim the credit when a company implements changes. It is much better to give management the credit; investors can take the fruits of such changes.

To conclude, we highlight what might be helpful to understand regarding engagements on sustainability issues in Japanese markets. A Japanese company expects an investor to understand its business well and therefore will be more open to a dialogue when an investor engages with a mixed agenda of strategic, financial and ESG issues rather than using a wholly ESG-centric approach. In our case, roughly 25 percent of engagement objectives relate to business strategy, 35 percent to financial matters, and 40 percent to ESG issues.

Japanese companies tend to be conscious of environmental and social issues, but available information is often limited to domestic operations, which makes it particularly difficult to assess important global issues such as companies' supply chain management.

Australia: Superannuation Funds Foster Active ESG Dialogue

Gordon Hagart and Edward John, Australian Council of Superannuation Investors (ACSI)

The Australian listed market has a long history of direct engagement between institutional investors (be they pension funds or asset managers) and the (nonexecutive or outside) directors elected to represent them. This relationship has strengthened significantly over the past decade. The majority of issuers understand that the ESG expectations of long-term investors are eminently reasonable, and often not difficult to satisfy. Issuers increasingly engage directly with asset owners as well as asset managers.

There are several key reasons why there is such an active, and mostly constructive, dialogue. First and foremost, there is a strong mutual recognition between investors and boards of their long-term alignment of interests, and the importance (value-add) of good corporate governance and, increasingly, management of investment risks and opportunities related to environmental and social issues. This is supported by the national policy framework (ACSI's Governance Guidelines, the Australian Securities Exchange's [ASX] Corporate Governance Principles and Recommendations, the Financial Services Council's Blue Book, and the like), through which the notion of best-practice corporate governance is "well-grooved." In addition, the discussion between investors and boards has evolved steadily from G (governance) to ESG.

On the investor side, the Australian second-pillar pension system (superannuation), with its quasi-compulsory participation and high minimum contributions, has resulted in a large and rapidly growing pool of long-term capital. The total assets of superannuation funds was estimated at \$1.7 trillion in June 2014. These funds have a large allocation to local listed equities, and many have coalesced around some investment beliefs that are germane to sustainability engagement. They believe that:

- ▶ *ESG issues can be drivers of financial risk and return for long-term investors, while the price-setting market and its agents can be short-term in outlook and poorly aligned with upstream asset owners.*

- ▶ *Ownership rights have financial value because they can be used to enforce better governance, affect other investment objectives or change the rules of the investment game. Those rights are therefore owed a duty of care.*
- ▶ *Capital markets are not always set up in a way that is optimal for providers of long-term capital. But asset owners are well positioned to influence the rules of the game.*

“...there is a strong mutual recognition between investors and boards of their long-term alignment of interests, and the importance (value-add) of good corporate governance and, increasingly, management of investment risks and opportunities related to environmental and social issues.”

Consistent with the above, Australian investors tend to see ESG and other active ownership as long-term investment issues rather than as “tick the box” compliance or legal exercises. Similar to the UK, corporate governance (and environmental and social issues) tends to be approached from a principles basis, which is then contextualized by the company's unique circumstances. Compliance with black-letter law and standards is, of course, important, but this is just the foundation.

As the asset owners (superannuation funds and similar) have grown and professionalized their investment functions, they have increasingly taken back responsibility for active ownership decisions from external fund managers. A more recent trend is for the largest funds also to internalize part of the asset management function itself, per the Canadian pensions' model. These trends support both the commitment to managing ESG issues and being active owners, and the ability to disintermediate shorter-term agents in the chain.

In terms of practical implementation, Australian investors recognize that these issues are complex and that the cost of acquiring ESG information and exercising ownership rights can be high. Collaboration between like-minded investors is therefore attractive, in terms of enhancing the effectiveness of active ownership and (cost) efficiency. There is a long history of collaboration in Australia on these issues through investor collectives such as ACSI and Regnan.

