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Incorporating ESG Considerations Into Engagement Practices

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Contents

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Executive Summary

Engagement – interactions between investors and current or potential investee companies with the goal of improving their practices – has been employed by many investors as a core tool of their stewardship programs. Although engagement encompasses many different strategies and approaches, and covers a wide range of topics including executive compensation, strategy and risk management, our focus is engagement on environmental, social and governance (ESG) issues.

The idea that engagement can potentially lead to improved performance on the topics of the engagement, and overall mean better returns, is fast gaining acceptance. This has led to a significant increase in engagement efforts, both private and public, on ESG issues.

For the purpose of this report we examined both private and public engagement practices. Private engagement is the route used most often by the majority of institutional investors. This can be in any form from emails, letters and phone calls to in-person meetings with company managers. In order to shed some light on private engagement practices, we interviewed Jem Hudson, Vice President, Credit Research at Breckinridge Capital Advisors and Michelle Edkins, Managing Director & Global Head of BlackRock Investment Stewardship, both members of the HMI Forum.

Public engagement on ESG issues has been on the rise, with the numbers of ESG proposals doubling between 1999 and 2013. Despite their increasing numbers though, voting in favor of ESG-related proposals has stayed consistently below 25% on average since 2010, short of the 30% threshold at which a company is expected to consider the issue. In this report, we present a very interesting case study of public engagement by highlighting contrasting results in the oil and gas sector by comparing similar proposals received by ExxonMobil, Chevron, BP and Shell and the very different management responses and investor voting outcomes.

> **Public engagement on ESG issues has been on the rise, with numbers of ESG proposals doubling between 1999 and 2013.**

Introduction

Shareholder engagement can be defined as interactions between the investor and current or potential investee companies with the goal of improving (or identifying the need to influence) practices and/or improve disclosure.[1]

According to the Institutional Shareholder Services Inc. (ISS), currently the largest proxy advisory firm, shareholder engagement includes efforts made by shareholders to engage with their respective companies on a wide range of topics including executive compensation, strategy, risk management, corporate governance and other topics falling outside of the usual financial and strategic conversations.[2]

Another term closely linked to shareholder engagement is that of active ownership. Active ownership is the use of the rights and position of ownership to influence the activity or behavior of investees. This can be applied differently in each asset class. For listed equities, it includes both engagement and (proxy) voting (including filing shareholder resolutions). For other asset classes (e.g. fixed income), engagement may still be relevant while (proxy) voting may not.[3]

The literature as to the effect of shareholder engagement to corporations is wide and far-reaching but the general academic view is that engagement broadly can have positive results for a corporation both strategically and financially.[4] Some commonly referenced benefits can include improving internal corporate governance, managing risk, improving transparency and optimizing board structure.[5]

Active ownership is the use of the rights and position of ownership to influence the activity or behavior of investees.

1. PRI (2016) PRI Reporting Framework 2016 Main Definitions
2. Mehta, T. (2013) Shareholder Engagement: Maximizing the Shareholder Relationship. ISS Corporate Services. Executive Compensation Insight.
3. PRI (2016) PRI Reporting Framework 2016 Main Definitions
4. Nili, Y. (2015) Shareholder Activism: an Engagement Opportunity. Harvard Law School
5. Shepherd, P. (2013) Active ownership offers win-win strategy, Financial Times

Shareholders wanting to engage with investee companies essentially have two options: to engage privately or publicly.[6] Displayed in Figure 1, Bauer, Moers and Viaha[7] depict the process behind both public and private approaches. While public engagement begins with filing a proposal, it is important to note that private engagement may also result in a public filing.[8]

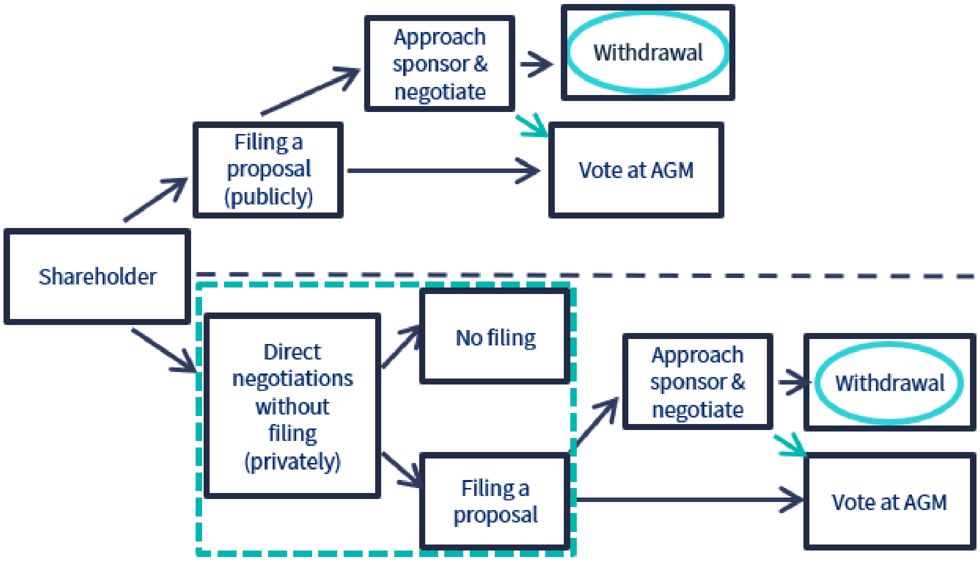

Figure 1: Public and Private Engagement

6. Deutsche Bank (2010) Corporate Engagement by Institutional Shareholders
7. Bauer, R., Braun, R., and Viehs, M. (2011). Industry competition, ownership structure and shareholder activism. ECCE Working Paper: Maastricht University
8. Mehta, T. (2013) Shareholder Engagement: Maximizing the Shareholder Relationship. ISS Corporate Service

Engagement Model

While engagement is fundamentally about communication, it can take a variety of forms. These depend on the type of investment, the investment time horizon, the investment beliefs around shareholder responsibilities and the level of interest from clients.[9]

Across the different approaches to engagement, there are also different variations and degrees to which investors can interact with companies' management. Some investors might consider engagement any communication with a company that would help improve a common understanding. For other investors, engagement is a means to bring a change of behavior at a company. Others would include full-blown activism in the definition of engagement.

Our review of current literature returned a lack of an overarching formal categorization of these levels of engagement. One classification suggested by the OECD can be shown in the table on page 7. The different degrees of ownership engagement of this model are determined by a number of different features and choices that together make up an institutional investor's business model (7 features and 19 choices).

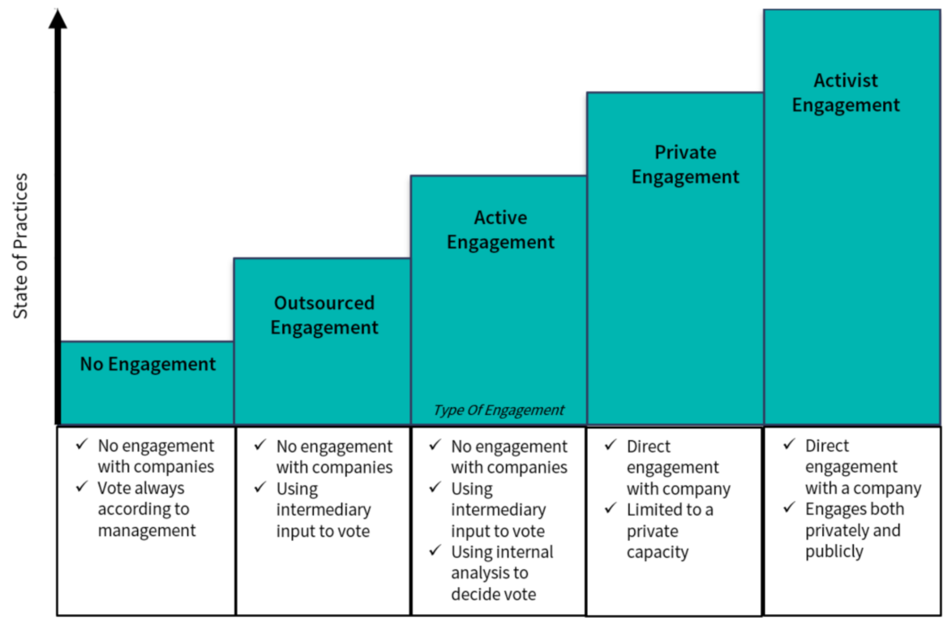

Figure 2: Models of Engagement

We have also produced a framework, shown in Figure 2, that can help classify different models of engagement. As Figure 2 demonstrates, while different levels of engagement require varying levels of interaction, the progressive criteria are often built on each other.

