

# **The Best Practices of Shareholder Engagement on Investee's ESG**

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# The Best Practices of Shareholder Engagement on Investee's ESG

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## The Best Practices of Shareholder Engagement on Investee's ESG

### INTRODUCTION

As the sustainability issue gains higher relevance on strategic decisions, the Shareholder Engagement is called upon for more profound Environmental & Social Governance (ESG) management practices. This provides the substance for the main objective of the proposed research: **to investigate the nature and the effectiveness of the Brazilian's Institutional Investors Engagement on its investee companies Environmental and Social Governance.**

Empirical evidence of existing positive correlation between the best practice of Environmental & Social Governance (ESG) and the process by which Company creates value have been the subject of many academy and business related studies.

Under intense pressure from Investors and other Stakeholders, Companies are in a hurry to be recognized as sustainable. Some of them are highly engaged on ESG issues. Unfortunately, there are a large number of Companies that are not. These, are shortcutting sustainability reputation branding creation throughout an intense, propagandist use of a semiotic-oriented communication strategy.

This misuse of communication tools submits corporate reputation to the *law of reversed effort*<sup>1</sup>, for it triggers increasingly higher external expectations about company's sustainability. The company is continuously forced do augment propaganda expenses because the true internal ESG performance is not congruent with such an externally misbranding-sold corporate image

Innovative investment strategists from Pension Funds as well as Asset Managers have been increasingly learning how to separate companies overinvesting in propaganda from the others which are truly committed to ESG development. These strategists are in search of new sources of gaining long-term competitive advantage by adopting sustainability initiatives as differentiation strategy. Also, they know that propaganda is not a source of durable competitive advantage.

According to a recent survey conducted at the MIT Sloan School of Management in association with the Boston Consulting Group, *making sustainability work* is the very challenge board members and senior executives are facing now. In the fall of 2009<sup>2</sup> over 1,500 worldwide executives and 50 global thought leaders were interviewed about their companies understanding and practice of sustainability.

Bringing both good and bad news, the survey focused on sustainability awareness and practice of corporate senior executives. The good news is that some companies who have demonstrated extreme commitment to sustainability strategies have also profited from that very commitment;

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<sup>1</sup> Alan W. Watts – The Wisdom of Insecurity, Pantheon Books, 1951.

<sup>2</sup> Source: "The Business of Sustainability: What it means to managers now" - MIT Sloan Management Review, Fall 2009.  
<http://sloanreview.mit.edu/>

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the bad news is that most companies do not understand what sustainability is and managers at all levels misunderstand and diverge about:

- I. The correlations between sustainability risk and financial performance;
- II. How to track sustainability value from where it is created;
- III. How its sustainability initiatives are converted into shareholder value;
- IV. The ways return on sustainability strategy can be measured.

From the surveyed people context, the MIT-BCG 'researchers understand that the best way to address competencies to overcome the above-listed weaknesses is to make institutional investors active owners heavily engaged on the process by which its investee companies create ESG value. This can trigger sustainability understanding and practice companywide and over the entire upstream-downstream company value chain.

Using its fiduciary duty and acting on behalf of its beneficiaries, institutional investors assume the mission to employ the best efforts to assure long-term sustainability objectives. In this context, environmental and social governance (ESG) issues which are supposed to significantly impact the long-term financial performance are the primary fiduciary responsibilities.

### 1 Research Main Objectives and Methodology

As Corporate Governance best practices evolve, institutional investors are increasingly becoming active owners and engaging in regular dialogue with their investee companies. This new behavior is aligned to the second of the six **Principles for Responsible Investment (PRI)**<sup>3</sup>, which states: "We will be active owners and incorporate ESG issues into our ownership policies and practices".

Among PRI's shareholder engagement, the proposed actions are:

- I. Develop and disclose an active ownership policy consistent with the Principles;
- II. Exercise voting rights or monitor compliance with voting policy (if outsourced);
- III. Develop an engagement capability (either directly or through outsourcing);
- IV. Participate in the development of policy, regulation, and standard setting (such as promoting and protecting shareholder rights);
- V. File shareholder resolutions consistent with long-term ESG considerations;

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<sup>3</sup>[www.unpri.org/principles](http://www.unpri.org/principles)

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- VI. Engage with companies on ESG issues;
- VII. Participate in collaborative engagement initiatives; and,
- VIII. Ask investment managers to undertake and report on ESG-related engagement.

As the sustainability issue gains higher relevance on strategic decisions, shareholder engagement is also called upon for more profound environmental & social governance (ESG) management practices. This provides the framework for the main objective of the proposed research: **to investigate the nature and the effectiveness of Brazilian Institutional Investors Engagement on their investee companies Environmental and Social Governance.**

This research methodology consists of a framework that mirrors the early work of James Gifford<sup>4</sup>, Executive-Director of the United Nations Principles for Responsible Investment – PRI. The Gifford study focused on European and American Companies.

### 1.1 The Nature of Shareholder Engagement

According to Gifford (2009) three factors contribute to the effectiveness of shareholder engagement: power, legitimacy, and urgency in shareholder claims. These factors constitute the framework for the analysis of engagement practices of Institutional Investors.