Regulatory settings and disclosure practices have supported and been driven by an enhanced level of engagement. Voting by shareholders is an important part of the process, and companies want to understand the drivers behind any votes against management. Probably the most important catalyst for engagement is the long-standing right of the investor to a binding vote on director candidates. Another vote driving engagement is “Say on Pay,” which has been in place since 2005. This was augmented by a binding vote on termination pay and the new “two strikes” legislation in 2011. Under the latter, shareholders can require the full board to stand for re-election if the proposal to approve the remuneration policy receives votes against of 25 percent or more at two successive shareholder meetings.

“Probably the most important catalyst for engagement is the long-standing right of the investor to a binding vote on director candidates. Another vote driving engagement is ‘Say on Pay,’ which has been in place since 2005.”

New reporting requirements are also encouraging engagement, particularly on ESG topics. As of 2014, the ASX’s Corporate Governance Principles and Recommendations require listed entities to disclose material environmental and social risks as well as the management of those risks (on a “comply or explain” basis).

Australia has some key differences to the US market that we have observed when it comes to engagement and how to be effective. Most significantly, Australian institutional shareholders have relatively easy, direct access to a company’s board Chair and other directors. The governance dialogue happens first and foremost with the Chair, who is almost always a nonexecutive. This creates a culture where the CEO is clearly accountable to the board, which is in turn accountable to the owners. Most engagement is not adversarial but done in a spirit of partnership; private or relational engagement is the dominant model. Accordingly, class actions and shareholder proposals are few and far between, as there is a strong preference to use the other tools available to shareholders, particularly on sustainability issues.

But we are not complacent, and there are several areas where investors in Australian companies need to focus their engagement. Board diversity and diversity throughout the workforce, covering the spectrum of diversity—not just gender—is a priority for many in the investor and corporate communities. In the case of board refreshment, this will require a broadening and deepening of the director talent pool, as well as leadership and more imaginative and meritocratic nonexecutive director recruitment processes. Similarly, there is a need at many companies to improve their ability to develop their management talent organically to facilitate effective succession planning at the highest levels. We expect shareholders to put boards and management under significantly more scrutiny on these aspects of their responsibilities and hold accountable those who are failing to act swiftly enough.

South Africa: Setting the Expectation for ESG Integration

David Couldridge, Element Investment Managers

There is a growing global awareness that the need to support generations of beneficiaries means pension funds require an investment strategy that embraces responsible and sustainable choices. Beneficiaries of funds expect transparency and action, to ensure that the investment funds that back their retirement benefits are not destroyed by short-term, return-chasing behavior.

The 2013–2014 World Economic Forum (WEF) *Global Competitiveness Report* ranked South Africa first for “Efficacy of Corporate Boards” and “Protection of Minority Shareholders’ Interests.” The WEF ranking could be challenged, but the global recognition that South Africa has received for corporate governance and responsible investment guidance and regulation cannot be ignored.

The *Code for Responsible Investing in South Africa* (CRISA) was the second investor-centered code after the UK Stewardship Code, but is the first code to require the integration of sustainability issues into investment analysis and decision making. The Pension Fund Act Regulation 28 requirement to adopt a responsible investment approach for the deployment of capital has caught the attention of the investment industry. More recently, the Sustainable Returns Project for Pensions and Society, an industry-driven partnership to integrate sustainability into mainstream retirement industry investment practices, has developed a guide to assist retirement funds to comply with Regulation 28 and CRISA.

“...the global recognition that South Africa has received for corporate governance and responsible investment guidance and regulation cannot be ignored.”

Change has been slow. Yet growing global sustainability risks and the expectations of fund beneficiaries are requiring the investment industry to start taking action.

The 2013–2014 WEF *Global Risks Perception Survey* highlighted the 10 global risks of highest concern. Among the top five were:

- ▶ *Water crises*
- ▶ *Severe income disparity*
- ▶ *Failure of climate change mitigation and adaptation*

Ernst & Young recently highlighted that water had become one of the most material risks for the mining industry. They pointed out that BHP Billiton and Rio Tinto are investing \$3 billion to build a desalination plant at Escondida, the Chilean copper mine. Recent strikes in the South African platinum industry have had a material impact on the sustainability of its business models. Extreme weather events increase risk that governments will price carbon at a higher price and sooner than the market expects. These are a few examples of what we call the “creeping risks” that eventually reduce corporate earnings, ratings and resultant market price.

