CHAPTER 6

ENGAGEMENT AND STEWARDSHIP

Stewardship is typically used as an overarching term encompassing the approach that investors take as active and involved owners of the companies and other entities in which they invest through voting and engagement. Voting is one aspect of stewardship activity and tends to focus on corporate governance matters raised at shareholders' meetings.

Engagement is the way in which investors put into effect their stewardship responsibilities in line with the Principles for Responsible Investment (PRI) principle 2 ("We will be active owners and incorporate environmental, social and governance (ESG) issues into our ownership policies and practices"). It is often described as purposeful dialogue with a specific objective in mind; that purpose will vary from engagement to engagement, but often relates to improving companies' business practices, especially in relation to the management of ESG issues.

Stewardship ought to be a consequence of investment. By contrast, activism is typically a specialist form of such engagement and stewardship, where an investment institution initiates an investment with the intent of generating investment outperformance through driving change with respect to a company's governance, capital allocation or business practices. Most frequently now associated with activist hedge funds, the activism mindset appears increasingly short-term and involves extraction of value rather than the longer-term value creation which is the driver for most engagement.

This chapter considers what we mean by stewardship and engagement, and covers the emergence of different styles of engagement. We consider the framework of guidelines and rules that direct the approach to stewardship and discuss how engagement can be delivered most effectively.

CHAPTER 6
ENGAGEMENT AND STEWARDSHIP

1 WHAT IS STEWARDSHIP? WHAT IS ENGAGEMENT?

6.1.1 Explain the purpose of investor engagement and stewardship.

Stewardship is an odd word that does not translate easily, yet it is regularly used globally to describe the responsibilities of institutional investors. It is a term that has a long history. The word 'steward' is derived from two Old English words ('stig' and 'weard') describing a guardian of a home – to protect the owner's assets. What in the Middle Ages was the home and its estate, in the 21st century is assets bought on financial markets. The steward is the representative of the owner, charged with acting in the owner's interests, and delivering returns and long-term value from their assets.

At the same time as the first stewards emerged, the concept of fiduciary duty was developed. Fiduciary duty is an obligation by the person (fiduciary) to look after another person's assets, and they must seek to protect and enhance the value of the assets with which they have been charged so that they are able to return them in good order to their owner. As a steward is the representative of the owner, caring for assets on their behalf, the steward should always feel the burden of fiduciary duty.

Stewardship is the process of intervention to make sure that the value of the assets is enhanced over time, or at least does not deteriorate through neglect or mismanagement. It can encompass the buying and selling of assets to maintain value within the fund as a whole, as well as acting as a good owner of assets. Engagement is one aspect of good stewardship; it is the individual interventions in specific assets to preserve and/or enhance value. In modern investment terms, this is the dialogue with the management and boards of investee companies and other assets. Voting is a particular form of engagement. It is the most visible because public company annual general meetings (AGMs) are public events and many institutions now make their voting actions public (some even ahead of the relevant meetings). However, by its nature it is formulaic because the nature of the resolutions on which shareholders vote is restricted by law. Engagement is much broader than just voting.

Given its focus on preserving and enhancing long-term value on behalf of the asset owner, engagement can encompass the full range of issues that affect the long-term value of a business, including:

- strategy;
- capital structure;
- operational performance and delivery;
- risk management;
- pay; and
- corporate governance.

ESG factors are clearly integral to these. Opportunities and challenges offered by ESG developments need to be reflected in the business's strategic thinking. Equally, a full assessment of operational performance must encompass not only financials, but vital areas relevant to the company's stakeholders:

- highlighting the long-term health of the business, such as relations with the workforce;
- establishing a culture that favours long-term value creation;
- dealing openly and fairly with suppliers and customers; and
- having proper and effective environmental controls in place.

An understanding of the complete range of key risks facing a business will always include ESG factors; and clearly remuneration and governance are integral to the **G** in ESG.

Stewardship and engagement are beneficial because they enhance shareholder value and support investors in the execution of their fiduciary duty – indeed for many, stewardship is simply putting fiduciary duty into effect. When done well, stewardship and engagement encourage enhanced information flows between investors and investees as the parties discuss and debate issues. This allows them to learn from each other and to build relationships, but most importantly to encourage change where shareholders communicate their perspectives on key issues that the company is facing.

As stewardship is a reflection of fiduciary duty, it needs to be actively considered by any party charged with fiduciary duties. This will include most parties in the modern investment chain from underlying beneficiary through to asset owner (pension fund, insurer or other fund) to fund manager and those directing the investment asset. Any of these parties could carry out stewardship functions but in practice the role typically rests with those with the greatest aggregated scale, usually the fund manager. Only the very largest asset owners seek to carry out stewardship activities themselves. The expectations for stewardship are typically set out in the investment mandate, the contract between asset owner and fund manager (which is discussed in detail in **Chapter 9**).

In a 2018 report, the Principles for Responsible Investment (PRI) highlighted three ESG engagement dynamics that it believes create value:

- communicative dynamics (the exchange of information);
- learning dynamics (enhancing knowledge); and
- political dynamics (building relationships).[1]

Developing these dynamics requires investors to go beyond a superficial understanding of the company and its activities. Unless the steward strives to build communication and relationships and has a desire to learn, engagement is unlikely to be successful. In order to be successful in engagement, investors need to respect the individual circumstances of the company, seeking understanding and rapport, and not simply declare that things need to change. This means that good engagement is time-consuming and tailored to the individual company.

Different investors have somewhat different definitions of what successful engagement is. The usual definition of engagement – a purposeful dialogue with a specific objective in mind – pre-supposes something vital: that the engager sets objectives for their engagement at the start of the process, and the dialogue's purpose is to deliver those objectives over time. While various investors both set objectives and measure their delivery differently, engagement is successful only to the extent that it delivers the pre-agreed objectives. Financial success in terms of business performance or share price performance may consequently occur, but will always be subsidiary to the first measurement of success. This is because much engagement is about safeguarding value rather than increasing it, and it is not possible to know what might have been in the absence of engagement.

This mindset of success being measured against the delivery of pre-agreed objectives fits well with the new thought process revealed in the UK's Stewardship Code (2020) (discussed in further detail in **Section 3**). The Financial Reporting Council, in the Code, repeatedly discusses the need for signatories to disclose the outcomes of their engagement work as well as the concrete benefits from stewardship activity for clients and beneficiaries. The Code also repeatedly uses the word 'outcome' to describe 'delivery of objectives that benefit clients'.

Just as with ESG and investment performance, there is a growing body of evidence that engagement adds value to portfolios. One of the earliest articles to provide a detailed academic analysis of engagement impact was *Returns to shareholder activism: evidence from a clinical study of the Hermes UK Focus Fund*.[2] This looked at the early years of the Hermes Focus Fund business (which was launched in late 1998) and considered the first 41 investments by the fund. It studied the internal records of Focus Fund team activities and considered their impact both in terms of delivering change at the companies in question and in delivering returns for the investors. To assess this, the study sought to identify engagement success by analysing the objectives that were set for each engagement at the start. It found that the majority of these stated objectives were achieved, with a 65% success rate overall, with greatest success in restructuring and financial policies, and slightly less so with regard to board change. Ironically perhaps, the lowest success rate was found in areas where shareholder engagement occurs more frequently, with only 25% of the remuneration policy changes sought achieved and only 44% of the sought improvements to investor relations. Whilst analysing this success, the study also found that the fund achieved positive financial returns. At the time, the overall performance of the fund was 4.9% net of fees a year in excess of the FTSE All-Share Performance, 90% of this excess return being estimated as due to activist outcomes.

In *Active ownership* a different (anonymous) fund manager's engagement record was studied in depth, looking at the years 1999–2009.[3] This study considered less activist investing and more what would now be considered standard ESG engagement and stewardship. One benefit of studying this style of engagement is that the number of cases covered in the study is substantial: even though it considered only US activity by the fund manager, it covered more than 2,000 engagements, involving over 600 investee companies, and had an overall success rate of 18%.

The core finding of this study was clear: that successful engagement activity was followed by positive abnormal financial returns. For example, for successes in climate change engagements over the study period, the excess return in the year following engagement was more than 10%, and nearly 9% for successful corporate governance engagements. Typically, the time between initial engagement and success was 1.5 years, with two or three engagements being required. On average, ESG engagement generated an abnormal return of 2.3% in the year after the initial engagement, rising to 7.1% for successful engagements and with no adverse response to unsuccessful engagement.

A more recent additional study finds that ESG engagement leads to a reduction in downside risk and that the effect is stronger the more successful the engagement is.[4] In this case, the effects were strongest in relation to governance (which also counts for the majority of engagement cases) and then for social issues (so long as these are also associated with work on governance).

These studies show that engagement – if carried out well, so that it is focused on material and relevant issues and pursued with persistence – can work. Engaged companies change their behaviours against ESG factors, and this leads to increased value.

Engagement also works, often, to further inform investment analysis and fill out an investor's understanding of the potential for a business model to adapt to a changing business environment and evolving expectations, and of the willingness of a particular management team and board to strategically address these challenges. Thus engagement for many is a crucial part of active investment decision-making.

2 WHY ENGAGEMENT?

6.1.2 Explain why engagement is considered beneficial and some of the key criticisms of engagement.

Engagement helps investee companies to understand their investors' (and potential investors') expectations, allowing them to shape their long-term strategies accordingly to suit them. Engagement also enables companies to explain how their approach to sustainability relates to their broader business strategy, and can provide an opportunity for companies to comment on ratings or scores driven by templates that they feel do not reflect the complexity of an issue.

Engagement also clearly allows investors to work closely with an investee over time on specific governance, social or environmental issues that the investor regards as posing a downside risk to the business. By working with companies' management – either individually or collectively – investment firms are able to influence companies to adopt better ESG practices, or at least to relinquish poor practices.

The Investor Forum – a UK group set up to facilitate collective dialogue between investors and investees – describes engagement as “active dialogue with a specific and targeted objective…the underlying aim…should always be to preserve and enhance the value of assets”.

In its 2019 white paper, *Defining stewardship and engagement*, the Investor Forum provides a framework for understanding the nature and key elements of stewardship.[5] Not least by defining stewardship in terms of assets with which an organisation has been entrusted, this deliberately frames stewardship within the context of fiduciary duty. Trustees (of pension funds or other assets) and directors fully understand that they are fiduciaries because they are charged with caring for assets on behalf of others. Because they are also entrusted with assets, similar fiduciary duties apply to investment institutions as well. The Forum argues that stewardship is one aspect of delivering on those duties.

