THE ROLE OF INVESTORS IN SUPPORTING BETTER CORPORATE ESG PERFORMANCE

Influence Strategies for Sustainable and Long-Term Value Creation

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About

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EXECUTIVE SUMMARY

Consider the following examples of institutional investors engaging companies they own on financially material risks tied to environmental, social and governance (ESG) issues:

Deforestation

Between 2011-2017, 51 shareholder proposals were filed by US investors asking for corporate policies to address financially material reputational and market risks associated with the sourcing of unsustainable palm oil and other deforestation-linked commodities. Twenty-three companies responded to these proposals by making commitments to protect their brand's reputations by sourcing sustainable palm oil and, in some cases, these companies even made cross-commodity no-deforestation commitments.[1] Research by CDP demonstrates the clear business case for companies with agricultural supply chains to address deforestation, and estimates that up to $906 billion in annual sales could be at risk from company exposure to deforestation.[2]

Workplace discrimination

Since the mid-1990s, institutional investors have played a significant role in supporting equal opportunity in the workplace by engaging more than 200 major companies through shareholder proposals and dialogue on the need to expand corporate non-discrimination policies to include LGBTQ employees. These efforts have led to policy changes at more than 175 companies.[3] A 2016 analysis by Credit Suisse found that, over the course of six years, 270 companies that provided inclusive LGBTQ work environments had outperformed global stock markets by 3 percent annually.[4]

Water risk

The global food and agriculture sector uses 70% of the world's freshwater and is the biggest polluter of waterways worldwide. In light of these dependencies on water, institutional investors have sought to better understand how major food companies are addressing material water risks in their agricultural supply chains. In 2015, following the release of a food sector water management benchmarking report by Ceres, 60 institutional investors with $2.6 trillion in collective assets sent letters to the 15 lowest scoring companies identified in the report, urging improved management and disclosure of water risks.[5] In response to the letter and subsequent investor dialogue, 13 of the companies agreed to this request, with the majority showing evidence of stronger management of agricultural water risks in their supply chain within two years.[6]

Climate change

In December 2017, a global coalition of investors and five investor membership organizations launched the Climate Action 100+, a five-year initiative to engage more than 150 of the world's largest and most systemically important corporate greenhouse gas emitters. Through this initiative, investors are asking companies to improve board oversight of climate change, curb emissions and strengthen climate-related financial disclosures. To date, more than 300 investors with $32 trillion in assets under management have signed on to the initiative.[7] A report by The Economist on the impacts of climate change calculates that the value at risk to the total global stock of manageable assets could range from $4.2 trillion to $43 trillion in losses before the end of the century.[8] Investors believe climate change requires particular attention because it is a risk that affects nearly all industries.[9]

While these examples show that investors and their membership organizations have played an active role in shaping corporate behavior on ESG issues, there is still a lack of comprehensive information about what outcomes can be expected from various investor influence strategies such as dialogues with company management, shareholder proposals and proxy voting, divestment and public policy engagement. Do these investor interactions have a tangible impact on corporate financial and sustainability performance? Which strategies are more effective? What are the main drivers of success?

To answer these questions, Ceres and EDF, with the support of KKS Advisors, undertook a comprehensive review of the literature and a series of in-depth interviews with investors and sustainability practitioners (for more on the methodology, see **Appendix A**). This report identifies the key impacts of investor influence strategies and proposes a framework for understanding the drivers of successful investor engagement efforts.

The impact of investor influence strategies

The evidence reveals that investor efforts to engage companies on ESG-related risks and opportunities are associated with better shareholder returns:

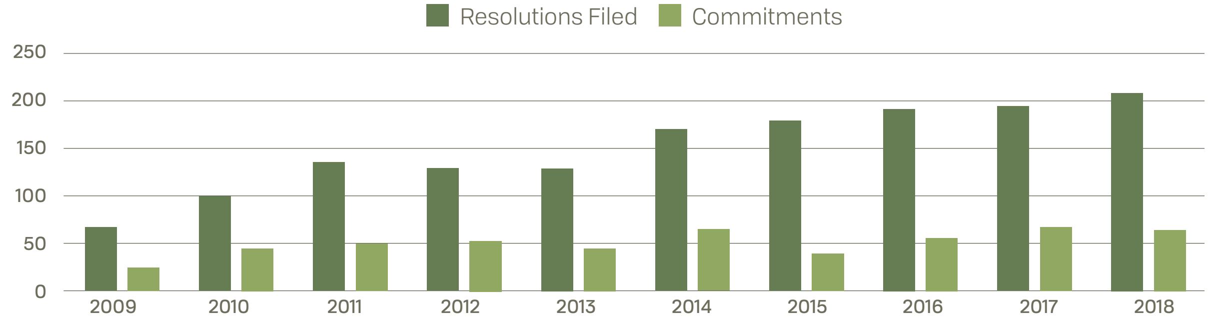
- Academic research on corporate social responsibility engagements with US public companies over the period between 1999-2009 shows that after successful engagements, companies experience improved accounting performance and governance.[10]
- An examination of private engagements conducted by fund manager Hermes demonstrated financial outperformance associated with investor engagement rather than stock picking.[11]
- An analysis of the stock performance of 188 companies placed on the "focus list" for ESG engagement by California Public Employees' Retirement System (CalPERS) found that these companies performed significantly better than their peers (15.27 percent above the Russell 1000 Index) over a 14-year period.[12]
- Evidence from collaborative dialogues involving 225 investment organizations over the period between 2007-2017 shows that after "successful" engagements (as defined by a set of pre-determined criteria and scorecards) have occurred, target companies experience improved profitability (as measured by return on assets), while unsuccessful engagements demonstrate no change.[13]
- Research from Harvard Business School indicates that filing shareholder proposals is effective at improving the performance of the company on the focal ESG issue, even though such proposals nearly never received majority support. Proposals on material issues are associated with subsequent increases in firm value.[14]

Research also supports that investor engagement efforts enhance company management of material ESG issues:

- An analysis of the engagement activities between 2005-2014 of a large European asset manager with 660 companies found that 60% and 53% of the firm's engagements on social and environmental issues respectively were successful, as defined by adjustment of the company's policy on one of more pre-determined ESG dimensions. The study also found that excess stock returns were higher after successful outcomes, where the difference between successful and unsuccessful engagements was mainly significant within a period of 6 to 12 months.[15]

- Analysis of data on climate-related shareholder proposals filed with U.S. companies between 2009-2017, found that 35% of resolutions led to commitments by the company in question.[16] Of these, data from Ceres found that when investors negotiate withdrawals of shareholder proposals in return for company commitments, over 70% of these commitments lead to concrete outcomes.[17]
- Evidence from collaborative dialogues on ESG issues involving 225 investment organizations and 964 companies over the period 2007-2017 shows that 25% of engagements were "successful," as defined as the company achieving movement against a set of pre-determined criteria and scorecards.[18]

Climate-Related Shareholder Resolutions in the U.S., 2009-2018
Resolutions Filed vs. Corporate Commitments Negotiated



Source: Ceres. 2018 resolution data as of June 26, 2018.

Drivers of success

Our research suggests that the effectiveness of investor engagement is a function of three key variables:

- **Investor-specific factors** that determine the level of influence a particular investor will have with a company
- The relative strength of the **influence strategies** employed by investors—and how well these strategies are executed
- **External actors** in the broader ecosystem that contribute to shaping outcomes, including the role of investor membership organizations that support investor coordination and effectiveness.

Our theory is that as more of these elements are activated or triggered by investors and other stakeholders, there is greater likelihood that an ESG issue will gain the attention of corporate management and be prioritized and addressed.

Investor-specific factors

Not all investor efforts to improve corporate management of ESG risks and opportunities receive the same level of response from corporations or the same outcomes. So, what are the key drivers of investor influence? A useful framing is to consider three attributes that determine the responsiveness of corporate managers to stakeholder demands—power, legitimacy and urgency.[19]

POWER	LEGITIMACY	URGENCY
→ Ownership levels (individual or collective) → Potential to use shareholder rights (e.g. shareholder resolutions, voting against management, director elections). → Ability to divest or reduce holdings (active management), if ownership stake is large	→ Presence of a strong business case/ financial materiality → Deep investor knowledge of the company & the ESG issue → Long-term share ownership → Investment firm reputation → Investor interpersonal or "soft" skills → Constructive, solutions-oriented interaction	→ Negative incidents (e.g. major employee or product safety failure) → Investor persistence, showing critical importance of ESG issue → Impending regulatory change → Reputational threats & activist campaigns → Media coverage that supports the investor perspective

LEVEL OF INVESTOR INFLUENCE

Investor Influence Strategies

Investors have a range of strategies at their disposal to engage corporate management and to communicate their views on corporate ESG risks to policy makers and the broader public. The most common strategies are direct dialogue, shareholder proposals and proxy voting, public policy engagement and divestment. Each strategy has its own benefits, drawbacks and success factors.

DIRECT DIALOGUE

Direct dialogue involves direct communication between investors and companies, through phone calls, emails, letters, and in-person meetings. Dialogues take many shapes, including bilateral dialogues between the company and one investor, dialogues involving multiple investors, and dialogues that bring investors together alongside ESG issue experts from nonprofits or academia.

DIRECT DIALOGUE		
Benefits	**Drawbacks**	**Success Factors**
· Enables constructive discussions on sensitive issues · Facilitates sharing of investor insights on solutions to complex ESG issues · Shapes corporate culture through discussions · Improves investor understanding of the company's culture, performance and strategy	· Lack of formal obligation for companies to meet with investors or respond to requests · Resource-intensive, with much time spent on preparation and communications · Difficulty in tracking short-term progress by the company on the ESG issue	· A strong business case and clear set of potential company actions are referenced · Sufficient time is devoted to research and preparation before the dialogue occurs · Company representatives with decision-making authority are involved in the dialogue · Dialogues are undertaken in collaboration with other investors · Geographic or cultural influences are taken into account to improve the quality of dialogue · Company performance is monitored over time · The tone of the dialogue is solutions-oriented · Meetings are face-to-face, whenever possible

Example: Collaborative dialogues

Collaborative investor dialogues with companies take many forms, and typically benefit from the involvement of a third-party that supports investor coordination and serves as a resource on key ESG topics. Examples of organizations that play this role include:

- **CDP**, which provides a collective mechanism for investors to aggregate their assets in support of annual requests for disclosure from the largest publicly listed companies on their exposure to and management of climate, water and forest-related risks and opportunities.
- **Ceres**, which brings sector and company-specific analysis, and supports coordination of hundreds of shareholder resolutions in the US on issues including climate change, water scarcity and deforestation; and also manages long-term dialogues on sustainability issues among companies, their shareholders and other stakeholders—including environmental and social NGOs and issue experts.
- **The Interfaith Center for Corporate Responsibility (ICCR)**, which supports the coordination of hundreds of investor-company dialogues every year on a range of social and environmental topics, using a structured engagement approach that involves a lead investor, and sometimes includes representatives from NGOs and community groups
- **United Nations Principles for Responsible Investment (PRI)**, which coordinates issue-specific investor-company engagements involving multiple investors over a defined time period.

SHAREHOLDER PROPOSALS

The ability to file shareholder proposals on ESG issues is an important legal mechanism for investors, enabling them to formally submit a recommendation for action to a company and its board of directors. Shareholder proposals are a cost-effective way for companies and boards to gain a better understanding of shareholder concerns. A significant proportion of shareholder proposals are voluntarily withdrawn by investors in return for commitments from the company to address the issue of concern.[20]

SHAREHOLDER PROPOSALS		
Benefits	Drawbacks	Success Factors
• High success rate in terms of securing corporate commitments (45% of social, environmental and sustainability proposals filed in 2018 were withdrawn) • Proposals create urgency as there is a timeline for the company to respond • Provides leverage for filer due to management's preference to avoid proposals going to a public vote • Facilitates board level involvement • Educates the shareholder community on emerging ESG issues • It is easy to observe trends and build datasets on filed proposals	• Can strain investor-corporate relationship as some companies are frustrated by the process or become defensive • Information asymmetry, as negotiations happen behind closed doors (many commitments remain confidential for at least the first year after they are made) • Symbolic responses by management solely interested in avoiding reputational damage	• Investors demonstrate a strong business case for the proposal • Investors strategically file proposals at large, highly visible companies to impact the rest of the market • Media attention raises the profile of investor concerns • The request addresses a serious reputational risk • Investors receive input from the wider investor community and ESG topic experts before filing on complex, emerging issues. • Companies agree to specific actions in writing, allowing investors to track if commitments are met • Tone of conversations is positive, and solutions based

Examples:

→ **Lobbying disclosure.** Since 2003, more than 150 large companies (including more than half of S&P 100 companies) have committed to disclosure and board oversight of their political spending with corporate funds in response to shareholder engagement.[21]

→ **Proxy access and board diversity.** Since 2015, investors, most notably the New York City Comptroller, have asked companies to make the right of investors to nominate directors on the company's proxy ballot a market standard. When these efforts began, just six U.S. companies had proxy access, with more than 425 offering it today, including 60% of the S&P 500.[22] Furthermore, over the past three years, at least 27 of the 51 companies that the Comptroller engaged on proxy access due to inadequate board diversity have added at least 43 directors who are women, non-white, or both, and the largest oil and gas company in the world, ExxonMobil, added a climate scientist to its board.