If responsible investment is about sustainable businesses that benefit investors, beneficiaries and society, why is responsible investment action (proxy voting, engagement and the integration of material sustainability factors) so uncommon? Apart from the growing research evidence that links better systems of governance to better performance, we have practical experience of how engagement benefits our clients. Engagement with companies has been undertaken independently or collaboratively with local and international investors. Engagement results include:

- ▶ *Greater information transparency and better corporate disclosure*
- ▶ *Improvement in systems of governance (including remuneration and board practices)*
- ▶ *Better risk management*
- ▶ *Improved and more sustainable returns*

Collaborative engagement in South Africa has included engagements to improve the information available to us. This helps us to identify and integrate material sustainability (or ESG) factors into our investment analysis and decision making. Some of these engagements include:

- ▶ Collaborative engagement with global investors to improve emerging market disclosure, through the Emerging Market Disclosure Project (EMDP)
- ▶ The Carbon Disclosure Project (now known as CDP), where Element Investment Managers was involved in sponsoring and bringing the project to South Africa

South Africa is a water-scarce region. We have been an investor signatory to CDP Water, from when the project was first introduced in South Africa.

When we realized that local investors were reluctant to participate in collaborative engagement activity, we worked with the Takeover Regulation Panel to develop collaborative engagement guidance. The purpose of the guidance is to avoid the negative consequences of acting in concert and to provide a safe, collaborative engagement path.

Most of our engagement activity has been independently undertaken. In South Africa, many large investors engage behind closed doors and write letters. We meet regularly with management to ensure that we understand the risks and opportunities of our client investments, but our engagement plans make use of a variety of engagement options:

- ▶ Writing letters
- ▶ Meeting with management
- ▶ Identifying material shareholders and understanding their views
- ▶ Approaching our Advisory Board for guidance
- ▶ Meeting with key members of a company's board
- ▶ Presenting to the board to ensure that there is common understanding of our concerns

“When we realized that local investors were reluctant to participate in collaborative engagement activity, we worked with the Takeover Regulation Panel to develop collaborative engagement guidance.”

- ▶ Targeting specific executives or directors who can provide support for engagement issues that are in the interests of the company
- ▶ Working with the press where the momentum of the engagement is slowing
- ▶ Attending AGMs and asking carefully planned questions
- ▶ Voting all resolutions in support of our engagement goals

The engagement plan for a specific company can include one or more of the above options. We do not have a standard approach or sequence to our action. The engagement options are selected, and the sequence depends on the engagement goals and the company culture.

Investing client funds into an uncertain future requires the use of all “investment tools” to encourage sustainable earnings in the short, medium and long term. Our engagement activity helps to reduce future earnings risk and provides information that improves the quality of our company valuations.

United Kingdom: Clear Policies Move the Needle on Stewardship and Engagement

Anita Skipper, Aviva Investors 1990–2012 and now an Independent Corporate Governance Advisor

Issuer-shareholder engagement on ESG matters in the UK is comparatively more established than in the US. One of the main reasons is that there is a clear policy framework. The first UK Corporate Governance Code (the *Cadbury Code*) was published in 1992, creating a now widely recognized “comply or explain” benchmark for good practice. To make it work, “comply or explain” requires engagement between shareholders and boards to accommodate sensible deviations from the code. As a result, the Companies Act, Takeover Panel Rules, Listing Rules, company and investor codes, regulatory bodies, and government all support engagement between company boards and shareholders. Importantly, the *Stewardship Code*, first published in July 2010, clarified the rules of engagement for shareholders. This further helped and encouraged shareholders to engage.

“...the Stewardship Code, first published in July 2010, clarified the rules of engagement for shareholders. This further helped and encouraged shareholders to engage.”