Table 6.1: THE COMPONENTS OF STEWARDSHIP

<table>
<tr><td colspan="2">Stewardship
Preserving and enhancing the value of assets with which one has been entrusted</td></tr>
<tr><td colspan="2">...delivered through...</td></tr>
<tr><td colspan="2">Investment approach and decision
Allocation of capital in accordance with investment purpose, mandate and client interests, at portfolio and individual asset levels</td></tr>
<tr><td colspan="2">Dialogue
Active discussions between companies and investors, of which there are two principal forms:</td></tr>
<tr><td>Monitoring
Dialogue for investment purposes: to understand the company, its stakeholders and performance.
Informs incremental buy/sell/hold decisions.</td><td>Engagement
Purposeful dialogue with a specific and targeted objective to achieve change.
Individual or collective basis, as appropriate.</td></tr>
<tr><td colspan="2">...typified by...</td></tr>
<tr><td>Detailed and specific questioning; investors seeking insights</td><td>Two-way dialogue; investors expressing opinions</td></tr>
<tr><td colspan="2">…characteristics of high-quality delivery…</td></tr>
<tr><td colspan="2">• Framed by close understanding of nature of company and drivers of its business model and long-term opportunity to prosper.
• Appropriately resourced, so dialogue can be delivered professionally in the context of full understanding of individual company.
• Dialogue must be consistent, direct and honest.
• Dialogue is respectful and seeks to build mutual trust.</td></tr>
<tr><td>• Set in a context of mutual understanding of fund manager's investment style and approach.
• Recognises that change within companies is a process and sometimes takes time to be reflected in external indicators of performance.
• Resources are used efficiently so that neither party's time is wasted.
• Fuller insight leads to better informed decisions.
• Includes feedback so that mutual understanding can be reinforced over time.</td><td>• Set in a context of long-term ownership and focus on long-term value preservation and creation, so that engagement is aligned with investment thesis.
• Recognises that change is a process; while haste may at times be needed, change cannot be inappropriately rushed.
• Overall resources used efficiently, so engagement coverage is as broad as possible, whilst also proving effective.
• Clear and specific objective leads to effective change.
• Involves reflection, so lessons are learned and taken fully into account in future.</td></tr>
<tr><td colspan="2">…resulting in…</td></tr>
<tr><td>• Changed investor decision-making.
• Efficient capital allocation by investors.
• Appropriate risk-adjusted returns for clients.
• Preserved/enhanced value.
• Delivery of client objectives and investment purpose.</td><td>• Changed company behaviours.
• Efficient capital allocation by companies.
• Appropriate risk management by companies.
• Preserved/enhanced value.
• Delivery of corporate purpose and culture, through effective oversight.</td></tr>
</table>

The Investor Forum (2019).[5]

Particularly key in this analysis is the contrast that it draws between monitoring and engagement dialogues. As the paper articulates, monitoring dialogues are the conversations between investors and management to more fully understand performance and opportunity, which are typified by detailed questions from the investor and which are likely to inform buy, sell or hold investment decisions. In contrast, engagement dialogues are conversations between investors and any level of the investee entity (including non-executive directors) featuring a two-way sharing of perspectives, such that the investors express their position on key issues, and in particular, highlight any concerns that they may have. This two-way dialogue and expression of clear positions is necessary for engagement to deliver on its intended outcomes, of changed company behaviours and so on. If engagement is to be effective in generating change outcomes, it requires that a clear objective has been set from the start.

This distinction between monitoring dialogues and genuine engagement shows the ways in which stewardship can sometimes be ineffective or inappropriate. There can be occasions where engagement activity is directed at companies which are unlikely to change and have no intent to enter into a productive dialogue with their investors. Engagement with these companies has limited benefit, yet some clients may suspect that it is an excuse to continue to hold onto a company which is otherwise unsuitable for a portfolio, but which the portfolio manager wishes to keep exposure to for performance reasons. This is not considered real engagement, but more like a cover for investment decision-making.

The opposite can also occur: engagement as a response to poor investment decision-making. Very often, a desire to engage arises from a share price fall. Active fund managers may then become concerned about issues that may have been apparent for a time but which may have been ignored as the performance was positive. Experience tends to show that such knee-jerk engagement is less likely to be effective than long-standing consistent messaging (where intensity may increase at moments of difficulty, but do not just begin at those moments). Key identifiers of successful genuine engagement include clarity and consistency about objectives, and ensuring that it is clear when the investor is communicating messages to the company and not just seeking information from it.

The delivery of concrete outcomes is core to the 'why' of engagement. Effective engagement generates change and, if the intended engagement outcomes have been chosen well, that change will preserve and enhance long-term value at the company subject to the engagement itself. Thus, engagement delivers on the promise of fiduciary duty: preserving and enhancing the value of assets that the investor is overseeing on behalf of clients and beneficiaries.

As well as this need for clear objectives, focused on effecting change, the paper also identifies a series of other characteristics of effective engagement. These are a gathering of the 'characteristics of high-quality delivery' set out in **Table 6.1**, and require that it:

- is set in an appropriate context of long-term ownership and has a focus on long-term value preservation and creation, so that the engagement is aligned with the investment thesis;
- is framed by a close understanding of the nature of the company and the drivers of its business model and long-term opportunity to prosper;
- recognises that change is a process and that, while haste may at times be necessary, change should not be inappropriately rushed;
- employs consistent, direct and honest messages and dialogue;
- is appropriately resourced so that it can be delivered professionally in the context of a full understanding of the individual company;
- uses resources efficiently so that engagement coverage is as broad as possible whilst using all the tools available, including collective engagement; and
- involves reflection so that lessons are learned in order to improve future engagement activity.

These characteristics are explored through the case studies and wider discussion below.

Engagement in practice

Some examples of how this form of process can influence companies to adopt improved ESG practices are described in this section.

Examples of engagement in practice

A PRI case study[6] describes Boston Common Asset Management's long-term engagement with VF Corporation (VF Corp) around the water risks in its cotton and leather supply chains. This multi-year engagement – during which Boston Common submitted and then withdrew a shareholder resolution (withdrawing it in response to the company's commitment to address the issue) – saw VF Corp improve relevant reporting, undertake material risk assessment and sign up to good practice standards in the Better Cotton Initiative.

Hermes EOS (Equity Ownership Services)'s engagement with Siam Cement[7] has seen that company improve from a level one company (the lowest score) to level three as rated by the Transition Pathway Initiative (an asset-owner led initiative that assesses companies' preparation for the transition to a low carbon economy). In early 2018, the investment firm met senior management to discuss its 2020 emissions targets. It then held a TCFD (Task Force on Climate-related Financial Disclosures) workshop with senior executives at Siam Cement to share industry best practice and to encourage the company to improve assessment of physical risks of its assets, take part in industry collaboration and establish a group-wide climate governance mechanism. The company has now committed to the Paris Agreement's global temperature limitation goal, extended its scenario planning and improved its governance and business management around climate.

In 2018, the Investor Forum worked with its members to address concerns around Imperial Brands' strategic direction, operational execution and disclosures. The chair engaged:

> *"rapidly and constructively …announcing a disposal programme, enhancing its communications on its approach to Next Generation Products and implementing changes to segmental reporting at the full year results".*[8]

There are also situations where engagement (or at least some form of stewardship) is *required* and when an investor must take a view. These could be corporate actions, such as share issuances in which the investor can choose to participate or not, or proposed takeovers where the investor must decide whether to sell up or, if it is permitted, to hold on to their shares. For most investors, some dialogue with the company will be needed before reaching the relevant conclusion.

Most investors now regard the vote as a client asset like any other, and thus as something to be considered carefully and exercised with due thought. Voting comes around annually, at the AGM, and occasionally in between at special meetings, in most countries called extraordinary general meetings (EGMs). In addition to voting to receive the report and accounts, the issues considered at each AGM depend on local law, but are often fundamental issues about the structure of the board, audit and oversight, executive pay and the capital structure of the company. Not considering such issues with due care can clearly be seen to be a failure of fiduciary duty, and due care will often require active dialogue with the company in order to understand the issues and express any concerns and perspectives.

Another driver for investors to act as good stewards is the growing expectations enshrined in codes, standards and regulations.

3 CODES AND STANDARDS

6.1.3 Explain the main principles and requirements of stewardship codes as they apply to institutional asset management firms: UK Walker Review (2009) and Stewardship Code (2020); US Employee Retirement Income Security Act (ERISA) guidelines; EU European Fund and Asset Management Association (EFAMA) Stewardship Code.

Regulators are convinced that engagement adds value, not just within investment portfolios but for markets as a whole. In his powerful 2008 report on the financial crisis, Sir David Walker stated:

> *"Before the recent crisis phase there appears to have been a widespread acquiescence by institutional investors and the market in the gearing up of the balance sheets of banks ... as a means of boosting returns on equity.*
>
> *The limited institutional efforts at engagement with several UK banks appear to have had little impact in restraining management before the recent crisis phase".*[9]

Regulatory interest in stewardship has grown from the disappointment of that financial crisis. As an adjunct to the institutional investor soul-searching that followed the crisis, the Walker Report ushered in a new era of shareholder engagement. The report formally called for the Financial Reporting Council (FRC) to issue a stewardship code to provide a framework for shareholder engagement, and that this code was to be reinforced by a Financial Services Authority (FSA – now the Financial Conduct Authority (FCA)) requirement that any registered fund manager must make a statement as to whether and how it approached its principles.

Following consultation, in 2010 the FRC issued the world's first stewardship code – largely unchanged from the existing *Statement of Principles on the Responsibilities of Institutional Shareholders and Agents* issued by the Institutional Shareholders Committee (dated 2005, but itself built upon a 1991 document, *The Responsibilities of Institutional Shareholders in the UK*). Industry best practice had not delivered in the run-up to the financial crisis, but a code with regulatory backing was thought likely to have greater force. Industry acceptance of the code was relatively rapid, particularly among fund managers.

The 2010 Stewardship Code had seven principles:

Institutional investors should:

- publicly disclose their policy on how they will discharge their stewardship responsibilities;
- have a robust policy on managing conflicts of interest in relation to stewardship and this policy should be publicly disclosed;
- monitor their investee companies;
- establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value;
- be willing to act collectively with other investors where appropriate;
- have a clear policy on voting and disclosure of voting activity; and
- report periodically on their stewardship and voting activities.

This UK Code went through a further iteration in 2012, clarifying the distinction between the roles of asset owners (pension funds and the like) and their fund managers and other agents, but leaving the principles themselves almost entirely unchanged. While some of the largest pension funds may seek to carry out stewardship activities themselves, most delegate this role, either by a specific contract or as part of their fund management services. Thus, the role of most asset owners is overseeing, challenging and assessing the stewardship activities of their service providers.