9. BlackRock and Ceres (2015) 21st Century Engagement: Investor Strategies for Incorporating ESG Considerations into Corporate Interaction

Degrees of Ownership Engagement

No Engagement

This category comprises institutions that do not monitor individual investee companies actively, do not vote their shares and do not engage in any dialogue with the management of investee companies. Examples include those exchange-traded funds that do not charge any fees to their investors, but instead generate income from share lending. Another example would be institutional investors that are subject to engagement limitations or an outright prohibition to vote their shares, like Turkish mutual funds.

Reactive Engagement

Reactive engagement represents voting practices that are primarily based on a set of generic, pre-defined criteria that guide voting with respect to the different proposals put before the shareholders' meeting. Reactive engagement often relies on buying advice and voting services from external providers such as proxy advisors. It may also consist of reactions to engagement by other shareholders; for example, when an otherwise passive shareholder supports initiatives by another institution such as an activist hedge fund who is attempting to influence the dividend policy in a specific company or to make changes to the board. It may also include reacting to public tender offers from a private equity firm.

Alpha Engagement

This engagement level is associated with ownership engagement that seeks to support short or long-term returns above market benchmarks. Using quite different strategies, both activist hedge funds and private equity funds can be examples of alpha engagement. Hedge funds that practice alpha engagement usually influence companies through small holdings, sometimes complemented by derivatives, actively seeking the support of other investors to support their intentions. Private equity firms on the other hand acquire large or controlling shares of companies in order to be able to restructure the company, improve its performance and, within a predefined period, sell with a profit.

Inside Engagement

Inside engagement is an engagement level characterized by fundamental corporate analysis, direct voting of shares and often assuming board responsibilities. Owners at this engagement level typically hold controlling or large stakes in the company. A good example might include a closed-end investment company such as Berkshire Hathaway, Inc. This company is the largest shareholder in Coca Cola, Inc. and is represented on the board of Coca Cola, Inc. by one of its directors. Inside engagement may also be practiced by some sovereign wealth funds.

Private Engagement

Private engagement is the route used most often by the majority of institutional investors. This can be in any form from emails, letters and phone calls to in-person meetings with company managers. Nowadays, many institutions have special engagement departments that deal with the communication of concerns and complaints to portfolio companies.

To illustrate the extent of private engagement we can examine one particularly active company in filing shareholder proposals on ESG issues, Calvert Investments.[10]

Over the course of 2014:

- 136 Companies engaged
- 247 Emails and letters sent
- 116 Phone calls
- 16 In-person meetings

This engagement resulted in:

- 56 Resolutions filed
- 27 Resolutions withdrawn
- 27 Resolutions presented for vote

These figures demonstrate the immense disparity between the number of direct engagements that do not reach the public and the prevalence at which these exchanges take place. While Calvert has only filed 56 resolutions, it has had 379 incidents of engagement with 136 different companies. In other words, only 17% of its engagement over the past year has been made publicly.

Grewal, Serafeim and Yoon analyzed this in further detail in their paper 'Shareholder Activism on Sustainability Issues.'[11] Their findings showed that over a period from 2003-2013, 840 unique engagements took place, of which 752 were through private methods, a strikingly high ratio in favor of private methods.

A recent study of board-shareholder engagement activities showed that private engagement is continuously increasing:

"50% of issuers, 64% of asset managers, and 53% of asset owners reported that they were engaging more. Only 6% of issuers and almost no investors reported a decrease in engagement. Shareholders, particularly institutional investors, believe that annual meetings are too infrequent and do not provide sufficient content to address their concerns."[12]

Our research of the top 25 asset owners and managers (by AUM) showed that these investors seldom file public proposals, indicating that they prefer private engagement strategies. To overcome this blind spot, and the lack of private engagement data more generally, we performed desk-based research and also interviewed members of the High Meadows Institute Forum who kindly offered to provide us insights in their engagement efforts.

10. http://www.calvert.com/resources/shareholder-advocacy
11. Grewal, J. Serafeim, G. & Yoon, A. (2016) Shareholder Activism on Sustainability Issues. Harvard Business School
12. Kim, J. and Schloetzer, J. D. (2013) Global Trends in Board-Shareholder Engagement. The Conference Board

Case Study

T. Rowe Price

The investment firm T. Rowe Price conceptualizes private engagement as either light, moderate or heavy.[13]

Light engagement involves short, direct conversations, typically by conference call occurring 1-2 times per year. Participants are typically non-board level, such as General Counsel and subject matter experts from the company. The purpose of light engagement is wide ranging, including to:

- Develop constructive relationships with company counterparts.
- Address issues outside the scope of analysts' ongoing due diligence meetings.
- Collect specific information on an ESG topic.
- Understand the pace of change within a company in addressing concerns.
- Discuss an upcoming vote.
- Add to the overall view of a company.

An example of light engagement is investigating new information concerning potential poor practice in a company, such as discovering that a company is poorly rated by external research providers on an ESG issue. This leads to discussions with the company to explore the low ranking, identifying if it is driven by limited disclosure rather than poor risk management, etc.

Moderate engagement is considered by T. Rowe Price to be less effective compared to light and heavy methods. Techniques include: 1) Issue-specific screens to identify engagement targets, and 2) a high quantity of written letters to portfolio companies expressing a view on a general sustainability topic.

Heavy engagement involves more intense, in-depth exchanges with a company, often extending over more than a year. This approach engages a company at the board level, initiated with a formal letter and followed by multiple in-person meetings. For heavy engagement to occur, a number of criteria must be met concerning the nature of the investment, understanding of the issue of concern and consensus of related parties.

The purpose of heavy engagement is relatively specific, to:

- share the investor's perspective with the board about a significant impediment to their ability to meet their investment goals
- explore ways to work constructively with the company to remove the impediment.

An example of heavy engagement is T. Rowe Price's experience with a pharmaceutical company that was failing to reach critical milestones, experiencing serious patient-safety issues and reporting disappointing financial results. The investors identified low diversity in skill sets at board-level, with too many turn-around experts, bankers and directors with distressed-debt experience (due to a previous period of financial distress that was successfully resolved). Over two years, investors advocated for a renewed focus on director skills and qualifications to incorporate medically trained experts and practitioners.

13. BlackRock and Ceres (2015) 21st Century Engagement: Investor Strategies for Incorporating ESG Considerations into Corporate Interaction

Case Study

Breckinridge Capital Advisors

Background
Breckinridge Capital Advisors is an asset management firm that focuses exclusively on managing high-grade fixed income portfolios. Working through a network of investment consultants and advisors, Breckinridge offers municipal, corporate, government and sustainable bond strategies in customized separate accounts. The firm actively integrates ESG factors into its investment research and analysis. We had the opportunity to interview Jem Hudson, Vice President, Credit Research.

How much work is being done through public vs. private engagement?
"Breckinridge focuses on private engagement. As a fixed income manager, we cannot engage in proxy voting, and have therefore prioritized private engagement as the appropriate tool for us. Although there are some significant multi-stakeholder engagement initiatives, we have found that there is a lot of value in conducting private engagement." The goal of Breckinridge's engagement efforts is to establish constructive dialogue with a company, learn more about their ESG efforts and create a sense of alignment in which both Breckinridge and the company are on the same side.

What is your engagement process?
"Our engagement process is a flexible and learning-oriented conversation with companies" said Hudson. Companies are asked to prepare written responses to a set of engagement questions prior to the engagement call. This set of questions is relatively small as opposed to a lengthy questionnaire. "The aim is to encourage companies to think carefully about what we are asking." The team will then go through the questions during the engagement call, asking companies to elaborate on selected points.

What are some typical questions you ask during engagement calls and meetings?
"The engagement process includes company-specific questions as well as more high-level industry questions. Our company-specific questions particularly focus on the most material ESG issues, which are defined through our internal research and analysis. Additionally, we aim to evaluate the quality of ESG management at the company, how strategic ESG is for the company and what is the link between the company's ESG efforts and financial results (e.g., revenues, cost structure, risk profile). Finally, we also ask fundamental credit questions to demonstrate that we consider ESG factors side-by-side with traditional credit drivers, in a fully integrated manner."

Case Study

Breckinridge Capital Advisors

Describe an example of a successful engagement
Hudson described an example of a successful engagement with a technology company. The company provided a wealth of information about their ESG efforts in their sustainability report, and further clarified the most important points in their responses to Breckinridge's questions, both before and during the call. "What was really exciting to us, and going back to the idea of constructive dialogue and being on the same team, was that at the end of the call, the company asked if Breckinridge would be able to offer feedback on the company's next sustainability report. They felt that we understood their business and their ESG priorities particularly well, and that this type of insight would be valuable to them as they think about how to best communicate with investors moving forward."