Engagement is further enhanced by the ease of in-person meetings, even at short notice. In the UK, engagement typically includes the executive board members (usually the CEO and CFO) as well as the independent nonexecutive (outside) directors. However, generally, discussions on governance and, increasingly, on environmental and social matters of concern to shareholders are led by the nonexecutive directors. Most of the UK’s domestic shareholders, and some non-domestic ones, are based either in the City of London or in Edinburgh, Scotland, a short flight away. Engagement is also made more manageable by the ownership structure of UK companies. Normally dominated

by a few large shareholders, companies will have a good sense of the views of the majority by talking to the top 20 shareholders. This relatively tight-knit investor and corporate community has helped establish relationships and, correspondingly, trust.

The prevailing view in the UK is that there is no substitute for direct communication. There are no intermediaries—such as regulators, financial and legal advisors, or proxy solicitors—who routinely intervene in director-shareholder engagements. Voting, a direct channel of communication for all shareholders, has significant impact in the UK, particularly for directors. If more than 50 percent of shareholders vote against the appointment of any director, the director must step down from the board, as such votes are binding. In order to protect themselves, directors want to understand shareholder views. In addition, “Say on Pay” is binding—and probably more in shareholders’ sights even than in the US—so boards will discuss their arrangements with shareholders, often well in advance of the proposal at the annual shareholder meeting.

There are two other significant differences between the UK and the US that inform the approach to engagement. First, because of the preference for, and effectiveness of, engagement, shareholder resolutions are rarely used in the UK—the influence happens behind the scenes. Second, shareholder litigation is extremely rare. There is an incentive in the UK to prevent destruction of value before it happens, as it is costly and risky to bring a case to court to recover losses, as in general the loser pays.

The above notwithstanding, there are headwinds currently affecting engagement in the UK, some of which are also evident in the US. By 2012, 53 percent of UK companies were majority owned by nondomestic investors who, broadly, are less inclined to communicate with UK companies or who have differing principles. Even where shareholders do engage, differences of opinion between shareholders mean there is no consistent message to a company board.

“By 2012, 53 percent of UK companies were majority owned by non-domestic investors who, broadly, are less inclined to communicate with UK companies or who have differing principles.”

the executives, collectively. A recent Government Review (the Kay Review) recommended that a formal group be established to facilitate collective engagement. The Investor Forum¹⁴ was formally launched in July 2014 with the goal of improving long-term returns from investment in companies through, among other things, facilitating engagement to drive constructive change that supports long-term shareholder value creation.

Market structures and trends also play a role:

- ▶ *Board or excessive portfolio diversification makes it difficult to engage on all stocks.*
- ▶ *An excessive number of intermediaries in the share ownership chain—including trustees, consultants, fund of funds or asset managers—slows the process.*
- ▶ *Stock lending obscures the link between engagement and voting because the vote goes to the borrower, who is only a temporary owner.*
- ▶ *Short-term investment horizons provide no incentive to engage.*
- ▶ *Conflicts of interest, through commercial relationships, may require being on good terms with management and boards of directors.*
- ▶ *The costs of engagement currently are borne by the investment firm.*

One response to at least some of these factors is to increase the number of collaborative engagements. This is done when a number of a company's shareholders work together on an engagement and meet the directors, or, if more appropriate,



KEY QUESTIONS TO ASK BY SECTOR

“A sector approach is essential to understand the differentiated impact of sustainability, as it groups together companies with similar business models and resource uses. It also facilitates integration with financial analysis, where sectors are widely used as an analytical framework from portfolio management to company analysis.”

—SASB STANDARDS—A PLAYBOOK FOR INVESTORS

Taking Investment Lessons from Socrates: Asking the Right Questions

John Wilson and Erika Karp, Cornerstone Capital Group, and Jerome Lavigne-Delville, the Sustainability Accounting Standards Board (SASB)

The smartest people we know, know how little they themselves know. That includes Wall Street sell-side analysts, strategists and economists. In fact, Socrates taught that “the only true wisdom is knowing that you know nothing.” That might sound a bit harsh, but the reality is that the very best investment analyses start with a question investors are struggling with in the context of their decision-making processes, and a pivotal question about which analysis will give greater predictive insight into investment decisions and economic outcomes. The bottom line is that great sell-side research is often “a question of questions.”