The UK Stewardship Code model has been followed around the world, and at the time of writing there are now such codes in 20 markets, either developed by stock exchanges or regulators, or by investor bodies themselves keen to advance best practice. Among these are:

- Global – *ICGN Global Stewardship Principles*.[10]
- Europe – *European Fund and Asset Management Association Stewardship Code 2018.*[11]
- Australia – *Australian Asset Owner Stewardship Code (2018)*.[12]
- Brazil – *AMEC Stewardship Code (2016)*.[13]
- Japan – *Principles for Responsible Institutional Investors.*[14]
- Singapore – *Singapore Stewardship Principles (2016).*[15]
- USA – *Investor Stewardship Group Stewardship Principles.*[16]

It is notable that while there is great consistency between the principles in each of these codes, as they are modelled closely on the seven principles of the 2010 UK Code, conflicts of interest are dealt with very differently. It has been stated that those codes drafted by the fund management industry are more likely to downplay the issue of conflicts, while those codes with greater regulatory backing place greater emphasis on the issue. Perhaps most striking is the European Fund and Asset Management Association (EFAMA) Code, as this is almost a direct copy of the 2012 UK Code except that it does not include a separate principle on conflicts and avoids the issue almost entirely.

Code revisions 2020

The UK Stewardship Code went through a more fundamental redrafting to produce the 2020 version of the code, published in late 2019.[17] The new code, which came into effect from 1 January 2020, includes twelve principles (plus an alternate six for service providers), where formerly there were seven, and a tripling of the number of pages as compared with the 2012 code. But the biggest change is not the growth of the document, but the increased ambition for practical delivery by signatories. The former focus on statements of intent no longer exists. Instead, investors are now expected to report annually on activity, and most importantly, on outcomes from that activity. The first such annual reports were expected to be delivered by the end of March, setting out policy, activity and outcomes during 2020.

Merely reporting on activity is not enough; each of the new principles has associated outcomes that must be reported on, and require concrete examples of what has been delivered practically for clients and beneficiaries. Signatories will no longer fulfil the demands of the Code by publishing policy statements filled with ambitious assertions, instead they must deliver practical effects from their actions.

The twelve new principles fall into four categories but cover two distinct functions:

- principles 1 to 8 address the foundations for stewardship; while
- principles 9 to 12 focus on the practical discharge of engagement responsibilities.

The need to report on concrete outcomes applies even to the foundational principles 1, 2, 3, 5 and 6 of the new code. These cover structural issues within the investment institution such as governance, culture and conflicts of interest management. The outcomes that need to be disclosed in relation to these issues are evidence that those structures concretely work in practice in the clients' best interests.

Principles 7 and 8 require the integration of ESG factors into the investment process and include an effective oversight of service providers. The disclosures of related outcomes need to be explanations of how these processes have delivered effectively on behalf of clients and beneficiaries.

Principles 9 to 12 cover engagement (and voting) activities. The intended outcome of these principles (that must be part of the annual reporting) is to show substantive change at companies (or other investee assets) as a result of the engagement activity. The disclosure of at least some voting outcomes, not just the investor's voting activity, is also expected.

Perhaps the most challenging of the 12 is principle 4, which charges signatories with identifying and responding to market-wide and systemic risks. Some investment institutions already recognise their obligation on behalf of beneficiaries and clients to maintain and promote well-functioning markets and social and environmental systems, but for many this may feel like a significant additional burden. To be required to “disclose an assessment of their effectiveness in identifying and responding to” such risks imposes a new and significant burden even for those who already recognise this as being a stewardship responsibility. Only the Australian Asset Owner Stewardship Code, developed by the industry body Australian Council of Superannuation Investors (ACSI), had a similar expectation in place, in its principle 5:

> *“Asset owners should encourage better alignment of the operation of the financial system and regulatory policy with the interests of long-term investors”.*

While this new UK Code may prove as much of a model for global stewardship codes as its predecessors, the latest country to propose changes is Japan, which has not followed the UK’s example closely. There is a move to require reporting on the outcomes of engagement activity, but this is downplayed and given little prominence so may only have a limited impact (the contrast to how central this is to the new UK Code is significant). Beyond this, the latest changes made to the Japanese Code were:

- to extend coverage to all asset classes, not only equity;
- to incorporate sustainability and ESG;
- to add encouragement for asset owners to become involved in stewardship, and provide a little more clarity on their role in the stewardship hierarchy; and
- to clarify the position of service providers in the hierarchy, and add higher expectations of proxy advisers.

Code provisions

Other than the new UK Stewardship Code, the principles of all the codes around the world are remarkably similar. Typically there are six or seven principles, with the first often requiring investors to have a public policy regarding stewardship, and the last noting the need for honest and open reporting of stewardship activities. The main body of the principles between these two usually call for:

1. regular monitoring of investee companies;
2. active engagement where relevant (sometimes termed “escalation”, or sometimes escalation is deemed worthy of a separate principle of its own); and
3. thoughtfully intelligent voting.

The two principles that are sometimes but not always present (though they appear in the UK Code in both its former and current iterations) require:

I. investors to manage their conflicts of interest regarding stewardship matters; and

II. the escalation of stewardship activity to include a willingness to act collectively with other institutional investors.

The collective engagement issue is controversial as there are concerns about the creation of concert parties (groups of shareholders so influential that they in effect take control of companies without mounting a formal takeover). This is not the intention of collective engagement, as is shown by the related discussion below.

Stewardship codes are usually now expressed to apply to all asset classes but their language tends to reveal an initial focus in practice on public equity investment. The stewardship thought process, both by regulators and by investors, and the practical delivery of stewardship actions by those investors, is most developed in public equities. There is a discussion about the application of stewardship to other asset classes later in this chapter; it is more straightforward than some practitioners sometimes indicate.

In 2016, the FRC went through a process of assessing the quality of the UK Code signatories (against the then extant Code, the 2012 version). This was not based on the substance of the stewardship activity delivered, but simply on the basis of the stewardship statements published by each signatory in response to principle 1. The regulator gave signatories an indication of which tier (1, 2 or 3) the quality of these disclosures placed them in, which led to a rapid improvement in the quality of disclosures.

The final results of this process showed that out of the 300 signatories in total, 120 were deemed to be tier 1 and best practice ("Signatories provide a good quality and transparent description of their approach to stewardship and explanations of an alternative approach where necessary"), compared to the 40 deemed by the FRC to be in that category in their initial assessment of Code disclosures at the start of the process. It is not yet clear whether or how the FRC will conduct a tiering process in relation to the new Code. If it does do so, the tougher expectations (and particularly the focus on outcomes) in the new 2020 Code seem likely to lead to a greater differentiation being drawn between signatories.

The number of stewardship codes in Europe is likely to increase significantly following the Shareholder Rights Directive II coming into force from June 2019. Among other things, SRD II, as it is known, will raise expectations in each country about the level of stewardship carried out by local investors. This is likely to supersede initiatives such as the voluntary EFAMA Code (updated in 2018 from the original 2011 version) and may move European markets towards expanding expectations that have regulatory backing. While by name it is about shareholder rights, in reality the directive is more about shareholder responsibilities.

Expectations with regard to stewardship are set by legislation as well as codes. Foremost among these is the US ERISA legislation, the **Employee Retirement Income Security Act of 1974**. Among the Act's requirements are a number that are relevant to stewardship, in particular that advisers should act as fiduciaries in relation to the beneficiaries (under the US regime, fund management firms are deemed to be advisers and so subject to this standard). Among the obligations expected under fiduciary duty (as narrowly defined in the Act (it is worth noting that elsewhere in this chapter 'fiduciary duty' refers to the general common law understanding of that duty and not this US-legislated definition)) is that the fund will vote at investee company general meetings and engage with companies.

In the past, the legal interpretation of the Act was thought to discourage ESG stewardship because of a bulletin statement indicating that engagement and proxy use on environmental and social issues would be rare. But fresh interpretative statements from 2018 are more supportive of stewardship. The regulator's views, set out in *Field Assistance Bulletin, No 2018-01*, confirm that fiduciaries can vote and use proxies if there is a reasonable expectation that such activities are likely to enhance the economic value of the investment after taking costs into account.[18] It added that engagement might be prudent for indexed portfolios where ESG issues represented significant operational risks and costs. There continues to be a clear view that engagement, and indeed ESG investing, needs a firm basis in value for beneficiaries – so engaging would not be permissible to achieve purely social policy goals without making a clear link to value.

4 ENGAGEMENT STYLES

6.1.4 Explain how engagement is achieved in practice, including key differences in objectives, style and tone.

Some asset owners will choose to engage with companies directly, through team members who act as stewards of the investment portfolios. Others expect their external fund managers to deliver this work, either through the portfolio managers who also take stewardship responsibility, or through stewardship specialists (or some combination of the two). Engagement activities can also be entirely outsourced to specialist stewardship service providers.

Almost all institutional investors lean at least in part on one group of these service providers, the proxy voting advisory firms. These proxy advisers offer analysis and (in most cases) voting recommendations across many public companies, and almost all institutions hire them to provide the pipework that ensures their voting decisions are delivered. Most also pay for their advice on those voting decisions.

Other stewardship service providers offer various degrees of engagement services, by effectively stepping into the shoes of the investor to engage on their behalf. By aggregating the interests of clients, the scale that is necessary to be present and visible enough in dialogue and engagement with company management and boards can be built. Boards can offer a form of collective engagement, enabling investors to have a greater reach and influence by working alongside others and sharing precious resources. Collaborative engagement can also take place through industry initiatives and collaboration platforms, such as one offered by the PRI or through the Investor Forum in the UK.

Styles: top-down and bottom-up

To an extent, engagement styles vary depending on the heritage of stewardship teams. There is a distinction in mindset and approach between those teams with a history of governance-led engagement and those that have worked more on the environmental and social side.

The most obvious distinction is as material E and S issues arise from the nature of a company's business activities, teams with this heritage tend to be organised by sector, whereas as G is determined more by national law and codes, such teams are usually split according to geography. Engagement style also follows this structure to some extent. Teams tend to focus on individual environmental and social issues and to pursue those vigorously across sectors or markets as a whole. This can encompass trying to establish better practice standards and highlighting leading practice as well as targeting those perceived as laggards. The dialogue would tend to start with investor relations or sustainability teams and then be escalated upwards, both to senior management and to the board level. Firms with a governance heritage tend to focus on individual companies, starting with the chair (often with the assistance of the company secretary), and working through the board and down to management from there.

These are generalisations, but they illustrate the distinction between top-down and bottom-up activity. Most investment houses mix the two, though company-focused, bottom-up engagement fits most naturally with active investment approaches, particularly those with concentrated portfolios, whereas issues-based, top-down engagement tends to align more closely with passive or otherwise broadly diversified investment portfolios.