From a change management theory point of view, who do you think could be key influencers to promote ESG integration?
Hudson pointed out the language barrier between the sustainability community and the more traditional CFO / investment community that ties into the C-Suite and CEOs. "What is really needed is a new crop of multilingual leaders who care about sustainability, but who also understand the business more broadly. In other words, we need leaders who are fluent in sustainability-related issues, but also in key financial drivers that ultimately play a role in financial valuation, and who have intuition for how capital markets really work. This would help companies look at everything they do through a broader, more strategic lens."

What do you think should be the future of the engagement process?
"There is a wealth of information out there on what big companies are doing, but less insight on what that really means for the company and how it is beneficial," said Hudson. Developing these types of insights is a major focus of Breckinridge's research and engagement process.

In an ideal world, what would you need in order to do your work more efficiently (in terms of methodologies, tools, data availability, etc.)?
Ideally, investors would like to see material ESG issues integrated into required SEC filings, and SASB has played an instrumental role in leading this effort. But this is just one piece of the puzzle. "ESG reporting needs to be required, but it also needs to be truly meaningful," emphasized Hudson. The information should be useful to investors. Furthermore, there should be a way to replicate that structure on platforms like Bloomberg and other data sources so that there is seamless flow of material information about a specific company that is consistent across data sources. This will then enable investors to focus on what is truly important for their investment research and analysis.

Public Engagement

The public engagement route is represented by a shareholder resolution, in which those who own a proportion of stock in the company are offered a free vote on proposals put forward to them. In the U.S., the criteria for voting requires ownership of a minimum of $2000 worth of shares or 1% of the company. Usually, proposals go directly to a vote at the Annual General Meeting (AGM), provided they meet regulatory requirements. Shareholder resolutions are non-binding and therefore the management of a company is not obliged to implement them even if they receive more than 50% of the votes. However, it is rare for a company to ignore them entirely. If management disagrees with them, it is more common to simply recommend shareholders to vote against the proposals.[14]

Shareholder resolutions can take any form and may cover topics such as corporate governance, general strategy, transparency or executive compensation. As an indicator of the most prevalent issues arising in public engagement, EY provides a break down of proposals voted on in 2015:[15]

- 34% Environmental/social
- 32% Board-focused
- 18% Strategic/anti-takeover
- 15% Compensation

The number of shareholder resolutions has increased significantly since 1999, representing a significant increase in the level of engagement by shareholders.[16] Evidence suggests that it is typically the bigger companies receiving the highest number of resolutions. According to Deutsche Bank for example, “ExxonMobil received more than 200 resolutions between 1997 and 2009, an average of 15 per year. More than half of the resolutions led over the period went to a vote at ExxonMobil’s AGM.”[17]

> **ExxonMobil received more than 200 resolutions between 1997 and 2009, an average of 15 per year.**

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14. Lemke and Lins (2013) Regulation of Investment Advisers, Thomson West, Washington
15. EY (2016) 2016 proxy statements, An overview of the requirements and observations about current practice, Ernst & Young LLP
16. Panayi, F. (2015) Shareholder Activism - It’s all French to Me, Global Proxy Solicitation
17. Deutsche Bank (2010) Corporate Engagement by Institutional Shareholders

Shareholder Engagement & ESG

One of the most significant aspects of public shareholder engagement concerns the increase in environmental, social and corporate governance (ESG) related activity. Indeed it has been reported that between 1999 and 2013, the number of ESG proposals doubled.[18] A recent report from EY showcased that as recently as 2005, "less than 3% of all shareholder resolutions on social and environmental issues reached the critical support threshold of more than 30% of votes cast. By 2010, 26.8% had hit that level. By the 2011 proxy season, ESG pertaining issues rose again to 31.6%, the largest category of any shareholder resolution."[19]

In their paper 'Shareholder Activism on Sustainability Issues,' the authors discuss how these proposals are impacting firms' subsequent ESG performance, concluding its importance as a "mechanism to improve firms' performance on the focal issue of the activism."[20] The paper highlights that while shareholder engagement on traditional corporate governance issues, including executive salary, takeover provisions and board of directors' composition, has had a direct impact on changing internal corporate governance, its impact on ESG performance is less well understood.

By examining 2,664 shareholder proposals that address ESG issues, the paper categorizes these as material and immaterial, using SASB's definition of materiality, and assesses the level of impact each has on the firm's ESG performance. The paper finds that shareholder engagement and filing of proposals has a measurable impact on a firm's performance on the focal ESG issue. However, the effect on the performance on the focal ESG issue varies according to its financial materiality. For engagements on financially material issues, companies improve their performance only when there is a relatively high percentage of votes in favor of the proposal. In contrast, withdrawn proposals are associated with better subsequent performance on the focal ESG issues for proposals concentrated on immaterial issues.

Further research analyzing an extensive proprietary database of corporate social responsibility engagements with U.S. public companies from 1999-2009 found that successful (unsuccessful) engagements are followed by positive (zero) abnormal returns.[21] The average one-year size-adjusted abnormal return after initial engagement is +7.1% for successful engagements, but there is no adverse reaction to unsuccessful ones.

18. Grewal, Jyothika and Serafeim, George and Yoon, Aaron S., Shareholder Activism on Sustainability Issues (July 6, 2016)
19. EY (2012) Is your company prepared?
20. Grewal, Jyothika and Serafeim, George and Yoon, Aaron S., Shareholder Activism on Sustainability Issues (July 6, 2016)
21. Dimson, E., Karakas, O. Li, X. (2013) 'Active Ownership,' Review of Financial Studies (RFS), Volume 28, Issue 12, pp 3225-3268, 2015

Key ESG Trends

The availability of data on shareholder resolutions allows for further research and insights into emerging trends. Figure 3 uses data compiled by Proxy Preview to show the proportion of resolutions filed across ESG in 2016.[22]

In Figure 4, the spread of issues are broken down into further categories. These figures show the prevalence of social issues in proposals filed, comprising over half of all ESG resolutions. These topics are largely made up of diversity in the workplace, human rights and employee health. Since 2010, shareholder engagement continues to rise on ESG albeit at a slower pace.

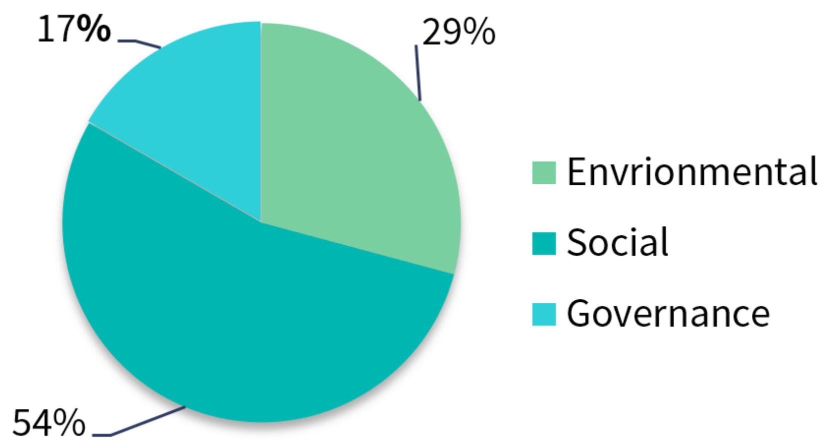


Figure 3: 2016 ESG Resolution Breakdown

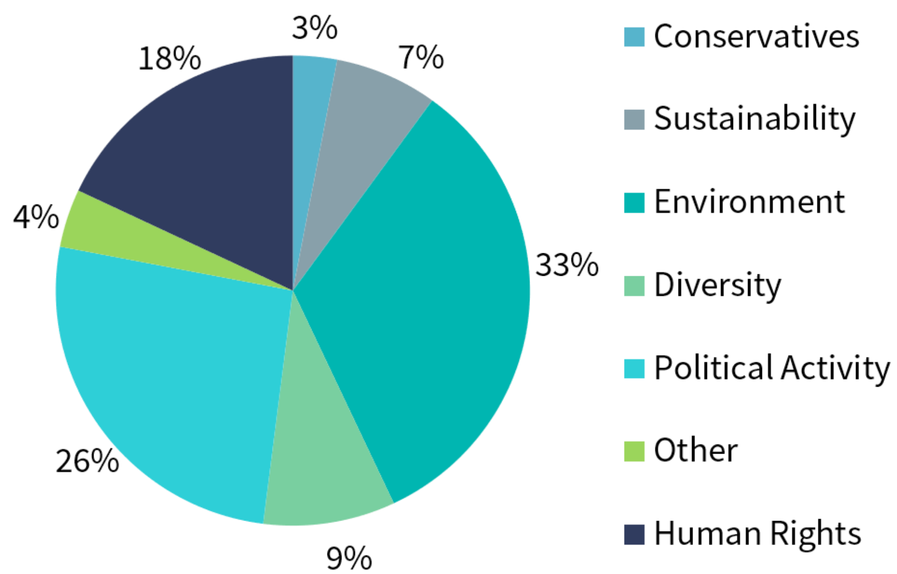


Figure 4: 2016 ESG Breakdown

* Data based on summing the no. of resolutions filed under each ESG category as outlined in the Proxy Preview 2016 report. **22.** Proxy Preview (2015) Helping Shareholders Vote their Values

