ESG Integration and Shareholder Engagement in the United States

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Preface

As a think-tank arm of SMBC Nikko Securities, Nikko Research Center conducts ongoing fieldwork-based survey research through various methods, including direct interviews with major institutions. This research is designed to illuminate not only the global dynamics behind today's investment markets and investors, but also background and secondary information.

Some of our survey research results have been compiled and published in two recent reports: "Engagement by European Institutional Investors" (November 2014) and "Learning from the United Kingdom for Japan's corporate governance and stewardship activities" (March 2016). The first of these two reports focuses on engagement, which is a central focus in Japan's Stewardship Code. The report uses examples from European institutional investors to discuss engagement issues and the processes to be used. The second report surveys how institutional investors in the United Kingdom are pioneering the application of both the Stewardship Code and the Corporate Governance Code in their practices, including the relationships between asset owners and investment managers. With regard to Japanese companies, it discusses and compiles institutional investors' opinions on the most discussed corporate governance themes, especially those originating from foreign institutional investors.

Both of these reports survey engagement among European institutional investors and provide suggestions for Japan. While Europe and the United States are often perceived together as the West, the United States has not created the types of codes that exist in the United Kingdom. However, with the United States' establishment of the Dodd–Frank Wall Street Reform and Consumer Protection Act in response to the global financial crisis, corporate governance through institutional investors' shareholder engagement has become common. We illuminate the state of ESG integration and shareholder engagement in the United States by surveying its institutional investors through field interviews. This report, ESG Integration and Shareholder Engagement in the United States, presents our findings. By combining the previous two reports, this report provides more substantive and practical insights for readers into stewardship activities and corporate governance.

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Hiroshi Miyai

Advisory Board Member

Nikko Research Center

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This report was created from the findings of a November 2015 interview survey of pension funds and investment managers in the United States. Despite the designated dates and times of these interviews, all interviewees graciously made time to respond to a wide range of questions in a serious and open manner. We would like to express our deepest appreciation for their help and support. We also thank SMBC Nikko Securities for its cooperation.

Participating Institutional Investors (in alphabetical order)

Acadian Asset Management

Boston Common Asset Management

CalPERS

CalSTRS

Eaton Vance Management

MFS Investment Management

Neuberger Berman

Pax World Management

Quotient Investors

Megumi Terayama

Kan Nakajima

Institute of Social System Research

Nikko Research Center


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Executive Summary

Section 1 Introduction

This document reports the findings of a November 2015 interview survey of institutional investors, namely investment managers and asset owners, in the United States. The survey covered ESG integration and shareholder engagement among these institutional investors, and it was a successor to the surveys of European institutional investors conducted in 2014 and 2015 (Terayama and Sugiura, 2014; Terayama and Sugiura, 2016). Europe and the United States are often perceived together as the West in Japan, where surprisingly little knowledge exists of the actual state of engagement in the United States and how it differs from European practices. We therefore conducted this interview survey on ESG integration and shareholder engagement in the United States to uncover implications for Japanese companies.

Section 2 ESG Integration in the United States

We found that the approach to ESG integration of mainstream investment managers was different from that of ESG-dedicated investment managers. Mainstream investment managers primarily incorporate ESG factors into stock selection processes, while ESG-dedicated investment managers generally allow them to influence not only their stock selection processes, but also their investment universes and investment guidelines. However, both commonly use ESG integration in order to improve long-term performance. Among quantitative investment managers, ESG integration is considered to be simply another factor affecting stock performance, resulting in the consideration of different ESG elements according to the quantitative investment model in use. In the United States, ESG integration is not a special approach, as ESG factors are incorporated in the same manner as the investment factors used in conventional investment methods.

Section 3 Shareholder Engagement in the United States

The corporate governance reform driven by the enactment of the Dodd–Frank Wall Street Reform and Consumer Protection Act after the global financial crisis has increased proactive engagement by institutional investors in the United States. Engagement approaches and methodologies vary among major public pension funds, ESG-dedicated investment managers, and mainstream (active) asset managers, but all investors vote and engage as a part of the investment process. “Say-on-Pay” is a voting right on executive compensation; however, it has become a vote of confidence on management. Another agenda item that investors demand is proxy access, or shareholders’ right to nominate corporate directors. Proxy access has come to be included in shareholder proposals, which have been filed by major public pension funds and have won majority votes in many companies. Institutional investor support is crucial to activist-initiated proxy contests, resulting in both activists and companies attempting to solicit institutional investors through engagement. Thus, shareholder engagement has recently become commonplace in the United States. Institutional investors in Japan could also become proactive in engagement when such agenda items as Say-on-Pay and proxy access arise.

Section 4 Conclusion

This report compiles the results of our interview survey on ESG integration and shareholder engagement among institutional investors in the United States. Our survey of ESG integration in the United States found that ESG factors are being incorporated into investment strategies similar to other investment factors used in conventional investment methods. Our survey of shareholder engagement found that proxy voting and engagement are perceived as a part of the investment process. We also found that shareholder engagement has recently become commonplace owing to governance reform such as Say-on-Pay and proxy access.

Section 1　Introduction

This document reports the findings of a November 2015 interview survey of institutional investors, namely investment managers and asset owners, in the United States (see Figure 1). The survey covered ESG integration and shareholder engagement among these institutional investors, and it was a successor to the surveys of European institutional investors conducted in 2014 and 2015 (Terayama and Sugiura, 2014; Terayama and Sugiura, 2016).

Respondents to the 2014 and 2015 interview surveys of European institutional investors frequently mentioned that engagement is not particularly common in the United States. They also indicated that while European companies allow frequent meetings between investors and chairs of the board or senior independent directors, meetings with independent directors are unusual in the United States. A representative at an investment manager in the United Kingdom explained that investors file shareholder proposals in the United States, while they instead engage in the United Kingdom. Further, the United States has nothing resembling the Corporate Governance Code or the Stewardship Code that have been established in the United Kingdom.