Styles: issue-based and company-focused

Passive investors, and others with broadly diversified portfolios, typically start with an issue, whether identified by the team from news or broader analysis, or through a screening or other research provider, and seek to engage with all the companies impacted by that issue (which may be a sector as a whole, or broader than this). Usually the starting point is a letter written to all those impacted, which is then followed up by dialogue. Active investors, particularly those with focused portfolios, start with the company itself and its business issues and develop a tailored engagement approach cutting across a range of issues, often with the investment teams taking a leading role. Companies selected for this approach are often identified from investment underperformers or ones that trigger other financial or ESG metrics. The starting point is typically to seek a direct discussion with senior management and then the board.

Larry Fink's annual letter to CEOs setting out BlackRock's engagement plans is an example of the issue-based approach taken by passive investors. In the 2019 letter, Fink wrote that their priorities for 2019 were:

> *"Governance, including your company's approach to board diversity; corporate strategy and capital allocation; compensation that promotes long-termism; environmental risks and opportunities; and human capital management. These priorities reflect our commitment to engaging around issues that influence a company's prospects not over the next quarter, but over the long horizons that our clients are planning for."*[19]

Issue-based approaches to engagement are often accompanied by examples of what best practice in a particular area looks like. These may be developed in advance of the first engagement dialogues but usually come out of the engagement process with those companies that are deemed to have leading practices. By expecting all companies in a given sector to adopt these best practices, investors may over time move sector or industry practice forwards overall. Company-focused engagement seeks to improve practice across a number of relevant ESG issues at an individual company; the aim is to enhance performance of the portfolio overall, both in terms of ESG and investment performance.

5 PRACTICALITIES OF EFFECTIVE ENGAGEMENT

6.1.5 Apply appropriate methods to establish an engagement approach: strategy and tactics: goal-setting; identifying who to talk with; formalities: hosting/agenda/managing expectations; communication: approach/tone/managing tensions; working towards agreement; escalation techniques, including collective engagement; ESG investment forums; proxy voting.

Forms of engagement

An Investor Forum white paper published in November 2019, *Collective Engagement: An essential stewardship capability*, identifies twelve different forms of engagement.[20] Five of these are types of individual engagement (engagement by a single investment institution):

1. generic letter: these are broad communications across a swathe of investment holdings;
2. tailored letter: these are more targeted and can cover a range of topics at varied levels of detail;
3. 'housekeeping' engagement: this is annual dialogue to help maintain and enhance a relationship with a company, but with only limited objectives;
4. active private engagement: targeted and specific engagement; and
5. active public engagement: engagement deliberately made public by the institution.

The others are forms of collaborative engagement (where an institution works with one or more others):

1. informal discussions: institutions discuss views of particular corporate situations;
2. collaborative campaigns: collaborative letter-writing or market/sector-wide campaigns;
3. follow-on dialogue: company engagement dialogue led by one or some investors in follow-up to a broader group letter or expression of views;
4. soliciting support: solicitation of broader support for formal publicly stated targets (e.g. 'vote no' campaigns, or support for a shareholder resolution);
5. group meeting(s): one-off group meeting (or a series of meetings) with a company, followed up either with individual investor reflections on the discussion or with a co-signed letter;
6. collective engagement: a formal coalition of investors with a clear objective, typically working over time and with a coordinating body; and
7. concert party: formal agreement, in any form, with concrete objectives and agreed steps (e.g. collectively proposing a shareholder resolution or agreeing how to vote on a particular matter).

The paper argues that as you go through the lists, there is a greater need for formality in approach and potentially greater regulatory attention. That greater formality requires increased clarity of the engagement objective(s), and can perhaps provide greater scope for influencing the change that is sought.

Gaining greater clarity of the engagement objective is particularly important as it forms one of the key success factors for effective engagement that the Investor Forum paper identifies (based on its own practical experience and a study of the academic literature).[20] In full, these six success factors are:

1. **Characteristics of engagement approach:**

   SF1 – Objective(s) should be specific and targeted to enable clarity around delivery.

   SF2 – Objectives should be strategic or governance-led, or linked to material strategic and/or governance issues.

   SF3 – The engagement approach should be bespoke (tailored) to the target company.

2. **Characteristics of investor collaboration:**

   SF4 – The participants should have clear leadership with appropriate relationships, skills and knowledge.

   SF5 – The scale of coalition gathered (both scale of shareholding and overall AUM of group) should be meaningful.

   SF6 – The coalition should have a prior relationship and/or cultural awareness of the target company.

   The paper continues by adding these success factors to a matrix alongside the twelve forms of engagement (listed above), indicating how likely each engagement is to fulfil the six stated success factors (the darker colour shows a greater likelihood). The following table shows the conclusions that are reached (which it notes include a number of assumptions and generalisations yet is informative).

Table 6.2: **SUCCESS FACTORS AND STYLES OF INSTITUTIONAL INVESTOR ENGAGEMENT**

	CHARACTERISTICS OF ENGAGEMENT FOCUS			CHARACTERISTICS OF INVESTOR GROUPING AND APPROACH		
Success factor	**SF1: Clear objective**	**SF2: Material and strategic**	**SF3: Bespoke**	**SF4: Effective leadership**	**SF5: Scale of coalition**	**SF6: Depth of relationship**
Potential impact on effectiveness (low to high)	Express concern Specify change	Narrow ESG focus Include strategy and finance	Generic approach Close cultural awareness	Informal grouping Formal coalition	Limited ownership Broad and material share ownership	Limited relationship Top-level access
Individual institutional engagement						
Generic letter-writing				n/a	n/a	
Tailored letter-writing				n/a	n/a	
Housekeeping engagement				n/a	n/a	
Active private engagement				n/a	n/a	
Active public engagement				n/a	n/a	
Collaborative engagement						
Informal discussions						
Collaborative campaigns						
Follow-on dialogue						
Soliciting support						
Group meeting(s)						
Collective engagement						
Concert party						

Source: The Investor Forum.[20]

Strategy and tactics: goal-setting

There are several challenges in engagement, the most significant being the question of resources. Does the investment firm have the time, the expertise and sufficient leverage with its investees to engage successfully?

Given the scale of most fund management firms, the number of companies in which they invest client money is large, meaning that just the monitoring element of stewardship is a significant obligation on its own. Even where individual portfolios are concentrated, the aggregate is a rather broader exposure, with many moderate-sized investment firms owning a few thousand companies and the largest fund management houses holding tens of thousands. Having enough resources to engage effectively across all the companies in a firm-wide portfolio is a significant challenge. In practice, every investor is resource-constrained.

Given these resource constraints, engagement strategies must be designed to deliver meaningful results in the most cost- and time-effective manner. In practice, this translates into a few operational challenges that need to be addressed in the following order:

1. Investors need to define the scope of the engagement and prioritise their engagement activities carefully in order to ensure it is value-adding for their clients/beneficiaries and impactful in terms of delivering improved corporate practices.
2. Investors need to frame the engagement topic (be it climate risk or supply chain risk) into the broader discussion around strategy and long-term financial performance with the management team and the board.
3. Investors must develop a clear process that articulates realistic goals and milestones so that both investment institutions and their clients have a clear indicator to measure their expectations and the effectiveness of the engagement strategy.
4. The engagement process needs to be adapted to the local context, language and cultural approaches to doing business. Beyond dialogue, investors also need to have clear escalation measures in case engagement fails.

In many ways, this represents two different forms of necessary prioritisation:

1. identifying which company in a portfolio is most in need of engagement; and
2. determining which engagement issues should be prioritised in the dialogue between the investor and company (if change is to be delivered effectively, it is impossible for an investor to raise every possible concern with the company – not least as they risk creating confusion as to what issues the investor believes are most in need of attention).

The approach to engagement must always sit within the framework of the fund manager's investment approach, and an active manager may well find it easier to prioritise both the company and the issue as those where most value is at risk within portfolios. The existence of risk suggests that if the manager is an active manager, selling a holding in a company (or other investment asset) will always be a possible appropriate action for a responsible fiduciary to take.

For passive investors, the same value at risk dynamic should be the driver, but may come less naturally to the decision-making teams, as they are less used to identifying where in the portfolio most value is at risk. This will usually tend to mean a focus on the largest companies and on the most material issues, though there may be issues that particular clients put particular emphasis on. These are then deemed to deserve greater attention and so move up the prioritisation list.

Many fund managers are building their stewardship resources by adding to their specialist stewardship teams. Passive fund managers (who invest in the broadest range of companies) perhaps have no option but to do so, while many active investment houses are working to ensure that their active portfolio managers can deliver stewardship alongside their regular monitoring of investee companies. Even where portfolio managers take the lead they will typically need the support and partnership of a specialist stewardship team.

Potentially, another key additional resource is external collective vehicles – commercial stewardship operations or investor groups. Many of these have staff with a different and complementary range of skills that fund managers can use. For example, engagement on a particular theme – such as palm oil or water – is likely to require particular knowledge and experience that may be difficult to resource internally. Collaboration with an investor with particular skill in an area, or with a collective vehicle which can bring alternative skills to bear, can enable an investor to make progress that might not be possible alone. In addition, working collectively can help those investors whose individual holdings might be relatively small to gain traction in their discussion with management and boards.

The behavioural challenges in working as part of investor coalitions are significant. These include:

- the challenge of reaching consensus;
- conflicts of interest; and
- competition.

Investors will often agree that there is a problem at a company, or at least that they share concerns about a company. But discussions about collective action often fail because the investors are unable to reach any consensus about what might need to change at the company to address the problem. Having said that, agreement is not always possible between investors even on the nature of the problem. Companies sometimes rightly feel that they receive such a range of views from investors that responding to them all is impossible (though some investors often feel this is an excuse rather than a reason for inaction).

The PRI's 2018 report on how engagement adds value for investors and companies found that individual engagement can be more strategically valuable (and might allow an investor to resolve an ambiguous or anomalous position that they might prefer to deal with alone), but that individual approaches can be time-consuming and costly.[1] They suggest that "engagement practices should be adapted to balance the trade-offs of individual and collective forms of engagement".

In the same report, the PRI identified common enablers and barriers to successful engagement from both corporate and investor perspectives.

Table 6.3: CONTRASTING PERCEPTIONS OF THE ENABLERS AND BARRIERS TO ENGAGEMENT SUCCESS

	CORPORATE PERSPECTIVES		INVESTOR PERSPECTIVES	
	ENABLERS	BARRIERS	ENABLERS	BARRIERS
RELATIONAL FACTORS	• Existence of an actual two-way dialogue. • Being honest and transparent in the dialogue, and having an 'open and objective discussion'.	• Language barriers and communication issues. • Lack of continuity in interactions.	• Good level of commitment on both sides to meet objectives. • Reciprocal understanding of the engagement process and issues on both sides. • Good communication and listening capacities on both sides.	• Language barriers and cultural differences can hamper dialogue.
CORPORATE FACTORS	• Responsiveness and willingness to act upon investor requests. • Selecting appropriate internal experts. • Knowing your investors, access to prior discussions to tailor conversations. • Systematic tracking of interactions with investors.	• Company bureaucracy preventing changes in internal practices and/ or external reporting on (new) practices. • Lack of resources, insufficient knowledge to meet investor demands. • Lack of actual ESG policies, practices and/ or results that can be reported externally.	• Corporate reactivity to requests. • Board-level access in targeted companies. • Access to appropriate corporate experts. • Long-standing relationships with key corporate actors. • Corporate proactivity to inform investors when engagement objectives/ targets have been met.	• Refusal by top executives to be engaged on ESG issues. • Functional/sustainability manager struggles to advance ESG related issues. • Too small a shareholding to attract sufficient attention. • Corporate inability to meet (on-going) objectives and targets.