PROXY VOTING

Exercising voting rights is a formal mechanism for investors to voice their concerns, enabling the investor to agree, disagree or abstain on a vote for a shareholder proposal. Voting is a useful mechanism to stimulate change given that it provides an opportunity for the entire shareholder base to weigh in on an issue that could be of wide concern.

PROXY VOTING		
Benefits	Drawbacks	Success Factors
· Uses collective pressure to influence corporate management · Forces management to carefully consider and clarify their position on an issue · Establishes a clear time frame for issues to be dealt with since investors will vote on the topic at the annual meeting · Encourages other investors to think about an issue because it is up for consideration · Provides insights to peer companies not subject to a shareholder proposal about investor views and concerns on a topic	· Important issues may initially receive low votes as there is a time lag for the investment community to learn about the issue and escalate concerns to the company · Companies may interpret non-majority votes as a sign that they can delay on acting on the issue. · Companies can decide to challenge proposals to the SEC rather than addressing the issue · Investors may suffer low votes for several years and need to give up	· The filer makes a strong business case for the proposal via both the proposal itself and supporting materials distributed to other investors · Investors seek the support of other institutional investors to help build a high vote and participate in early vote declaration campaigns offered by investor networks such as Ceres and PRI · Investors focus on large and high-profile companies to impact the rest of the market · Voters are familiar with important ESG risks and opportunities and have proxy voting guidelines that allow them to vote "For" proposals · Educational campaigns and media coverage are used to raise awareness and initiate collective action

Example:

→ **2-degree scenario-analysis.** In 2017, Ceres and IIGCC mobilized large asset owners to provide pre-declarations of support for a proposal with ExxonMobil asking the company to conduct a 2-degree scenario analysis. These pre-declarations of support created motivation among asset managers to support the proposal, ultimately achieving a tipping point with 62% of shareholders voting in support of the proposal at ExxonMobil, including Fidelity, Vanguard and Blackrock—the company's largest shareholder. Majority votes were also secured on similar environmental proposals at electric utility PPL (57%), and Occidental Petroleum (67%).

PUBLIC POLICY ENGAGEMENT

Investors can engage in public policy at various stages in the policy-making process. They can initiate policy discussions when they notice gaps or weaknesses in regulatory frameworks, provide information and views that support effective decision-making, facilitate implementation and evaluation of policies, and call for the termination or renewal of policy measures. Some investor member organizations help organize investors to speak with a collective voice—in some cases, together with company voices—enabling investors to amplify their influence.

PUBLIC POLICY ENGAGEMENT		
Benefits	Drawbacks	Success Factors
· Aligns long-term incentives for companies to take significant action on ESG issues · Corrects market failures that investors become aware of through their interactions with many companies · Addresses systemic risks that undermine long-term value creation · Promotes binding standards of transparency and ESG disclosure that can be legally enforced	· Engaging in public policy requires longer timeframes than engaging directly with corporations · Policy-making can be a complex process and may require technical knowledge that investors may not already have · Outcomes will be less clear if there is weak policy design, monitoring or enforcement	· Investors raise their voice collectively on public policy, with support from investor membership organizations · Resources are dedicated to regular policy engagement on ESG issues · Investors help to educate policy-makers on complex ESG challenges · Investors participate in designing policy solutions

Examples:

→ In 2017, 390 investors representing more than USD $22 trillion in assets issued a letter urging governments of the G20 nations to support and implement the **Paris Climate Agreement**.

→ The 2010 decision of the **US Securities and Exchange Commission (SEC)** to release formal guidance for companies to disclose climate risks in their 10-K filings. Ceres and its investor members first called for this type of disclosure in 2003, and the scale of investor support was an important signal to the SEC that climate change was a critical issue for investors.[23] Investors are involved in ongoing work to improve the quality of disclosures that are required.[24]

DIVESTMENT

Divestment is the sale of shares by dissatisfied shareholders, and is often tied to the objective of shifting the opinions of policy makers and the general public on an issue of broad concern. It ranges from full divestment from a category of assets (e.g. from all fossil fuel assets) to partial divestment (e.g. divesting of companies that derive more than a determined percentage of their revenues from activities related to fossil fuels).

Example:

→ **Palm oil.** Since 2012, the Norwegian sovereign wealth fund NBIM has divested from 58 companies associated with deforestation impacts, mainly in the palm oil sector. These decisions to divest are disclosed as part of the fund's annual responsible investment report.[25] These actions have been widely reported in the financial media and leveraged by environmental campaigners to increase pressure on irresponsible palm oil producers.

DIVESTMENT		
Benefits	Drawbacks	Success Factors
· Raising awareness and sparking public and political debate · Elevating the negative impacts of an issue with policy makers, corporate executives and board members · Stigmatizing the reputation of companies and sectors by linking them to negative impacts (e.g. health effects of tobacco, droughts due to climate change) · Increasing the negotiating power of shareowners seeking to engage management on the issue · Redirecting investments towards transformational change (e.g. the transition to a low-carbon economy)	· Foregoing ownership rights such as filing shareholder resolutions · Limited direct impacts on a corporation's cost of capital · Unexpected consequences (e.g. divested holdings are bought by neutral investors who might put less pressure on corporations to change)	· Public statements, reports and media attention are used to communicate the decision · Widespread awareness and momentum is created, which attracts attention of policy-makers and the general public · Moral arguments are buttressed by financial arguments around the riskiness of a company or sector (e.g. the "carbon bubble" argument in the case of fossil fuel divestment) · The issue is brought to the agenda of management and the board, and drives internal company debate

External actors and the broader ecosystem of influence

Investor strategies exist within a broader ecosystem that influences corporate behavior. Across the ecosystem, there are a variety of different actors (e.g. NGOs, governments, consumers, employees, communities), networks (e.g. investor membership groups), and tools (e.g. technology, ESG research) that support progress on ESG issues. Considering the leverage points that exist within the broader ecosystem provides investors with opportunities to magnify their level of influence. Collaboration among different actors is often a valuable way to combine resources, reduce duplication of efforts and share knowledge to tackle complex ESG issues.

Different investors can generate different pressure points on a company through complementary strategies. For example, not all investors believe that divestment is an effective way for them to voice their concerns about a company's management of ESG risks. However, if one investor chooses to sell off stocks and draws attention to the issue, this can provide a second investor with greater leverage in direct dialogue with a company. The drawback of one strategy (e.g. divestment ends a relationship) can be to the benefit of another by increasing the saliency of an issue (e.g. sparking constructive discussions during private negotiations).

The role of investor networks in supporting engagement

Nonprofit investor membership networks such as Ceres, ICCR and UN PRI have played a central role in enabling investors to efficiently and effectively engage large numbers of corporations on ESG issues. Through coordination of activities, provision of relevant analytics and business case information, as well as legal and communications support, these organizations add staff capacity and greatly enhance the collective effectiveness of the investment community. These collaborations combine size, ownership stakes and reputations to increase investor influence, while benefiting from efficiencies derived from sharing research sources, workloads and costs, and preventing duplication of efforts.[26]

DRIVERS OF INVESTOR INTEREST IN ESG

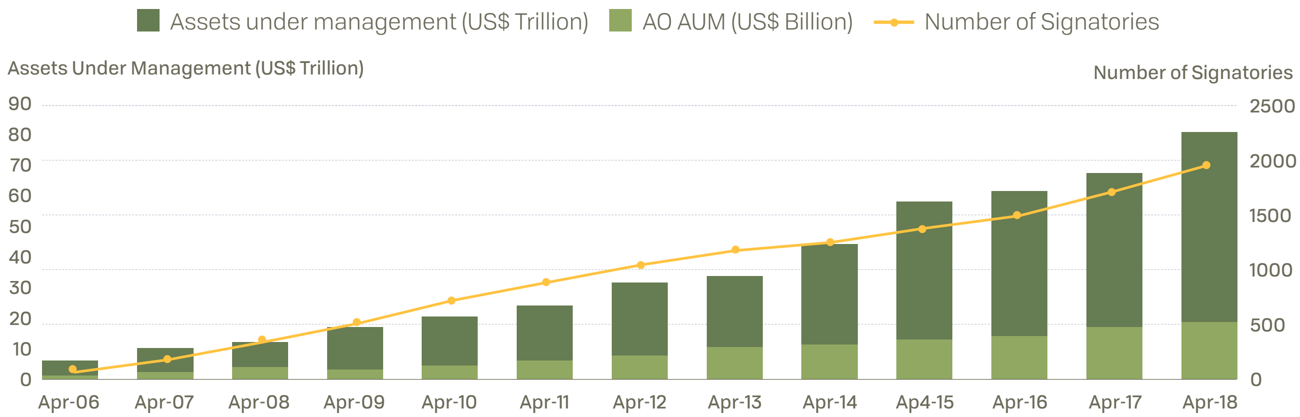
As owners of and lenders to companies, investors have a vested interest in seeing companies proactively address material **environmental, social and governance (ESG)** issues that affect short and long-term value. Good ESG performance is good business—helping to mitigate risk and maximize returns—in addition to being part of a company's fiduciary duties. The role of investors in engaging corporations on their management of sustainability and governance issues is gaining attention as ESG and responsible investing become more mainstream. There is now significant evidence that ESG performance is value-enhancing, leading to significantly better shareholder returns.

ESG performance is value-enhancing for investors

- A comprehensive analysis of existing research conducted by Deutsche Asset Management and the University of Hamburg concludes that the large majority of research shows a positive relation between ESG criteria and corporate financial performance.[27]
- According to 2017 research by Bank of America Merrill Lynch, ESG attributes are a better signal of future earnings volatility that any other measure.[28]
- Academic research analyzing 2,000 US companies between 1993-2013 shows that companies that make significant investments in material ESG issues relevant to their industry have better future performance than companies that do not address these issues, experiencing high growth in profit margins and superior risk-adjusted stock returns.[29]
- Research by MSCI using data for 1,600 stocks between 2007-2017 found that ESG ratings for a company are a useful financial indicator. The data revealed that high ESG-rated companies tended to show higher profitability, higher dividend yield and lower business-specific tail risks, in addition to displaying less systemic volatility and higher valuations.[30]

As the evidence mounts, investors have responded in several ways, including working together through collaborative initiatives such as Ceres and the UN-supported Principles for Responsible Investment (PRI) to advance ESG and responsible investment. In a recent survey of 475 institutional investors, 73% said they consider active ownership—in the form of shareholder engagement with companies they own—an integral part of their ESG investing.[31]

PRI Signatories and Assets Under Management — 2006-2018



Source: Principles for Responsible Investment

In addition to the growing financial case, investors are increasing subject to policy contexts that encourage active ownership and engagement with portfolio companies. In the UK, Japan, Taiwan and Hong Kong, governments have passed legislation focused on investor stewardship, known as Stewardship Codes, helping to raise the visibility of certain ESG issues and encouraging investors to explain their approach to engaging and monitoring company behavior.[32, 33] At the same time, growing numbers of asset managers are being asked and evaluated by investment consultants (on behalf of their asset owner clients) about the frequency and focus of their engagement activities with companies on material ESG issues.