Europe and the United States are often perceived together as the West in Japan, where surprisingly little knowledge exists of the practical situation of engagement in the United States and how this differs from European practices. Therefore, we conducted an interview survey on ESG integration described in Section 2 and shareholder engagement described in Section 3 in the United States to uncover the implications for Japanese companies.

Figure 1. United States institutional investors interviewed for this survey

1. Investment managers
A. Fundamental strategies
i. Mainstream investment managers
Eaton Vance（315.1[b]）、Neuberger Berman（243.0[b]）、MFS（427.6[a]）
ii. ESG-dedicated investment managers
Boston Common (2.1[d]), Pax World (3.6[c])
B. Quantitative strategies
i. Quantitative investment managers
Acadian (69.0[b]), Quotient Investors (0.5[d])
2. Asset owners
CalPERS (289.9[b]), CalSTRS (188.8[a])

Note: Numbers in parentheses denote the amounts of assets under management(in billions of dollars; as at April 30, 2016 [a], March 31, 2016 [b], December 31, 2015 [c], and December 31, 2014 [d]).

Sources: Publicly available information on company websites; *RI Transparency Report 2014/2015.*


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TO C-SUITE.

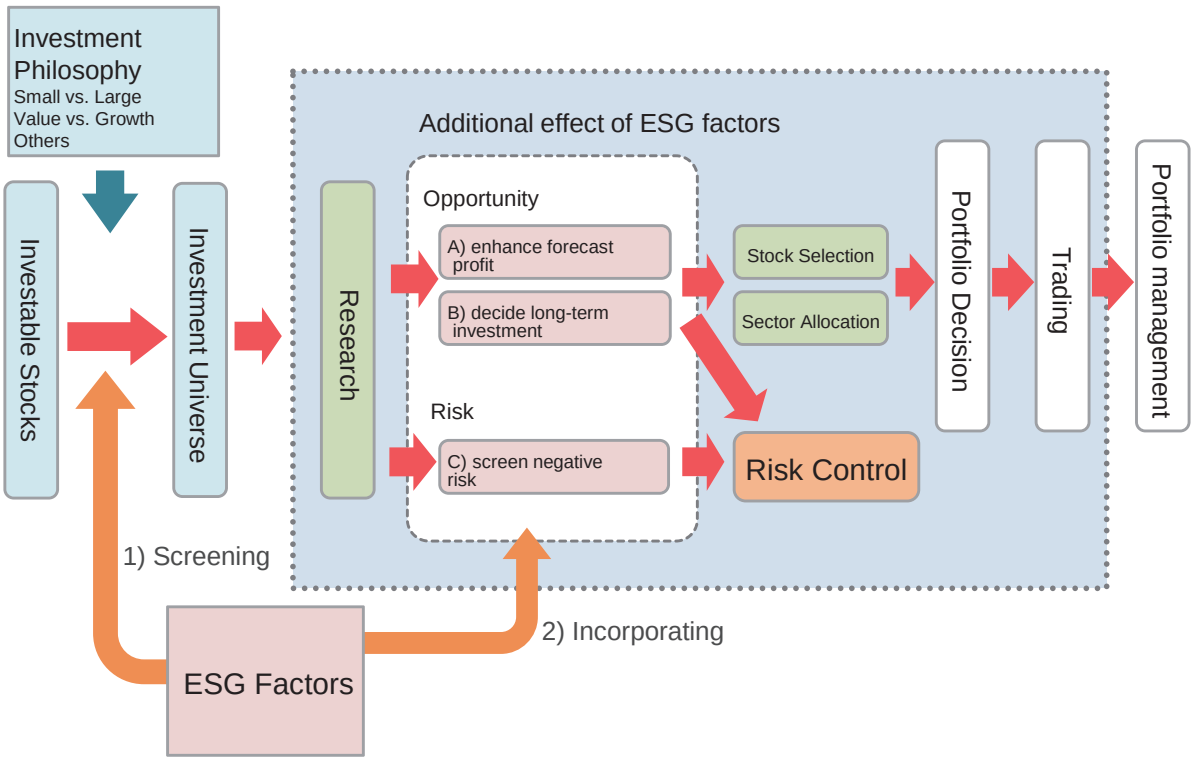
Section 2　ESG Integration in the United States

1. Methods of incorporating ESG factors into equity portfolios

Screening and integration methods are commonly used to incorporate ESG factors into stock portfolio construction processes (see Figure 2). The screening method is used when determining the investment universe. The investment universe is selected from among the investable stocks in the investment country/region targeted by the investment manager, usually by considering the manager's investment style and/or the investment guidelines instructed by the client. This process incorporates ESG factors by combining investment criteria for investing in stocks that have above-average ESG scores (i.e.,positive/best-in-class screening) with those for avoiding investment in particular sectors such as weapons and tobacco manufacturing (i.e., negative/exclusionary screening). Thus, the investment universe tends to be limited when using the screening method to take ESG factors into account.

The integration method involves incorporating ESG factors when carrying out equity research in order to select stocks for inclusion in the investment portfolio. Specifically, the effect of ESG factors on individual stocks and sectors is assessed in terms of investment opportunity and risk; this approach is used to construct a portfolio that incorporates ESG factors. Some investment managers have established trading rules that call for stocks to be removed from the portfolio when their ESG factors no longer satisfy the predetermined assessment criteria. However, the ESG incorporation methods described here are only general investment processes, and the methods used in practice will depend on the individual investment manager.

Figure 2. Methods of incorporating ESG factors into equity portfolios



Source: Nikko Research Center.

All the investment managers described in this section are signatories to the Principles for Responsible Investment (hereinafter referred to as the PRI). Mainstream and ESG-dedicated investment managers take a qualitative approach based on the fundamental strategy when they select appropriate stocks to construct the investment portfolio. The former believes that incorporating ESG factors into the framework of traditional investment methods will result in better investment decisions, while the latter is characterized by incorporating ESG factors as an investment belief. Quantitative investment managers, by contrast, refer to approaches that select stocks by using mathematical models based on a quantitative strategy. These approaches contain no elements of discretion in investment decision-making and incorporate ESG factors as simply another quantitative data type to be included in their models. The following subsections describe the ESG incorporation methods used by mainstream investment managers, ESG-dedicated investment managers, and quantitative investment managers.