Most analysts are trained to start their stock calls to portfolio managers and analysts with their “conclusion first.” They start by telling investors what to do with their money. From our standpoint, why would investors possibly listen? We argue that analysts have to “earn the right” to offer advice—the right to be heard above the barrage of noise.

“...the reality is that the very best investment analyses start with a question investors are struggling with in the context of their decision-making processes, and a pivotal question about which analysis will give greater predictive insight into investment decisions and economic outcomes.”

More specifically though, it’s not just research into any questions. It’s research into the most pivotal, difficult, complex, global, sector- and macro-based issues that need to be addressed at any given time. In other words, what is truly “material” such that a reasonable investor needs to absolutely consider it in the context of making a buy or sell decision? There is a vast distinction between questions that are related to the “here and now,” and questions that offer critical insights into longer-term corporate strategies, tactics, and ultimately stock price performance.

We circle back to the problem of retraining Wall Street analysts to not focus on sharing all that they know, but rather to be transparent and constructive about what they don’t know. What they don’t know, they might try to obfuscate or simply avoid. Respectfully, we argue that this is a poor strategy. It will be found out by savvy investors who,

collectively, represent much of the information that’s already discounted in the price of a stock.

From where does that information advantage come? In our view, it could come from the earnest, objective analysis of the broad swath of subjects covered in seeking environmental, social and governance excellence, or lack thereof, in the corporate sector. In fact, that enhanced version of investment analytics captures almost everything one can think of when making an investment decision. We argue that a lack of the systematic analysis of ESG factors implies poor due diligence in the investment process deployed by the analyst—an inadequate evaluation of risk-adjusted returns to express to investors.

With regard to understanding precisely which ESG factors are most critical to a particular company, we would suggest that an industry-based or sector-based approach is essential. The book is still being written with regard to the establishment of “standards” for the disclosure of these factors, notably by organizations such as SASB (the Sustainability Accounting Standards Board) in the US. This critical piece of “infrastructure” is a starting point for inquiry in what matters most, by sector, to analysts and investors.

The bottom line though, is that just because an analyst can’t yet answer pivotal questions doesn’t mean they shouldn’t try to. Shouldn’t analysts at the very least look at scenarios of possible share value destruction associated with stranded assets for oil and gas companies if a carbon policy were put in place to deal with climate change? Isn’t it worth noting which companies can best articulate the value of optimal employee engagement, succession planning and great corporate governance? Wouldn’t it be valuable to know which companies are optimally evolving their business models to embrace the potential of social media, big data, and demographic shifts? Absolutely. In fact, we state again that the best investment research is indeed a “question of questions.”

So, without attempting to be all-inclusive, we turn to some sectors and specific questions below that can be posed by investors and analysts to build a more robust and comprehensive understanding of risk and value creation—those questions that raise even more important questions that analysts should be exploring.

We would argue that all these questions might better be posed in a more systematic way than is currently the norm. The questions, and others that are beginning to become part of the dialogue in the mainstream of the capital markets, represent a material enhancement to the current analytical process. They represent a more nuanced basis from which to triangulate the answer to the question of whether to buy, sell or hold.

Key Questions by Sector

OIL, GAS AND MINING

1. Has the company modeled scenarios that include low-carbon public policies and impacts on demand and supply? How does the company evaluate the risks of assets becoming stranded because of potential climate change regulation, water risks, or other factors affecting demand and price? How has the company's evaluation of new exploration activities changed in light of this analysis?
2. Given the uncertainties surrounding the company's long-term investments, how does executive pay incentivize an appropriate balance of short-term performance and long-term strategic orientation?
3. How does the company identify the risk of local community opposition? How does the company account for the costs should such opposition occur? Which operations are located in regions where they may face these risks and how are you addressing them?
4. What has the company learned from the numerous safety and emissions events in the extractives sector over the last several years, and how have you enhanced safety processes and governance in response?
5. What emerging forms of corruption concern you? How do you identify new forms of corruption and adapt your compliance training and practices? How are managers incentivized to prevent corruption?

