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Different ESG Investment Engagement Styles, Asset Management Standards, and Laws

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12/2023

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

Before the recent crisis, there appeared to be widespread acceptance by institutional investors and the market of bank balance sheet preparation… as a means of enhancing returns on equity. Limited institutional efforts to engage with some UK banks appear to have had little impact on regulatory restraint before the recent crisis.

Regulators' interest in the role of stewardship grew in the wake of the financial crisis. As a tool to help institutional investors recover from the crisis, the Walker Report ushered in a new era of shareholder engagement. The report formally called for the Financial Reporting Council (FRC) to issue a stewardship code to provide a framework for shareholder engagement, and for this code to be reinforced by a requirement from the Financial Services Authority (FSA, now the Financial Conduct Authority or FCA) that fund managers who participated make a statement about whether and how they approached their principles.

Following consultation, in 2010 the FRC published the world's first Asset Management Code — largely unchanged from the existing Statement of Principles on the Responsibilities of Institutional Shareholders and Agents issued in 2005 (which was itself based on a 1991 document, The Responsibilities of Institutional Shareholders in the UK). Industry best practice had not been effective before the financial crisis, but a code with legal backing was seen as more likely to be effective. Industry acceptance of the code was relatively rapid, especially among fund managers.

The Asset Management Code 2010 has seven (7) principles: Institutional investors should:

- Disclose their policy on how they will carry out their asset management responsibilities;
- Have a robust policy on managing conflicts of interest in relation to asset management and this policy must be publicly disclosed;
- Monitor their investee companies;
- Establish clear guidelines on when and how they will conduct their activities as a means of protecting and enhancing shareholder value;
- Be prepared to act jointly with other investors where appropriate;
- Have a clear policy on voting and disclose voting activities; and
- Report regularly on their asset management and voting activities.

The UK Code was further amended in 2012, clarifying the distinction between the roles of asset owners (pension funds and similar funds) and their fund managers and other agents, but the principles remain almost entirely unchanged. While some of the largest pension funds may undertake management activities themselves, most delegate this role either by specific contract or as part of their fund management services. The role of most asset owners is therefore to monitor, challenge and evaluate the asset management activities of their service providers.

The UK Stewardship Code has been adopted around the world and at the time of writing there are now such codes in 20 markets, developed by stock exchanges or regulators or by investment bodies themselves seeking to improve best practice. These include:

- Globally— ICGN Global Stewardship Principles (2016).
- Europe— EFAMA Stewardship Code (2018).
- Australia— Australian Asset Owner Stewardship Code (2018).
- Brazil— AMEC Stewardship Code (2016).
- Japan— Principles for Responsible Institutional Investors (2020).

It is worth noting that while there is a high degree of consistency between the principles in each of these codes, which are closely modelled on the seven principles of the UK Code 2010, conflicts of interest are treated very differently. It has been argued that industry-led rules are more likely to downplay the issue of conflicts of interest, while those with greater legislative backing place greater emphasis on the issue. Perhaps most notably, the European Funds and Asset Management Association (EFAMA) Code is an almost direct copy of the UK Code 2012, except that it does not include a separate conflict of interest principle and almost avoids the issue entirely.

UK Asset Management Amendment Act 2020:

The UK Asset Management Act underwent a more fundamental drafting process to produce the 2020 version of the law, which was published in late 2019. The new code, which came into effect on 1 January 2020, includes 12 principles (plus 6 alternative principles for service providers), up from 7 previously and three times the number of pages in the 2012 law. But the biggest change is not the growth of the document but the increased ambition of the signatories' ability to deliver. The previous focus on statements of intent is gone. Instead, investors are now required to report annually on their performance and, most importantly, the results of that performance. The first such annual reports were submitted at the end of March, setting out policy, activities and results for 2020.

Reporting on activities alone is not enough; each new principle has associated outcomes that must be reported and requires concrete examples of what has been practically delivered for customers and beneficiaries. Signatories will no longer meet the Code's requirements by publishing policy statements filled with ambitious assertions, but instead must deliver tangible results from their actions.

The 12 new principles are divided into four (4) criteria but cover two (2) separate functions:

- Principles 1 to 8 address the foundations of asset management.
- Principles 9 to 12 focus on the practical implementation of interactive responsibilities.

The need to report specific results applies to the core principles 1, 2, 3, 5 and 6 of the new Code. They cover structural issues within the investment organisation such as governance, culture and conflict of interest management. The results to be disclosed in relation to these issues are evidence that those structures are operating in practice in the best interests of clients.

Principles 7 and 8 require the integration of ESG factors into the investment process and include effective monitoring of service providers. Disclosure of relevant outcomes should be

an explanation of how these processes have delivered results on behalf of clients and beneficiaries.