2. Methods used by mainstream investment managers

The methods of the three surveyed investment managers are described below.

(1) Eaton Vance Management

Eaton Vance is a successor to the Massachusetts Investors Trust (MIT), the first United States mutual fund established in 1924. Eaton Vance manages equity funds both globally and in the United States and pursues many investment strategies including value, growth, and small-cap strategies. The company's clients are primarily retail investors, and it has few institutional clients. It has attempted to integrate ESG factors into all its investment processes, and its ESG analysis is performed by in-house financial analysts instead of being delegated to an ESG team. Generally speaking, typical investment managers have a dedicated team for carrying out ESG analysis. On the contrary, the approach used by Eaton Vance, which allows analysts to show discretion in the extent to which ESG assessments are applied to investment decision-making, is uncommon. Thus, ESG factors are considered in the investment process just as in financial analyses.

The company does not consider all ESG factors to be of equal value, reporting that corporate governance can be a source of added value, whereas it is difficult to extract added value elements from environmental and social factors. However, the company states that considering environmental and social factors provides clear value in terms of risk management, and it identifies these factors as risk factors. Eaton Vance tolerates the discretionary nature of its financial analysts' investment decisions and expects to improve the accuracy of its ESG analysis through discussions with portfolio managers.

(2) Neuberger Berman

Neuberger Berman, an independent investment manager, was founded as a privately held company in 1939. The company not only manages SRI funds, but also incorporates ESG factors into other investment strategies. As it has no predetermined investment universe, its stock selection targets all companies listed in the world. Approximately 60% of its clients are retail investors, with the remaining 40% representing a wide range of clients such as institutional investors and high net worth individuals. The company's investment philosophy is based on the conviction that selecting strong businesses provides a source of excess returns, or so-called "alpha." Neuberger Berman selects companies by first observing their business models and then analyzing the effects of various ESG elements on that business model. Specifically, it investigates risk factors from the environmental, social, and corporate governance perspectives.

It also seeks investment opportunities, primarily regarding environmental factors. These investment processes are used to select stocks that have a strong long-term business model. In discussing the importance of ESG analysis, the company has stated that ESG integration is less important over short-term investment periods such as three to six months, but more important when adopting a long-term perspective (e.g., three to five years).

(3) MFS Investment Management

Another MIT successor like Eaton Vance, MFS emerged from a restructuring of the MIT in 1969 before Eaton Vance emerged from a subsequent restructuring in 1979. This company has an abundant lineup of investment products, and it manages both regional and global equity funds. Its clients are evenly divided between retail and institutional investors. The company believes that long-term investing is crucial for seeking alpha in active investing and focuses on ESG integration. Specifically, MFS believes that considering ESG factors in addition to financial ones can contribute to long-term performance and the analysts at MFS investigate ESG in their valuation processes. Thus, when ESG factors may negatively affect the company's valuation, the analyst could conceivably decide not to invest in that company's stock based on these factors. In addition, dedicated ESG analysts investigate the impact of thematic ESG factors on performance to improve investment processes from the broader macro-level perspective. The results of this analysis are then fed back to the financial analysts to provide them with a comprehensive understanding of how ESG factors could affect the financial performance and stock valuations of the company. A distinctive feature of MFS is that its financial analysts also provide detailed analyses of ESG factors for sectors and individual stocks, just as they do for financial analysis.

3. Methods used by ESG-dedicated investment managers

The methods of the two surveyed ESG-dedicated investment managers are described below.

(1) Boston Common Asset Management

Boston Common is a relatively new investment manager, founded in 2002. Its name was inspired by a Massachusetts park of the same name, which was once provided to the community as pastureland. This name conveys the company's mission to contribute to both the economy and the social lives of the community. Boston Common manages both domestic and global equity funds. Most clients are retail investors such as high net worth individuals and family groups. Its investment approach considers ethics and sustainability while advocating ESG integration. The company's investment philosophy involves incorporating ESG factors into every investment strategy. Specifically, it first screens using financial and ESG standards to determine the investment universe. Companies involved with tobacco, alcohol, gambling, weapons manufacturing, and the military are excluded from investment. Each global sector is then ranked by ESG risk and investment opportunity, and investments are made in companies with above-average rankings. Therefore, the company's method of incorporating ESG factors can be considered to be a combination of negative/exclusionary screening and positive/best-in-class screening. While an ESG analysis is performed by its in-house financial analysts, external ESG ratings from ESG service providers are also used for benchmarking within global sectors. When using best-in-class screening, Boston Common creates rankings based on a substantial number of ESG themes. The majority are grouped into the areas of climate change, environmental risk management, human rights, corporate governance, sustainability reporting, and global health problems.

(2) Pax World Management

In 1971, Pax World launched the first socially responsible investment mutual fund in the United States to provide an ethical investment vehicle for the United Methodist Church. The equity funds managed by the company, except for its index funds, are generally U.S. domestic equity funds. Its primary clients are retail investors, and most are individual 401(k) accounts. Although the company has an investment philosophy that includes both ethics and investment performance improvement, it emphasizes the latter element. It believes, in other words, that sustainable companies provide superior long-term performance.

Pax World's investment process begins by excluding companies involved in weapons manufacturing and tobacco from the investment universe for ethical reasons. The negative screening of these sectors is a result of the company's investment belief. Environmental impact, product safety and integrity, labor practices (e.g., safety, diversity, labor–management relations, human rights), effect on the community, and corporate governance are then selected as ESG themes. Pax World uses both top-down and bottom-up investment approaches. The former is primarily used to manage theme funds, while the latter is always used for selecting a stock for investment. In practice, the company's investment management division selects attractive sectors or stocks, which are then subject to an ESG analysis. While this analysis is generally completed in a day or two, it can sometimes take considerable time. The company's guidelines prohibit investment in stocks of the company that receive poor ESG assessments.