Figure 5 shows the key changes that have taken place since 2010. As it can be seen in the figure, social and environmental issues have risen since 2010 with the exception of 2013, while 2016 marks a slow down.[23]

Figure 6 shows a further break down of ESG proposal sub-topics since 2010. Political activity constituted the most popular topic between 2011 and 2014. Reflecting their increasing prevalence, environmental issues formed the most frequent sub-topic of ESG proposals in 2016.

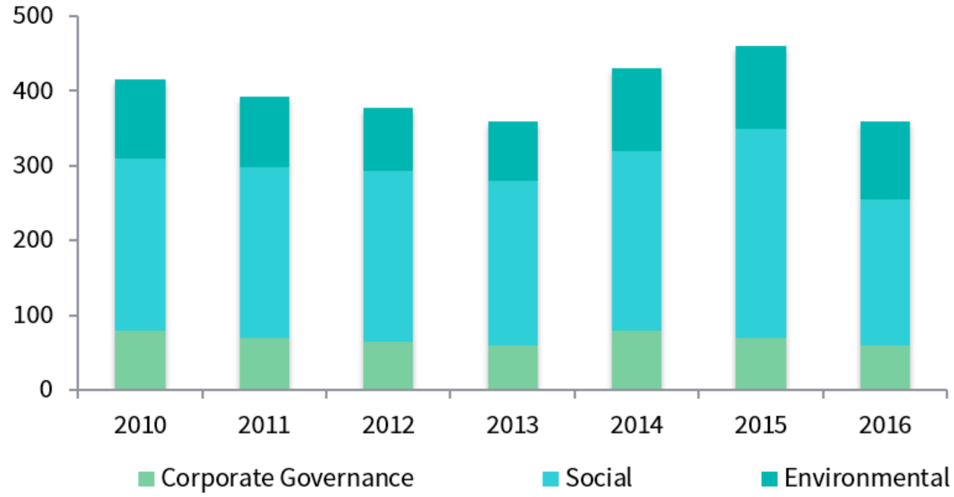


Figure 5: ESG Proposals Since 2010

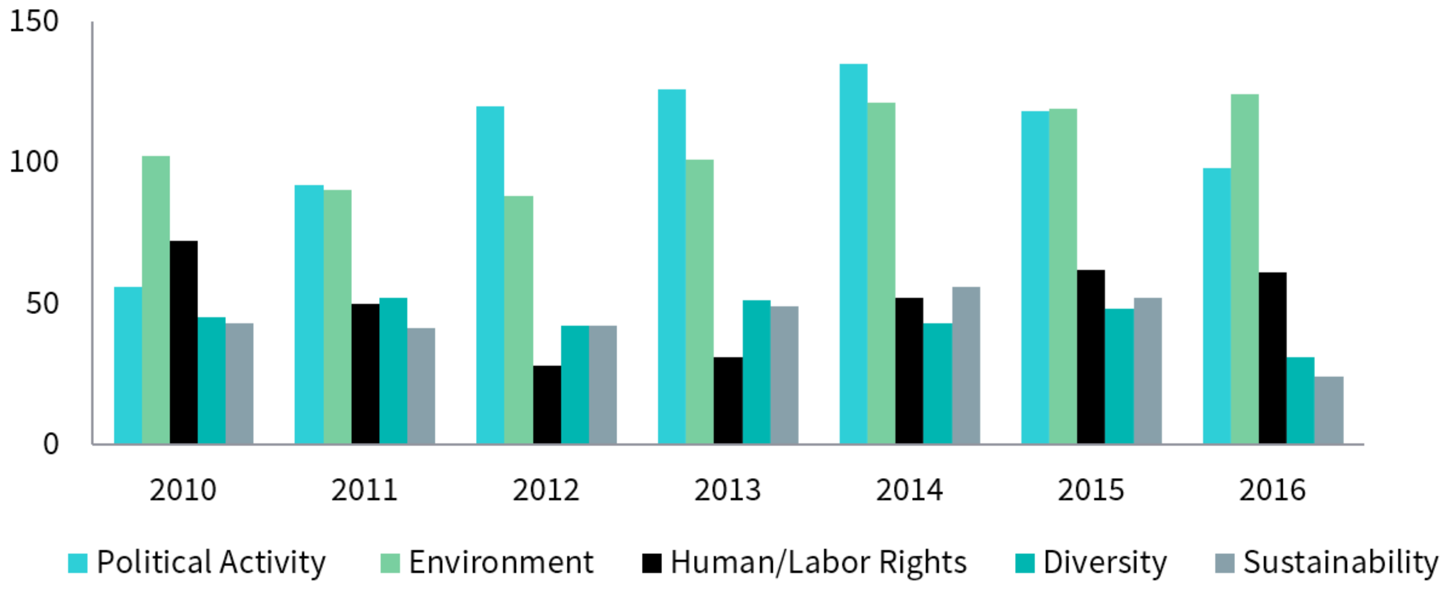


Figure 6: Key Trends of ESG Sub-topics Since 2010

23. Proxy Preview (2015) Helping Shareholders Vote Their Values

Voting Rates and Resolution Withdrawal

When resolutions are put to a vote, they are reliant on achieving a majority level of support. Despite their rising numbers, Figure 7 shows that shareholder support for ESG resolutions still remains relatively low; consistently under 25% between 2010-2015.[24] Figure 8 shows the average vote (quantity and percentage) in favor of ESG resolutions for each sector between 2010 and 2014. The Energy sector received both the highest number of votes and proportion of support.