The first is the attributes of shareholder power may be:

- I. Coercive, if the shareholder request is supported by either implicit or explicit threat to employ the formal shareholder rights to influence resolutions like replacement of directors, for example;
- II. Utilitarian, as shareholders have their claims prioritized throughout threatening divestment, for example;
- III. Normative, when the engagement acquires potentiality to affect the company or its manager's reputation.

The second factor, the source of legitimacy, can be broken down into four levels:

- I. Individual, when attached to the credibility, expertise, experience and status of the individuals engaging with the company;

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<sup>4</sup>E. James M. Gifford. Effective Shareholder Engagement: the factors that contribute to shareholder salience, 2009 – [www.unpri.org](http://www.unpri.org)

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- ii. Organizational, from existing alignment between shareholders' interests and those of the company, and the perception that the investor organization is a credible and respected member of the investment community;
- iii. Pragmatic, when the shareholder has a strong argument behind the proposed action in favor of the interests of the company, and the shareholder provides new valuable information to the company;
- iv. Societal, if the shareholder proposition embodies an issue widely accepted in society or comes accompanied by supportive political and policy environment.

The third factor regards the source of shareholder urgency:

- i. Time-sensitive, when shareholder proposition is accompanied by some forms of deadline to create time pressure;
- ii. Critical urgency, related to the quality of the proposition that can be attached to subjective or objective factors.

### **1.2 The Main Objective of the Research**

The main objective of this research is to investigate the means by which active ownership occurs and the effective results involving Brazilian institutional investors and asset managers' engagement on their company's ESG issues.

The process of investigation will:

- i. Verify the existence, level and the focus of the of shareholders engagement (proposals and interventions) into investee companies' ESG issues; and,
- ii. Verify, when that engagement exists, whether correlations between them and the company managers' action can be identified with measurable results.

The process of investigation will contemplates both the perspectives of both the Investor and the Investee Company.

### **1.3 The Research Universe**

Brazilian institutional investors and asset managers signatories of the United Nations Principles for Responsible Investment (PRI) will be the research target, as well as its related Investee Companies.

From one side, investigation aims to reach investors' nominated members of the board of advisors and of the board of directors, including CEO and C-Suite Officers. From the other side,

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the same level of advisors and directors of the investee company will be invited to be interviewed.

### 2 Research Framework & Schedule

Four months will be necessary to accomplish the research objectives - Figure 1.

FASE	MAIN ACTIVITIES	MONTHS			
		1	2	3	4
1 <b>Support Negotiations</b>	Institutional Sponsorship	■	■		
	Financial Sponsorship	■	■		
	Board of Advisors Inaugural Meeting	■	■		
2 <b>Preparatory Activities</b>	Targeted Public Mapping and Contacting	■	■		
	Research Methodology and Tools Development	■	■		
3 <b>Collecting and Treating Information</b>	The Institutional Investors Side Interviews		■	■	
	The Investee Companies Side Interviews		■	■	
	Data Treatment and Analysis		■	■	
4 <b>Conclusions and Edition of the Report</b>	Research Report First Draft			■	
	Board of Advisors Discussion Meeting			■	
	Research Report Edition				■
5 <b>Research Diffusion</b>	Sponsors Presentation Meeting				■
	Media Diffusion Preparation and Releasing				■
	International Conference on ESG Shareholder Engagement				■

Figure 1–Research Framework & Schedule

The first three months will be dedicated to the research itself; the fourth to the diffusion of the research results, including an International Conference on ESG Shareholder Engagement design and preparation.

### 3 Research-Based Objectives on RI's Management Capabilities

The best practices of shareholder engagement on investee companies increasingly gains attention from capital markets, as a Corporate Sustainability Strategy which is anchored in the Responsible Investment Paradigm.

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The United Nations Principles for Responsible Investment (PRI) drives and endorses that paradigm that is gaining substantive adhesion of private investor led in the major Pension Funds worldwide.

The core initiatives of the PRI have been focused on institutional development and enhancing the aggregation of capital markets and financial services institutions from around the world. Today 776 organizations (Figure 2) have signed and committed to implement the PRI's six principles, 42 of them from Brazil.

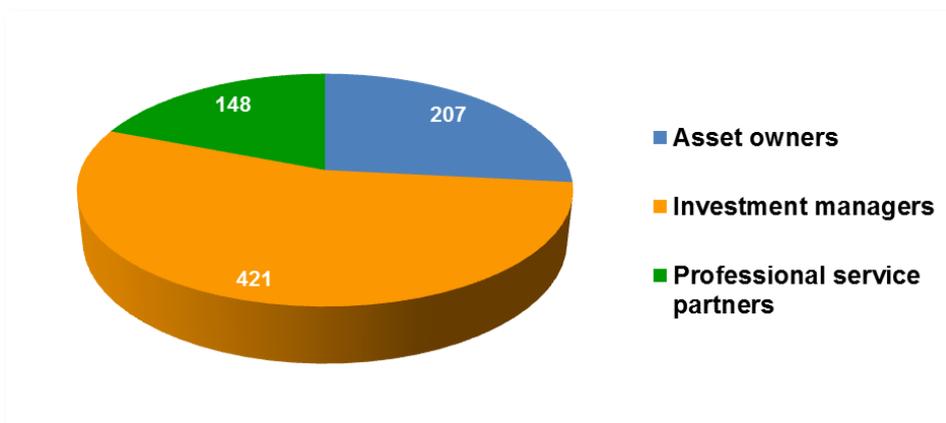


Figure 2 – PRI Signatories Profile

A range of institutional and management framework to support signatories' implementation of the Principles have been developed (Annex 1):