Principles 9 through 12 cover engagements (and voting). The intended outcome of these principles (which should be part of the annual report) is to disclose significant changes in the companies (or other investee assets) as a result of the engagement. Disclosure of at least some voting results, not just investor voting, is also expected.

Perhaps the most challenging of the 12 principles is principle 4, which requires signatories to identify and respond to systemic and market-wide risks. Some investment institutions already recognise their obligations on behalf of beneficiaries and customers to maintain and promote well-functioning markets and social (S) and environmental (E) systems, but for many this can feel like a significant additional burden. The requirement to "disclose an assessment of their effectiveness in identifying and responding" to such risks imposes a new and significant burden even on those who already recognise this as an asset stewardship responsibility. Only the Australian Asset Owner Stewardship Code, developed by industry body the Australian Council of Superannuation Investors (ACSI), has a similar expectation, under principle 5:

Asset owners should encourage better alignment between the functioning of the financial system and regulatory policy with the interests of long-term investors. (ACSI 2018) While the new UK Code may prove to be a model for global regulatory rules like its predecessors, the latest country to propose changes is Japan, which has not followed the UK model closely. There is a move to require reporting on the results of the interaction, but this is understated and low-profile and may have only limited impact (contrast this with the importance of the new UK Code). In addition, the latest changes made to the Japanese Asset Management Code are as follows:

• Expand coverage to all asset classes, not just equity;

• To incorporate sustainability and ESG;

• To encourage asset owners to engage with asset management and provide greater clarity about their role in the asset management hierarchy; and

• To clarify the position of service providers in the hierarchy and raise the expectations of

The UK Investment Management Code:

Apart from the new UK Investment Management Code, the principles of all codes around the world are remarkably similar. There are typically six or seven principles, with the first principle often requiring investors to have a public policy on asset management and the last principle noting the need for honest and open reporting on asset management activities. The core of the principles that fall between these two typically require:

• Regular monitoring of investee companies;

• Active engagement where relevant (sometimes referred to as "escalation", or where escalation is deemed worthy of a separate principle); and

• Thoughtful intelligent voting.

Two principles that are sometimes but not always present (although they appear in the UK Code in both its old and current versions) require the following:

• Investors are required to manage their conflicts of interest in relation to asset management matters; and

• The escalation of asset management activity includes a willingness to act jointly with other institutional investors.

The issue of collective engagement is controversial because of concerns about the creation of so-called concert parties (groups of shareholders so influential that they effectively control companies without a formal takeover). This is not the purpose of collective engagement, as is demonstrated in the relevant discussion in this section.

Current asset management laws are often presented as applying to all asset classes, but their wording tends to reveal their original focus in practice on public equity investments. The thought processes around asset management, both by regulators and investors, and the actual implementation of asset management actions by those investors, were most developed for listed equity investments.

In 2016, the FRC undertook a quality assessment of the UK Code's signatories (against the then current 2012 Code). This was not based on the content of the asset management activities undertaken but simply on the asset management statements published by each signatory in response to Principle 1. The regulator provided signatories with guidance on which level (1, 2 or 3) of quality these disclosures were at, leading to a rapid improvement in the quality of disclosures.

The final outcome of this process was that of the 300 signatories, 120 were considered to be Tier 1 and best practice ("Signatories provide a good quality and transparent description of their asset management approach and explain alternative approaches where appropriate"), compared to 40 that the FRC considered to be in that category in its initial assessment of the Code's disclosure at the start of the process. It remains unclear whether and how the FRC will undertake a tiering process in relation to the new Code. If it does, the more stringent (and particularly results-focused) expectations in the new 2020 Code are likely to lead to greater divergence between signatories.

The number of asset management codes in Europe is likely to increase significantly following the entry into force of the Shareholder Rights Directive II in June 2019. The SRD II, as it is known, will raise national expectations regarding the level of asset management exercised by domestic investors. This is likely to replace initiatives such as the voluntary EFAMA Code (updated in 2018 from the original 2011 version) and could push the European market towards broader regulatory expectations. Despite its name, the directive is more about shareholder responsibilities.

Expectations regarding asset management roles are set by law as well as by rules. The first of these is the US ERISA law, the Employee Retirement Income Security Act of 1974. Among the requirements of the Act are several that relate to asset management, in particular, that investment advisers act as fiduciaries in relation to beneficiaries (under the US regime, fund management companies are considered advisers and are therefore subject to this standard). Among the obligations required under the fiduciary duty (as narrowly defined in the Act; it should be noted that in this article, "fiduciary duty" refers to the common law understanding of that duty and not the US statutory definition) is that the fund will vote at general meetings of the investee companies and interact with the companies.