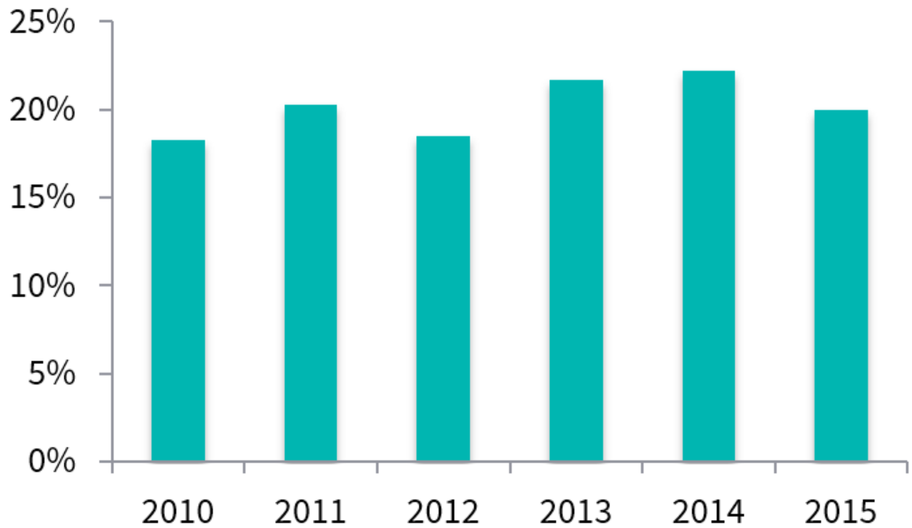


Figure 7: Average Support Per ESG Resolution

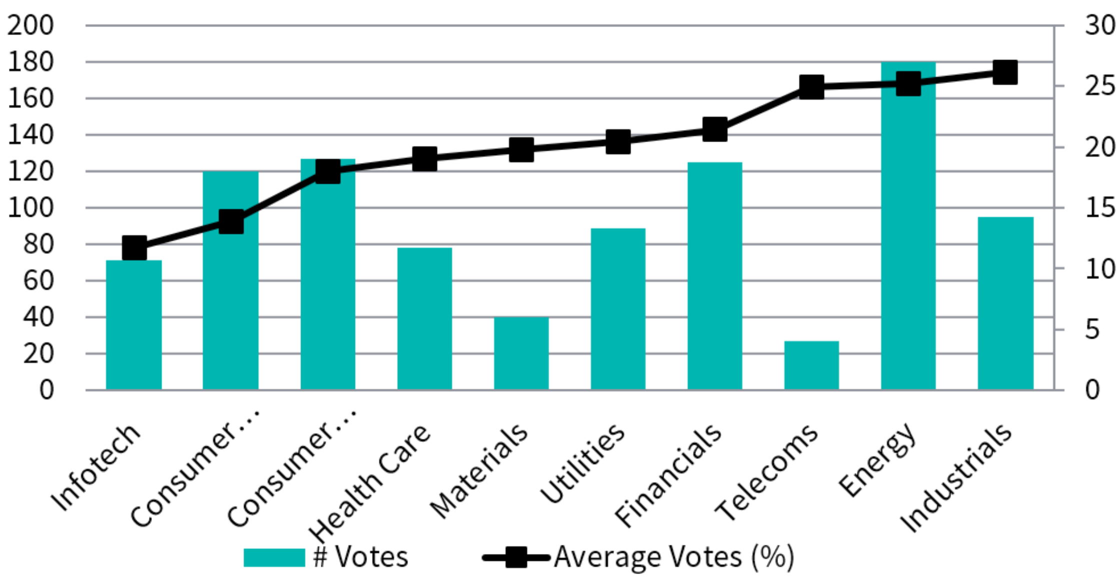


Figure 8: Votes By Sector for ESG Proposals, 2010-2014

24. Welsh, H. Passof, M. (2016) Proxy Preview 2016

While many proposals are put to vote, not all make it to the voting stage. Often a significant number are either withdrawn or omitted entirely before shareholders are granted a vote. Figure 9 below shows that the number of proposals filed has increased overall since 2006. On the other hand, the number of proposals withdrawn has also increased.[25] This part of the process was shown early on in Figure 1 as the step 'approach sponsor and negotiate.' This typically occurs when a company's management want to avoid the negative publicity that a vote might bring or an adverse vote result at the AGM.[26] A withdrawn proposal usually reflects a success for shareholders because their request has been partially or fully implemented.

To demonstrate the extent of withdrawn proposals that result in private settlement, Walden Asset Management, one of the leading filers for shareholder proposals, have publicized every resolution that they have filed. Out of the 13 proposals withdrawn in 2015, 11 were withdrawn 'under agreement.' In other words, management has committed to incorporate at least some aspect of the proposal.[27]

The trend in omitted, withdrawn and voted proposals can be further broken down by sector, as shown in Figure 10.[28] The Energy sector currently receives the highest number of resolutions that are voted on, while the Consumer Discretionary sector involved the most resolutions filed.

A withdrawn proposal usually reflects a success for shareholders because their request has been partially or fully implemented.

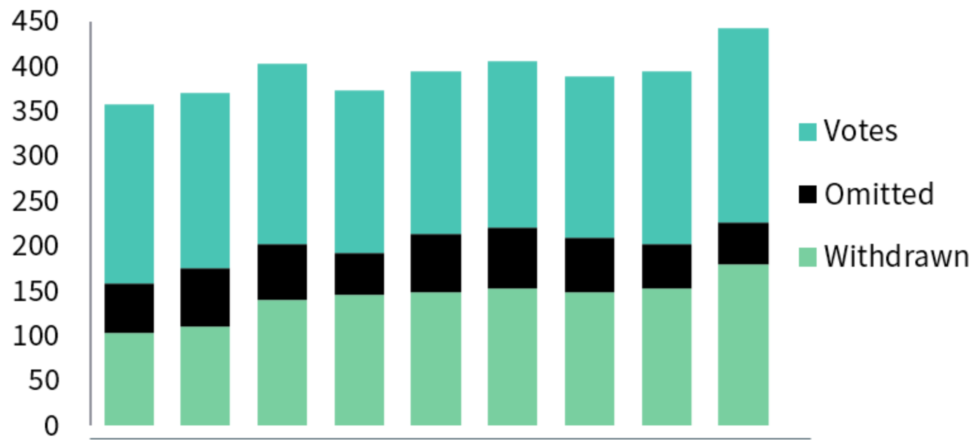


Figure 9: Environmental and Social Proposals Filed, 2006-2014

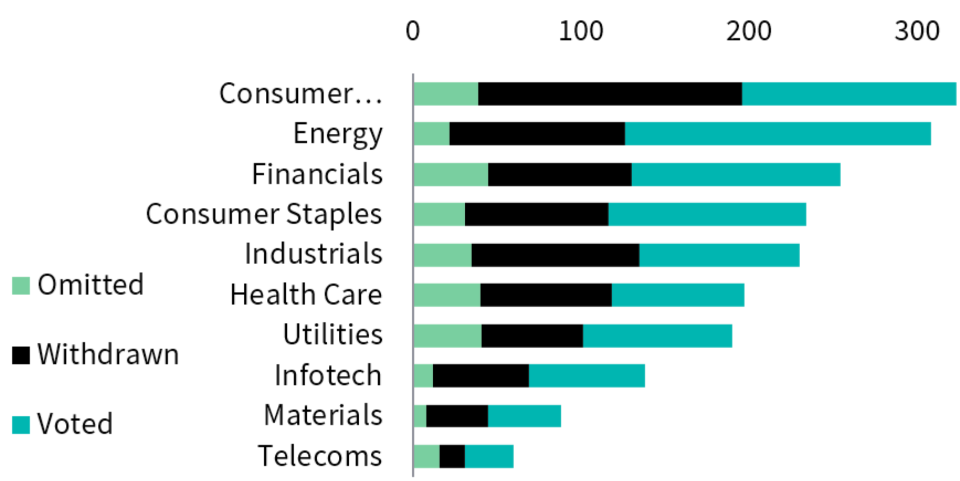


Figure 10: Environmental and Social Proposals Filed By Sector, 2014

25. http://www.waldenassetmgmt.com/investing-for-Change/shareholder_resolution_history
26. Deutsche Bank (2010) Corporate Engagement by Institutional Shareholders
27. Welsh, H. Passof, M. (2016) Proxy Preview 2016
28. Ibid

Investors Filing ESG Proposals

In addition to the content and outcome of ESG-related proposals put forward for vote, a pertinent question is, which organizations exactly are filing these resolutions? Using raw data from Proxy Preview, a comprehensive U.S. resolution database, we completed an audit from 2015-2016 of all publicly listed U.S. shareholder resolutions to identify the investors filing the most ESG proposals.[29] The top 8 proposal filers, As You Sow, NYSCRF, Trillium, Walden, AFL-CIO, Arjuna Capital, Calvert and NCPPR, made up 35.33% of all the total resolutions filed in 2016 (compared to 42.69% in 2015). This change may signify that ESG proposals are being filed by an increasing number of investors.

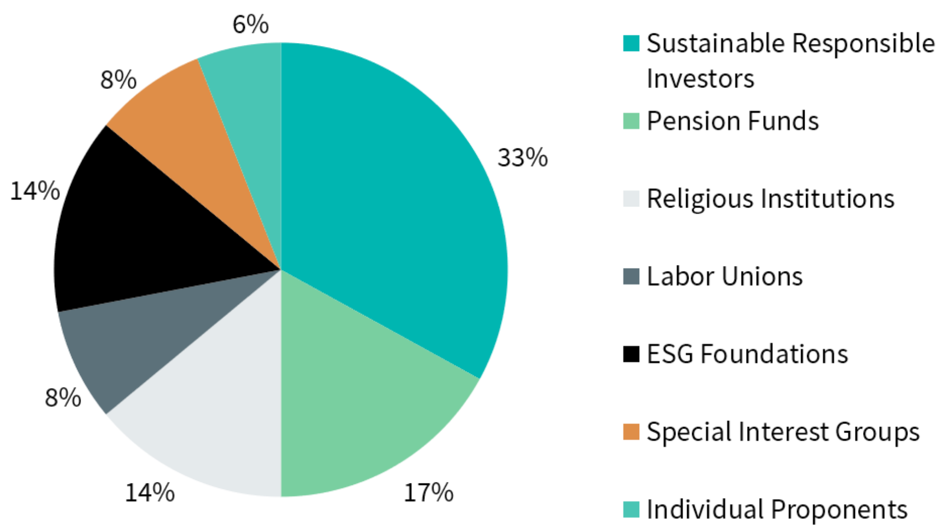


Figure 11: Primary Filers of ESG Proposals by Investor Category, 2016

The most prevalent filers of ESG proposals are funds and asset managers with a good understanding of ESG integration. The four classifications of investors filing the most ESG proposals are Sustainable Responsible Investors (e.g. Walden Asset Management or Trillium), Pension Funds (e.g. NYSCRF), Religious Institutions (e.g. Mercy Investment and Unitarian Universities) and ESG Foundations (e.g. As You Sow).