BANKING AND FINANCE

1. What analyses has the bank undertaken to assess its broad social and economic impact in the communities in which it operates? Which lines of business are most affected by these assessments? What is the process for incorporating these concerns into financing decisions?
2. How does the bank ensure that customers always receive services that are appropriate for their situations, and understand the nature of the risks they are taking?
3. What are the key factors influencing customers', regulators' and business partners' trust in the bank and how is the bank managing these factors?
4. What are the bank's policies on the environmental impacts of its lending activities?
5. How does the company factor in long-term social and environmental trends, especially rising climate change, into its enterprise risk management systems? What is the process of board and management oversight of this?
6. Given the breadth of the bank's/financial institution's global business lines, how does its governance structure address concerns about complexity risk?
7. How does executive compensation create incentives for long-term performance at a reasonable level of risk? How do the company's compensation policies for ordinary employees create incentives for appropriate risk-taking?

INSURANCE

1. How does the company factor in climate change into its enterprise risk management systems, actuarial analyses, underwriting, or investment strategies? What is the process of board and management oversight of these?
2. How is the company minimizing the risk of the misuse of “big data” when using large data sets to better assess, price or create products?
3. Given that the insurance sector has more detailed and personal information on individuals or customers than most industries, how does the company assess the quality and adaptability of its cybersecurity measures? How often are your plans for security refreshed or re-evaluated?
4. How has the company developed strategies to create future products or coverage to attract a wider range of customers spanning a broader socio-economic spectrum? What are the company’s long-term plans for growing market share in an environment where major risks continue to put at risk the affordability and availability of insurance products?
5. How does the company ensure timeliness and ease of claim processing, as well as transparency of policies? How do the company’s products incentivize healthy, safe, and/or environmentally conscious behavior? (e.g., promote energy efficiency and low carbon technology?)

INFORMATION TECHNOLOGY

1. How does the company analyze and mitigate concerns about cybersecurity? What policies are in place to protect the reasonable privacy rights of its customers and business partners? How does the company think about balancing privacy rights with reasonable expectations of transparency?
2. How has the company assessed water-related risks to operations and in the supply chain?
3. How does the company assess the potential physical impacts of climate change to its infrastructure? How is the company addressing this?
4. Does the company source any raw materials from conflict-affected areas (or does the company trace its supply chain back to conflict-affected areas)? How do you assess and manage the risk of supply chain disruptions from these areas?
5. How does the company measure the productivity of its human and intellectual capital? How does the company assess the diversity of its work force? What steps is the company taking to improve diversity?
6. How is the company addressing shortages in the science, technology, engineering, and math (STEM)-trained workforce?

Key Questions by Sector

ELECTRIC UTILITIES

1. Has the company assessed the physical risks to its infrastructure posed by extreme weather events and other climate impacts? How does the company assess emerging water-related risk? How does this analysis impact the company's investments in systems upgrades?
2. How is the company positioned relative to public policies designed to ensure a reliable and affordable energy supply, possibly at the expense of profitability?
3. How does the company analyze and mitigate security threats, including cybersecurity and potential threats to physical assets, including substations and nuclear plants?
4. Is the company adapting its business model in response to increased demand-side efforts to mitigate climate change, such as energy efficiency and plug-in hybrids? How is the company addressing the growth of distributed renewable energy generation?
5. How is the company affected by the secular decline in renewable energy prices, and related advancements in distributed energy?

APPAREL AND RETAIL

1. What emerging or potential natural resource constraints concern you the most? How does the company evaluate its water-related risks? How are you adapting your supply chain management systems in response?
2. What steps have you taken to incorporate principles of sustainable product design?
3. How is the company positioned with regard to taking advantage of increased buying power in middle-income countries? What impact do rising wages have on the company's procurement practices?
4. How does the company evaluate its risks of high profile safety or other negative labor-related events in its supply chain? How is the company evolving its procurement practices in response?
5. With regard to its own employees, what is the company's strategy for maximizing the productivity and motivation of its workforce, particularly customer-facing employees?

