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Global Governance Practices and Investors' ESG Engagement Styles

ESG & Sustainability Transformation

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ESG Transformation

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As we know, the UK is a global model for corporate governance principles as well as investment management, with engagement being a key aspect of investor stewardship.

Stewardship is a broad term for an investor acting as a good long-term owner of assets, standing in the shoes of their clients to ensure that value is added or preserved over time.

Engagement is the process of active dialogue with a company where the investor is seeking specific change. This can often be a lengthy process and involve repeated contacts with senior representatives of the company.

Investment managers believe that engagement adds value, not just within the portfolio but also for the benefit of the market as a whole. In his powerful 2008 report on the financial crisis, Sir David Walker stated:

Prior to the recent crisis, there appeared to be widespread acceptance by institutional investors and the market in general of bank balance sheet preparation… as a means of increasing returns on equity.

The limited institutional efforts to engage with some UK banks appeared to have had little impact in curbing governance prior to the recent crisis.

Regulatory interest in stewardship has grown since the disappointment of the 2008 global financial crisis. As a tool to aid the post-crisis recovery of institutional investors, the Walker Report ushered in a new era of shareholder engagement. The formal report called for the Financial Reporting Council (FRC) to introduce a Stewardship Code to provide a framework for shareholder engagement, and this was reinforced by the Financial Services Authority (FSA, now the Financial Conduct Authority or FCA) requiring all registered fund managers to declare their approach to the principles of the law and how they approached it.

Following a consultation, in 2010 the FRC published the world’s first Investment Stewardship Code — largely unchanged from the existing Statement of Principles on the Responsibilities of Institutional Shareholders and Agents issued by the Institutional Shareholders Committee in 2005. It itself built on a 1991 document, The Responsibilities of Institutional Shareholders in the UK. Industry best practice had not been effective in the run-up to the financial crisis, but a code with regulatory backing is seen as likely to carry more weight. Industry acceptance of the code has been relatively quick, especially among fund managers.

The 2010 Investment Stewardship Code has seven principles: Institutional investors should:
• Publicly disclose their policy on how they will exercise their stewardship responsibilities;

• Have a robust policy on managing conflicts of interest in relation to stewardship and this policy should be publicly disclosed;

• Monitor their investee companies;

• Establish clear guidelines on when and how they will escalate their actions as a means of protecting and enhancing shareholder value;

• Be prepared to act collectively with other investors where appropriate;

• Have a clear voting policy and make voting activity public; and

- Regularly report on their stewardship and voting activities.

The UK Code underwent an amendment in 2012, clarifying the distinction between the role of asset owners (pension funds and similar funds) and their fund managers and other agents but leaving the principles almost entirely unchanged. While some of the largest pension funds may seek to undertake the management activities themselves, most funds in the market today delegate this role, either by specific contract or as part of their fund management services. The role of most asset owners is therefore in terms of monitoring, challenging and evaluating the management activities of their service providers.

The UK Investment Stewardship Code model has been adopted around the world and there are now such codes in at least 20 markets, developed by stock exchanges or government regulators, or by institutional investors themselves who want to promote 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).
- Singapore — Singapore Stewardship Principles (SSP) for Responsible Investors (2016).
- United States — The Principles (2016).

It is notable that while there is a great deal of consistency between the principles in each of these codes, as they are closely modelled on the seven principles of the 2010 UK Code, the issue of conflicts of interest is treated very differently. Codes drafted by the fund management industry tend to downplay the issue of conflicts of interest, while codes with greater regulatory backing place greater emphasis on the issue. Perhaps most notably, the European EFAMA Stewardship Code is almost a direct copy of the 2012 UK Code except that it does not include a separate principle on conflicts and almost completely avoids the issue.

The 2020 Amendment Code

The UK Investment Regulation Code has undergone a more fundamental rewrite to produce the 2020 version of the code, which was published in late 2019. The new code, which came into effect on 1 January 2020, includes 12 principles (plus 6 replacement principles for service providers), up from 7 previously and is three times the number of pages as the 2012 code. But the biggest change is not the size of the document, but the increased ambition for the delivery of real results by signatories. The previous focus on statements of intent and commitments is gone. Instead, investors will report annually on their activities and, most importantly, the results from those activities. Annual reports must be submitted by the end of March, setting out policies, activities and results of activities during the previous year.

Merely reporting on activities is not enough; each new principle requires that relevant results be reported and requires the provision of concrete evidence of what has been delivered in practice to clients and beneficiaries. Signatories (investment institutions) will no longer meet the Code’s requirements by publishing policy statements filled with ambitious commitments, but must instead deliver tangible results from their actions.

The 12 new principles are divided into four categories but cover two distinct functions:

• Principles 1 to 8 cover the foundations for governance.

The need to report on specific outcomes applies to core principles 1, 2, 3, 5 and 6 of the new code. These cover structural issues within the investment organisation such as governance, culture and conflict of interest management. The outcomes that should be disclosed in relation to these issues are evidence that these structures are specifically useful 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 accompanied by an explanation of how these processes have been effective on behalf of clients and beneficiaries.