- I. Academic Network;
- II. Engagement Clearinghouse;
- III. Reporting and Assessment Tool;
- IV. Emerging Markets and Developing Countries;
- V. Private Equity Network;
- VI. Property Network;
- VII. Public Policy Network.

However, that strong knowledge platform does not ultimately support the responsible investment mainstream, because executive education schools are not prepared to regularly offer RI-tailored management programs.

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The lack of focused, clear-intended corporate education programs to address management competencies on responsible investment obstructs and retards the PRI's paradigm pervading investor's organizations and investee companies, as well.

The lack of programs urges and legitimates a research-based *Management Capabilities* platform building addressed to complement managerial skills for PRI's orbiting organizations (Figure 2) such as Pension Funds, Asset Managers and other Financial Service providers.

### **3.1 Building ESG's Shareholder Engagement Business Cases**

There aren't many significant, diffused business cases about shareholder engagement on investees environmental & social governance elaborated in both the academia and the businesses environment. Nevertheless, the present research's focus, methodology and involved target-public encourage the researchers to pursue strongest business cases on responsible investment building.

The research provides the opportunity to explore the largest and richest responsible investment: A knowledge-exchanging platform. This has the potential to develop practical learning business cases and consolidate RI's best practices as well.

From such a fruitful source of knowledge and practice it is reasonable to build a comprehensive set of *ESG's Shareholder Engagement Business Cases*. This best practices knowledge framework could be replicated throughout the entire RI's value chain.

### **3.2. Shareholder Engagement on Investee's ESG International Conference**

An international conference that is expected to gather UNPRI and its surrounding community (academic and practitioner professionals) will be designed and organized. This is the best way to share research findings and business case studies.

During this Conference participants are expected to bring their own experiences about *Responsible Investment practice* into the research findings. As a consequence, a responsible investment management knowledge network-exchange platform would be launched.

From this conference, the best practices of *Corporate Responsibility Investment Management* gains stature to be top-ranked in the investors and investees agenda. The City of Rio de Janeiro will host the International Conference on Shareholder Engagement on Investee's ESG.

### **3.3 Developing Responsible Investment Executive Education Platform**

The PRI Academic Network<sup>5</sup> pioneered *Responsible Investment Corporate Education*. However, with the exception of the innovative Australian RI Academy<sup>6</sup> and the Young Scholars

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<sup>5</sup> <http://www.unpri.org/workstreams/#0>

<sup>6</sup> <http://www.riacademy.org/>

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Finance Academy <sup>7</sup>(a PRI' partnership with the Swiss-based oikos Foundation), there aren't any recognized, continuous executive education programs designed to complement practitioners' management skills.

The research focus, methodology and targeted-public create a unique opportunity to build a rich knowledge-exchanging platform. From this at least two customized conceptual-practical learning frameworks, addressed to nourish world's executive professional development necessities, will be developed.

### **3.3.1 Shareholder Engagement on Investees ESG's Executive Program**

Addressing board members and C-Suite executives' development from investor and investee sides, the purpose is to directly challenge the previously mentioned gap between corporate sustainability strategy and execution.

The program goal is to develop and pervade RI management capabilities. This helps integrate ESG policies on corporate strategy by creating a culture of sustainability, which ultimately contributes to the companywide engagement for making sustainability work.

### **3.3.2 Responsible Investment Strategy & Management's Executive Program**

The focus of a Responsible Investment Strategy & Management Program is that professionals from banking and capital markets are expected to improve their professional capability in handling sustainability finance issues.

C-Suite executives of environmental-intensive industries of which the dependency of natural resources is a crucial business risk, can also incorporate new and profitable sustainability management competences from the program.

## **4 Research Team**

The work will be conducted by researchers from the Department of Engineering Management of the Institute of Post-Graduation and Research (COPPE) of the Federal University of Rio de Janeiro (UFRJ), Brazil, and from the Doctoral Department of the Business School Lausanne, Switzerland. The research team is:

- I. Professor Carlos Alberto Nunes Cosenza, DSc (COPPE-UFRJ, Brazil);
- II. Jose Antonio Chaves, DBA Candidate (Business School Lausanne, Switzerland).

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<sup>7</sup> [http://www.oikos-international.org/fileadmin/oikos-international/international/Finance\\_Academy\\_2010/oikos\\_PRI\\_2010\\_Final\\_Programme.pdf](http://www.oikos-international.org/fileadmin/oikos-international/international/Finance_Academy_2010/oikos_PRI_2010_Final_Programme.pdf)