TRANSPORT

1. How are you modeling the impact of potential climate change regulation on market demand or pricing? How does the company's long-term business strategy position the company for uncertainties related to future climate policy? How do rising energy prices affect your manufacturing and distribution strategies?
2. What emerging or potential natural resource constraints concern you the most? How are you adapting your supply chain management systems in response?
3. How is the company positioned to supply mobility in the emerging megacities of the developing world?
4. How does your governance structure support a culture of safety within the firm? How are executives incentivized to ensure that safety remains a priority throughout the economic cycle?

FOOD AND BEVERAGE

1. How does the company assess water-related risks in its supply chain? How is the company assessing its need to adapt to the physical impacts of climate change? More generally, what is the company's assessment of the impact of growing relative scarcity of agricultural commodities on its business?
2. How has the company assessed the impact of potential future climate change mitigation policies on its supply chain, including transportation costs? How is the company addressing the physical impacts of climate change on its supply chain?
3. How does the company assess the risk associated with increasing relative scarcity of agricultural land and pressures on biodiversity?
4. What is the impact of rising incomes in the developing world on the company's business, from both a supply and a demand perspective?
5. With regard to its own employees, what is the company's strategy for maximizing the productivity and motivation of its workforce, particularly customer facing employees? How does the company manage reputational risks associated with a possible high profile labor event (such as a safety failure or discovery of forced labor) in its supply chain?
6. How does the company assess the impact to its business of rising concerns in the United States about nutrition and health? How is the company managing the potential impacts of these shifting attitudes?

HEALTHCARE AND PHARMACEUTICALS

1. What are the key factors influencing the trustworthiness of the company from the perspective of patients, healthcare providers, and regulators? How is the company managing these factors?
2. What steps has the company taken to ensure that its products are marketed in an ethical way? How do you assess whether these steps are effective? What bribery controls are in place?
3. How will changing demographics, including the aging of populations in developed countries and rising incomes in developing countries, affect product demand? How is the company positioned for these changes?
4. How does the company's executive compensation policy create incentives for excellence in patient outcomes?
5. How is the company making efforts to improve access to medicines? What are the strategic objectives of these efforts and how do you measure their effectiveness?
6. With regard to its own employees, what is the company's strategy for maximizing the productivity and motivation of its workforce, particularly customer facing employees?



BIOGRAPHIES

We would like to thank the following authors for their time and contributions to this guide. Each is considered a well-known expert on engagement, and is sharing insights from hands-on experience.



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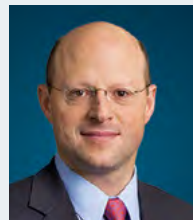
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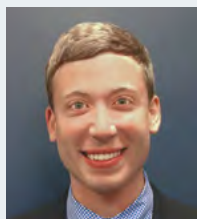
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(ICGN)

Ms. Waring is responsible for driving ICGN's strategy across 45 countries with investor members representing assets under management in excess of \$26 trillion.

Resources

[An Investor Handbook for Water Risk Integration](#)

Incorporating feedback from dozens of institutional investor surveys, this Ceres guide illustrates current practice for integrating water risk into engagement activities, and investment policies and practice. March 2015.

www.ceres.org/issues/water/water-and-esg-risk

[CalPERS' Towards Sustainable Investment and Operations Report](#)

A 2014 progress report on incorporation of ESG factors into the investment process, across asset classes.

www.calpers.ca.gov/eip-docs/about/pubs/esg-report-2014.pdf

[CDP Investor Engagement Tool](#)

Guidance for engaging companies that are non-responsive to CDP information requests.

www.cdp.net/Docs/investor/investor-engagement-tool.pdf

[Defining Engagement: An Update on the Evolving Relationship Between Shareholders, Directors and Executives](#)

A study conducted by Institutional Shareholder Services for the Investor Responsibility Research Center Institute. Marc Goldstein, April 10, 2014.

irrinstitute.org/pdf/engagement-between-corporations-and-investors-at-all-time-high.pdf

[Global Risks 2015](#)