Interestingly, the top 25 asset owners and asset managers[30] have not been primary filers of ESG related resolutions for 2015-2016 nor is there a historical trend of such instances. The top 25 asset owners and asset managers are more likely to employ private engagement as their engagement strategy rather than shareholder resolutions. Figure 11 shows the proportion of ESG resolutions filed in 2016 across all classifications.[31]

29. Welsh, H. Passof, M. (2016) Proxy Preview 2016
30. We are consistently using the top 25 asset owners and asset managers (by assets under management) as an indication of mainstream practices within the investment community
31. Ibid

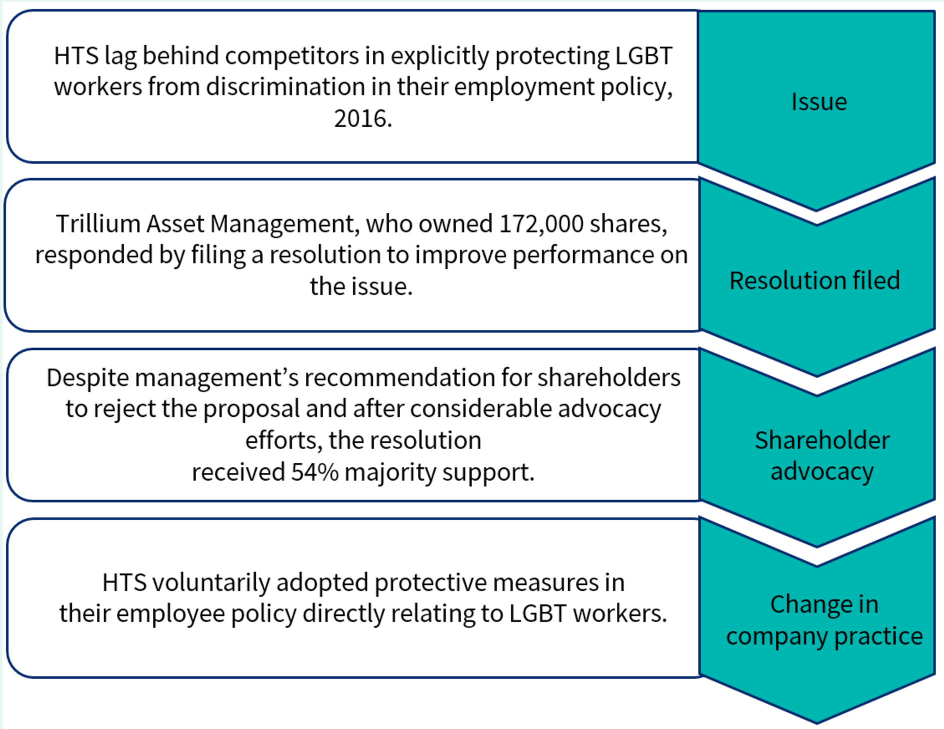
Case Study

Trillium Asset Management

In April 2016, the shareholders of J.B. Hunt Transport Services, a U.S. based transportation company, voted on a proposal to protect lesbian, gay, bisexual and transgender workers from discrimination in the company's employment policies following reports of unfair treatment. Hearing the reports of treatment, Trillium Asset Management, who owned more than 172,000 shares of J.B Hunt, filed the resolution in a bid to improve and consolidate the firm's Social practice.[32]

Following the filing of the resolution, the company's board of directors had strongly recommended that shareholders vote against the proposal referring to it as "unnecessary." As a result of lobbying and despite management's recommendation, the vote passed with 54% in favor of the resolution. According to ISS, five similar investor measures were withdrawn after the companies voluntarily adopted protective language.

The head of Shareholder Advocacy at Trillium stated following news of the result: "That is a very significant vote...There usually are only a handful of ESG proposals that receive a majority."

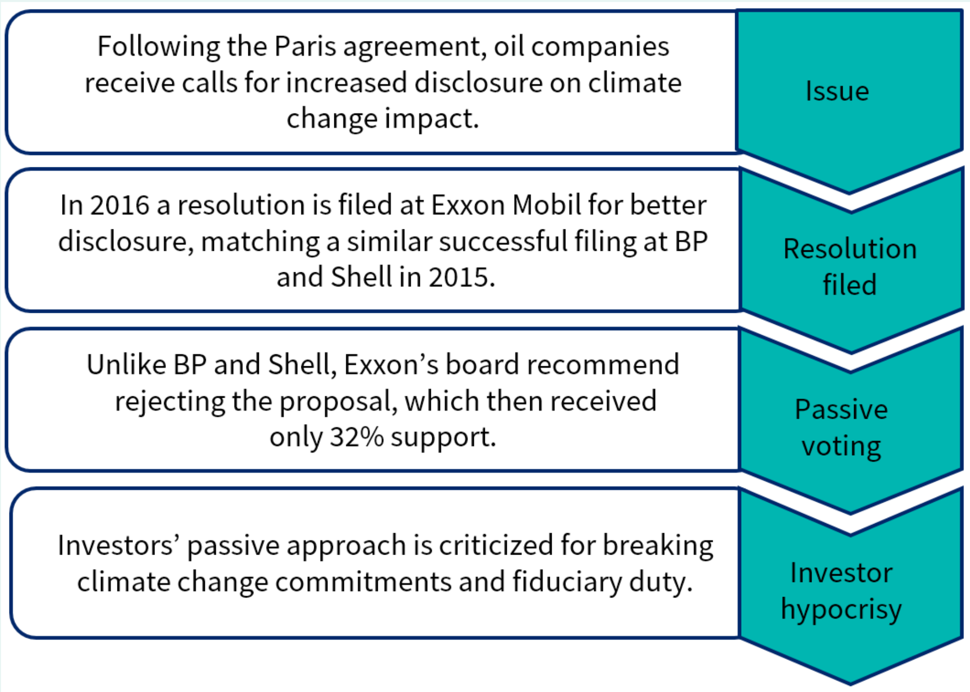


32. Colby, L. (2016) Bloomberg. Trucker J.B. Hunt Bucks Investor Call for LGBT Protections

Case Study

Contrasted Results in the Oil and Gas Sector

In 2016, ExxonMobil and Chevron each received similar proposals requesting incorporation of greater transparency over impact on their business of the global commitment to limit climate change to 2°C.[33] This resolution, which was a direct result of the 2015 Paris Agreement, received a no vote recommendation from the management of ExxonMobil and eventually received 38% of shares in favor (with the similar proposal at Chevron receiving 41%). The number of votes for this resolution was the largest number any climate change resolution has received at the two largest oil and gas companies in the U.S. At the same time, it revealed an inconsistency in the voting behaviors of several investors. Similar resolutions filed in 2015 with the European oil and gas companies BP and Shell received 98.3% and 99.8% of the votes respectively. In both cases, the management recommended voting for the resolutions.



To better understand this disparity, the cases of BP and ExxonMobil are now more closely examined. Over 150 institutional shareholders led the resolution requesting BP to explain their strategies and policies regarding climate change. Some of the largest included CCLA Investment Management, The Local Authority Pension Fund Forum (LAPFF) and Rathbone Greenbank. The management backed the proposal, which received a 98% approval rate. In direct contrast to BP, ExxonMobil shareholders' rejection of the proposal was coupled with an active request by management to vote against the motion: the firm unsuccessfully attempted to have it struck off the ballot altogether by the SEC.

33. Item 12 on ballot. Resolution: annually assess risks of 2-degree scenario. Description: company must publish annual assessment of long-term portfolio impacts of a 2-degree scenario. Lead filer: New York State Comptroller

Case Study

Contrasted Results in the Oil and Gas Sector

Resolution: annually assess risks of 2-degree scenario. Description: company must publish annual assessment of long-term portfolio impacts of a 2-degree scenario. Lead filer: New York State Comptroller.

What makes this case particularly interesting is the extensive overlap in investors at ExxonMobil and BP, suggesting that the contrast in voting outcomes involved the same investors voting differently on the same issue for two companies.[34] This inconsistency illustrates how passive engagement and voting in line with management can hamper progress to sustainability and subverts wider public commitments such as to PRI, CERES and CDP. [35]

A silver lining in the Exxon case is the support of over 60 institutional investors who voted for the resolution. Some of the largest of these include State Street, Amundi, AXA Investment Management, BNP Paribas, CalPERS, Legal & General Investment Management, Natixis Asset Management, New York City Retirement Fund and The Norwegian Government Pension Fund Global and Schroder's.[36] The world's two leading independent proxy advisors, ISS and Glass Lewis, also supported the proposal. While the motion may never have passed, the resolution represents a significant revolt from shareholders with 32% voting against management in favor of an ESG issue.