Previously, the legal interpretation of the Act was considered to discourage ESG management, as a statement in a Bulletin indicated that engagement and use of proxies for

environmental and social issues would be rare. But new interpretive statements from 2018 support a more asset stewardship role. The regulator's view, outlined in the US Department of Labor's Field Assistance Bulletin No. 2018-01, confirms that trustees may vote and use proxies if there is a reasonable expectation that such activities are likely to enhance the economic value of the investment after implementation, after taking into account costs. The Bulletin adds that engagement may be prudent for index-based portfolios where ESG issues pose significant operational risks and costs. There continues to be a clear view that engagement and indeed ESG investing needs to have a solid basis in value for beneficiaries – so engagement will not be allowed to achieve purely social policy objectives without making a clear link to value.

ESG Investment Engagement Styles:

Some asset owners will choose to engage directly with companies, through team members who act as portfolio managers. Others will rely on their external fund managers to do this, either through portfolio managers who are also responsible for managing the assets, or through asset management professionals (or a combination of both). Engagement activities may also be outsourced entirely to professional asset management service providers.

Almost all institutional investors rely at least in part on a group of these service providers, proxy voting advisory firms. These proxy advisors provide analysis and (in most cases) voting recommendations for many public companies, and almost all institutional investors hire them to provide the framework for ensuring their voting decisions are made. Most also pay for their advice on those voting decisions.

Other asset management providers offer varying degrees of investor engagement services, effectively acting as investors to engage on their behalf. By aggregating client interests, the necessary scale and clarity of dialogue and engagement with company management and boards can be built. The board of an investee company can provide a form of collective engagement, allowing investors to have greater reach and influence by working together with others and sharing valuable resources. Collective engagement can also take place through industry initiatives and engagement platforms, such as those provided by PRI or the Investor Forum in the UK.

ESG Engagement Styles: Top-Down and Bottom-Up

To some extent, engagement styles differ depending on the heritage of the asset management teams. There is a difference in thinking and approach between teams that have a history of engagement that is Governance-led (G) and those that have worked more on the Environmental (E) and Social (S) aspects.

The most obvious difference is that since material E and S issues arise from the nature of the company's business, teams with this heritage tend to be organized by sector, while G is more defined by national laws and regulations and such teams are often separated by geography. Engagement styles also follow this structure to some extent. Teams tend to focus on individual Environmental and Social issues and pursue them aggressively across sectors or markets. This may include trying to establish better practice standards and highlight leading practices as well as targeting those perceived to be lagging. The conversation will tend to start with investor relations or sustainability teams and then move up to senior management and board levels. Investment organisations with a Governance tradition tend to focus on individual companies, starting with the chairman (often assisted

by a corporate secretary) and working through the board and down to management from there.

These are generalisations, but they illustrate the difference between top-down and bottom-up activism. Most investors combine the two, although a bottom-up, company-focused engagement is most naturally aligned with active investment approaches, particularly those with concentrated portfolios; Meanwhile, top-down, issue-based engagement tends to be more closely aligned with passive or broadly diversified portfolios.

ESG Engagement Styles: Issue-Based and Company-Focused

Passive investors and others with broadly diversified portfolios typically start with an issue, whether identified by the team from news or broader analysis or through screening or other research providers, and seek to engage with all companies affected by that issue (whether an industry as a whole, or even more broadly). Typically, the starting point is a letter written to all affected companies, followed by a conversation. Active investors, especially those with focused portfolios, start with the company itself and its business issues, and develop a tailored, multi-issue engagement approach, often led by the investment team. Companies selected for this approach are often identified as underperforming companies or companies that enable other financial or ESG metrics. The starting point is usually to seek a direct discussion with senior management and then the board.

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

Governance (G), including your firm's approach to board diversity; corporate strategy and capital allocation; compensation that promotes long-termism; environmental risks and opportunities (E); and human capital management (S). These priorities reflect our commitment to addressing issues that impact the firm's prospects, not just in the next quarter, but in the long-term vision our clients are planning for.

Issue-based approaches to engagement typically include examples of best practices in a particular sector. These may be developed prior to the initial engagement dialogue but often emerge from engagement with companies that are considered to have leading practices. By expecting all companies in a given sector to adopt these best practices, investors can move the sector or overall industry practices forward over time. Company-focused engagements aim to improve practices on a number of relevant ESG issues at an individual company; the goal is to improve the performance of the overall portfolio, both in terms of ESG and investment performance.

To learn more about ESG and sustainability-related models, please contact **YTT Consulting**!