The World Economic Forum's annual assessment of global risk. Includes current perceptions of the global risk landscape, interconnectivity of risk, and emerging trends, and assesses specific environmental, geopolitical, social, and other ESG risks, with extensive mapping.

reports.weforum.org/global-risks-2015

[International Corporate Governance Network \(ICGN\)](#)

A global, investor-led organization of governance professionals, it promotes effective standards of corporate governance to advance efficient markets and economies worldwide. The website includes the *2014 ICGN Global Governance Principles*, and a list of markets with investor stewardship codes.

www.icgn.org/images/ICGN/Global_Governance_Principles_2014.pdf

[Principles for Responsible Investment's Fixed Income Investor Guide](#)

ESG best practices in fixed income investment, written by a coalition of international investors, including a chapter on fixed income engagement.

www.unpri.org/viewer/?file=wp-content/uploads/PRI-fixed-income-investor-guide-2014.pdf

[Principles for Responsible Investment's Integrating ESG in Private Equity—A Guide for General Partners](#)

A guide for incorporating ESG into private equity, including tips for engagement by GPs.

www.unpri.org/press/pri-publishes-guide-to-integrating-esg-in-private-equity

[Shareholder-Director Exchange \(SDX\)](#)

SDX participants discuss shareholder-director engagement and used their collective experience to develop the SDX Protocol, a set of guidelines to provide a framework for such engagements.

www.sdxprotocol.com

The 21st Century Corporation: The Ceres Roadmap for Sustainability

A practical guide for companies and investors on corporate expectations on ESG practices. Covers governance, stakeholder engagement, disclosure, and performance indicators.

www.ceres.org/roadmap-assessment

The 21st Century Investor: Ceres Blueprint for Sustainable Investing

A guide for institutional investors on the investment case for integrating ESG factors into the investment process, outlining 10 steps for doing so, with examples of good practice.

www.ceres.org/resources/reports/the-21st-century-investor-ceres-blueprint-for-sustainable-investing-summary/view

The Aspen Institute

An educational and policy organization that provides a nonpartisan venue for convening commissions to help resolve specific issues.

www.aspeninstitute.org

The Conference Board's Guidelines for Investor Engagement

The Conference Board Governance Center Advisory Board on Corporate/Investor Engagement collaborated to produce guidelines to assist companies and investors in evaluating the costs and benefits of engaging with each other on corporate governance and sustainability matters.

www.shareholderforum.com/access/Library/20140306_ConferenceBoard-Guidelines.pdf

Also refer to:

www.conference-board.org/governance/index.cfm?id=14728

The Sustainability Accounting Standards Board (SASB)

SASB is an accredited non-profit that issues sustainability accounting standards for US publicly-listed companies, designed to guide corporations in the disclosure of material and decision-useful sustainability information, under existing US securities rules.

www.sasb.org

The Value of Responsible Investment: Investment Leaders Group, University of Cambridge Institute for Sustainability Leadership, 2014

Written by a coalition of long-term investors, this report discusses the financial value of engagement, details the macroeconomic context for risk and opportunity that ESG issues pose, and includes a literature review discussing the findings of many studies correlating ESG performance with aspects of financial performance and risk management.

www.cisl.cam.ac.uk/Business-Platforms/Investment-leaders-group.aspx

Why BlackRock

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Visit BlackRock's CGRI section of their website to find the publication:

www.blackrock.com/Governance

About Ceres

Ceres is a nonprofit organization mobilizing business and investor leadership on climate change, water scarcity and other sustainability challenges. Ceres directs the Investor Network on Climate Risk (INCR), a network of institutional investors with collective assets totaling more than \$13 trillion. Ceres also directs Business for Innovative Climate & Energy Policy (BICEP), an advocacy coalition of dozens of companies committed to working with policymakers to pass meaningful energy and climate legislation. For more information, visit www.ceres.org or follow on Twitter [@CeresNews](https://twitter.com/CeresNews).

To access this downloadable publication online, go to:

www.ceres.org/EngagementGuide

* AUM as of 3/31/15.

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