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	CORPORATE PERSPECTIVES		INVESTOR PERSPECTIVES	
	ENABLERS	BARRIERS	ENABLERS	BARRIERS
INVESTOR FACTORS	• Listening capacities of investors. • Communicating in different languages. • Providing questions in advance. • Prior knowledge of corporate ESG practice and performance. • Genuine interest in (improving) the management of ESG issues at the company. • Patience and understanding regarding corporate ability to address ESG challenges.	• Lack of investor preparation, overly generic questions/ requests. • Lack of knowledge about the company (e.g. ESG policy, track record). • Lack of sufficient investor tracking process to determine whether engagement requests have been met. • Changing engagement objectives and targets.	• Client or beneficiary requests for the consideration of ESG issues. • Top-management support for ESG-related investment activities. • Well-resourced and experienced ESG team. • Clear engagement objectives and targets. • In-house tracking tools to monitor and evaluate engagement progress. • Pooling of resources through collective engagement.	• Lack of buy-in from clients and/or top management for ESG-related investment activities. • Small, under-resourced ESG team. • Lack of clear engagement policies, objectives and monitoring systems. • Under-developed relationships with key corporate actors. • Difficulty demonstrating materiality of engagement. • For (interested) asset owners: Insufficient mechanisms to guarantee asset managers conduct successful engagements.

Source: PRI (2018).[1]

Conflicts of interest can also be a behavioural barrier to engagement. The fact that many stewardship codes call for transparency around conflicts that might impinge on stewardship activities, explicitly acknowledges this issue. The PRI notes that:

> *"Conflicts can arise when investment managers have business relations with the same companies they engage with or whose AGMs they have to cast their votes at. A company that is selected for engagement or voting might also be related to a parent company or subsidiary of the investor. Conflicts can occur when the interests of clients or beneficiaries also diverge from each other. Finally, employees might be linked personally or professionally to a company whose securities are submitted to vote or included in the investor's engagement programme. The disclosure of actual, potential or perceived conflicts is best practice."*[21]

A final barrier is the emergence of competition. As, historically, few people worked in this once considerably under-resourced area, stewardship professionals had been content to work together, both informally and in more formal collaborations, recognising that working together on thematic and specific issues might be the best way to deliver change on behalf of clients.

As stewardship is becoming more important to clients and an increased focus for investment consultants and fund managers, there are signs that this collaborative approach may be waning. There are exceptions however, such as the Climate Action 100+ (CA 100+) collaborative engagement to which most major institutional investors now adhere. Even there, however, various institutions are seeking to differentiate themselves by adopting different approaches (individual CA 100+ engagements are very distinct), and although each company engagement is seemingly led by a single investor, in a number of cases other institutions are taking forward their own initiatives under the CA 100+ banner.

As engagement practices evolve, a degree of competition between service providers in terms of the quality of their resources and reporting is helpful as that enables innovative and effective services to be developed at a greater scale, lowering costs for individual fund managers. It is important that the benefits of collective activity are not forgotten and that the investor sector should continue to explore synergies in engagement priorities and amplify their collective impact.

Setting engagement objectives

The first key step in engagement is to set clear objectives. Given that engagement is dialogue with a clear purpose – not just dialogue for the sake of dialogue – knowing what the purpose is matters. This is why the stewardship service providers all apply some milestone measure or set of key performance indicators (KPIs) to their engagements so that their clients can hold them to account for delivery. This also explains why the PRI sets itself a key KPI that its members should set objectives for the majority of their engagements. The PRI's 2020 annual report confirms that 71% of members implement this, though this is short of its 80% target.

Outcomes matter more than activity and given the impossibility of attributing share price movements to any individual engagement success (indeed, even attributing changes in corporate practices to any individual engagement success can be a challenge), having some mechanism to test whether the objectives have been achieved is the best way for clients to have confidence about the success of engagement. Some investors also have objectives that provide a practical roadmap of concrete measures that the engagee company can adopt to move towards the broader objective of the engagement dialogue.

Having clear objectives helps set a clear agenda. Though successful engagement is always a conversation and so may cover much ground, the engager needs to always know those handful of issues (at most) that really need to be probed hard and brought into real focus in the discussion. In many cases, the investor will share at least a version of this agenda with the company so that there are few surprises and a framework of honesty and openness is set from the start.

Clarity around objectives will also help to identify the right company representative to work with. For ESG operational matters, this will typically be the sustainability and/or Investor Relations teams, with escalation to the senior management and then to the board. For business strategy or operational matters, the starting point will typically be the CEO or CFO, with escalation if need be to the non-executive directors. For governance matters, the usual starting point will be the chair, often with the company secretary (or equivalent role) as a part of the conversation, with the ability to seek further discussions with the senior independent director or lead independent director – or with other non-executives.

Practicalities of engagement

If the matter is purely a voting issue, the first contact is normally with the company secretary (at least in those markets where such a role has prominence – in the USA and some of continental Europe the contact is more likely to start with the investor relations team), and then further dialogue may be with the chair of the relevant board committee (remuneration or audit) and/or the chair of the board. There are no fixed rules and these models are often not what happens in practice. Investors need to respond accordingly to what is appropriate at the individual company. Occasionally, it can take longer to persuade a company that the dialogue an investor is seeking is worthy of the relevant corporate representative's, particularly non-executive director's, time.

Meetings can be held at the corporate head office or at the investment firm. Typically the choice between the two is only a matter of mutual convenience, though visiting the company's office can help to demonstrate the investor's interest. On rare occasions, engagement may happen on an operational or supplier site visit. An investor fully educating themselves through dedicated time on operational site visits, or through visits to one or more supplier(s), can provide further standing to their engagement dialogue and serve to reinforce the points that they are seeking to make.

The engager typically has an hour with a single individual to explore a set of issues, perhaps only one of which will be the main focus for the meeting. Listening is as important – often more important – than speaking. Good engagement seeks understanding and constructive dialogue as the engager explains how a proposed course of action is in the company's best interests, not purely those of the single investor. It is helpful to demonstrate knowledge of the company and the sector to build relations as it shows an earnest approach and helps the investor be most convincing in engagement actions (hence the additional status in engagement gained from site visits).

There is also a need to identify possible reasons why the company may not want to adopt a measure that is commonly understood as beneficial. Frequently, a company's culture, history or individuals might stand in the way of change – one reason why successful engagement is often a multi-stage, multi-year activity. Investors can find that their role has been to add weight to one side of a discussion that is already ongoing at the company, helping those who are already seeking change to win that debate in the boardroom.

In order to be constructive, the dialogue should initially take place privately without media attention, not least because media interest often entrenches positions rather than allowing the fluidity that may be necessary for change to occur.

Nevertheless, over time it may become clear that greater force is required for the investor's message to be heard properly in a dialogue. This is where escalation tools may be needed.

Escalation of engagement

Whilst escalation is dealt with in the new Stewardship Code under Principle 11, the former UK Code set out a helpful list of escalation measures that can be considered to advance engagements. While the first three might be seen by many engagement professionals as part of a standard set of tools in normal dialogue with companies, the subsequent four will certainly be recognised as forms of escalation:

- holding additional meetings with management specifically to discuss concerns;
- expressing concerns through the company's advisers;
- meeting with the chair or other board members;
- intervening jointly with other institutions on particular issues;
- making a public statement in advance of general meetings;
- submitting resolutions and speaking at general meetings; and
- requesting a general meeting, in some cases proposing to change board membership.

Additional methods used by some as part of their escalation models might include:

- writing a formal letter setting out concerns, usually following one of the above meetings, and typically to the chair; such letters are usually private, but may occasionally be leaked publicly if frustrations worsen (sometimes those leaks come from within the company, if there are internal individuals who are frustrated by a lack of progress);
- seeking dialogue with other stakeholders, including regulators, banks, creditors, customers, suppliers, the workforce and non-governmental organisations (NGOs) (stakeholder dialogue is most typically a tool in European markets and is specifically referenced as important in the Shareholder Rights Directive II, but is increasingly being used elsewhere as well);
- formally requesting a special audit of the company (a right for shareholders in certain countries, most notably Germany, to consider particular areas of concern);
- taking concerns public in the media or in some other form, not only as the code said in relation to AGMs or other general meetings;
- seeking governance improvements and/or damages through litigation, other legal remedies or arbitration; and
- formally adding the company to an exclusion list, or otherwise exiting or threatening to exit from the investment.

The idea of escalation is that it is a ladder of additional steps to raise the stakes in an engagement. Many engagement objectives can be managed without any escalation, and indeed investors may choose to move slower in an engagement rather than escalate so as to maintain positive relations with a company they may wish to remain invested in for many years. But where escalation is seen as necessary, the investor must consider what additional steps might be needed to generate the change that is sought, and this consideration may go through a number of stages so that the escalation goes step by step up the ladder, or occasionally by jumping up several steps at once if change is felt to be particularly urgent. There is no particular ordering of the steps, though some steps are clearly more significant than others.

Given resource constraints, an investor must always be prepared to take the view that little further progress can be made at any given time and so an engagement should be paused. The investor will also need to consider whether the steps are warranted by the objective; on occasions the right thing may be to withdraw and step away from the objective for some time. Typically, this is done by a formal letter setting out the investor's concerns, which can be referred to in future years when the board may be different or in different circumstances and so may be more responsive to engagement.

Many escalation tools need to be used wisely and not over-exploited: for example, litigation must be used rarely not least given the expense and the staff time taken up with any legal case; the step of making concerns public through the media or social media needs to be applied with care because the investor who rarely raises issues in public will be listened to more on the occasions when it does than an investor who is always expressing views publicly. But often, moving an engagement from the private sphere into the public is seen as one of the most important ways to bolster influence.

One form of public engagement is putting forward a shareholder resolution – a shareholder right in most jurisdictions, though the local law often restricts the nature of the resolution that can be proposed, as well as the size and period of shareholding that the proponents of the resolution must represent in order to hold the right. In many jurisdictions, the proposal of a resolution must be made public by the company; but in the USA, where they are most common, they do not typically enter the public domain until the papers for the relevant AGM are published. Typically, this will be after the company has tried to exclude the resolution from the AGM agenda and sought a ruling from the Securities and Exchange Commission (SEC) as to whether this exclusion is permitted. Proposing a shareholder resolution in the USA can therefore be the trigger for private engagement, which may reach enough of a satisfactory conclusion for the investor to withdraw the resolution, and thus never coming to public attention.