4. Methods used by quantitative investment managers

The methods of the two surveyed quantitative investment managers are described below.

(1) Acadian Asset Management

Founded in 1977, Acadian was the first investment manager in the world to provide an international index-matching strategy, which is an active country selection strategy. The company currently manages actively managed funds and quant funds worldwide along with such products as region-specific and long-short strategy funds.

The company was motivated to become a PRI signatory by the belief that the consideration of ESG is good business practice. Therefore, its investment philosophy holds that the consideration of ESG factors should be approached as an extension of conventional investment strategies. The recent availability of standardized quantitative ESG data has also helped the company integrate ESG factors into its investment strategies. As Acadian uses a quantitative approach, its investment processes are quantitative in nature; specifically, it incorporates individual ESG factors into its quant models to predict alpha more accurately. It does not conduct negative/exclusionary screening or sell companies with low ESG scores.

When incorporating ESG factors into its investments, Acadian fully integrates corporate governance factors, but not environmental or social factors, and continuously studies candidate factors for potential use. As the company believes that corporate governance factors are most material among ESG factors, the corruption factor is highlighted in emerging markets and accounting practices across multiple industries as examples of factors with high explanatory power. However, the company posits that regarding environmental and social factors, varying methods of measurement cause problems in the data's reliability, making it a challenge to obtain high-quality data.

Acadian dynamically changes ESG factor weights by investment region, sector, and time. These weights are reviewed on a monthly basis. Factors that have ceased to function are weighted as zero; however, they are not removed to allow for the possibility that they could start working again later. New factors experience a rigorous pre-adoption process; specifically, they are tracked for 12 to 18 months and, after exhibiting a significant impact of alpha, are adopted with the permission of the company's investment committee and senior management. Many factors are examined, but most are never adopted.

(2) Quotient Investors

Founded by an investment team from the Japanese investment advisor firm DLIBJ Asset Management, currently known as Asset Management One, Quotient Investors was established as a spinoff in 2008 using seed money from CalPERS. It is currently operated by four people, and it only manages U.S. domestic equity funds.

The company's investment strategy resembles Acadian's in that ESG factors are incorporated into its quant models. The difference is the use of overall ESG scores provided by external ESG service providers, resulting in environmental, social, and corporate governance factors equally weighted when applied to the models. The company states that it uses overall ESG scores because it is difficult to gauge the merits of individual ESG scores as well as understand the overall implications derived from individual factors.

Another feature of Quotient Investors' quant models is that stock price is estimated by using a different model for every 50 to 60 industries. The company feels that the overall ESG score's explanatory power varies by industry, as it does when using traditional investment factors. It reports that the overall ESG score is a positive predictive factor for approximately one-third of all industries, neutral for one-third, and a negative predictive factor for the remaining one-third. The score's predictive power over the entire market reportedly disappears when applied across all industries, and ultimately it is only meaningful for relative comparisons within a given industry. Therefore, ESG rankings are unrelated to the weights of the stocks in the portfolio; the ESG score is considered to be just another factor in alpha prediction models, and stocks without ESG ratings are included in the investment universe. Ultimately, the company's goal for ESG integration is to capture alpha, and it does not consider ESG to be an important factor for the risk management of the portfolio.

5. Summary

This section discussed ESG integration among investment managers in the United States based on the results of a November 2015 interview survey. We found that the approach to ESG integration of mainstream investment managers was different from that of ESG-dedicated investment managers. Mainstream investment managers primarily incorporate ESG factors into the process of selecting stocks, while ESG-dedicated investment managers generally allow such factors to influence their process of selecting stocks as well as their investment universes and guidelines. However, both commonly practice ESG integration in order to improve long-term performance. Among quantitative investment managers, ESG integration is considered to be just another factor explaining stock returns, resulting in the consideration of different ESG elements according to the quant model in use. The survey results suggested that ESG integration is not considered to be unusual in the United States, as ESG factors are incorporated in the same manner as the investment factors used in conventional investment strategies.


To New York,
Track 3

Section3 Shareholder Engagement in the United States

1. Corporate governance reform in the United States

The predominant concept of corporate governance in the United States is a simple shareholder model, which requires management to maximize shareholder value. However, many take a pessimistic view toward overcoming the agency problem that arises between shareholders and management, as they consider it to be difficult to prevent self-serving managers from deviating from the course of shareholder value maximization. However, the global financial crisis built the momentum to enhance corporate governance, resulting in the enactment of the Dodd–Frank Act,[1] the first financial regulation reform legislation in the United States since the Great Depression. “Say-on-Pay” voting has been introduced to enhance shareholder monitoring by institutional investors, and investors’ involvement in directors’ appointments has also been reinforced. These corporate governance reform measures have inevitably created the need for more frequent dialog between institutional investors and their portfolio companies, which has led to the recent and rapid increase in shareholder engagement in the United States. The following sections discuss shareholder engagement by the investor types covered by this survey, including major public pension funds, ESG-dedicated investment managers, and mainstream (active) investment managers.[2] Then, we feature Say on Pay, shareholder proposals, proxy access, and proxy contests as themes that motivate active engagement.

2. Shareholder engagement by investor type

(1) Engagement by major public pension funds

We interviewed CalPERS and CalSTRS, which are respectively the largest and second-largest public pension funds in the United States by assets under management. Regarding equity investment, both pension funds manage passive and other quant strategies in-house and outsource active strategies. They vote and engage to protect their beneficiaries’ benefits. Therefore, all holding stocks, including stocks held by outsourced managers, are subject to proxy voting and engagement by these two pension funds themselves. However, only larger pension funds are able to implement such a practice; as most smaller pension funds have less human resources to dedicate to proxy voting and engagements, they delegate all discretion to outsourced managers. In fact, investment managers have noted that few pension fund clients want to retain proxy votes and engagements on investee companies.