> “Your company’s strategy must articulate a path to achieve financial performance. To sustain that performance, however, you must also understand the societal impact of your business as well as the ways that broad, structural trends—from slow wage growth to rising automation to climate change—affect your potential for growth...To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society.”
>
> **Larry Fink**
>
> CEO, Blackrock, 2018 Letter to CEOs

Finally, in recent years, significant attention has been placed on large passive institutional investors,[*] who now rank among the largest investors of public companies.[34] In effect, these investors are "universal owners" with diversified and long-term holdings representative of the global economy, and consequently, they have significant exposure to systemic risks tied to certain environmental and social issues that threaten global economic growth.[35] As awareness of this exposure grows, large passive institutional investors are increasingly motivated be active owners who engage with companies to address these risks and capitalize on opportunities for value creation. In 2018, Larry Fink, the CEO of BlackRock (the world's largest asset management firm), released a letter to CEOs of major publicly listed companies warning them that their businesses should serve a social purpose, arguing that without a sense of purpose companies will lose their social license to operate and yield subpar returns.[36]

CLARIFYING TERMS

Shareholder Activists vs. "Active Ownership" on ESG Issues

Active ownership is "the use of the rights and position of ownership to influence the activities or behavior of investee companies." Active ownership activities by investors on ESG issues are quite different from the activities of traditional "activist" investors such as hedge funds, which generally buy relatively large stakes in a company to achieve short-term financial value—often by placing specific directors on the board and advocating for asset restructuring. ESG engagement usually concentrates on longer-term issues relating to risks and opportunities associated with sustainability, based on the premise that addressing these issues will enhance long-term financial value.

[*] Passive investment strategies aim to mimic the investment holdings of a particular index, while more traditional active investment strategies focus on outperforming the market compared to a specific benchmark. Index funds are branded as passively managed because each has a portfolio manager replicating the index, rather than trading securities based on his or her knowledge of the risk and reward characteristics of various securities. Because this investment strategy is not proactive, the management fees assessed on passive portfolios or funds are often far lower than active management strategies. By the end of 2017, passive investments accounted for almost 45 percent of all equity assets in U.S. mutual funds and exchange-traded products, up from 20 percent in 2007. *Source: Institutional Investor.*

DRIVERS OF INVESTOR INFLUENCE

As owners and stewards of corporations, investors are in a unique and highly influential position to shape corporate behavior. By providing capital to corporations, investors have the opportunity to engage with companies, raise issues of concern, and have a say on outcomes. In turn, corporations are fiduciaries of the capital entrusted to them by investors and have the responsibility to create corporate value both over the short and long-run.

Academic evidence shows that after successful ESG engagements, US public companies experience improved accounting performance and governance.[38] An examination of private engagements conducted by fund manager Hermes also demonstrated that financial outperformance is associated with investor engagement rather than stock picking.[39] Similarly, an analysis of the stock performance of 188 companies placed on the "focus list" for ESG engagement by California Public Employees' Retirement System (CalPERS) found that they performed significantly better (15 percent above the Russell 1000 Index) over a 14-year period.[40]

Not all investor efforts to improve corporate management of ESG risks and opportunities receive the same level of response from corporations or the same outcomes. So, what are the key drivers of investor influence?

A useful framing is to consider three attributes that determine the responsiveness of corporate managers to stakeholder demands—power, legitimacy and urgency.[41]

- → **Power** to influence the company
- → **Legitimacy** of the investor's claim on an issue
- → **Urgency** for an issue to be addressed immediately due to it being time-sensitive and critical nature

POWER

- → Ownership levels (individual or collective)
- → Potential to use shareholder rights (e.g. shareholder resolutions, voting against management, director elections).
- → Ability to divest or reduce holdings (active management), if ownership stake is large

LEGITIMACY

- → Presence of a strong business case/ financial materiality
- → Deep investor knowledge of the company & the ESG issue
- → Long-term share ownership
- → Investment firm reputation
- → Investor interpersonal or "soft" skills
- → Constructive, solutions-oriented interaction

URGENCY

- → Negative incidents (e.g. major employee or product safety failure)
- → Investor persistence, showing critical importance of ESG issue
- → Impending regulatory change
- → Reputational threats & activist campaigns
- → Media coverage that supports the investor perspective

LEVEL OF INVESTOR INFLUENCE

According to the theory, stakeholders that have power, legitimacy and urgency are the most salient to corporate managers. Importantly, levels of power, legitimacy and urgency do not hold constant but rather change over time. The illustration below outlines key sources of power, legitimacy and urgency for investors seeking to influence corporations on ESG issues.

Power

Research indicates that power is the most important factor for an investor to influence a corporation. Power has the most important effect on salience, followed by urgency and legitimacy.[42] Power is typically associated with greater levels of company ownership. As one asset manager stated during an interview, "I think influence comes down to how much stock you hold, I mean if you hold more you are more influential. It's a pretty linear relationship."

Company ownership does not explain, however, why investors with relatively small or insignificant ownership stakes might be powerful. Can smaller investors have other sources of power? The use of shareholder rights is an interesting case, as all investors that meet the minimum threshold of ownership ($2,000 in the US) are equally entitled to file a resolution. The experience of religious investors in the US shows that use of minority shareholder resolutions, which is an example of a power-oriented strategy, was needed to capture management's attention and open the doors to subsequent engagement.[43] This highlights that power can be gained through multiple sources, particularly through the proxy voting process, which aggregates the power of numerous investors.

Overall, it appears that investors only use as much power as they need to garner the attention of the company. Once an investor has received sufficient attention from the company, there is typically a preference not to use power to exert influence. Some investors are particularly cautious with decisions such as filing resolutions and voting against management since these actions may seem adversarial and can limit their ability to have positive and constructive interactions. However, others believe that filing a resolution is the most effective way to use their power to initiate or escalate engagements with a company.

Legitimacy

There is significant evidence that legitimacy is a key driver of investor influence. Research demonstrates that legitimacy is a critical attribute for investors to influence managers to raise corporate ESG standards.[44] A strong business case and focus on materiality, combined with a reputation for positive, solution-oriented outcomes is found to increase success.[45] Success is also more likely when the shareholder understands the ESG issues and when the proposed changes are realistic in terms of both scope and time.[46] Investors can build their legitimacy by acquiring knowledge that is beneficial to their relationship with the company. For example, data showing the performance of corporations on ESG issues can help prove the validity of concerns. Given the importance of building legitimacy, softer skills such as communication and relationship-building are key strengths for investors to develop. Nonetheless, our interviews revealed that the importance of relationship factors is often vastly underestimated.

> "It's a real skill to be able to steer the company in the right direction and appropriately influence them in an effective way. It requires framing the interests of the company and the investor without being adversarial."
>
> **Paul Chandler**
> Head of Environmental Issues, Principles of Responsible Investment

> Increasingly our engagements with companies on material ESG issues include both management and directors. This encouraging development allows for more meaningful discussions around identifying and managing relevant business risks and opportunities over the long term. Importantly, companies whose long-term strategy is clearly articulated and well understood by investors in good times are able to have more effective conversations with investors in the face of headwinds. Continued investor support in a time of crisis can help management and the board focus on getting back on course.
>
> **Danielle Sugarman**
> Vice President, Investment Stewardship, BlackRock

Urgency

What makes certain ESG issues raised by investors gain traction at particular moments in time? The answer may lie in the degree of urgency there is for a company to respond. Investors can help foster a sense of urgency by communicating their expectations and support for companies to address ESG issues as an immediate and critical concern. Investors can play a role in increasing the urgency of issues within the company—for example by communicating an issue to the board chair, who is responsible for setting the board's agenda. Influence strategies that include deadlines (e.g. negotiating the withdrawal of a shareholder proposal before the proxy statement is issued) benefit from a degree of urgency. Furthermore, an issue might become a higher company priority when investors are consistent with their demands, since several companies note that persistence is a key driver to success.[47]

The issues raised by investors can gain urgency from relevant pressures that help gain management and board-level attention. Firstly, certain highly visible negative events—for example, a large oil spill, worker safety incident or product safety failure—increase the urgency for companies to respond to investor requests. Secondly, the nature of the ESG issue in question might imply that time-sensitive action is needed from corporations. For instance, scientific evidence showing the scale and impacts of human-induced climate change underscore the need for immediate change.[48] For an issue such as energy efficiency, there is a clear financial justification for the company to act urgently, given that increasing efficiency can imply an immediate reduction in costs. Thirdly, when there are immediate reputational risks arising from ESG issues, this can add pressure for companies to respond. Reputational concerns can be magnified when there is significant media coverage of poor company practices or issues go viral on social media. Similarly, impending regulatory change can create urgency for companies to respond to issues before new rules come into effect.

HOW DO INVESTORS DEFINE SUCCESS?

Success is ultimately a highly nuanced term. Whether investors consider their efforts to be successful depends both on their intentions and on the type of outcomes that can be achieved over various time horizons. Defining success can be tricky; most investors do not define success in binary terms, but rather see their role as supporting companies to move along a continuum of progress. Success is also something that is scalable, maximizing the positive impacts of investor-corporate interactions.

Success depends on intentions

Investors interviewed agreed that there is no one definition of what success means when seeking to change corporate behavior on ESG issues. Firstly, the intentions of investors can vary widely—ranging from company-specific objectives to broader market-level change. Where an investor sits on the intentionality spectrum will determine how they perceive success.* In one context, an investor might request a specific corporate policy and be satisfied when that policy is created, whereas in another context, success might be measured by a company agreeing that a given issue is important and conducting an internal assessment to generate more information upon which to base decision-making. All "successful" outcomes are dependent on what the intentions and the objectives were in the first place. Every investor needs clarity on their theory of change and their intentions for engaging with a company.

> We prefer to describe the impact of our engagements rather than simplistically describe a success or victory. Engagements often are a long-term process with multiple stages. An example would be a company first measuring its carbon footprint, then identifying ways to reduce greenhouse gases and finding ways to improve every year. So, it's an ongoing piece of work. For both investors and the company. But clearly having been involved in this work for 45 years we can affirm that shareholder advocacy has made an identifiable difference in company policies, practices and thinking.
>
> **Tim Smith**
>
> Director of ESG Shareowner Engagement, Walden Asset Management

There are many types of outcomes

At times, the outcomes of investor efforts are tangible and quantifiable in terms of ESG outcomes and financial returns, and at other times, they are not. For example, an investor might be focused on increasing the number of women on a particular board, while another investor might be focused on building general awareness among an entire portfolio of companies on the business-benefits of diversity in the workplace. Success with the former can be demonstrated by a percentage, while success with the latter is much harder to quantify.

Evaluating outcomes also depends on the lens of focus—does the investor seek to shift one company or is she or he trying to reduce ESG risks for an entire industry or market? Outcomes can be at the company-level or relate to broader industry and systems change. If the aim is much broader,

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* Refer to "Prioritizing Objectives" section on page 20.

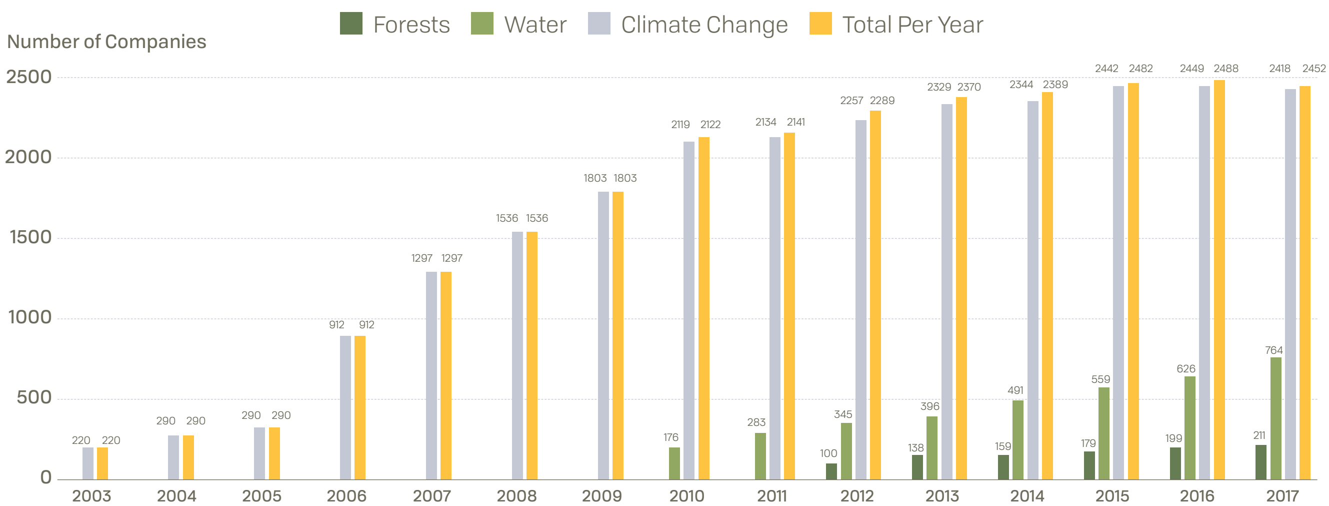
at which point can it be said that success happened, or isolate the effect of the efforts of one investor from the rest of the market powers acting at the time? For example, if an industry leader or high-profile institution transforms their ESG approach, this can have ripple effects throughout an industry.