Collective engagement is sometimes seen as an alternative model of engagement, but we will treat it in this chapter as another form – often the most powerful form – of escalation. This is looked at in further detail below.

Perhaps counterintuitively, one form of escalation that is considered by many institutions is disinvestment. This can only really escalate influence where it is done through a formal process so that the company is aware that it is approaching the point where the investor may feel obliged to sell its shares. An example of a public and influential divestment process is that followed by the Norwegian Government Pension Fund Global. There, an independent ethics council considers whether companies should be excluded from the fund because of business activities (such as the production of indiscriminate weaponry or thermal coal) or because of breaches of behavioural norms (the UN Global Compact standards).

For example, in recent years the ethics council has recommended divestments based on a criterion adopted in 2016 – behaviour that leads to unacceptable carbon emission levels, including an assessment of companies' willingness and ability to change such behaviour in the future. The manager running the fund (Norges Bank Investment Management, usually referred to as NBIM) considers these recommendations, and can exclude companies on these grounds. It has, for example, excluded four companies involved in oil sands production as a result.

NBIM makes the full list of its exclusions public and publicises its decisions to exclude individual companies (and on occasions remove the exclusion).[22] This publicity forms part of an escalation process with the companies in question and also as a potential influence on other companies. The NBIM exclusion list is observed by a number of other investors with some of its exclusions being adopted by others.

Collective engagement

The other way in which investors can share resources is through collective engagement. This may be done informally, through quiet and non-specific dialogue between individual fund managers' stewardship teams – while taking care to avoid reaching agreements or even sharing concrete plans, because of the constraints of acting in concert and other regulations. In addition to these informal dialogues, there are also active collective engagement vehicles of various sorts.

Collective engagement is often the most resource-efficient method for engagement – every investor is inevitably resource-constrained and pooling those limited resources should enable greater efficiency. Such efficiency has a benefit for the corporate recipient too because it reduces the weight of messages received, which in some cases can feel like a broad spectrum of conflicting opinions of which it is difficult to make much sense. The pooling of resources by investors can aid their own education about an issue, and also add weight and emphasis to their concerns, which may mean they are more likely to be heard.

The challenges around collective engagement are perhaps the obvious ones of coordinating a potentially disparate group of separate investors, and trying to maintain a consistent perspective, or at least enough consistency of perspective, that the company receives a clear message from its investors in the key areas. A number of investors are also concerned by the rules in particular markets around anti-competitive behaviour or activities that abuse or exploit the market (such as those dealing with acting in concert – where a number of separate investors work together to use their holdings as a single bloc). Some market regulators have made clear that there is a safe harbour for institutional engagement, but such safe harbours do not exist everywhere and none have been tested robustly. Thus, unless they are careful, such investors may be seen to be acting in concert and so may potentially face serious regulatory consequences – the most significant of which being a possible need to launch a takeover bid for the company. Hence the care with which collective engagement is approached is essential.

A number of asset owner organisations globally support their members in their stewardship work. These are bodies such as:

- the Asian Corporate Governance Association (ACGA);
- Associação de Investidores no Mercado de Capitais (AMEC) in Brazil;
- Assogestioni in Italy;
- the Australian Council of Superannuation Investors (ACSI);
- the Council of Institutional Investors (CII) in the USA;
- Eumedion in the Netherlands; and
- the Pensions and Lifetime Savings Association ((PLSA), formerly the National Association of Pension Funds (NAPF)) in the UK.

Most have a much broader remit, with stewardship being just one element of their offering.

In addition, investor coalitions covering ESG have been created recently – with environmental issues in particular rallying investors together. Among these is Climate Action 100+ (CA 100+). Climate change groups such as the Asia Investor Group on Climate Change (AIGCC), Australia's Investor Group on Climate Change (IGCC), Europe's Institutional Investor Group on Climate Change (IIGCC) and Ceres (which coordinates the USA's investor efforts in this regard), each of which has a regional remit but all of which now seek to coordinate their actions, have largely focused on lobbying and playing an effective role in the political debates on climate, but are increasingly developing company engagement, not least by performing a coordinating role on CA 100+.

CA 100+ targets the most polluting companies, appointing one institution as lead engager and a number of small groups of institutions to work alongside it. In theory, there is a common approach and agenda but the coordination is flexible and the lead engager is invited to respond to the specific circumstances of each company so there can be a good deal of inconsistency between the engagements. CA 100+ has had some notable successes, not least in relation to strategic changes by the European oil majors, such as Spain's Repsol, France's Total, Italy's ENI, UK's BP and Royal Dutch Shell of the UK/Netherlands, each of which has in recent years dramatically shifted its planned scope of future investments.

The PRI also has its own collective engagement service – the Collaboration Platform. Its main focus is on company engagements, occasionally targeting just a single company, but more frequently identifying an issue that a number of companies face and proposing a collective approach to engaging with the relevant companies. Usually a single investor raises something on the platform and invites other PRI members to participate in the proposed engagement; typically, the engagement is then led by a small working group of investors. According to the PRI's statistics, there have been more than 2,500 groups and more that 600 engagements run through the Collaboration Platform, targeting 24,667 companies with the involvement of over 2,000 signatories.

Case study

Slave labour and rainforest charcoal in the Brazilian pig iron supply chain

An early example of the PRI's Collaboration Platform in action was its collective engagement regarding the use of slave labour and rainforest wood charcoal in the Brazilian pig iron supply chain – an important source of raw materials for many iron and steel producers and consumers, particularly in North America. This collaboration formed in 2006/7 following a *Bloomberg Markets* cover story, 'The secret world of modern slavery'.[23]

The collaboration identified several companies whose supply chains were impacted by this issue, among them was US steel producer Nucor. US ethical investment house, Domini Social Investments performed the leadership role in the investor coalition in relation to Nucor, and wrote to the company in April 2007 in a letter co-signed by ten investors from around the world. Nucor's response was inadequate in the view of the investors, and Domini and another group of (this time predominantly US) investors co-filed shareholder resolutions at the company on the issue, at the end of 2008, 2009 and 2010.

The company continued to make a weak response, leading to the 2009 shareholder resolution winning support from some 27% of shareholders voting on the issue. This set the scene for more constructive discussions in relation to the 2010 shareholder resolution. In the end, Nucor and Domini announced an agreement that led Domini to withdraw the shareholder resolution for that year. Nucor had agreed to work with two key NGO initiatives in Brazil – the National Pact for the Eradication of Slave Labor and the Citizens Charcoal Institute (ICC). Specifically, it would require all its top-tier Brazilian pig iron suppliers either to join the ICC or to endorse and commit to the National Pact. Nucor also agreed to provide funding to ICC to give it the resources needed to be truly effective, and to report annually on its delivery around commitments to appropriate behaviour in its supply chain.

Domini later published this story in *Fighting Slavery in Brazil: Strengthening Local Solutions*.[24]

Formal collective stewardship vehicles take different forms. There are the commercial approaches, predominantly offered by fund managers that offer stewardship overlay services, taking forward engagement work on behalf of clients whether they invest money on their behalf or not. Some of the main players in the overlay market are:

- BMO Global Asset Management;
- Federated Hermes EOS;
- Robeco; and
- Sustainalytics (who bought the former GES International in 2019, and is part of Morningstar).

These operations cover both voting advice and direct engagement activities. There are also non-commercial operations, offering collaborative vehicles to members. Prominent among these is the UK's Investor Forum, created in 2014 as a response to the Kay Review call for such a vehicle.[25] The forum is being watched closely in other markets as a potential model to follow.

The Investor Forum has a detailed collective engagement framework (available in full only to its members), through which its engagements avoid falling foul of the rules around acting in concert and market abuse. Many investors see such market abuse rules as limiting their ability to carry out collective engagement effectively.

The Investor Forum publishes ten key features of this private collective engagement framework:

1. **Trusted facilitator, not an adviser**: Members retain full voting and other investment rights in respect of their shareholdings. No control is ceded to the forum or other members.
2. **Opt in/opt out**: A member actively chooses to participate in an engagement involving a company in which it is a shareholder. It can also choose to opt out of an engagement at any time.
3. **Complementary to members' direct engagement**: Members are actively encouraged to continue their direct interaction with companies outside the forum's auspices.
4. **Confidentiality**: Members must agree to comply with confidentiality obligations during an engagement. Disclosure of identities and public statements must be agreed by participants during an engagement.
5. **Nominated key engagement contact**: Members retain full control as to whether or not they receive information, and who receives that information.
6. **Hub and spoke model**: A bilateral model is the usual method of communication between the executive and members involved in engagements.
7. **No inside information**: The forum is not intended to be a means of facilitating the exchange of inside information between companies and members or among members themselves. Participation in an engagement will not exempt any person from any law or regulation governing the use and dissemination of inside information.
8. **No-concert party and no-group**: Members agree that while participating in a forum engagement they will not form a concert party in respect of the relevant company, including by requisitioning a board control-seeking resolution or seeking to obtain control of the company.
9. **Heightened procedures**: At various points in an engagement, heightened procedures may be deemed necessary, including seeking specialist advice. Particular attention will be paid to the case of engagements involving companies with dual US or other foreign listings and companies or members that are subject to the Bank Holding Company Act.
10. **Conflict of interest avoidance**: The forum maintains control procedures to avoid conflicts of interest which could impact either its own governance or individual engagements. Members are reminded of their own obligations to manage conflicts of interest and should note that participation in an engagement is not a substitute for, and does not release them from, those obligations.

It is this formal structure that the forum has developed – and its apparent effectiveness in engagement (such as in relation to Unilever's retreat from its plan to shift its headquarters)[26] – that has led to international interest in the forum as a model for other markets (for example, in a November 2019 report *Activisme Actionnarial*, France's Club des Juristes proposed that France ought to seek to create a similar organisation).[27]

In particular, the collective engagement framework is seen as a key mechanism to mitigate the risk that sometimes impedes collective engagement – the regulatory rules against seeking control of public companies except through formal takeover bids, or market abuse and insider trading constraints.

Voting

As mentioned earlier, shareholders have the right to vote at AGMs and EGMs, and in some markets, occasionally at other investor gatherings. In almost all cases, voting is proportionate to the percentage shareholding in the company and resolutions are usually passed when more than half of those voting support a vote. In a few cases, special resolutions require support by 75% of those voting, and there are unusual circumstances where the number of votes cast must exceed a threshold in terms of the overall share capital (and rarer still when the number of shareholders is important). Institutions typically vote for or against, though in many markets, there is also scope for a conscious abstention (for example, in the UK these votes are collated despite not legally being considered votes as such). This is considered an active decision rather than just an absence of a vote. Abstention can sometimes be a useful tool in an engagement process where the investor does not have a fixed view on an issue but certainly does not want to be in the potential position later of being hampered in its criticism of an action that it has in effect endorsed through its voting.

