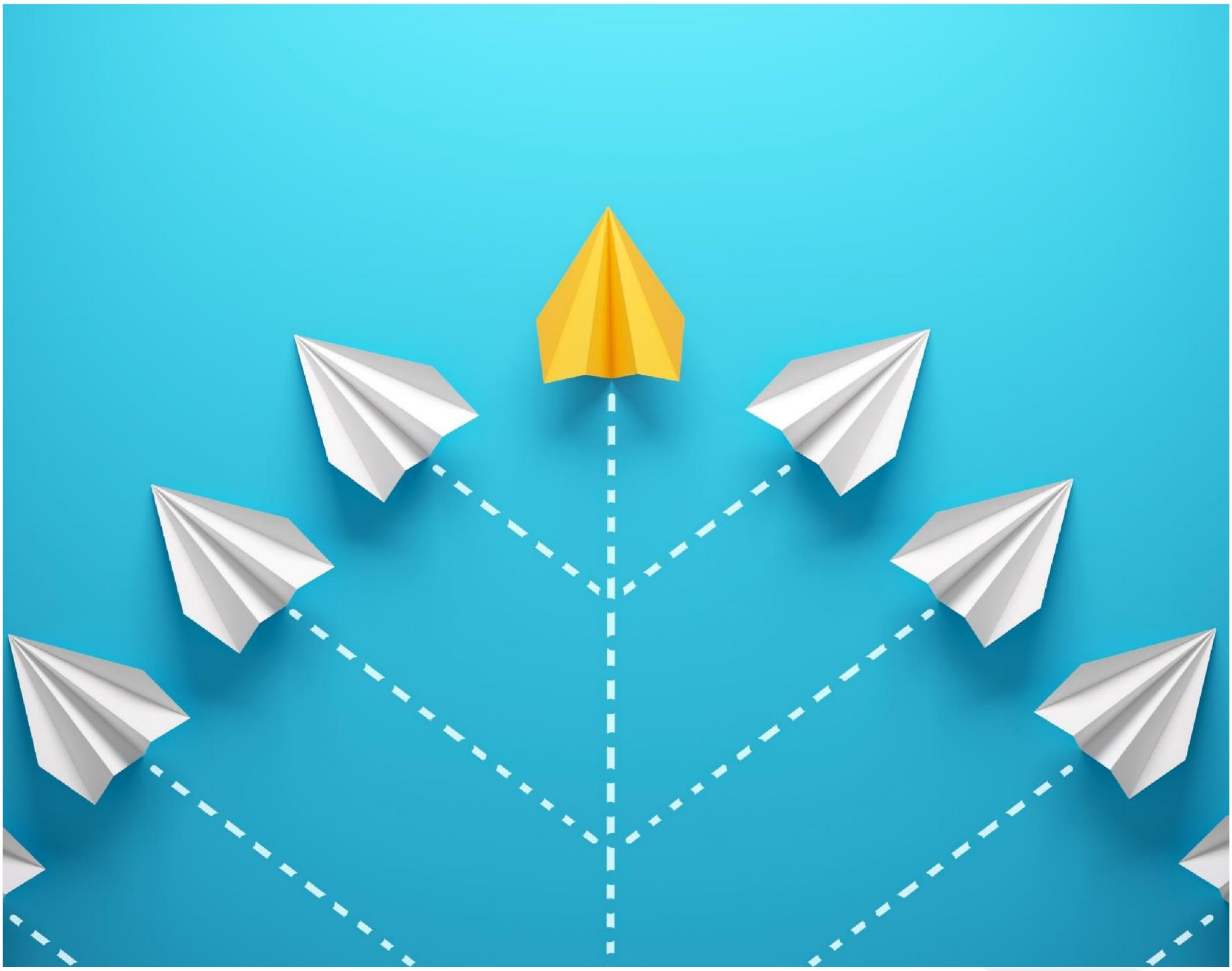

Investors exercise their rights, obligations and influence through voting on material ESG issues in the AGM

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

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

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

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

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

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

Active and constructive participation at AGMs is one of the most important activities of the engagement program used by active investors or active ownership strategies.

Active ownership "is the use of the rights and position of ownership to influence the activities or behaviour of investee companies." Its investment approaches employ a number of different shareholder strategies aimed at driving positive change in the way a company is governed and managed. In effect, it takes the opposite approach of negative screening, as it views the act of divestment alone as incapable of collectivizing and directing investor preferences towards change.

Active ownership may leverage direct engagement between investor and company management, collaborative engagement where investors collectively drive for change, filing shareholder proposals and resolutions as well as a proxy voting strategy that is driven by a clear agenda to:

- Encourage greater disclosure;
- Improve transparency; and
- Increase stronger awareness around ESG issues.

Companies that trade at meaningful discounts to their peer group or whose debt is distressed often have poor ESG metrics. Through influencing companies' behavior, the strategy is based on the theory that a linkage exists between improvements in corporate ESG metrics and the re-rating in equity value or credit through tighter spreads. The vote is a key tool for the active investor, and any voting decision should be aligned with the investment thesis for the holding and any stewardship agenda that the institution has in relation to the company. Thus, for example,

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

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

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

This can be seen for example with the recent debate about the incorporation of climate change issues into the financial accounts (the financial statements in the back of the annual report, rather than the narrative reporting in the front half). In September 2020, investor groups representing more than US$100 trillion in assets published an open letter calling for companies to follow International Accounting Standards Board (IASB) guidance and incorporate material climate change issues in their financials, fully disclosing their relevant assumptions. The investor groups also asked that auditors play their part in ensuring the delivery of this and indicated their preference that the assumptions used should be compatible with the goals of the Paris Agreement. A number of investors are considering how their voting might respond to any failures to live up to this call from investors. In particular, some are likely to vote against reports and accounts where it is not clear that climate change has been incorporated or that the assumptions are not disclosed. Some are considering voting against auditors of heavily climate-exposed companies that do not include climate issues among the key audit matters in their auditor reports. And others expect to vote against key board directors of companies that do not show sufficient signs of climate awareness where they have key risk exposures.

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

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

To learn more about ESG and sustainability-related models, don't hesitate to contact **YTT Consulting**!