> Our most impactful work is where we address market-level governance issues such as proxy access or board diversity, so I think it is a good use of our resources to go broad rather than to stay very focused on very small number of companies. I think that serves our interest and the market better.
>
> **Michael Garland**
>
> Assistant Comptroller for Corporate Governance and Responsible Investing, New York City Office of the Comptroller

Success is relative to time horizons

A corporation's ability to respond to investors can change over time, depending on factors such as the state of knowledge on the issue, management and board's level of attention to ESG issues, what the company is reasonably able to do at a particular point in time, whether practical solutions are already in existence, what competitors are doing, and external pressures that affect the level of priority given. Success is highly dependent on timing—did the investor interact at a time that was good for the company internally, and at a time when external pressures were aligned? Similarly, since outcomes take time to materialize, success cannot always be assessed within a short time frame, and often requires a longitudinal perspective. Consider for example, how today most large companies in major developed markets measure and report climate metrics. When environmental disclosure organization CDP began asking companies for climate data in the early 2000s, it received responses from only 220 companies; by 2017 this figure had risen to 2,418 companies. Over the long-term, the progress made has dramatically shifted corporate disclosure practices. As a result, today's investors are far more conscious of climate risks and opportunities and can therefore engage with companies to better manage these issues.

Growth in Disclosing Companies — 2003-2017



Source: CDP

Success is a continuum of progress

Rather than being binary, success can be understood as a continuum of progress. Different corporations may be at vastly different starting points, but over time investors can help companies to move along the continuum towards a fuller integration of ESG risk and opportunity into the business and ultimately, better financial performance. That progress could be incremental, or it could be transformational change—as is the case when new technologies come into play or when a company begins to play a leadership role within its industry to solve industry-level risks such as human rights violations in shared supply chains.

In Practice: *Tracking success through an internal platform*

After relying on spreadsheets to track progress, the team at NEI Investments decided to build an internal database to record engagement work based on a three-factor success assessment. Given that each interaction has a determined objective, the first observation recorded by the team is whether the company has responded to the investor request, or alternatively if the company has managed to demonstrate that the issue is not a true cause for concern. The second factor is an assessment of whether a company was responsive or unresponsive on the issue of concern. Third, the database captures a broader picture of the company's responsiveness on ESG issues, an important consideration for further investment. Overall, the database enables the team to evaluate when progress is being made, and to make better decisions about where to focus investor efforts. By gathering data across multiple influence strategies, the team hopes to be able to divert future resources towards the most effective options.

Success is often a joint effort

The decision to allocate investor resources to influence corporate behavior on ESG issues requires an underlying rationale as to what the effect of that resource allocation will be. Our interviews revealed that many investors accept that success cannot always be directly attributed to their organizations efforts alone. Addressing complex challenges often requires the joint effort of many actors. The collaborative nature of success needs to be considered by investors when deciding how to scale up efforts efficiently.

In Practice: *Tracking success through the Ceres Engagement Tracker*[49]

As part of broader investor efforts to encourage companies to address ESG risks and opportunities, Ceres tracks shareholder resolutions filed by members and allies of their Investor Network through an online database. The database contains information about companies that have been engaged, the nature of proposals filed, voting results, and most importantly, the outcomes—such as withdrawals of proposals in return for company commitments. Tracking this data has enabled Ceres to evaluate progress, for example showing that 73% of companies that make commitments to investors on climate change fully meet these commitments.[50]

IMPLEMENTATION OF INFLUENCE STRATEGIES

HOW INVESTORS DETERMINE CORPORATE PRIORITIES

The ability of an investor to influence corporations towards better management of ESG risk and opportunity will largely depend on the approach from within the investment institution—starting from setting beliefs and policies, prioritizing objectives, allocating resources and preparing to interact.

The identity of investors: What does it mean to "own" a corporation?[51]

Research acknowledges that ownership goes beyond investors acting as value-maximizing agents, and extends to encompass a wide variety of conceptual framings, relevant to different types of investors:

- **Ownership as rights**—Being owners gives investors a bundle of rights they can exercise
- **Ownership as commitment**—Being owners creates psychological and emotional ties to the object of ownership
- **Ownership as stewardship**—Investors are motivated to engage with companies to support their long-term welfare.

Whether an investor is interested in interacting with companies on ESG issues will depend on their ownership profile. For active and frequent traders with short-term interests, ownership rights tend to be highly transient. If a company is bought and sold within a short period of time, there will be little opportunity to address ESG issues. For universal owners that have stakes in major portions of the global economy, their interests will lie in the long-term performance of companies, the economy, and society as a whole.

Setting beliefs and policies

Some, but not all, institutional investors have formal investment beliefs and policies that both help align institutional goals with investment practices and inform corporate engagement priorities. Belief statements help provide clear guidance and expectations to internal teams, external managers and portfolio companies. Clearly articulating investment beliefs and policies can inform the investment decision-making processes and drive engagement priorities.

> "Investment Beliefs Statements articulate the fundamental perceptions of trustees and their institutions on the nature of financial markets and the role they play within these markets...they set forth the institution's rationales for the selection of investment styles and managers; the principles they apply in the investment process; and the strategic decisions they make and why. A belief statement sets forth the institution's fundamental goals. Policy statements describe the specifics of how the institution hopes to achieve those goals."
>
> **Modified from the Initiative for Responsible Investment (IRI)**
> The Hauser Center, Harvard University

Investment beliefs and polices have primarily been used by asset owners to inform ESG priorities. Lately, a growing number of asset managers state that having their own clear set of beliefs and policies that integrate ESG issues can help build deeper relationships with clients and drive new product development.[53] In their *Blueprint for Sustainable Investing*, Ceres describes the importance of establishing a commitment to sustainable investment through a statement of investment beliefs or investment policies. Ceres recommends that, "an assessment of beliefs helps to identify distinct views on sustainable investing issues such as climate change and resource scarcity." Ceres suggests that, "the strength of the beliefs held will determine how the investment strategy can be adapted to take account of long-term factors."[54]

Prioritizing objectives

An investor's priorities and goals will reflect the organization's own values, objectives for shareholder value creation, style of investing and level and type of engagement. A spectrum of ESG priorities and goals exists, which involves increasing levels of "intentionality" that can be aligned with an investor's beliefs and policies.[55] On one end of the intentionality spectrum, an investor might choose to focus on improving ESG disclosure among its portfolio companies. This decision provides the critical foundation for investor stewardship, as it generates the ESG information needed to facilitate interactions and identify those companies that are proactively identifying and managing material ESG risks, as well as seizing opportunities to innovate, potentially increasing future earnings and long-term value. On the other side of the spectrum, an impact investor might be focused on investing in transformational business models that maximize positive social or environmental return on investment. This task requires developing a deep understanding of the potential impacts that investment opportunities might bring, designing new measurement processes and identifying the greatest ESG investment opportunities.

The amount and type of resources allocated will also vary according to the magnitude of the issue and the type of relationship that an investor seeks to develop with a company. For some investors, it may be important to work in partnership with the company, acting as a "sounding board" on ESG issues and providing regular input on strategic discussions. In other cases, the goal may be to interact on a short-term basis to resolve specific issues. The choice between being more vocal and out-front on controversial ESG issues as opposed to a more private method of advocacy depends on the type of investor, who their constituents are and how they perceive their fiduciary duty. These factors all form part of the internal culture that impacts the way that investors can influence corporations.

Allocating resources

Prioritizing objectives will eventually lead to resource allocation, especially when there is buy-in from senior leadership at the investment institution. Despite a trend of growth in the number of staff being dedicated to engaging with companies on ESG issues, most departments are still relatively understaffed given the number of portfolio companies they invest in.

Many investors choose to join collaborative initiatives on ESG issues, which helps improve the effectiveness of their engagements without the need to add much in the way of dedicated staff. These collaborations effectively combine size, ownership stakes and reputations to increase investor influence, while benefiting from efficiencies derived from sharing research sources, workloads and costs, and preventing duplication of efforts.[56]

Preparing to interact

How can investors most effectively make the case for companies to address material ESG issues? Investors can set the foundations for success by undertaking preparatory steps before initiating engagement. These steps include:

- **Establishing the facts on the company**—Many investors conduct "fact-finding" activities to build a solid picture of the company's performance. Research on the company's history and current state with the ESG issue can also help the investor to gauge what is a reasonable request for future progress. Our interviewees also noted that gaps in corporate disclosure do not necessarily mean that the issue is not being addressed.
- **Deepening knowledge on the ESG issue**—Building deeper knowledge on the ESG issue in question is an enormous aid to a good engagement, and particularly important for topics that are highly technical or complex—for example deforestation impacts in agricultural supply chains or methane leakage in the oil industry. In these cases, investors often benefit from working with NGOs and investor members groups that provide research support and engagement guides on specific topics.
- **Clarifying the objective and the business case**—When investors have clear and predetermined objectives for reaching out to companies, this can facilitate smooth and focused interactions with corporations. Clarifying the business case for corporate action will both establish the investor's legitimacy and help companies understand why investors would be interested in engaging on issues that many may still see as moral or "special interest" topics.
- **Researching what competitors are doing**—Gathering evidence on how a company is performing relative to competitors can be a key leverage point for change. Companies that are significantly underperforming may have more motivation to make rapid improvements to bring their performance in line with expectations.
- **Ensuring effective communication**—Productive investor-corporate interactions rely on good communication. Investors can foster good communication by considering the tone of their engagement and the key messages they seek to convey. To ensure focus, investors may decide to prioritize a smaller number of key messages to communicate at a time. Many investors choose to notify companies of their intentions in advance in order to allow time for the company to prepare and gather information that will inform the interaction.

> "We are very persistent. We will keep coming back if a company doesn't respond to us. But I would say, we also have some humility. The company knows more about most of these topics than we do. They're working at it from the inside, so we try to be very respectful."
>
> **Michelle de Cordova**
> Director – Corporate Engagement and Public Policy, NEI Investments

→ **Thinking about the corporate perspective**—The corporate perspective can help investors understand when a company will be most responsive to certain ESG issues. Certain times of the year are more conducive to change. For example, it may be more strategic to talk about long-term strategy in the period after the AGM, as beforehand can be very busy. Pinpointing the right people at the company to interact with is also highly valuable. Our interviewees outlined the need to go beyond Investor Relations teams to reach key decision-makers, and if appropriate, to elevate concerns to the board.

> "The more time we take preparing for the interactions we have, the better the conversations run. Internally, we devise the agenda, develop our talking points and compile the research. We also prepare the company, so often the lead investor will take some time to have a quick conversation with the company to set expectations, and we'll send an agenda in advance."
>
> **Nadira Narine**
>
> Senior Program Director—Strategic Initiatives, Interfaith Center on Corporate Responsibility

ESG research resources

Investors relay on a range of data sources to inform their understanding of ESG issues and corporate performance and guide their engagement with companies. These include ESG disclosure standards, company data, scorecards and rankings, reports, frameworks and tools, often produced by NGOs, investment data providers and sustainability practitioners.

RESOURCE TYPE	PROVIDERS	EXAMPLES
Thematic and industry research	Sell side research providers such as Bank of America Merrill Lynch, Deutsche Bank, Goldman Sachs, Morgan Stanley, and UBS; ESG data research firms such as MSCI and Sustainalytics. Non-profits such as Carbon Tracker, CDP, Ceres and PRI.	Carbon Tracker's reports on the impact of the energy transition on capital markets and the risks of investment in high-cost, carbon-intensive fossil fuels support investors in mapping both risk and opportunity on the path to a low-carbon future, and have helped mainstream the terms the "carbon bubble" and "unburnable carbon."
Corporate analysis and scoring	For-profit ESG data providers such as MSCI, Sustainalytics, Trucost and Vigeo Eiris. Investor-focused non-profits such Ceres, CDP and FAIRR; NGOs such as Greenpeace, Oxfam and Supply Change/Forest Trends.	Ceres' biannual assessment of progress of 600 large US companies against the Ceres Roadmap for Sustainability is a comprehensive resource for investors for identifying leading practice by a range of sectors on material ESG issues such as climate change, water pollution and scarcity and human rights abuses.
Platforms that aggregate self-reported corporate data	For-profit financial data providers such as Bloomberg and Thomson Reuters, and non-profits such as CDP.	CDP's database of corporate disclosures on climate, water and forest-related risks and opportunities derives from annual surveys completed by more than 6000 global companies.
ESG disclosure frameworks	Frameworks providing ESG disclosure guidance to companies include those developed by the Global Reporting Initiative (GRI), the International Integrated Reporting Council (IIRC), and the Sustainability Accounting Standards Board (SASB).	The GRI's Sustainability Reporting Standards are the first and most widely adopted global standards for sustainability reporting. Thousands of global companies currently report against the GRI standards.
Investor engagement guides	Ceres, EDF, PRI	EDF and PRI's Investor Guide to Methane provides a framework for investors to help them identify concrete next steps companies can take to improve management, benchmark company performance and engage on methane risks.