Principles 9 to 12 cover engagement (and voting) activities. The expected outcomes of these principles (which should be part of the annual report) should demonstrate a significant change 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 market-wide and system-wide risks. Some institutional investors already recognise their obligations on behalf of their beneficiaries and customers to maintain social and environmental systems and promote well-functioning markets, but for many institutional investors 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 investors who already recognise this as a stewardship responsibility. Only the Australian Asset Owner Stewardship Code, developed by industry body the Australian Council of Superannuation Investments (ACSI), has a similar expectation, under principle 5:

Asset owners should encourage better alignment between the operation of the financial system and regulatory policy with the interests of long-term investors. (ACSI 2018)

While this new UK Code may prove as much of a model for global stewardship rules as its predecessors, the latest country to propose change is Japan, which has not followed the UK's lead. There is a move to require reporting on the results of engagement, but this is so low-key and low-profile that it is likely to have only limited impact (the contrast with the centrality of the new UK Code is significant). In addition, the latest changes made to the Japanese Stewardship Code are as follows:

• To expand the scope of application to all asset classes, not just equity;

• To incorporate sustainability and ESG;

• To encourage asset owners to participate in stewardship and clarify their role in the stewardship hierarchy; and

• To clarify the role of service providers in the hierarchy and add higher expectations for proxy advisers.

Code Rules:

Unlike the new UK Stewardship Code, the principles of all codes around the world are very similar. There are typically six or seven principles, with the first principle often requiring investors to have a public policy in place regarding stewardship and the last principle noting

the need for honest and open reporting on stewardship activities. The main body of principles between these two typically calls for:

• Regular monitoring of investee companies;

• Active engagement where appropriate (sometimes referred to as "escalating engagement", or sometimes escalation is deemed worthy of its own dedicated principle); and

• Smart and thoughtful voting.

Two principles that have not always appeared (although they are present in the UK Code in both its original and current revisions) require the following:

• Investors are required to manage their conflicts of interest in relation to governance issues; and

• The escalation of governance activity to include a willingness to act collectively with other institutional investors.

The issue of collective engagement is controversial because of concerns about the creation of concert parties (groups of shareholders so influential that they effectively take control of companies without a formal takeover). This is not the intention of collective engagement, as demonstrated by the relevant discussions in this section. The Investment Management Act is often presented as applying to all asset classes, but its language tends to favour an initial focus in practice on listed equity investments. The thought processes of management, both by regulators and investors, and the delivery of actual management actions by those investors, are most developed in the area of public equity investing.

ESG Engagement Styles:

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

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

Other stewardship service providers offer varying levels of engagement services, effectively putting themselves in the shoes of investors to engage on their behalf. By aggregating client interests, the necessary scale of presence and sufficient visibility in dialogue and engagement with company management and boards can be built. Boards can provide a form of collective engagement, allowing investors to have greater reach and influence by working together with other investors and sharing valuable resources. Collective engagement can also take place through industry initiatives and collaborative platforms, such as those offered by PRI or the Investor Forum in the UK.

Style: Top-Down and Bottom-Up:

To some extent, engagement styles differ depending on the heritage of the management teams. There is a difference in thinking and approach between teams with a history of governance-led engagement and those with more experience in the Environmental and Social aspects.

The most obvious difference is that when E and S issues arise from the nature of the investee company's business activities, teams with this heritage tend to be organized by industry, while G factors are more determined by local laws and regulations, and such teams are often divided by geography. Engagement styles also follow this structure to some extent. Groups tend to focus on individual environmental and social issues and pursue them aggressively across sectors or markets as a whole. This may include trying to establish better standards of practice and highlight best practice as well as targeting companies that are perceived to be lagging. The conversation will tend to start with investor relations or sustainability teams at the investee company and then escalate upwards, both to senior management and to the board. Institutional investors with a governance legacy tend to focus on individual investee companies, starting with the company chairman (often assisted by the company secretary) and working through the board and down to lower levels of management.

These are generalisations, but they illustrate the difference between top-down and bottom-up engagement. Most investors combine both of these engagement styles, although company-focused, bottom-up engagement fits most naturally with active investment approaches, particularly those with concentrated portfolios; whereas issues-based, top-down engagement tends to be more closely associated with passive or broadly diversified investment portfolios.

Style: Issue-Based and Company-Focused:

Passive investors and others with broadly diversified portfolios typically start with an issue, whether identified by the team from broader news or analysis or through self-screening or from other research organizations, and seek to engage with all companies affected by that issue (which may be an entire industry, or even more broadly). Typically, this begins with a letter written to all affected companies, followed by conversations.

Active investors, especially those with focused portfolios, start with the investee company itself and its business issues and develop a tailored engagement approach that is stripped down to the issues, often with investment teams taking the lead. Investee companies selected for this approach are often identified from underperforming companies or companies that are triggering other financial or ESG metrics. The starting point is often to seek a face-to-face discussion with senior management and then the board.

Larry Fink's annual letter to investee company CEOs outlining BlackRock's engagement plan for the global investment giant 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, including your company's approach to board diversity; corporate strategy and capital allocation; incentives to promote long-termism; environmental risks and opportunities; and human capital management. These priorities reflect our commitment to engaging on issues that impact the company's prospects not just for the next quarter, but over the long term that our clients are planning for.

Issue-based approaches to engagement often include suggested examples of what best practices look like in a particular industry. These may be prepared in advance of initial

engagement conversations, but these examples are often drawn from previous engagements with companies that are considered to have leading practices. By expecting all companies in a given industry to adopt these best practices, investors can improve the entire sector or industry practice over time moving forward. The company-focused engagement seeks to improve practices across a number of relevant ESG issues at an individual company; the aim is to enhance the performance of the overall portfolio, both in terms of ESG and traditional investment performance on the financial side.

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