Given the public nature of company general meetings, where the results are announced publicly by the company, and the events themselves are often open to the media, voting decisions are often the most visible element of stewardship and engagement. It thus gains disproportionate media attention, and major votes against earn significant media coverage. Fund managers are therefore often held to account, both in the public arena and by their clients, for individual voting decisions.

Voting is often referred to as 'proxy voting' because the investor rarely physically attends the meeting where the voting occurs, but instead appoints an individual as proxy to cast the votes on their behalf (in most cases, this will be the chair of the company, though anyone physically at the meeting can be appointed). Votes vest in the legal owner of the shares, which may be the custodian or a unit trust vehicle or some other intermediary, meaning that even an institutional investor will usually need various formal paperwork in order to attend the meeting and to vote, not least that clearly identifying the individual who is physically representing the investor at the meeting.

With sizeable portfolios of companies, and AGMs usually occurring over compressed time periods (a few months in some markets, with the extreme being Japan where thousands of AGMs are held over just a few days), resourcing is a particular issue in the area of voting. Institutional investors typically lean on proxy firms to assist in processing votes and in providing advice on them. There are two dominant firms in this market:

- ISS, with around 80% of the market; and
- Glass Lewis, with the bulk of the remaining 20%; along with
- a few much smaller rivals, which have some market share, especially in a few localised markets.

The proxy advisers are often criticised by companies for taking what may appear to be narrow, inflexible approaches to voting and not facilitating the explain aspect of 'comply/apply or explain'. But most investors would argue that the advisers' role is to lack flexibility and to focus on the general guidance, and that it must be up to investors to display their closer understanding of individual companies and respond appropriately to explanations. The extent to which investors do indeed use their own judgment and avoid relying on their proxy advisers – particularly in often long tails of smaller holdings outside of their home market – is variable.

The vote is a key tool for the active investor, and any voting decision should be aligned with the investment thesis for the holding and any stewardship agenda that the institution has in relation to the company. Thus, for example:

- If there are concerns about the **capital structure and financial viability of the business**, investors need to pay close attention to votes in relation to dividends, share buybacks, share issuance or scope for further debt burden.
- If there are concerns about the **effectiveness or diversity of the board**, that needs to be reflected in voting decisions on director re-elections (and particularly in relation to the members of the nominations committee).
- Worries about the **independence or effectiveness of the audit process** should be taken into account when voting on the reappointment of the auditor, its pay and the reappointment of members of the audit committee.

Given the level of attention on executive pay, it is perhaps not surprising that investors take a close interest in resolutions on remuneration. In many markets there are both non-binding annual resolutions to approve pay in the year, and binding votes on forward-looking policies and any new pay schemes. These are in addition to votes on the appointment of the members of the remuneration committee.

Investors will also often reflect concerns about financial or sustainability reporting in their votes to approve the report and accounts. In most markets this is a symbolic resolution, but the message sent by voting against it can still be significant. It is important to remember that though most resolutions are seen as being purely G issues (e.g. the approval of the accounts and the dividend, the election of directors, related party transactions, appointment of the auditor, and capital structure decisions – share issuance and buyback authorities), there is no reason why investor decisions on such resolutions should be driven solely by G considerations.

This can be seen for example with the recent debate about the incorporation of climate change issues into the financial accounts (the financial statements in the back of the annual report, rather than the narrative reporting in the front half). In September 2020, investor groups representing more than US$100 trillion (£71tn) in assets published an open letter calling for companies to follow International Accounting Standards Board (IASB) guidance and incorporate material climate change issues in their financials, fully disclosing their relevant assumptions.[28] The investor groups also asked that auditors play their part in ensuring the delivery of this, and indicated their preference that the assumptions used should be compatible with the goals of the Paris Agreement. A number of investors are considering how their voting might respond to any failures to live up to this call from investors. In particular:

- some are likely to vote against reports and accounts where it is not clear that climate change has been incorporated, or that the assumptions are not disclosed;
- some are considering voting against auditors of heavily climate-exposed companies which do not include climate issues among the key audit matters in their auditor reports; and
- some are expected to vote against key board directors of companies that do not show sufficient signs of climate awareness where they have key risk exposures.

Any vote will rarely be meaningful in itself because there may be a range of reasons that an investor might have for voting in any particular way. Institutions therefore usually have active programmes to communicate to companies why they have voted in particular ways, either in writing or in dialogue. Many seek to have active discussions with companies as they work towards their voting decisions (helping them to tailor decisions to companies' particular circumstances) and use that as an opportunity to explain the thought process that lies behind any decision-making. This dialogue is a form of low-level engagement, but it will only ever have limited impacts.

Though, mostly, institutional investors do not physically attend shareholder meetings, perhaps stewards should give this opportunity more active consideration. Particularly at mid-sized and smaller companies, the attendance at AGMs can be small or negligible, and so an investor can gain unusually direct access to many directors at one time, with much scope for informal dialogue. Further, since the full board typically attends most AGMs, these meetings can offer investors an unusual insight into board dynamics and the ease of relationships within the boardroom. Shareholder meetings usually offer opportunities for formal questioning of many board members (typically any committee chair will respond directly to questions, as well as the chair and executive directors; in some circumstances the audit partner is in attendance too and may answer relevant questions, something that ought to increase if the recommendations of the Brydon Review are reflected in this respect), and this formal questioning can provide scope for both insight and influence. But many will find that it is the informal insights from actually participating in general meetings that are of as much value.

6 ASSET CLASSES

6.1.6 Distinguish between different types of engagement across a range of asset classes.

Although most stewardship codes assert that they are intended to apply to all asset classes, their language and approach seems very much based in the world of public equity investment. This chapter has reflected that tendency of thinking first of public equity investment, but its application is much broader. That is because the Codes (and this chapter) are written in terms of principles, which can be applied with good sense and intelligence across the full range of asset classes.

Many investment structures involve businesses investing in assets that in some ways look like public companies; with the immediate responsibility for managing direct property or infrastructure assets within their own boards, and where directors and investors can engage. Private equity and other fund investment structures (including indirect property or infrastructure investments) will usually see the interface for investors being with the fund management organisation rather than the underlying assets. However, the sense of accountability and the need for alignment arises just as much in these relationships as it does in any corporate governance structure.

The concepts of engagement need to be applied in a different way to respond to the circumstances and the levers of influence that are available. Since engagement is usually about influence rather than control, investors should have some scope for engagement success whichever formal structure they invest through.

Usually in these latter, more indirect, investment structures, the engagement issues are related to policies and approaches to ESG issues rather than specific individual asset concerns, but if a concern about an individual asset demonstrates that policy approaches may not be what the investor expects, then the engagement can be very specific indeed. An interesting case study of this has been the exclusion from private equity holdings in gun manufacturers and retailers by a number of asset owners, most notably CalSTRS (the Californian teachers' pension scheme, which was responding in particular to the number of shootings on US school premises). For example, Cerberus enabled its investors, including CalSTRS, to exit underlying holdings in retailer Remington Outdoor in 2015.

While, in these cases, investors will not generally have a vote and do not have formal sanction on the parties, the sanction of selling a position or being unwilling to invest in future opportunities remains. That is clearly a powerful sanction in most circumstances (especially if the asset owner is a large one) and is certainly enough for the investor's counterparty to pay attention to concerns that are raised.

Corporate fixed income

Fixed income investors may ultimately be concerned with the likelihood of default, but ESG factors can impact credit ratings and affect spreads, leading to short-term changes in value. Companies that regularly raise capital in fixed income markets are becoming more conscious of investors' interest in ESG as a material factor in their pricing of debt.

ESG engagement is also important to private debt, private equity and property and infrastructure investments. These investments are often illiquid, relatively long-term and involve close partnership between the investor and investee. As a consequence, there is both motive and opportunity for ESG engagement.

In relation to fixed income, the PRI's guide to *ESG engagement for fixed income investors: Managing risks, enhancing returns* recommends that investors should prioritise engagement based on:

- the size of a holding in the portfolio;
- lower credit quality issuers (with less balance sheet flexibility to absorb negative ESG impacts);
- key themes that are material to sectors; and
- issuers with low ESG scores.[29]

The greatest opportunity to push for conditions and disclosures around ESG is likely to be pre-issuance. This can be difficult to implement in fast-moving public markets, but is easier to effect in private debt issuance.

The investor's interaction with corporate debt issuers is most commonly with corporate treasury rather than more senior officials. In most cases, the parties are used to dialogue in relation to strategy, risk and financial structure (especially where the proposed debt sits in the debt hierarchy) and also, the covenants and protections for debt investors. Increasingly though, dialogue about risk encompasses ESG matters, and debt investors are finding they can have some influence on the approach of fixed income issuers.

This scope for influence is particularly clear where debt investors engage alongside equity investors (or where single investment firms bring together their engagement approaches in relation to investments in a single issuer regardless of the asset class exposure and the portfolio in which it is held). There are instances where equity and debt investors are direct rivals over issues, for example in the case of some transactions or capital structurings, or in the case of the company nearing insolvency. However, in almost all cases relating to ESG matters at companies that are going concerns, the interests of long-term investors (whether they are exposed to equity or debt) very much align and it will benefit all if the corporate effectively deals with an ESG concern.

Sovereign debt

The stewardship interaction with sovereign debt issuers is likely to be much more limited. Here, only the largest investors are likely to have any scope to influence the stance of nation states, and even then, the influence may be minimal. Therefore, the ESG approach usually applied in this asset class is screening or an ESG tilt in the investment process rather than engagement.

Having said that, there are early signs of steps to advance investor activity in this area, and the PRI has produced a guide for those seeking to engage with sovereign issuers.[30] This makes clear the fledgling nature of engagement in this area, and is more focused on learning how engagement might happen rather than on highlighting successful case studies. There is a particular focus on educating sovereign issuers about the value of green bonds and the strong market appetite for such instruments.

The leading case study for sovereign debt engagement is the work by a group of 29 investors with assets of around US$3.7tn (£2.6tn) to encourage the Brazilian government to do more to limit the destruction of the Amazon rainforest. Having also had contact through the Brazilian embassies in their home nations, the group wrote to the government in June 2020 noting among other things that "Brazilian sovereign bonds are also likely to be deemed high risk if deforestation continues". At least some of the group are reported to be considering divesting existing holdings and excluding Brazilian debt from their sovereign portfolios to reflect these concerns.[31] Sadly, it is unclear if this effort has had any positive influence, as other reports suggest that Amazon destruction accelerated through 2020, to a twelve-year high.