DIRECT DIALOGUE

Direct dialogue involves direct communication between investors and companies, through phone calls, emails, letters, and in-person meetings. These dialogues may be short-term in nature, tied to a specific issue or event, or longer-term ESG-oriented discussions that may over time cover a number of issues. Dialogues take many forms. These include bilateral dialogues between the company and one investor, dialogues involving multiple investors, and dialogues that bring investors together alongside ESG issues experts from nonprofits or academia. Through dialogues, investors may have the opportunity to interact with different levels of individuals within the corporate hierarchy, for example internal company experts, senior management and the board.[57] Increasingly investors are also engaging in dialogue with companies through their role as bond holders, providing an additional access point on ESG for investors with fixed income holdings.[58]

Why choose direct dialogue?

Direct engagement helps investors gain a clearer sense of whether (and how effectively) ESG issues are being identified, managed, governed, and integrated into business strategies and operations. Because direct engagement is typically solutions-oriented, it sets the stage for improved access and influence with the company over time. When undertaken collaboratively, it provides an avenue to engage directly alongside other investors and stakeholders to demonstrate the importance of these issues and helps surface a range of ideas and potential solutions. For both companies and investors, understanding the impact of ESG issues on future business success can be challenging; a healthy dialogue between investors and companies is therefore a powerful instrument to develop this strategic foresight.

Benefits of direct dialogue

- **Enables constructive discussions** on sensitive issues
- **Facilitates sharing of investor insights** on solutions to complex ESG issues
- **Shapes corporate culture** through discussions
- Improves investor understanding of the **company's culture, performance and strategy**

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

Anne Simpson
Director of Corporate Governance, California Public Employees Retirement System

When you interact with a company, whether you're on the fixed income side or the public equities side, you are still trying to influence the same management team. It's still the same Chief Sustainability Officer and CEO and Board of Directors. And, ultimately, they need to make cohesive decisions about the company that make sense to all investors. So, when you really start asking about things like strategy and how important sustainability is within the strategic planning process, you essentially become asset class agnostic. At the end of the day, it's about the company itself as a primary unit of analysis."

Jem Hudson
formerly of Breckenridge Capital Advisors

Success factors

Our research suggests the following factors help maximize success in changing corporate behavior through direct dialogue:

- A strong business case and clear set of potential company actions are referenced
- Sufficient time is devoted to research and preparation before the dialogue occurs
- Company representatives with decision-making authority are involved in the dialogue
- Dialogues are undertaken in collaboration with other investors
- Geographic or cultural influences are taken into account to improve the quality of dialogue
- Company performance is monitored over time
- The tone of the dialogue is solutions-oriented
- Meetings are face-to-face, whenever possible

Drawbacks of direct dialogue[61]

- **Lack of formal obligation** for companies to meet with investors or respond to requests
- **Resource-intensive** as there is much time spent on preparation and communications
- **Difficulty in tracking short-term progress** by the company on the ESG issue

Is direct dialogue effective?

Direct dialogue appears to be a highly effective means to influence corporate behavior on ESG issues for long-term results. For example, a study investigating the impact of dialogue with 188 companies over the period of 1999 to 2013 by California Public Employees' Retirement System (CalPERS), found that companies placed on the "focus list" for engagement performed significantly better (15 percent above the Russell 1000 Index) and has been dubbed the "CalPERS Effect."[59] The success of direct dialogue seems to lie in the subtleties of how to engage, when to engage and who to engage with. According to data gathered by Hermes Investment, personal interactions have a substantial influence on the success of engagement; on average each additional personal meeting increases the chance of the company making progress by about five percentage points.[60]

Dialogue can be particularly effective when it is collaborative. Collaboration is more prevalent for environmental and social engagements compared to corporate governance issues, as it helps combat the challenge of convincing company managers to make changes that are less standard and often costlier to implement.[62] Collaborative dialogue unifies the voice of many investors and combines resources, ownership stakes and reputations to mount pressure on corporations. Research shows that collaborative engagement combines different sources of power, legitimacy and urgency helping attract manager's attention, while facilitating organizations such as the PRI, Ceres and ICCR can help to lower the barriers to entry, provide a mobilizing structure and space for dialogue, and add persistence to collaborative projects.[63]

Theme	Number of dialogues	Number of successful dialogues	Success rate	Average days till success
Environmental	750	209	28%	622
Social	176	85	48%	1,122
Governance	75	63	84%	1,069

Source: Adapted from PRI (2017)

Evidence from collaborative dialogues involving 225 investment organizations over the period 2007-2017 shows that after successful engagements have occurred, target companies experience improved profitability (as measured by return on assets), while unsuccessful dialogues demonstrate no change.[64] The data also identifies that success rates are elevated by about one-third when there is a lead investor heading the dialogue, and that success rates are higher when participants have significant ownership of target companies.

Collaborative Dialogues

Collaborative investor dialogues take many forms, and often benefit from the involvement of a third-party that supports investor coordination and serves as a resource on key ESG topics. Examples of organizations that play this role include:

- **CDP**, which provides a collective mechanism for investors to aggregate their assets in support of annual requests for disclosure from the largest publicly listed companies on their exposure to and management of climate, water and forest-related risks and opportunities.
- **Ceres**, which supports coordination and tracking of hundreds of shareholder resolutions in the U.S. on issues including climate change, water scarcity and deforestation, and also manages long-term, multi-stakeholder dialogues on sustainability issues among companies, their shareholders and other stakeholders—Including environmental and social NGOs and issue experts.
- **The Interfaith Center for Corporate Responsibility (ICCR),** which supports the coordination of hundreds of investor-company dialogues every year on a range of social and environmental issues, uses a structured engagement approach that involves a lead investor, and sometimes includes representatives from NGOs and community groups.
- **UN PRI**, which coordinates issue-specific investor-company engagements involving multiple investors over a defined time period.

In Practice: Timing is key[65, 66]

The California State Teachers' Retirement System (CalSTRS) is the largest educator-only pension fund in the world, with an investment portfolio market value of almost $223 billion.[67] In deciding when to engage, individuals from CalSTRS recognize that certain times are not conducive to direct communication. In particular, they have found that conversations are most valuable before earnings announcements, when companies are in a "closed period" and that discussions about long-term issues are most productive after AGMs. They recommend that determining how often the board meets and when the board would next be discussing the issue is valuable as it allows for coordination of discussions with the board's timeline. If a sustainability issue is of strategic importance, CalSTRS engages the board because they are charged with overseeing management. To ensure that issues are overseen by the board, it can help to speak with the individual responsible for setting the board's agenda, usually the board chair.

***In Practice:* Tracking the progress of dialogue at Schroders**[68]

In 2017, the ESG team at Schroders undertook 1,013 specialist ESG engagements with 781 companies in 50 countries. These engagements typically involved one-on-one meetings, written correspondence or phone calls, discussions with company advisers and stakeholders, and joint engagement with other investors. Over 600 engagements were noted as 'fact finding' dialogue, while the rest were focused on 'change facilitation'. The team logged all instances where change was requested at companies on ESG issues, categorizing progress according to a five-point scale ranging from "achieved" to "no further change required." Schroders note that it takes time for outcomes to materialize, and therefore they look at progress over a multi-year time-frame. Of the engagements that started in 2013, 56% of change requests have been "achieved" or "almost achieved."

THE SHAREHOLDER PROPOSAL PROCESS

The shareholder proposal process consists of three key aspects:

(1) filing a shareholder proposal

(2) negotiating a withdrawal and

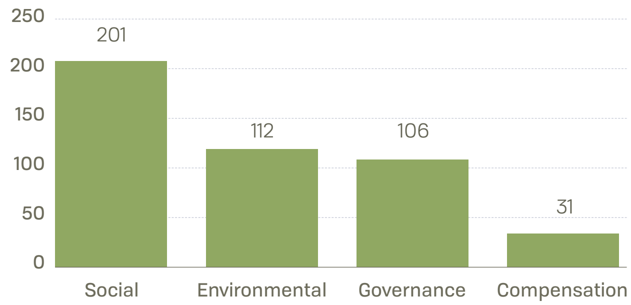
(3) voting.

FILING A SHAREHOLDER PROPOSAL

The ability to file non-binding shareholder proposals on ESG issues is an important legal mechanism for investors around the world, with rules varying by jurisdiction.[69] Filing proposals is most common in the United States, where investors owning a minimum of $2,000 in stock or a 1% stake of a publicly traded company for a minimum of one year have the right to file a resolution.

In 2018, more than two-thirds of shareholder proposals filed at Russell 3000 companies concerned environmental and social issues, continuing the recent trend of social and environmental issues outnumbering governance and compensation-related proposals.[70]

2018 US Shareholder Proposal Filings at Russell 3000 Companies[71]



Source: ISS Analytics via Mishra, 2018

Why choose to file a shareholder proposal?

Investors may choose to file shareholder proposals as they represent a cost-effective way for companies and boards to gain a better understanding of shareholder concerns. Experienced filers can draft proposals quickly and potentially target many companies by adapting the same mechanism to different situations. An important feature of the shareholder proposal process is that it does not distinguish between different shareholders, since the quality of one's ideas is independent of the size of one's investment.[72] While the shareholder resolution has been an important instrument for large asset owners, filing proposals can be particularly well-suited for smaller investors that cannot rely on ownership control but rather seek to gain traction based on the strength of their arguments.

Filing a shareholder proposal enables investors to follow a standardized approach—in the US, resolutions are limited to 500 words and constitute a formal "ask" that needs to be aligned with rules set by the Securities and Exchange Commission (SEC).[73] Resolutions are a means of fast-tracking progress on issues that need to be addressed with a sense of urgency because companies need to decide by a certain date whether to include the resolution in their proxy statement or negotiate a withdrawal by the flier. Relative to other investor influence strategies such as private dialogue, the process of submitting proposals also attributes a sense of formality and importance to an issue because there is the potential for all the company's shareholders to vote on the proposal and because voting outcomes or company commitments related to shareholder proposals can be tracked in the public domain.

Benefits of shareholder resolutions

- Proposals **create urgency** as there is a timeline for the company to respond
- Provides **leverage for filer** due to management's preference to avoid resolutions going to a public vote
- Facilitates **board level involvement**
- **Educates the shareholder community** on emerging issues
- It is easy to **observe trends and build datasets** on filed proposals
- **Raises awareness** on ESG issues in the public domain
- Shareholder proposals can **open the door to dialogue**

> Our members are long-term shareholders who can attest to the fact that for over 45 years the shareholder proposal process has served as a cost-effective way for corporate management and boards of directors to gain a better understanding of shareholder priorities and concerns and to benefit from those insights on critical and emerging risks and opportunities. The process has proven to be valuable to numerous companies and has given shareholders an important voice.
>
> **Letter to the White House** from the UN PRI, US SIF, ICCR, Ceres and CII[74]

Success factors[75, 76]

Our research suggests the following factors help maximize success in changing corporate behavior through filing shareholder resolutions:

- Investors demonstrate a strong business case for the proposal
- Investors with similar requests coordinate on filing
- Investors receive input from the wider investor community and ESG topic experts before filing on complex, emerging issues
- Media attention raises the profile of investor concerns
- Investors strategically file resolutions at large, highly visible companies to impact the rest of the market
- Proposals address topics that are important to both the company receiving the proposal and to society
- Proposals are carefully worded to avoid violating SEC rules that permit companies to omit proposals from their proxy statements

Drawbacks of shareholder resolutions

- Can strain **investor-corporate relationship** as some companies are frustrated by the process or become defensive
- **Loss of trust** from corporate management negatively impacting private dialogue

Is filing a shareholder proposal effective?