They are advised how to vote by proxy advisors; however, the final voting decisions are held by them. The funds have their own voting policies and corporate governance guidelines, with which they conform when voting. All voting results are thoroughly disclosed, and some areas are even subject to prior disclosure.

While the funds aim to vote on all the agenda items in their stockholdings, they limit their engagement actions to match the priority they assign to each. In addition to the aforementioned voting-related engagement, the funds also implement actions when unresolved ESG or similar issues exist. Instead of ending an engagement after a single discussion, the funds aim to initiate the process by building a relationship with the portfolio company. U.S. pension funds typically

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[1] Officially known as the Dodd–Frank Wall Street Reform and Consumer Protection Act (Pub. L.111–203, H.R. 4173); a federal law enacted in July 2010.

[2] The term “mainstream asset management institution” refers to a generic institution as opposed to one specializing in ESG.

have equity-biased asset allocations and consider themselves to be long-term investors. As Mr. Rice from CalSTRS stated, “We’ll stay here for a while. [They will continue holding stocks.] We have time.”

The funds are also active participants in the PRI as well as joint engagement projects implemented by nonprofit organizations such as Ceres and the International Corporate Governance Network. Their actions are not limited to engagement on individual companies, but include lobbying regulatory authorities and Congress. Public pension funds often lead these joint engagement projects. When engagement through individualized meetings ends poorly, some pension funds escalate matters by writing to the CEO, voting against director nominations, or filing a shareholder proposal.

(2) Engagement by ESG-dedicated investment managers

An investment idea about either a stock or a sector does not come from the ESG analysis but rather from the investment team, even if it is in a sustainability equity strategy offered by an ESG-dedicated investment manager. After a fundamental analysis comes up with an investment idea, the investment team enlists an ESG analyst to perform ESG due diligence. The ESG analyst decides whether to include the proposed stock or sector in the portfolio in light of the ESG-related risks and opportunities, based on the ESG scores provided by ESG research companies. A stock with an above-average ESG score will be included. Therefore, the portfolio comprises stocks with average or better handling of ESG issues. The selected stocks, in other words, are not necessarily the best ESG ones. The strength of ESG-dedicated investment managers lies in how they commit investee companies after purchase; through voting and engagement, they attempt to improve how these companies handle ESG issues. Thus, engagement is a major component of the ESG approach used in their investment processes.

Proxy voting is used by ESG-dedicated investment managers to deliver their intentions to their portfolio companies, and this is considered to be more than simply management approval. Managers have proxy voting guidelines that include ESG-related provisions; if any of these provisions is violated by a portfolio company’s actions, managers would not hesitate to vote against the appointment of directors. For example, Pax World disapprove the board member appointments of all Japanese portfolio companies because it requires an independent board (i.e., the majority of the board should be independent) according to its corporate governance guidelines.

These ESG-dedicated investment managers actively work on engagement with their portfolio companies. They establish several common engagement themes on which to focus during the year and then approach the targeted companies. For example, one manager focused on board diversity and engaged with all companies in his/her portfolio with no female director on the board. At times, managers opposed the appointment of directors and even filed shareholder proposals in some cases. Regarding climate change, one manager engaged with investee companies to set a greenhouse gas reduction target. As many environmental or social themes often apply to only specific sectors, the companies targeted for engagement can also be limited. For example, engagement in water resource issues targeted only two companies, namely a food/beverage manufacturer and a shale gas company.

Managers use various methods to engage. They meet individually with investee companies, lead joint initiatives, and participate in collective engagement. Their names often show up with

public pension funds in those collaborative efforts. They engage approximately 100 companies annually. As engagement with targeted companies or industries lasts for some years, they have built long-term relationships with major companies' management. They believe that gaining an industry's trust is important for engagement. However, as engagement aims to reform investee companies, when institutions feel that dialogs are insufficient, they would consider escalating matters. They may write to CEOs, vote to oppose the appointment of directors, and, albeit to a lesser extent, may file shareholder proposals.

Global Engagement

Engagement has a strong home bias. Some countries have created stewardship codes that demand institutional investors meet their duty of investing in domestic capital markets. Home bias is particularly evident in the United States; as the United States has the largest equity market, most ESG-dedicated investment managers manage U.S. equity funds. Therefore, engagement targets are usually assumed to be U.S. companies. One exception is Boston Common Asset Management, an ESG-dedicated investment manager that manages global equity strategies and that has practiced engagement with global companies since its establishment. In response to the Rana Plaza collapse in Bangladesh, Boston Common led an initiative for engagement with brand-name clothing manufacturers. This resulted in the Accord on Fire and Building Safety in Bangladesh, signed by 190 companies. The engagement representative visited the subcontractor's sewing factory of an investee company in the field.

(3) Engagement by mainstream investment managers

Mainstream investment managers incorporate ESG into their active investment processes, which forms a stock selection base for the fundamental analysis. Active investment teams consider company meetings to be part of the investment process; therefore, engagement is also conducted by investment teams. They say that many of the questions asked during these meetings are about the usage of free cash flow, optimal capital allocation, and business strategies. However, considerable time is also spent on corporate governance areas such as capital structure and minority shareholder rights. They may also discuss environmental and social risks with the companies while being assisted by the in-house ESG analysts. Therefore, ESG factors for active investment teams directly relate to investment decisions.

Active managers consider proxy voting to be a part of the investment activities to maximize returns on the assets received from clients; thus, with the exception of some major public pension funds, few clients usually take responsibility for proxy voting. These managers have their own companywide voting guidelines, and proxy advisors such as ISS and Glass Lewis make recommendations based on these managers' guidelines. Based on the recommendations, managers' proxy committees develop companywide voting policies, and these policies are used to vote. However, investment teams have the final authority on voting for companies within their own strategies. If an investment team wants to vote in a manner that contradicts the company's voting policies, it would then consult the proxy committee. The investment team's voting decision will also be affected by the company's importance relative to the overall portfolio. When handling

shareholder proposals or proxy contests initiated by hedge fund activists, as described later, investment managers will instead be in a position to be engaged by both proponents/activists and companies.