Key findings:[37]

- 45% of the largest shareholders who voted against the resolution are signatories to PRI, and 25% to CDP.
- 3% of the 1069 funds responded to letters of thousands of members urging disclosure on voting intentions.
- 29% of asset owners who responded to members admitted outsourcing the voting decision.

34. Eccles, R. (2016) Investor Leadership: The unfinished story of ExxonMobil and Chevron
35. Asset Owners Disclosure Project (2016) ExxonMobil Investor Engagement Report
36. Anglican News (2016) Church Commissioners lose ExxonMobil fight
37. Asset Owners Disclosure Project (2016) ExxonMobil Investor Engagement Report, http://aodproject.net/exxonmobil-investor-engagement-report/

Key Conclusions and Further Research

Key Conclusions

- Active ownership can be a very effective tool. Successful engagements lead to alphas of 7.1% in the year following the engagement[38]
- Private engagement seems to be the preferred method of engagement. Investors view private engagement as an opportunity to develop a better understanding of the investee companies as well as enhance and protect the value for the ultimate beneficiary or client
- Shareholder proposals are an effective method of furthering ESG issues. While not always successful, they can prompt corporate action and raise awareness
- Institutional shareholders show an increasing level of understanding of ESG issues, but further education and coordination is necessary

Further Research

One of the major developments of the recent years is the growth of passive funds that have accumulated significant stakes in large corporations, often collectively exceeding the holdings of actively managed funds. These funds are now building new teams that deal with engagement practices and want to make their weight felt. Further research is needed on how these investors, with common ownership of multiple companies within the same industry, can affect company behavior, what their current ESG engagement practices are and what could potentially be their future role in advancing the ESG integration agenda.

38. Dimson, E., Karakas, O. Li, X. (2013) 'Active Ownership', Review of Financial Studies (RFS), Volume 28, Issue 12, pp 3225-3268, 2015

Appendix

Literature on Active Ownership

In the following pages, we present some of the most current academic and industry evidence for the impacts of shareholder engagement.* The papers are grouped on 4 key themes that examine:

1. the increase in active ownership and the growing role of institutional investors as activists;
2. the link between corporate social responsibility, shareholder activism and corporate financial performance;
3. the market reactions following shareholder campaigns;
4. the effects of active ownership on companies' social and environmental performance.

The Rise of Active Ownership and The Role of Institutional Investors

Activist Insight (2015) An Annual Review of Trends in Shareholder Activism
http://www.shareholderforum.com/access/Library/20150130_ActivistInsight-SRZ.pdf
The latest "Annual Review of Trends in Shareholder Activism" published by Activist Insight (2015) argues that corporate governance is now more shareholder-centric as a result of the activist movement, with far less passivity from shareholders and proxy voting advisors, even in areas traditionally within the exclusive remit of the board of directors. The report indicates that a total of 344 companies worldwide were subjected to activist demands in 2014, up 18% from the 291 recorded in 2013. In 2014, 75% of demands were at least partially satisfied, up from 67% in 2013.

OECD (2014) Institutional Investors and Ownership Engagement
http://www.oecd.org/corporate/Institutional-investors-ownership-engagement.pdf
This recent OECD (2014) report provides evidence of the rise of public equity held by institutional investors across the world. In the last 50 years in the UK, the portion of public equity held by individual investors, as opposed to institutions, has decreased from 54% to only 11%. Similar trends are observable elsewhere in the world as well. In the mid-1960s, individuals held 84% of all publicly listed stocks in the United States, whereas today they hold around 40%. In Japan the proportion of direct shareholdings is even smaller – in 2011 only 18% of all public equity was held by individuals.

Burkhart, M., Gromb, D., and Panunzi, F. (1997). Large shareholders, monitoring, and the value of the firm. The Quarterly Journal of Economics, 112(3), pp. 693-728
Shleifer, A. and Vishny, R. (1986) Large Shareholders and Corporate Control. Journal of Political Economy 94(3), pp. 461-488.94(3).
According to Burkhart, Gromb and Panunzi (1997), as well as Scheifer and Vishny (1986), large shareholders are important and powerful corporate monitors because they have more influence and incentives to incite change in corporate behavior due to their large stake in targeted firms. However, investment portfolios tend to be greatly diversified as shareholders seek to mitigate risk by spreading their shares across a variety of different companies. As the recent Kay Review of

UK Equity Markets and Long-Term Decision Making (2012 – published by BIS) revealed, the price of this diversification is a loss of information and control. Investors are less familiar with the activities and performance of any one individual company in their portfolio.

Deutsche Bank Group (2012) Corporate Engagement by Institutional Shareholders
https://www.db.com/cr/en/docs/DBAdvisors_CorpEngagement_090113.pdf
The paper cited above argues that: “Corporations increasingly face a new type of shareholder: the shareholder activist. The rise of shareholder activism suggests that engagement with companies can be an effective approach to socially responsible investing.” Institutional investors can successfully promote change at investee companies because they are the most powerful shareholder group and can put pressure on the board of directors. This report by the Deutsche Bank group is based on research produced by the European Centre for Corporate Engagement. It assesses the importance of withdrawn shareholder resolutions as a governance mechanism and analyzes a sample of proposals at S&P1500 companies from 1997 – 2009. The results indicate that a significant number of proposals are withdrawn (approximately 20% each year). Institutional investors filed 2,392 proposals over the period, of which 810 or 33.9% were withdrawn before the AGM, indicating the reaching of an agreement with management. The paper argues that institutional investors appear able to promote changes in corporate behavior pertaining to ESG issues.

Sparkes R. and Cowton C. J. (2004) The Maturing of Socially Responsible Investment: A Review of the Developing Link with Corporate Social Responsibility. Journal of Business Ethics 52(1), pp. 45–57.
Sparkes and Cowton (2004) argue that, compared to other more passive SRI strategies, shareholder activism is a more powerful tool for influencing companies. The impact of investors is likely to remain marginal at best if they continue adopting a passive policy focused on avoiding investment in companies disapproved of. Large institutional investors have the ability to express meaningful dissent, and influence company policy, rather than just divest from companies.

Bauer, R., Clark, G. and Viehs, M. (2013) The Geography of Shareholder Engagement: Evidence from a Large British Institutional Investor.
Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2261649
McCahery, J. A. and Sautner, Z. and Starks, L. T. (2011) Behind the Scenes: The Corporate Governance Preferences of Institutional Investors (June 2015). Journal of Finance, Forthcoming.
Available at SSRN: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1571046
Goldstein, M. (2014) Defining Engagement: An Update on the Evolving Relationship Between Shareholders, Directors and Executives. Institutional Shareholder Services,
http://irrcinstitute.org/wpcontent/uploads/2015/09/engagement-between-corporations-and-investors-at-all-time-high1.pdf
Skancke, M., Dimson, E., Hoel, M., Kettis, M., Nystuen, G. and Starks, L. (2014) Fossil-Fuel Investments in the Norwegian Government Pension Fund Global: Addressing Climate Issues Through Exclusion and Active Ownership. Report by the Expert Group appointed by the Norwegian Ministry of Finance. Oslo,
https://www.regjeringen.no/contentassets/d1d5b995b88e4b3281b4cc027b80f64b/expertgroup_report.pdf
All four references cited above, which are representative of the recent corporate governance literature, discuss the growing importance of corporate engagement by institutional investors (see McCahery, Sautner, and Starks, 2011; Skancke et al., 2014; Bauer, Clark, and Viehs, 2013). According to Goldstein (2014), the extent of engagement between corporations and investors is now at an all-time high.

The Economic Evidence for Stewardship - the Link Between Sustainability and Corporate Financial Performance

Arabesque Partners and University of Oxford (2015) From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance,
http://www.arabesque.com/index.php?tt_down=51e2de00a30f88872897824d3e211b11
This 2015 report published by Arabesque Partners, an asset manager, in association with Oxford University, assesses over 200 of the highest quality academic studies to provide a broad perspective on the economic evidence for sustainability. The results suggest that 90% of studies on the cost of capital reveal that sound sustainability practices lower the cost of capital for firms and 88% of the research suggests that solid ESG practices lead to better operational performance of companies. Similarly, 80% of studies show that stock price performance is positively influenced by good sustainability practices. The report argues that strategies incorporating ESG issues outperform similar non-ESG strategies.