Once a resolution is filed, it can be actively challenged by the company and potentially be subject to exclusion from the proxy ballot if it is not aligned with SEC rules on the filing process. Omitted proposals are in effect unsuccessful proposals that have a very limited ability to create change.[77] On the other hand, the mere process of successfully filing a proposal can be effective in raising an issue with management even before it culminates in a withdrawal or goes to a vote. Proposals often raise the profile of an issue internally within the company, as a formal investor request can make it easier for the board to prioritize and address the issue. For many filers, shareholder proposals are considered as one step among broader efforts to improve corporate management of material ESG issues and used as a tool to open the door for dialogue.[78]

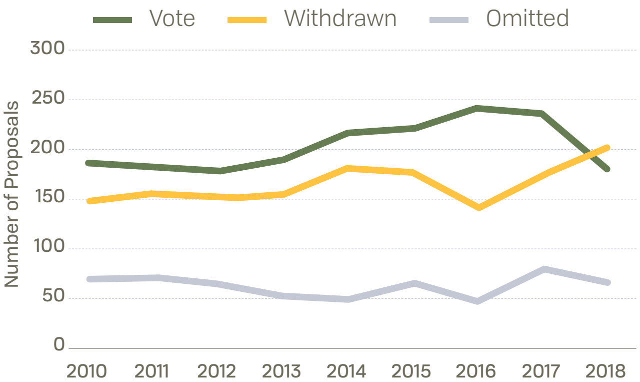
> "There have been instances where we have heard from company management that the filing of a shareholder resolution helped put the issue on the board's agenda. While a risk or an issue may have been recognized internally, in the absence of a shareholder resolution, it may not have been likely to get the board's attention in the near future."
>
> **Michael Garland**
>
> Assistant Comptroller for Corporate Governance and Responsible Investing, New York City Office of the Comptroller[79]

NEGOTIATING A WITHDRAWAL

A company and the filer of a shareholder proposal (proposal sponsor) may engage in private negotiations prior to the company's annual general meeting (AGM). If the negotiations satisfy the shareholder's requests, the sponsor can choose to voluntarily withdraw the shareholder proposal. For the vast majority of investors who file shareholder proposals, "success" in filing a proposal is defined by achieving a withdrawal tied to a mutually agreed upon set of actions the company will take disclose or act upon the issue that has been raised.

Data on proposals filed on social, environmental and sustainability issues between 2010-2018 from the Sustainable Investments Institute shows that a significant proportion were withdrawn.[80] In 2018, 45 percent of these resolutions filed were withdrawn.

Social, Environmental and Sustainability Proposals Filed



	2010	2011	2012	2013	2014	2015	2016	2017	2018
Vote	186	185	180	192	217	221	243	237	181
Withdrawn	147	154	150	153	181	178	139	173	200
Omitted	65	68	61	50	46	60	45	77	64

Source: Sustainable Investments Institute (Si2), as of 6/30/18

Benefits of negotiating withdrawals

- **High success rate** in terms of securing corporate commitments
- The **threat of going to a vote** puts the investor in a **strong position to negotiate**
- Negotiations can be **very focused** due to shareholder proposal detailing **specific concerns and requests**
- Presents an opportunity to reach a **win-win outcome for both the company and the investor**
- **Accelerates discussions** on an issue ahead of the AGM
- Corporations can **prepare for the negotiations** based on the information provided in the filed resolution
- Over time, implementation of **commitments can be evaluated**

Why choose to negotiate a withdrawal?

Voting on shareholder proposals is not the only opportunity for investor requests to be heard, as there is a window of opportunity to enter negotiations in the period preceding the AGM. Indeed, a significant proportion of shareholder proposals are voluntarily withdrawn by investors in return for commitments from the company to address the issue of concern.[81] It is increasingly common for investors and companies to talk through issues even when raised through formal means, and this is representative of a wider trend towards dialogue over more formal mechanisms.[82] While the initial filing of a resolution is sometimes viewed as combative by the company, withdrawing after negotiations is sign of more positive relations with the company.

Negotiated withdrawals represent a win-win outcome for investors and companies. For investors, a withdrawal typically means that the company accepts that the issue is important enough to warrant cooperation and makes a commitment to partially or fully implement the investor's request.[83] From the corporate perspective, negotiations offer an opportunity to better understand investor concerns. Often, management is motivated to avoid having the issue included in the proxy statement.[84]

> Quite often resolutions are withdrawn after they promoted dialogue with the company leading to a win-win outcome, an exchange of views or a better-shared understanding between shareholders and the company.
>
> **Letter to the White House** from the UN PRI, US SIF, ICCR, Ceres and CII[85]

Success factors[86]

Our research suggests the following conditions help maximize success in changing corporate behavior through negotiating withdrawals:

- The request relates to a material ESG issue and is aligned with risk management and value creation
- There is support for the request by a broad coalition of investors
- When the company's competitors have already taken the requested action
- The request addresses a serious reputational risk
- Tone of conversations is positive, and solutions based
- Companies agree to specific actions in writing, allowing investors to track if commitments are met

Is negotiating a withdrawal effective?

Shareholder proposals give the investor significant leverage during negotiations because corporate managers typically seek to avoid external proposals being put to a vote.[87] And according to data from Ceres, around 70% of these commitments are implemented by companies. Academic research reaches a similar conclusion, showing that 79% of withdrawn resolutions were followed by a concrete outcome.[88] A potential pitfall of withdrawals is that the company may make commitments but delay implementation or follow through on commitments with poor implementation. While some commitments can be evaluated quantitatively, others can only be evaluated qualitatively. For example, if the company commits to issue a two-degree scenario report, it may produce an excellent one or a very poor one. Judging the effectiveness of settlements is also somewhat time-dependent. In the short term (the first year), the details of the commitment may remain confidential and outcomes may not immediately manifest. In the medium term (after a year or so), the commitments made by a company can be better evaluated. Over time, if the progress of commitments does not satisfy the investor, there is still the opportunity to file another resolution and put the issue to a vote in the future or to escalate, such as by voting "no" on individual board members.

Drawbacks of negotiating withdrawals

- **Information asymmetry**, as negotiations happen behind closed doors (many commitments remain confidential for at least the first year after they are made)
- **Symbolic responses** by management solely interested in avoiding reputational damage
- **Loss of the impact** of going to a public vote (e.g. other shareholders express views, media attention around voting)

VOTING ON SHAREHOLDER PROPOSALS

Shareholder proposals can be brought to a vote at the annual general meeting (AGM) of U.S. headquartered companies. An investor can choose to vote in person at the AGM, by return mail or via a proxy vote.

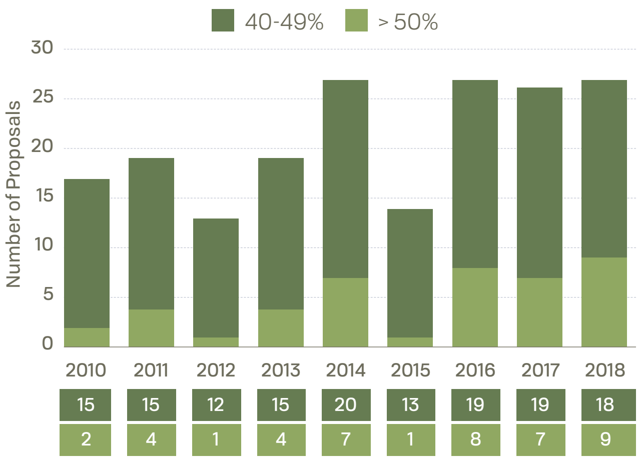
VOTING RESULTS ON PROPOSALS FILED ON SOCIAL, ENVIRONMENTAL AND SUSTAINABILITY ISSUES, 2010-2018

	Environment	Sustainability	Social	ESG Average
2010	15.7%	25.2%	18.4%	18.3%
2011	17.9%	19.0%	20.7%	19.8%
2012	16.4%	19.4%	19.0%	18.5%
2013	16.4%	24.2%	23.0%	21.7%
2014	21.1%	18.7%	23.3%	22.2%
2015	18.0%	19.2%	21.6%	20.0%
2016	24.7%	20.9%	19.2%	21.1%
2017	28.3%	20.2%	18.7%	21.4%
2018	25.1%	20.4%	22.0%	22.4%
Overall Totals*	20.6%	20.6%	20.7%	20.6%

** Excludes 3 not opposed by management*

Source: Sustainable Investments Institute (Si2)

High Scoring Shareholder Proposals* 2010-2018



* Opposed by management on environmental, social and sustainability issues.
Source: *Sustainable Investments institute* (Si2), as of 6/30/18

Benefits of proxy voting

- **Uses collective pressure** to influence corporate management
- Forces management **to carefully consider and clarify their position** on an issue
- Establishes a **clear time frame** for issues to be dealt with since investors will vote on the topic at the annual meeting
- Encourages **other investors to think about an issue** because it is up for consideration
- **Provides insights to peer companies** not subject to a shareholder proposal about investor views and concerns on a topic

Why choose to exercise voting rights?

Exercising voting rights is a formal mechanism for investors to voice their concerns, enabling the investor to agree, disagree or abstain on a vote for a recommended course of action. Bringing an issue to a vote often signals that a company has been insufficiently responsive to investor concerns. Voting is a useful mechanism to stimulate change given that it provides an opportunity for the entire shareholder base to weigh in on an issue that could be of wide concern. As voting results are publicly available, this strategy also offers leverage for investors as they engage other companies to address potential ESG risks. Finally, the public nature of the process provides a higher degree of transparency over issues that are a significant concern to investors, unlike dialogue that often occurs behind closed doors.

The decision on how investors will cast their votes is usually informed by proxy voting policies that detail guidelines for considering what type of social and environmental proposals they will support. It is important to note that many institutional investors hire proxy advisors such as ISS and Glass Lewis to provide advice on how to vote on issues.[89] This dramatically boost the efficiency of the voting process for large institutional investors who face thousands of voting decisions each year. Finally, it is important to note that in the US, many institutional investors are required to make public their proxy voting guidelines and proxy votes.

> “Resolutions that are not withdrawn can be voted on by all holders of voting stock—giving the board and management input far beyond that of the shareholder(s) who initially filed the resolution.”
>
> **Letter to the White House** from the UN PRI, US SIF, ICCR, Ceres and CII[90]

Success factors

Our research suggests the following factors help maximize success in changing corporate behavior through voting:

- The filer makes a strong business case for the proposal via both the proposal itself and supporting materials distributed to other investors
- Investors seek the support of other institutional investors to help build a high vote and participate in early vote declaration campaigns offered by investor networks such as Ceres and PRI
- Investors focus on large and high-profile companies to impact the rest of the market
- Voters are familiar with important ESG risks and opportunities and have proxy voting guidelines that allow them to vote "For" proposals
- Educational campaigns and media coverage are used to raise awareness and initiate collective action
- Proposals align with the voting trends of large institutional investors and proxy advisors who are ESG-aware

Is voting on shareholder proposals effective?

Driving a proposal through to a vote and even securing widespread shareholder support are not guarantees of corporate action or responsiveness.[91] However, despite being non-binding in nature, shareholder votes are effective in sending a strong signal to the board, creating visibility on and pressure for management to address ESG issues.[92]

Even in the absence of majority votes, research from Harvard Business School shows that shareholder proposals on ESG issues are effective at improving the performance of the company on the issue.[93] In a sample of non-majority vote ESG proposals, management was found to be responsive to the issues raised, while proposals on material issues were associated with subsequent increases in firm value. Over time, the average percentage support levels for environmental and social proposals are showing an upward trend.[94]

In 2017, three climate change proposals received majority support, compared to one the previous year, helped along by a shift in voting practices of large institutional investors that are exerting greater pressure on companies to address material issues.[95] The evidence suggests that beyond the immediate outcomes of voting (gaining majority support or not), the wider impact of voting is that it gradually builds momentum for change. Shareholders can resubmit proposals in subsequent years if they meet the minimum thresholds for eligibility (at least 3% in the first year, 6% in the second year and 10% in the third year)[96] and this can help raise investor and corporate awareness on issues, especially as educational campaigns are run in advance of the AGM in a bid to gather widespread support.

Drawbacks of proxy voting

- Important issues may initially receive **low votes** as there is a time lag for the investment community to learn about the issue and escalate concerns to the company
- Companies may interpret non-majority votes as a sign that they can **delay acting** on the issue
- Companies can **decide to challenge proposals** to the SEC rather than addressing the issue
- Investors may suffer **low votes** for several years and need to give up

> For most companies, when a resolution gets 10% support, the board starts working on it. Some start even earlier than that because they know it's an issue.
>
> **Sr. Patricia Daly**
> The Tri-State Coalition for Responsible Investment[97]

> Often, a shareholder resolution will fail to win a majority of the shares voted, but still succeeds in persuading management to adopt some or all of the requested changes because the resolution was favored by a significant number of shareholders.
>
> **USSIF: The Forum for Sustainable and Responsible Investment**[98]

In Practice: *Big Oil and the Impact of Environmental Shareholder Proposals*

Historically, the largest institutional asset managers have voted against all environmental shareholder proposals. This has meant that, even in the face of a strong shareholder vote major companies such as ExxonMobil could credibly claim that their approach to climate change and climate risk disclosure was supported by the company's largest investors. The 10-20 largest investors in many companies are a particular focus of management attention and engagement, in many cases out of proportion to the absolute size of their holdings. Any attempt to change management behavior benefits significantly from having these investors on their side.