Engagement is a more important job for investment teams compared with proxy voting. They attempt to maintain frequent communication with investee companies, since engagement is also conducted through this communication. They only engage about ESG issues that could affect companies' performance. When an issue has prevented a company from achieving its initially anticipated performance, active investment teams can either choose to engage with the company to improve or can sell the company and seek another investment opportunity. As investment teams' sole mission is to maximize the value of clients' assets, the choice to implement engagement must rationally align with that mission. Therefore, active investment teams rarely become deeply involved in engagement beyond typical meetings with investee companies, and almost never participate in shareholder proposals or joint initiatives.

3 . Say on Pay

The Say-on-Pay vote asks investors to vote on the compensation of the top executives of the company. The Dodd–Frank Act was introduced in the United States in 2010 as part of an effort to improve corporate governance after the global financial crisis. The Act set a new rule to require shareholders' advisory votes on the compensation of CEOs, CFOs, and three other company management executives at general meetings at least once every three years.

The first Say-on-Pay votes in 2011 passed with high approval rates (90% on average among all companies). However, 44 companies failed to win majority support (i.e., the dissenters won advisory votes), which comprises 1.6% of all listed companies, while eight companies in the S&P500 failed, including Hewlett-Packard, which accounts for 1.9%. Thus, although the numbers were small, some companies failed the Say-on-Pay votes. Subsequently, 52 companies failed in 2012 (including Citigroup) and 53 did so in 2013.[3]

Although Say-on-Pay is a non-binding advisory vote, it is influential, as it provides shareholders with an opportunity to publicly express their opposition to companies' executive compensation. A stagnant stock price combined with high director compensation seems to compel investors to vote in dissent. A low support rate in the Say-on-Pay vote may indicate investor dissatisfaction with a stagnant stock price or long-term investment returns more than with the executive compensation package itself. Of the companies that failed their Say-on-Pay votes in 2011, 25% subsequently replaced their CEOs. This is a considerably higher rate than the average CEO replacement rate in the S&P500 (9%). Some companies that failed the Say-on-Pay vote also nominated new chairs of the board or senior independent directors.

Even CEOs who are not replaced interpret a failed Say-on-Pay vote as severe disapproval from shareholders, and they aim to gain investors' approval in the next vote. For example, Beazer Homes USA, a U.S. homebuilder, failed to gain majority support for its Say-on-Pay vote in 2011. Thereafter, the company hired a compensation consultant to clarify its executive compensation policy and make its compensation system more performance-linked. Moreover, the company took other steps to improve its disclosure practices; its Say-on-Pay vote in 2012 passed with a 95% approval rate. The company also proactively engaged with investors to explain its

[3] US SIF(2014).US Sustainable, Responsible and Impact Investing Trends 2014, p84

compensation system and seek their understanding. [4]

Every investor interviewed for this survey favored linking management compensation to medium- to long-term stock performance. Although high CEO pay in the United States was often argued, the investors in the survey said that this is not a problem as long as it is commensurate with earnings and shareholders receive returns to match. In fact, high executive compensation is an incentive and a result of performance at the same time. However, one problem is that management with poor performance receives the same high compensation as in times of good earnings, or that high compensation is guaranteed with no relation to earnings. When investors dissent in a Say-on-Pay vote, they also vote against the appointment of the chair of the remuneration committee.

Thus, Say-on-Pay in the United States has given investors the opportunity to express their opinions on compensation, a previously untouchable preserve of management, making this a highlight of general meetings. CEOs perceive a high Say-on-Pay approval rate as investor support for management. For investors, Say-on-Pay has become more than a way in which to simply approve or disapprove of a compensation plan; it is ultimately an expression of dissatisfaction with earnings. In years of upcoming Say-on-Pay votes, management review compensation plans, proactively meet with investors, and try to obtain advanced support. Companies are particularly prone to approach major institutional investors when the previous vote had a low support rate, and as a result, a natural increase in engagement with companies and institutional investors has occurred in the United States, such as meeting for talks on occasions other than AGMs or proxy voting.

Furthermore, pay gap disclosures will be mandated from 2018. When Say-on-Pay votes are held, companies will be obliged to inform investors of (A) the median salary of all employees, (B) the CEO's compensation, and the ratio of (A) and (B). This pay gap information will also affect investors' Say-on-Pay votes. The desired figures should vary among companies. It could lead the argument about whose contribution to the company's earnings. Investors will also need to prepare for setting their voting policies and best practices on companies' remuneration plans.

4. Shareholder proposals

European investors appear to believe that investors in the United States seldom participate in engagement. Instead, they frequently file shareholder proposals. In fact, in the United States, any shareholder who owns a stake of more than $2,000 or 1% of the company for at least one year is able to file a shareholder proposal. Many shareholder proposals are actually filed by individual investors.

Filing a shareholder proposal only involves creating a proposed agenda item, of up to 500 words in length, and bearing certain legal costs. The proposal will be included as a shareholder's proposed agenda item in the proxy statement created by the company and will be voted on if the proponent attends the general meeting. However, the company can refuse to include the shareholder proposal in the proxy statement by asking the Securities and Exchange Commission (SEC) to issue a no-action letter (NAL). Even if a proposal reaches the voting stage, the vote will be a non-binding advisory vote, with which the company is not obliged to comply.

[4] Emily Chasan(2012) 'Say on Pay' Changes Ways. *Wall Street Journal*

Therefore, a proposal must involve a NAL-exempt topic to be included in the proxy statement. The SEC has published a list of areas for which NALs are issued, which includes items related to ordinary business operations. Executive compensation and the appointment of directors have always been classified into the category of ordinary business operations, making it impossible to file shareholder proposals for these items. However, ESG-related shareholder proposals are likely to be NAL-exempt and thus many ESG-related shareholder proposals have been filed (see Figure 3).