Private equity

Within private equity investments, direct ESG engagement will be undertaken by the general partner (GP, the private equity house) rather than the limited partner (LP, the asset owner), though individual LPs may wish to engage with their GPs on the ways in which they are monitoring and acting on ESG issues across their portfolios. As the PRI report, *ESG Monitoring, Reporting and Dialogue in Private Equity* points out:

> *"The process of portfolio monitoring has value protection and enhancement potential in itself, as a systematic approach for identifying material ESG issues, setting objectives and regularly tracking progress. It enables GPs: to identify anomalies and achievements; support regular engagement with the portfolio company on these issues; and strengthen company reporting practices that could have implications at exit."*[32]

Given that private equity provides a form of share ownership, the logic of extending the principles of the Stewardship Code to such investments may come more naturally. That's especially true where the companies are early stage and the investor has a more substantial influence. The poor quality of the governance of a number of companies coming through the private equity system – for example, the very public failure of WeWork's initial public offering (discussed briefly in **Chapter 5**) was in significant part caused by poor corporate governance – suggests that often, less effective ESG is instilled in private equity companies than ought to be the case given the levers that private equity investors hold.

Infrastructure

Infrastructure investors are exposed to ESG across the economic lifetime of their assets. These exposures extend beyond issues related directly to a specific asset – such as health and safety, supply chains and environment – to factors such as climate change, bribery and corruption and the social licence to operate. The PRI recommends that investors consider eight potential mechanisms to act as engaged owners in infrastructure:

1. Use ESG assessments undertaken during due diligence to prioritise attention to ESG considerations and potential for improving profitability, efficiency and risk management.

2. Include material ESG risks and opportunities identified during due diligence into the post-acquisition plan of each asset or project company and integrate this into asset management activities.

3. Engage with, and encourage, the management of the business to act on the identified ESG risks and opportunities using the mechanisms available.

4. Define and communicate the expectations of ESG operations and maintenance performance to the infrastructure business managers.

5. Ensure ESG factors identified as material during due diligence are explicitly woven into asset-level policies.

6. Advocate a governance framework that clearly articulates who has responsibility for ESG and sustainability.

7. Set performance targets for preserving or improving environmental and social impact, including regular reports to the board and investors.

8. Where possible, make ESG information and expertise available to the asset or project company to help it develop capacity.[33]

Like private equity and property, many investors in infrastructure will work through specialist managers. In these situations, the investor's responsibility is to monitor and engage with the manager. AustralianSuper, one of Australia's largest pension schemes, has been investing in infrastructure since 1994. In a 2012 case study for the PRI, they reported that one of their infrastructure managers had used detailed questionnaires based on the Global Reporting Initiative to analyse the impact of ESG issues for each of its 28 existing assets.[34] This analysis and benchmarking across the assets enabled the fund manager to:

- improve the governance at each of the boards on which it sits;
- arrange for four Australian airports to work together to develop market best practice health and safety processes based on practices from each of the airports; and
- measure the electricity and water usage and carbon emissions of each its assets on a regular basis, enabling the identification of energy savings for many assets.

Property

Like fixed income, there is good evidence of the positive effect of ESG on returns to real estate investments. Friede, Busch and Bassen's 2015 study showed that 57% of equity studies had a positive effect, though the positive share for bond studies was 64%, rising to 71% for real estate.[35]

A 2014 INREV study[36] indicated that there was a 2.8% difference in return spread between the top 10% and the bottom 10% of Global Real Estate Sustainability Benchmark (GRESB) rated properties.[37] Regulatory changes are also driving a need for greater engagement in relation to ESG in real estate.

Investors should engage indirectly by requiring their managers to report on the frameworks and metrics that they should use to monitor holdings. In addition, UNEP FI recommends that real estate investment stakeholders:

- engage, directly or indirectly, on public policy to manage risks;
- support research on ESG and climate risks; and
- support sector initiatives to develop resources to understand risks and integrate ESG.[38]

Fund investments

For funds of funds as an asset class, engagement with fund vehicles, covering any underlying asset class, sometimes becomes a little more complex. However, there is typically a fund board, which should be there to represent investor interests and that can be subject to engagement. Investors are often distanced from the underlying assets, but the role is then to hold to account the managers of the fund for their own investment and stewardship efforts. Closing the agency gap in these sorts of vehicles can be harder and take more effort, but as long as the investor has this in mind, there is certainly a role for engagement to play.

KEY FACTS

1. Stewardship is active, responsible ownership of companies or other assets on behalf of a long-term owner, a reflection of the investor's fiduciary duty to its clients and beneficiaries.

2. Engagement is active dialogue with companies with a particular purpose. Typically, it covers one or more ESG matter(s).

3. Voting at shareholder meetings is one element of stewardship. Often it is the most public, so it gains external attention, but it is nevertheless a limited element with limited influence on its own. Few investors attend company general meetings but could benefit from the insights and influence that come from doing so.

4. There is strong evidence that engagement, if carried out well, can positively influence corporate behaviour and that the changes made can deliver long-term value.

5. Many markets have stewardship codes in place, and increasing numbers are developing such codes; increasingly, these are codes with regulatory backing.

6. Generally, engagement is most successful if carried out positively and consensually, recognising that the changes sought are in the company's interests not in an investor's self-interest.

7. Yet sometimes engagement must be escalated in order to have effect. This can be through a range of mechanisms, including making concerns publicly known, proposing shareholder resolutions, or working collectively with other shareholders.

8. One of the most significant constraints on investors delivering effective stewardship and engagement is resources – particularly where the investor has broad investment portfolios. Finding responses to these resource constraints is currently one of the major challenges, and among the answers being found are:

- hiring new resource;
- prioritising with care;
- expecting more ESG delivery from mainstream fund management teams; and
- using collective and collaborative engagement resources.

9. Some forms of engagement start bottom-up, by focusing on the specific issues faced by an individual company, while others operate top-down by applying a perspective on particular issues (e.g. climate change) across all companies in a sector or market as a whole. Typically, the approach is linked to the investor's investment approach.

10. The most effective engagement starts with clarity over the engagement objective and how delivery against that objective will be measured over time. Greater clarity in these respects will be required by the focus on outcomes in the new UK Stewardship Code, and increasingly by clients. Engagement success often takes years to deliver in full.

11. Collective engagement is a key route to maximising effectiveness from limited resources, but investors must beware of regulatory constraints such as rules against acting in concert.

12. Engagement can be carried out across the full range of investment asset classes. The principles and mindset of engagement and stewardship need to be applied with good sense and judgment to the different circumstances and the levers that the investor controls.

CHAPTER 6

SELF-ASSESSMENT

These self-assessment questions are provided only to enable you to test your understanding of the chapter content. They are not indicative of the types and standard of questions you may see in the examination.

Questions

1. **Which principle in the Principles of Responsible Investment (PRI) is the 'engagement principle'?**
   (a) Principle 1.
   (b) Principle 2.
   (c) Principle 3.
   (d) Principle 4.

2. **What are the origins of the term 'stewardship'?**
   (a) A butler, or steward, delivering food to the lord's table.
   (b) The steward responsible for mixing appropriate ingredients for a feast.
   (c) The steward left in charge of an absentee landlord's estate.
   (d) A steward steering a ship.

3. **What post-financial crisis report led to the creation of the first stewardship code?**
   (a) The *Walker Report*.
   (b) The *Oban Report*.
   (c) The *Kay Report*.
   (d) The *Arthur Report*.

4. **What is the most significant difference between monitoring dialogues and engagement?**
   (a) Monitoring will influence trading decisions, engagement voting decisions.
   (b) Monitoring is only done by portfolio managers, engagement only by stewardship staff.
   (c) Monitoring occurs with investor relations staff, engagement with board directors.
   (d) Monitoring is one-way information seeking, engagement two-way dialogue.

5. **Which of the following is NOT among the seven areas typically covered by the top-level principles of a stewardship code?**
   (a) Engagement and escalation.
   (b) Voting.
   (c) Reporting and transparency.
   (d) Stock lending (or securities lending) policies.

6. **Which principle, more typical in regulatory codes, is frequently neglected in codes developed by investor groups?**
   (a) Conflicts of interest.
   (b) Reporting and transparency.
   (c) Stock lending (or securities lending) policies.
   (d) Voting.

7. **Which of the following is NOT one of the prioritisation decisions that an investor must take in relation to stewardship?**
   (a) Which company to focus engagement attention on.
   (b) Which annual general meeting (AGM) resolutions to vote on.
   (c) Which sectors face the greatest ESG risks.
   (d) Which are the key engagement issues for the individual company in question.

8. **Which of the following is a new area of focus in the UK Stewardship Code 2020?**
   (a) Voting.
   (b) Outcomes.
   (c) Collaboration.
   (d) Conflicts.

9. **Which of the following is NOT among the main barriers to effective engagement?**
   (a) Limited resources.
   (b) Difficulty of reaching consensus.
   (c) Unwillingness to act without specific client instruction.
   (d) Conflicts of interest.

10. **Which of the following is NOT among the identified key mechanisms for the escalation of engagement?**
    (a) Holding additional meetings.
    (b) Operating collectively with other shareholders.
    (c) Withdrawing a shareholder resolution.
    (d) Proposing new board members.

11. **When might escalation NOT be the right step in an engagement that has made no progress?**
    (a) When collective engagement is prevented by regulatory standards.
    (b) When no progress has been made and the objective does not warrant excess activity.
    (c) When divestment is the likely step should no change be made.
    (d) Pending a forthcoming shareholder resolution.

12. **Which of the following is NOT a typical form of collective engagement?**
    (a) Informal collaboration between investors.
    (b) Specialist stewardship service providers.
    (c) Investor associations aggregating member views.
    (d) Internet campaigns aggregating consumer perspectives.

13. **What is the major constraint on collective engagement approaches?**
    (a) Acting in concert rules.
    (b) Client best interests.
    (c) Maintaining discretion over institutional shareholding.
    (d) Investors are never in contact with each other.

14. **Which of these is NOT a way for investors to make their voting activity more effective and influential?**
    (a) Hold an active dialogue with the company ahead of the decision.
    (b) Attend the AGM, perhaps to make a spoken intervention.
    (c) Writing afterwards to highlight the reasons for the voting decision.
    (d) Only vote on resolutions where they have a clear opinion.

15. An active investor concerned about the financial viability of the business is most likely to reflect that concern in their voting on:

(a) Board Director re-appointment.

(b) Auditor pay.

(c) Dividends issue.

(d) Audit Committee member re-appointment.

CHAPTER 6

SELF-ASSESSMENT **ANSWERS**

1. b.
2. c.
3. a.
4. d.
5. d.
6. a.
7. b.
8. b.
9. c.
10. c.
11. b.
12. d.
13. a.
14. d.
15. c.

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