To address this dynamic at ExxonMobil, Ceres and IIGCC mobilized large asset owners to coordinate and co-file a resolution with ExxonMobil asking the company to conduct a 2-degree scenario analysis, and coupled the filing with proactive outreach to the asset management community. Pre-declarations of support for the resolution were secured from major asset managers and made public, building awareness with other asset managers. In parallel, Walden Asset Management led the filing of a shareholder proposal at BlackRock, the world's largest asset manager and

ExxonMobil's largest shareowner, asking for a review of its voting process and record on climate change. This proposal was withdrawn following constructive dialogue and a commitment from BlackRock to make climate risk a priority in their engagements with public companies. In 2017, these collective efforts reached a tipping point as 62% of shareholders voted to support the proposal at ExxonMobil, including Blackrock, Fidelity, and Vanguard. Majority votes were also secured on similar environmental proposals at electric utility PPL (57%), and Occidental Petroleum (67%).

ENGAGING IN PUBLIC POLICY

Investors can engage in public policy at various stages in the policy-making process.[99] They can initiate policy discussions when they notice gaps or weaknesses in regulatory frameworks, provide information and views that support effective decision-making, facilitate implementation and evaluation of policies, and call for the termination or renewal of policy measures.

Opportunity for investors to shape policy	Example
Public position statements and letters to policy-makers	In 2017, 390 investors representing more than USD $22 trillion in assets issued a letter urging governments of the G20 nations to support and implement the Paris Climate Agreement.
Respond to consultations and policy proposals	The Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD) received 132 responses from the financial sector.
Join initiatives that seek to shape public policy	The Institutional Investors Group on Climate Change (IIGCC) is a network of nearly 150 members. The IIGCC policy program communicates investor positions on policy and regulatory frameworks.
Author reports on effective policy solutions	Aviva authored a publication entitled *Seeing Beyond the Tragedy of Horizons*, which outlines the need for policy-makers to manage a rapid but smooth transition to a low-carbon economy.
Direct meetings with legislators and regulators.	Both US SIF and Ceres coordinate lobby days in Washington, DC for investors on material ESG issues
Engage directly with companies to encourage changes in their public policy positions.	In the 2018 US proxy season, 40 lobbying disclosure resolutions related to climate change were filed.

Why choose to engage in public policy?

Investors are increasingly likely to engage with policy-makers to develop effective long-term policy frameworks.[100] For instance, the Public Policy Program of US SIF is a leading platform for investment professionals to influence key public policy debates, including environmental, social, governance and financial reform policies.[101] Globally, 44% of signatories to the PRI indicated that they engaged with policymakers in 2017.[102] As investors see the financial materiality of ESG issues, engaging with policy-makers and regulators is seen as a vital practice to protect their long-term financial interests.[103] A lack of regulation or regulatory uncertainty at the national or global scale both introduces risks and reduces corporate value. Climate-related risk, for instance, is understood by investors to be a risk that affects nearly all industries.[104] Engaging in public policy therefore helps to address systemic risks across asset classes and portfolios.[105] Lastly, engaging in public policy enables investors to tackle corporate transparency issues, defining the quality and standards of information that investors will have access to on ESG issues.

Success factors[107]

Our research suggests the following factors help increase the likelihood of success through engaging in public policy:

- Investors raise their voice collectively on public policy, with support from investor membership organizations
- Resources are dedicated to regular policy engagement on ESG issues
- Investors help to educate policy-makers on complex ESG challenges
- Investors participate in designing policy solutions

Benefits of public policy engagement[106]

- **Aligns long-term incentives** for companies to take significant action on ESG issues
- **Corrects market failures** that investors become aware of through their interactions with many companies
- **Addresses systemic risks** that undermine long-term value creation
- **Promotes binding standards of transparency and ESG disclosure** that can be legally enforced
- **Creates urgency** for corporations to respond to new legal mandates

> We see participation in the public policy process as a central part of being a responsible investor. While a few forward-looking companies will voluntarily take a leadership position on issues such as climate change, corruption or labor standards, it is often only when the playing field is levelled through regulation that a step change occurs. As investors, we can communicate to governments and regulators what type of policies will improve ESG standards in a way that also enhances competitiveness and long-term value for investors.[108]
>
> **BMO Global Asset Management**

Is engaging on public policy effective?

Recent public policy developments confirm that governments do listen to the views of investors. For instance, investors have played a critical and effective role in the following:

- The 2010 decision of the **US Securities and Exchange Commission (SEC)** to release formal guidance for companies to disclose climate risks in their 10-K filings. Ceres first called for this type of disclosure in 2003, and the scale of investor support was an important signal to the SEC that climate change was a critical issue for investors.[109] Investors are involved in ongoing work to improve the quality of disclosures that are required.[110]
- The enactment of the **UK Modern Slavery Act** in 2015 where investors played a key role in pressing Parliament for this act, including a group of 21 investors with £940 billion in assets under management issuing support for the inclusion of a "Transparency in Supply Chains" clause.[112]

Drawbacks of public policy engagement[111]

- Engaging in public policy **requires longer timeframes** than engaging directly with corporations
- Policy-making can be a **complex process** and may require **technical knowledge** that investors may not already have
- **Outcomes will be less clear** if there is **weak policy design, monitoring or enforcement**

Once in place, public policy can be effective in driving corporate action and reporting on ESG issues. For example, public policy helps to provide investors with better quality information on ESG issues, thereby supporting companies to improve their decision-making and performance. Evidence from mandatory sustainability reporting measures introduced in various countries around the world shows that mandates have been effective in improving disclosure quantity and quality as well as corporate value."[113] Furthermore, public policy helps align long-term incentives for corporations to address material ESG risks and opportunities.[1146]

> Investors can complement engaging with companies by also looking to public policy-makers and pressing for public policy solutions. Climate change and methane are great examples of that. Investors can run on both tracks; we engage companies and explain to them why it's in their own self-interest to set GHG or methane reduction targets but at the same time, we still push for public policy solutions like federal or state rules to reduce methane and GHG emissions. At the end of the day, everybody needs to set these targets, everybody needs to reduce their GHG emissions—and that can be achieved through a combination of individual corporate action and public policy.
>
> **Jonas Kron**
>
> Senior Vice President, Trillium Asset Management

DIVESTMENT

Divestment is the sale of shares by dissatisfied shareholders.[116] It ranges from full divestment from a category of assets (e.g. from all fossil fuel assets) to partial divestment (e.g. divesting of companies that derive more than a determined percentage of their revenues from activities related to fossil fuels).[117, 118] Some investors choose the option of stock-picking based on ESG criteria within a sector or adjust the weighting of assets, also known as "best in class" or "tilting" (e.g. overweighting carbon-efficient companies and underweighting carbon inefficient-companies).

Why divest?

Divestment is one method investors can use to register their dissatisfaction with corporate behavior and communicate support for broader public policy objectives. Investor exit via divestment has traditionally been understood as the alternative to engaging with management directly to bring about change. Consequently, divestment is often viewed as a last resort, after engagement has failed to influence management.[120] The historical

Benefits of divestment[119]

- **Raising awareness** and sparking public and political debate
- **Elevating the negative impacts of an issue** with policy makers and corporate executives and board members
- **Stigmatizing the reputation of companies and sectors** by linking them to negative impacts (e.g. health effects of tobacco, droughts due to climate change)
- **Increasing the negotiating power** of shareowners seeking to engage management on the issue
- **Redirecting investments towards transformational change** (e.g. the transition to a low-carbon economy)

objectives of divestment have varied widely and include the following: redirecting capital away from certain companies, industries and countries (e.g. South Africa, Burma), raising awareness and shifting mindsets, sparking a public debate, and damaging the reputation of companies and powerful institutions.[121]

Success factors

Our research suggests the following factors can help maximize success in changing corporate behavior through investor divestment:

- Public statements, reports and media attention are used to communicate the decision
- Widespread awareness and momentum is created, which attracts attention of policy-makers and the general public
- Moral arguments are buttressed by financial arguments around the riskiness of a company or sector (e.g. the "carbon bubble" argument in the case of fossil fuel divestment)
- The issue is brought to the agenda of management and the board, and drives internal company debate

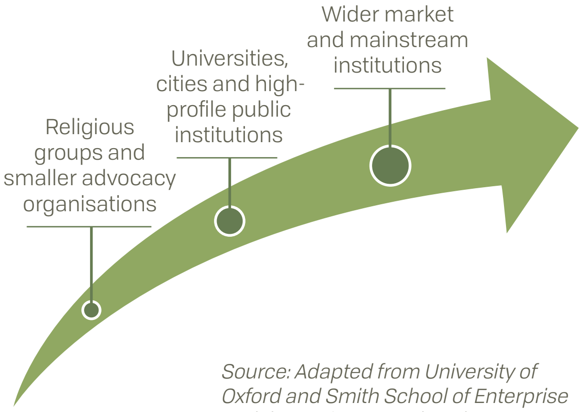
Is divestment effective?

Divestment movements typically create impact over three "waves," starting with religious groups and advocacy organizations, before spreading to universities, cities, national governments, and finally to the wider market.[122]

Divestment is often initially taken up by investors when there needs to be a wider conversation and public debate about transformational change and no single company can solve a problem. Divestment efforts therefore can be viewed as successful if they contribute to achieving a specific policy objective, such as instituting a price on carbon.[123]

In the academic literature, divestment is often linked to the objective of hitting companies financially by raising their cost of capital.[124] Selling shares sends signals that will reach management through the market—a method for investors to make their position known.[125] However, the financial impact appears to be limited as divested capital may not be significant and shares sold can always be bought by another investor who may not pressure the company as much.[126] That being said, investors who divest rarely cite this outcome as the rationale for divestment. Instead, many investors point to divestment as a method of communicating concerns to other shareholders

The Three Waves of a Divestment Campaign



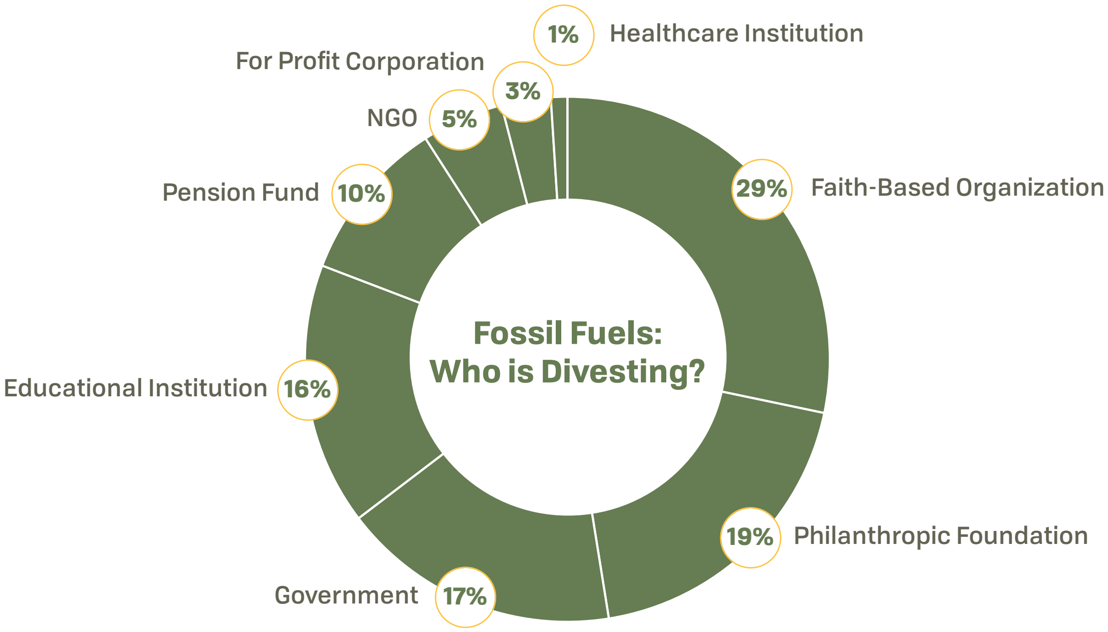
Source: Adapted from University of Oxford and Smith School of Enterprise and the Environment (2013)

Drawbacks of divestment[127]

- **Foregoing ownership rights** such as filing shareholder resolutions
- **Limited direct impacts** on a corporation's cost of capital
- **Unexpected consequences** (e.g. divested holdings are bought by neutral investors who might put less pressure on corporations to change)

and to the company. Others tie divestment decisions to the objective of reducing their financial exposure to companies and sectors that face significant regulatory or market risks expected to have long-term negative impacts on share price.