Friede, G., Busch, T. and Bassen, A. (2015) ESG and Financial Performance: Aggregated Evidence from More than 2000 Empirical Studies Journal of Sustainable Finance and Investment 5(4), pp. 210-233
Deutsche Asset Management and the University of Hamburg recently conducted an exhaustive overview of academic literature on the link between ESG criteria and corporate financial performance (CFP, hereafter). The results of this meta-analysis of more than 2200 empirical studies published since 1970 reveal that roughly 90% of papers find a non-negative ESG-CFP relation, with the majority (62.6%) reporting that ESG issues have a positive impact on corporate financial performance. The study also explores whether any of the three factors – social, environmental and governance – has a dominating effect on CFP and concludes that environmental studies offer the most favorable relation (58.7% positive findings compared to 4.3% negative).

Dimson. E., Karakas, O. and Li, X. (2015) Active Ownership. Review of Financial Studies, Forthcoming,
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2154724 Dimson, Karakas and Li (2015) examine the highly intensive environmental, social and governance corporate engagement activities at 613 U.S. firms between 1999 and 2009 (the sample consists of a total of 2,152 engagement sequences). The findings reveal that ESG engagements generate a cumulative size-adjusted abnormal return of 2.3% over the year following initial engagement. Successful engagements, where the institutional investor achieved change, generate much higher cumulative abnormal returns of +7.1%. The research provides evidence that ESG engagement activities can be value enhancing for shareholders as the targeted firms' operating performance, profitability, efficiency and governance indices improve as a result of successful engagements.

Alliance Trust Investments (2015) Sustainable Investing: Separating Fact from Fiction, Institutional Investor Attitudes to the Role of Sustainable and ESG-based Investing,
http://www.alliancetrustinvestments.com/ global/documents/6076/2015/October/Sustainable-investing-Separating-fact-from-fiction
Recent research by Alliance Trust Investments (2015) compared a set of companies over time – one set with a strong ESG program, and another similar set with no emphasis on ESG or sustainability. The findings show that the group of companies with a strong sustainability focus outperform their peers both in terms of stock market value and financial returns. Such evidence suggests that investor engagement with investee companies with the goal of improving their sustainability performance results in clear benefits for shareholders.

Becht, M., Franks, J., Mayer, C. and Rossi, S. (2010) Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund. Review of Financial Studies, 23(3), pp. 3093-3129.
Similarly, Becht et al. (2010) studied the private

engagement activities of the Hermes UK Focus Fund and concluded that they create shareholder value, which also translates into superior performance of the entire fund. The fund substantially outperforms benchmarks and the authors estimate that returns are largely associated with engagements rather than stock picking.

Margolis, J. D., and Walsh, J. P. (2003) Misery Loves Companies: Rethinking Social Initiatives by Business. Administrative Science Quarterly, (48)2, pp. 268-305.
Margolis and Walsh (2003) review 127 empirical papers examining the relationship between companies' socially responsible conduct and their financial position and conclude that the majority of results point to a positive relationship between social and financial performance.

Positive Market Reactions to Shareholder Activism

Cunat, V., Gine, M., and Guadalupe, M. (2012) The Vote is Cast: The Effect of Corporate Governance on Shareholder Value. Journal of Finance, 67(5), pp. 1943-1977.
This study investigates the market reaction to shareholder-filed governance proposals that pass or fail by a small margin of votes at AGMs. The findings reveal that passing a proposal leads to significant positive abnormal returns. Adopting one proposal increases shareholder value by 2.8%.

Klein, A., and Zur, E. (2009) Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors. Journal of Finance, 64(1), pp. 187-229.
The authors examine shareholder activism campaigns by hedge funds and other private investors. The main similarities between the groups are a significantly positive market reaction for the target firm around the initial Schedule 13D filing date, a further significant increase in share price for the subsequent year, and the activist's high success rate in gaining its original objective.

The Effectiveness of Active Ownership In Changing Company Behavior

Reid, E. M. and Toffel, M. W. (2009) Responding to Public and Private Politics: Corporate Disclosure of Climate Change Strategies. Strategic Management Journal 30(11), pp. 1157 – 1178.
http://onlinelibrary.wiley.com/doi/10.1002/smj.796/abstract
Reid and Toffel (2009) hypothesize that shareholder actions and regulatory threats are likely to prime firms to adopt practices consistent with the aims of a broader social movement. They find empirical evidence of direct and spill over effects. In the domain of the company's internal operations, shareholder resolutions filed against a firm and others in its industry increase a firm's propensity to engage in practices consistent with the aims of the related social movement. Similarly, in the realm of public politics, threats of state regulations targeted at a firm's industry as well as regulations targeted at other industries increase the likelihood that the firm will engage in such practices. These findings show that both activist groups and government actors can spur changes in organizational practices, and that challenges mounted against a single firm or a single industry can inspire both firm and field-level changes.

Lee, M. P. and Lounsbury, M. (2011) Domesticating Radical Rant and Rage: An Exploration of the Consequences of Environmental Shareholder Resolutions on Corporate Environmental Performance. Business & Society 50(1), pp. 155-188.
With a geographical focus on the U.S., the authors examine the effect of environmental shareholder resolutions on chemical and petroleum firms' environmental performance. They track thirty eight public corporations for thirteen years, using data from the Toxic Release Inventory, and conclude that the resolutions have a significant and positive effect on the targeted firms' environmental performance.

Telman, J. A. (2011) Is the Quest for Corporate Responsibility A Wild Goose Chase? The Story of Lovenheim V. Iroquois Brands, Ltd. Akron Law Review 44(2), pp. 479-528.
In a study that discusses socio-ethical shareholder proposals from a legal perspective, Telman (2011) explores in detail the legal case of Lovenheim v. Iroquois Brands (1985). The article's main argument is that filing shareholder proposals facilitates open, clear and specific communication between firms' management and shareholders, and has the potential to influence corporate decision making. Moreover, the implementation of activists' ideas advanced by the proposal can be of benefit to the corporation.

Del Guercio, D., Cole, L. S. and Woidtke, T. (2008) Do Boards Pay Attention When Institutional Investor Activists 'Just Vote No'? Journal of Financial Economics, 90, pp. 84 – 103.
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=575242
The authors examine 'Just Vote No' campaigns whereby activists encourage their fellow shareholders to withhold votes towards a director's election in order to express dissatisfaction with performance or the firm's corporate governance structure. The results suggest that such campaigns are effective and lead to companies taking actions as operating performance improvements and abnormally high CEO turnover are observable following such interventions. A recent example of this happening in practice is Aviva's 2012 AGM held during what became known as the 'Shareholder Spring' where almost 60% of all votes (against and withheld) did not support the company's executive pay proposal and, as a result, Aviva's CEO Andrew Moss stepped down.

Ertimur, Y., Ferri, F. and Muslu, V. (2010) Shareholder Activism and CEO Pay. Review of Financial Studies, 24(2), pp. 535 – 592.
http://rfs.oxfordjournals.org/content/early/2010/11/18/rfs.hhq113
In another study that explores vote-no campaigns, Ertimur, Ferri and Muslu (2010) analyze 134 vote-no interventions and 1,198 shareholder proposals related to executive pay between 1997 and 2007. Mostly sponsored by union pension funds, the majority of proposals relate to the pay-setting process (e.g., proposals to subject severance pay to shareholder approval). The results reveal that firms with excess CEO pay targeted by vote-no campaigns experience a significant reduction in CEO pay ($7.3 million).

Stevens, J., Steensma, H., Harrison, D., and Cochran, P. (2005) Symbolic or Substantive Document? The Influence of Ethics Codes on Financial Executives' Decisions. Strategic Management Journal, 26(2), pp.181-195.
This study is based on a survey of 302 senior financial executives and the aim is to test the extent to which ethics codes are actually used by executives when making strategic choices as opposed to being merely symbolic. The authors find that financial executives are more likely to integrate their company's ethics code into their strategic decision processes if they perceive pressure from market stakeholders to do so (suppliers, customers, shareholders). Shareholder activism is related to the adoption and internalization of ethics codes by financial executives

About the Authors

KKS Advisors is a leading advisory firm specializing in strategy and research, formed with the vision to reshape markets. Our goal is to enable clients to create long-term value through the integrated management of economic, environmental, social and governance factors. KKS works with companies, investors, NGOs and policy-makers to drive systemic change, across a range of service offerings including - strategy, corporate governance and reporting, sustainable investing, sustainable development and branding. KKS provides thought leadership by regularly publishing research that inspires decision makers to drive market transformation.

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