Figure 3. Themes of ESG-related shareholder proposals (2015)

Theme	Number of Proposals
Environment	117
Political activities	113
Human rights and labor issues	65
Sustainability	52
Diversity	39
Natural conservation	22
Animal welfare	9
Other	17
Total	434

Source: Proxy Preview 2015 (www.proxypreview.org/).

Although a shareholder proposal is a non-binding advisory vote on an item that is not regarded as ordinary business operations, a company seriously considers this voting result in terms of the shareholder's intention it represents. While few shareholder proposal agenda items win majority support, companies respond in some way to shareholder proposals with approval rates over 30%. Thus, even if they come from a single individual, shareholder proposals that gain strong support from other minority shareholders could elicit actions from the companies. The shareholder proposal, therefore, is broadly perceived as one engagement approach open to individuals and small-stake shareholders.

In the interview survey, we sought institutional investors' views on shareholder proposals. While individuals could devote all their energy to creating proposals, institutional investors consider the opportunity cost. Considering capacity limits, even an ESG-dedicated investment manager files 10 shareholder proposals at most annually. Among major public pension funds, CalSTRS is willing to file shareholder proposals, having done so in practice. On the contrary, CalPERS hardly files its own shareholder proposals, as this is not an area of its expertise. Indeed, mainstream investment managers never file their own shareholder proposals, viewing them as beyond the domain of managers who solely manage client assets.

However, a shareholder proposal is an opportunity for an institutional investor to express its intention as a minority shareholder. Institutional investors perceive voting on shareholder proposal agenda items as an opportunity to send a message to management, just as for the agenda items proposed by the company. Companies are also concerned with how institutional investors vote on shareholder proposals. In conclusion, institutional investors play a key role in shareholder proposals, while this opportunity is created by shareholder proponents.

In the fiscal year of 2014, 443 shareholder proposals were submitted, of which 46 were struck down by NALs from the SEC, 180 were withdrawn by proponents, and 217 were actually voted on at general meetings. Thus, a considerable number of shareholder proposals are withdrawn before the AGM, while some are withdrawn because of a promise of action from the company before the vote. When shareholder proposals seem to gain overwhelming support, companies cannot ignore their shareholders' demands. Companies that anticipate such support will listen to shareholder demands through prior engagements in a considerable number of cases.

Thus, shareholder proposals provide engagement opportunities both for investors and for companies. A considerable number of shareholder proposals might be withdrawn because companies admit their agendas and promise certain actions. Those withdrawals might be considered to be successful engagement cases. In any event, shareholder proposals appear to raise active dialog between investors and companies.

5. Proxy access

Proxy access is a process that enables a shareholder who meets certain requirements to nominate his or her own candidate and have the candidates included in the proxy statement provided by the company. In a proxy contest by an activist to install his or her own directors, the activist has to develop his or her own proxy materials to nominate directors and send these to shareholders. By contrast, proxy access enables an investor to nominate a director for costs similar to those for filing a shareholder proposal.

As one of the major highlights of the Dodd–Frank Act, the SEC was given the power to regulate proxy access; however, the law was turned down after challenge by business lobbies. Then, investors started filing shareholder proposals demanding proxy access. The SEC refused to issue NALs for proxy access proposals, meaning that shareholder resolutions for proxy access occurred in many companies.

● New York City Pension Fund Project

In November 2014, the NYC Fund (a conglomerate of five New York City government employee pension funds with US$163 billion in assets under management) started an initiative called the Boardroom Accountability Project to demand proxy access. The project filed a shareholder proposal with a blanket demand for proxy access from 75 companies with low board diversity, low approval rates of Say-on-Pay voting, and high carbon footprints. Seven companies responded by agreeing to amend their bylaws and the proposals were withdrawn. Sixty-six companies voted on the proposal at their general meetings. The proposal averaged a 56% approval rate in these votes, receiving majority votes in two-thirds of the companies. As a result, 25 companies amended their bylaws to add proxy access by 2015. The SEC stated that the NYC Fund project raised the shareholder value of the 75 targeted companies by an average of 0.5%. Other government employee pension funds such as CalPERS and CalSTRS collaborated on the NYC Fund project.

Shareholder proposals often took up majority votes or board declassifications, which demand greater shareholder involvement in the appointment of directors. Proxy access actions aim to bring real-world boards (in which company management actually appoints the board of directors) in line with how corporate governance is meant to be conducted (in which directors represent shareholders and act on their behalf to monitor management). Before the Dodd–Frank Act, shareholders, particularly minority shareholders, had almost no say, as directors were nominated by a nominating committee and appointed by plural votes.[5] As proxy access enables minority shareholders to nominate director candidates, this brings corporate governance a step closer to its ideal form—directors appointed by shareholders, who are the company's owners, acting on behalf of the shareholders to monitor management.

As of February 2016, 150 S&P500 companies had added proxy access to their bylaws,[6] but there have still been no cases of shareholder-proposed director candidates' inclusion in proxy statements. Shareholder proposals for proxy access or engagement are thought to continue for a while and at some stage, long-term investors might use proxy access to reform the boards of companies that have poor performance.

6. Proxy contests

A proxy contest is a challenge to a company, initiated by a hedge fund activist seeking to propose its own agenda items for approval at the general meeting. There is no need for a shareholder proponent to send its own proxy statement to shareholders, as the proposals are included in the company's proxy statement. On the contrary, the activist making the challenge in a proxy contest must send its proxy statement to shareholders and work to gain other shareholders' support. This process is much more expensive than a shareholder proposal. However, unlike a takeover bid, which involves the purchase of a majority of the company's shares to obtain management power, a successful proxy contest enables a hedge fund activist to install its own directors and affect the company's management by owning a small percentage of the company's shares.