For many large institutional investors, divestment is not viewed as a viable option and engagement is typically the chosen strategy to influence corporate behavior. Investors who choose to engage, however, often benefit from the pressures that divestment activity and campaigning puts on corporate management, who as a result may be more open to investor requests.[128]



Source of data: GoFossilFree.org

Investors that have chosen to selectively stock pick or underweight portfolios have found it effective. According to BlackRock, it is possible to cut a portfolio's carbon footprint by around 70% while keeping the tracking error within 0.3%.[129] The table below shows some examples of leading carbon-efficient investment products and their performance:

PRODUCTS FOR CARBON-EFFICIENT INVESTMENTS AND THEIR PERFORMANCE

Institution	Name of Index	Benchmark	Index Carbon Footprint Relative to Benchmark	Index Performance Relative to Benchmark	Index Tilting Method
UBS	Europe Carbon Optimised Index	DJ Stoxx 600	30-40% less than benchmark	-0.45%	Sector-neutral reweighting based on carbon efficiency
BofA Merril Lynch	BofA Merrill Lynch Carbon Leaders Europe Index	DJ Stoxx 600	516% less than benchmark	-2.62%	60 stocks with highest ranking based on carbon footprint and P/E ratio in respective sectors
S&P	US Carbon Efficient Index	S&P 500	No specific target	+0.36	No more than 375 shares; Negative screen based on carbon footprint and sector weighting
S&P/TSE	S&P/TOPIX 150 Carbon Efficient Index	TOPIX 150	No specific target	+2.18%	Negative screen based on carbon footprint and sector weighting

Source: UNEP FI

In Practice: Divesting to enforce global agreements[130]

Research suggest that investors rarely adopt divestment as a stand-alone influence strategy. AP7, Sweden's largest pension fund, is one of the few examples where no engagement efforts are made prior to divestment. According to their policy, a company found to violate any global agreement adhered to by the Swedish government is to be sold and a 5-year suspension put in place. Reinvestment may occur if the company makes well-evidenced improvements in behavior. The divestment strategy is based upon global agreements signed by the Swedish Government. Since the beginning, this approach has led to swift responses to company violations—in 2001 the first assessment revealed that a company in Mexico was discriminating against pregnant employees. AP7 immediately sold its shares and the media broke the news of this decision publicly. After the negative press, the company's management checked the story and admitted it was true. Subsequently, they made a public apology and agreed to put an immediate stop to discrimination.

In Practice: Divesting from palm oil

Norges Bank Investment Management (NBIM), Norway's sovereign wealth fund, divests from companies where it considers long-term environmental, social and governance risks to be too high.[131] For example, companies are assessed on their exposure to and management of palm oil risks, as the production of palm oil in Malaysia and Indonesia is recognized as a major contributor to tropical deforestation, which is a main source of greenhouse gas emissions. Between 2012 and 2017, NBIM divested from 58 palm oil companies that were considered to produce palm oil unsustainably. NBIM is transparent about the criteria for divestment and in extreme circumstances, also places companies on an exclusion list that is publicly available. Naming companies on the exclusion list has been used to signal when companies are responsible for severe environmental damage. In 2015, the *Financial Times* reported on the exclusion of four of Asia's biggest companies due to major concerns over their Indonesian palm oil plantations.[134]

THE BROADER ECOSYSTEM OF INFLUENCE

It is important to note that the investor strategies discussed in this report exist within a broader ecosystem that shapes corporate behavior. When the various actors in the ecosystem—such as governments, consumers, NGOs, communities, the media, employees and labor unions—are aligned in their concern around a particular ESG issue, the institutional investor's influence is magnified. There are also various networks (e.g. investor membership groups) and tools (e.g. technology) that support progress on ESG issues. Considering this broader ecosystem in concert with the range of influence strategies available to them provides investors with valuable opportunities to magnify their level of influence with companies on financially material ESG issues. Collaboration among different actors is often a valuable way to combine resources, reduce duplication of efforts and share knowledge to tackle complex ESG issues.

> It's when a few of these different pieces of the ecosystem align, that companies are supported to change their behavior.
>
> **Emily Chew**
> Global Head of ESG Research and Integration, Manulife Asset Management

LEVERAGING THE LARGER ECOSYSTEM

Different investors can generate different pressure points on a company through complementary strategies. For example, not all investors believe that divestment is an effective way for them to voice their concerns about a company's management of ESG risks. However, if one investor chooses to sell off stocks and draws attention to the issue, this can provide a second investor with greater leverage in direct dialogue with a company. The drawback of one strategy (e.g. divestment ends a relationship) can be to the benefit of another by increasing the saliency of an issue (e.g. sparking constructive discussions during private negotiations).

> We are more comfortable being public about our engagements than other similar investors, who are more focused on quiet dialogue. We can say things that other investors might believe but might not want to say publicly. So, in the broader investor ecosystem we all have our roles to play.
>
> **Michael Garland**
> Assistant Comptroller for Corporate Governance and Responsible Investing, New York City Office of the Comptroller

Leveraging investor networks to enhance influence

Nonprofit investor membership networks such as Ceres, ICCR and UN PRI have played a central role in enabling investors to efficiently and effectively engage large numbers of corporations on ESG issues. Through coordination of activities, provision of relevant analytics and business case information, as well as legal and communications support, these organizations add staff capacity and greatly enhance the collective effectiveness of the investment community. These collaborations combine size, ownership stakes and reputations to increase investor influence, while benefiting from efficiencies derived from sharing research sources, workloads and costs, and preventing duplication of efforts.[133]

Engaging through multiple strategies

Rather than relying on one influence strategy at a time, investors often use multiple strategies to engage corporations. Investors might start with one strategy and switch to a different strategy if it appears ineffective or does not generate significant progress. Investors can also adopt multiple influence strategies in unison. For example, investors might undertake private dialogues with a portfolio company over an ESG issue while at the same engaging in public policy to promote effective regulation.

Multiple investors asking for the same change

Multiple different investment institutions often engage companies with the same request. Whether this is pre-coordinated or not, the culmination of these requests can have a larger collective impact on corporate behavior. Coordination can help to reach a critical mass, since it involves several investors hitting home the same message.

> “We had great success in an engagement this year, when multiple other shareholders separately happened to be making more or less the exact same request to a company. The company realized how important the issue was and responded very quickly. A similar situation arose with a different company, but it hasn't got us anywhere. So, the investors are now talking to each other about whether we need to become coordinated and all approach the company in a very focused, disciplined way to elevate our concerns.”
>
> **Jonas Kron**
>
> Senior Vice President, Trillium Asset Management

Collaboration among diverse actors

Collaboration has become a popular and well-regarded method to promote change in industry-wide practices across the investment community.[134] Due to the complexity of ESG issues, it can sometimes take multiple touch points and actors engaging before a company responds. Collaboration among different actors (e.g. investors, NGOs, corporations, governments) can therefore help maximize success by aligning efforts and magnifying the influence of all those involved.

For example, many NGOs in the sustainability field produce research clarifying the business case for investors and companies to address ESG issues. Investors can use these resources to better inform their own internal priorities and engagement efforts. An example is a recently developed index for investors that ranks the 60 largest producers of meat, poultry, dairy and aquaculture on their management of critical business risks from water to waste, food safety to worker safety—the Coller FAIRR Protein Producer Index—which provides a strong rationale (and underlying data) for investors to engage with companies on critical risks.

Collaboration at the industry level is an exciting area for progress to be made in tackling ESG issues. For example, the Alliance for Responsible Denim (ARD) aims to promote sustainable denim production by tackling the industry's major challenges—water, energy and chemicals. Supporting companies themselves to prioritize pre-competitive collaboration with their industries offers an opportunity for investors to help facilitate progress. For example, research from the Harvard Business School shows that although certain ESG issues may be a collective concern for corporations in the long-term, they might be too costly to be addressed by one corporation alone in the short-term—and that large institutional investors could provide a commitment mechanism to build and sustain pre-competitive collaborations.[135]

> Many large asset managers and other mainstream investors are very sympathetic to campaigns that touch on material issues. If you can make that tie between the issue you are raising and the financial ramifications, you're going to get a lot of traction and buy-in for any measures suggested.
>
> **Courteney Keatinge**
>
> Director of ESG Research, Glass Lewis

Tapping into key leverage points

Investors can be more effective in engaging companies on material ESG risks and opportunities by considering other pressures facing companies. The addition of consumer pressure, NGO campaigns, media coverage, and regulations can strengthen the business case for corporations to act. Investors can make reference to these factors in order to further legitimize the issues they raise. Leverage points may emerge without investor involvement, for example when unsolicited media attention creates reputational concerns that must be addressed. Investors can also play a role in creating additional leverage points, for example by using data they have on companies to conduct ESG research that makes a strong business case for addressing issues. For instance, Credit Suisse used their company dataset to inform research on gender diversity, showing that investing in companies where gender diversity is an important strategy leads to excess returns running at a compound annual growth rate of 3.5%.[136]

> When an issue becomes highly prominent in the press, in reports, in government conversations and regulations, it supports investor engagement with companies. Obviously, investors have leverage, but the leverage is magnified if the other ingredients are there.
>
> **David Schilling**
>
> Senior Program Director for Human Rights, Interfaith Center on Corporate Responsibility

Taking advantage of tools and technology

Across the ecosystem, there are a range of existing tools that can help educate the market and raise awareness on ESG issues. These include resources for investors and corporations, the media, and technology. When multiplied with the different investor influence strategies, these create more momentum for companies to change their behavior on ESG issues.

ESG Research & Benchmarking: Many resources exist to guide investors and corporations on ESG issues, including toolkits, frameworks and benchmarking reports focused on engagement, disclosure and materiality.* These resources offer solutions that can be implemented, guide the evolution of standards and best practices on ESG issues and support investor identification of industry leaders and laggards. These resources—particularly those that are survey-based, directly influence corporate disclosure and thus are also a vehicle for investors as a whole to collectively communicate emerging ESG disclosure expectations to companies.

> A good understanding of what peer companies are doing is vital. Being able to make the case that they are lagging behind their competitors or that many other companies are taking action is a very important part of dialogue.
>
> **Michael Garland**
>
> Assistant Comptroller for Corporate Governance and Responsible Investing, New York City Office of the Comptroller

Technology: In a world that is increasingly technology driven, investors have become aware of the benefits that would result from technological solutions to ESG challenges. Automation, digitization and artificial intelligence will massively reshape the financial system in coming years.[137] For example, blockchain technology is already being utilized to enable greater transparency in global supply chains.[138]

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* See table "ESG research resources" on page 22 for more detail.

APPENDIX: METHODOLOGY

The methodology for this report consisted of a comprehensive literature review and interviews with investment professionals and sustainability practitioners.

Literature review

The literature review included academic studies and research published by leading sustainability practitioners (including analyses conducted by NGOs, think-tanks, investment professionals and consultancies) detailing the range of investor influence strategies that can be adopted to promote better corporate performance on ESG issues. The literature review was used to inform the overarching framework for the report, which involved mapping out different investor influence strategies and elements that supported success (drivers of investor influence and the broader ecosystem). Particular attention was paid to robust quantitative research that offered evidence of the effectiveness of investor strategies (in terms of corporate behavior change and the link to financial performance).

Interviews

Informed by the literature review, we conducted fourteen in-depth interviews with investment professionals and sustainability practitioners to gain deeper insights on the research topic. We conducted semi-structured interviews, covering the following key themes:

- Investor influence strategies and internal preparation for engagement
- Definitions of success and how investors can be effective in supporting better corporate ESG performance
- The overlap between different investor strategies and the role of other actors
- The future of investor-corporate interactions

The breakdown of interviewed organizations is as follows:

- 3 socially responsible investors
- 3 investor networks / NGOs
- 2 large asset managers
- 1 fixed income investor
- 2 religious investors
- 1 large pension fund
- 1 proxy advisory firm
- 1 large publicly-listed company

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