Altogether, 350 activists targeted U.S. companies in 2015 (65 among S&P500 companies), approximately half of which related to the appointment of directors. Most cases were settled with management before the proxy contest. In total, 23 cases went to vote. Through either settlement or voting, an average of 1.2 directors nominated by activists were appointed. If more than one appointment is counted as a win, activists' winning ratio is 48%.

The key factor to winning a proxy contest lies in how an activist obtains wide support from institutional investors, who represent minority shareholders. Both the activist and the company's management engage to persuade institutional investors. While institutional investors hardly invoke proxy contests, proxy contests from activism give them opportunities to show their perspectives to companies' management. When deciding whether to trust a company's existing management or side with the activist, all our respondents in the interview survey said that they would decide based on the merits of the individual case, considering engagement from both sides and recommendation from a proxy advisor.

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[5] A method in which a panel of candidates is voted on and the candidates with the most votes win. This enables candidates with even a single vote to be appointed.

[6] *Bloomberg Briefs,* 'Sustainable Finance', February 11 2016.

Companies with poor earnings or low stock prices attract activism. In this setting, activists' claims to management often appear persuasive. On the contrary, active managers select stocks based on their fundamental analysis. They hold those shares because they trust the management of the companies. The managers were in favor of management, at least when they were purchased. The managers also have an option to sell the stock and seek another investment opportunity, instead of taking an action to forcibly install directors as demanded by the activist. These considerations necessitate case-by-case decision-making. While the proxy committees provide assistance, the investment teams make the final decisions. Some public pension funds manage in-house passive strategies, which may position them similarly to passive managers. Thus, they seldom consider selling shares as their first option; CalSTRS is known to collaborate with activists, and it has an activist program to hire hedge fund activists.

Lastly, as these institutions were not included in this interview survey, we were unable to hear passive managers'' perspectives of proxy contests. Since passive managers hold large shares, they may have the decisive power. In the DuPont case, the largest proxy contest in 2015, the activist side backed by ISS and CalSTRS was thought to be advantageous; however, the company side won by a narrow margin, supported by passive managers such as BlackRock, Vanguard, and State Street.

Thus, institutional investors' support for activists is the key factor that determines their ability to install their own directors. The textbook model for corporate governance defines that shareholders appoint the directors at the AGM and the board of directors monitors management on behalf of shareholders. However, the directors of many boards are actually appointed by management. On the contrary, a director sent by a hedge fund activist will literally represent minority shareholders. Activism will move a company's corporate governance one step closer to the textbook model. Therefore, activism could align with the interests of institutional investors seeking to improve long-term company value, and institutional investors will side with activists in some cases. In a proxy contest case, institutional investors are engaged by hedge fund activists and gain opportunities to wield influence as shareholders.

7. Summary

The Dodd–Frank Act has significantly changed the engagement situation in the United States. Shareholders hold more sway over executive compensation and the appointment of directors, requiring companies to engage in dialog with them. From the textbook corporate governance perspective, in which directors are appointed by shareholders, both proxy contest by activists and proxy access sought by long-term institutional investors such as pension funds could find common ground. Therefore, these two sides could increasingly collaborate in the future. The creation of a "report card" represented by a Say-on-Pay vote has also compelled company management to realize a greater need for dialog with shareholders. In this way,, corporate governance reform after the global financial crisis has resulted in active shareholder engagement in the United States.

While similar developments have begun to occur in Japan, notable differences exist. Japan developed a Stewardship Code in 2014, and it now demands shareholder engagement. However, the Code has no specific provisions as to what the subjects of this engagement should be. A Corporate Governance Code, expected as a guideline for engagement, was developed in the following year. Institutional investors that have accepted the Stewardship Code are

working on engagement, as is evident from investor disclosure. However, in Japan there is no definitive agenda to compel institutional investors and companies toward engagement, such as Say-on-Pay or proxy access in the United States.

Japanese institutional investors may lower their voice because of a potential conflict of interests. Their voice may lack strength because of the negative attitude toward collaborative engagement. This perspective is evidenced by institutional investors' unwillingness to exert much influence through engagement. However, once Japanese institutional investors acquire a strong motivation to increase their influence, just as public pension funds in the United States began to demand proxy access from their portfolio companies, active engagement could naturally follow.


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Section 4 Conclusion

This report compiled the findings of an interview survey of ESG integration and shareholder engagement among institutional investors, namely investment managers and asset owners, in the United States. The survey findings on ESG integration can be summarized as follows. We discovered that the ESG integration of mainstream investment managers was different from that of ESG-dedicated investment managers. Mainstream investment managers primarily incorporate ESG factors into the process of selecting stocks, while ESG-dedicated investment managers generally allow it to influence their process of selecting stocks as well as their investment universes and guidelines. However, both commonly use ESG integration to improve long-term performance. Among quantitative investment managers, ESG integration is considered to be simply another factor explaining stock returns, resulting in the consideration of different ESG elements according to the quant model in use. ESG integration is not considered to be unusual in the United States, as ESG factors are incorporated similar to the investment factors used in conventional investment strategies.

The survey findings on shareholder engagement can be summarized as follows. The corporate governance reform caused by the enactment of the Dodd–Frank Act after the global financial crisis has resulted in proactive engagement by institutional investors in the United States. Although the approaches and methodologies of engagement vary among the major public pension funds as well as between ESG-dedicated investment managers and mainstream active investment managers, we discovered that all those investors consider proxy voting and engagement to be a part of the investment process. The Say-on-Pay vote is an advisory resolution on executive compensation; however, it became a virtual confidence vote in management. Another agenda item that investors demand is proxy access, or the shareholders' nomination of candidate directors. Proxy access has come to be included in shareholder proposals, which have been filed by major public pension funds and have won majority votes in many companies. Institutional investor support is a key factor to proxy contests, resulting in both activists and companies attempting to persuade institutional investors through engagement. Thus, shareholder engagement has recently become active in the United States. Institutional investors in Japan could also work proactively on engagement when agenda items arise, such as Say on Pay and proxy access.

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