Active ownership: the keys to success

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Enterprise for Society (E4S) is a joint venture of the University of Lausanne through its Faculty of Business and Economics (UNIL-HEC), the Institute for Management Development (IMD) and the Ecole Polytechnique fédérale de Lausanne (EPFL), under the stewardship of its College of Management of Technology, with the mission of spearheading the transition towards a more resilient, sustainable, and inclusive economy. E4S is committed to training the next generation of leaders, inspiring economic and social transformation, and promoting change by strengthening start-ups and boosting innovation.

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Exit vs. voice – this is the general choice that responsible shareholders face when invested in a company that behaves in a way that does not align with their values. The first option is to dissociate themselves and divest. The second is to engage in dialogue to initiate positive change. The latter strategy refers to active ownership and is the focus of this analysis.

But how to facilitate the success of active ownership? When are companies more likely to comply with investors' ESG demands? And what to do when they do not? Target companies have a specific profile and this profile, together with that of the investor and the characteristics of the engagement itself, will impact on the outcome of shareholder initiatives.

Mature companies under financial constraints are often targeted, whether they have questionable ESG practices or demonstrate expertise in this area. Targeting large companies has several advantages, such as greater potential for impact and the increased visibility it would provide to the investor. Also, a company under financial pressure and underperforming its peers would be more likely to accept shareholder demands. However, shareholder activists are interested in both companies with a high margin of progress in their ESG practices and companies with proven ESG expertise.

There are three categories of factors influencing the outcome of shareholder initiatives: company profile, investor profile, and engagement characteristics. It is most likely that mature and ESG-conscious companies will comply with shareholder demands. Local institutional investors with a history of successful engagement with the company seem to achieve their goals more frequently. Additionally, two-tiered collaborative engagements, addressing corporate governance and taking a more aggressive approach seem to be more successful.

When active ownership does not work, what should you do? More emphasis should therefore be placed on collabora investments led by local investors, pref bly large asset managers, and targeting mature, ESG-conscious companies. Although their likelihood of success is lower, smaller companies and laggards should not be forgotten. When an initial engagement has failed, intensifying the engagement or collaborating with other actors, such as bond investors and creditors, can help.

KEY TAKEAWAYS

1 Mature and financially constrained companies are more often the target of active ownership.

2 Three categories of factors influence the outcome of shareholder initiatives: company profile, investor profile, and engagement characteristics.

- **a.** Mature, ESG-conscious companies are most likely to comply with shareholder demands.
- **b.** Local institutional investors with a history of successful engagement with the company appear to achieve their goals more often.
- **c.** Collaborative engagements that are multi-level, address corporate governance or have a more aggressive approach appear to be more successful.

3 Although less responsive to engagement, smaller companies and laggards should not be left out. Increased engagement and collaboration with other actors such as bond investors and creditors can help when an initial engagement fails.

E4S SERIES ON ACTIVE OWNERSHIP

In December 2021, E4S studied the **impact of divestment** as a responsible strategy. The E4S series on active ownership investigates an alternative to divestment: engagement and voting. The first analysis of the E4S series on active ownership, **Active ownership : by whom and how ?**, develops the status quo of this strategy. The second one, **Active ownership : for what impact ?**, studies the benefits and costs for the investor who engages as well as the reactions and behavioural changes of the target company. To be successful in their engagements, however, investors will need to consider several factors. Active ownership: the key to success develops how the profile of the target company and of the investor, as well as the characteristics of the engagement, can influence the outcome of a shareholder initiative.

2 INTRODUCTION

Exit vs. voice – this is the general choice that responsible shareholders face when invested in a company that behaves in a way that does not align with their values. The first option is to dissociate themselves and divest. The second is to engage in dialogue to initiate positive change. The latter strategy refers to active ownership and is the focus of this analysis.

Through their rights and in particular, their status, shareholders can signal disapproval or influence corporate strategy. The goal is to promote the company's sustainability and thus protect and increase its value [3]. These are the principles on which active ownership is based.

It generally applies to publicly traded shares and is based on two main components: voting and engagement. Both are extremely interrelated, complement each other and can be triggered by one another. Engagement may be private or public, individual, or collaborative, or a combination depending on the receptivity of the target company. The themes and stakeholders are diverse and the regulations and culture around active ownership vary by region. Also, the engagement extends to other asset classes such as corporate and sovereign bonds, as well as private equity [4]. Environmental, social, and governance (ESG) issues are the focus of this analysis.

Active ownership affects both engaging investors and target companies. Engaging investors incur high administrative and indirect costs but are often rewarded with higher returns. Target firms generally improve their ESG practices, especially when they lag behind their peers. Financial and operational performance also improve.

But how to facilitate the success of active ownership? When do companies more likely follow investors' ESG requirements? And what to do when they do not? The pragmatic choice of active ownership versus exclusion is based on two conditions. Firstly, it seems feasible to change company behaviour through this strategy, and secondly, successful active ownership seems to have a relatively greater net positive impact than exclusion. Assessing these two aspects ex-ante is undeniably challenging. There are, however, some factors that may indicate the prospects for success. The purpose of this analysis is to further define what "success" means in the context of active ownership and to describe the characteristics observed in the target companies (Section 3). It will give an overview of the various success factors, in particular those related to the profile of the target company (Section 4.1), the profile of the engaging investor (Section 4.2), and the characteristics of the engagement (Section 4.3). Finally, it will discuss the steps to be taken when the company does not respond to an initial engagement (Section 5).

3 CHARACTERISTICS OF THE TARGET

ESG activist investors tend to target companies with a specific profile. Their size, ESG expertise, financial situation, performance and shareholder structure are relevant criteria in the ESG engagement decision. Often, mature companies with financial constraints are targeted, regardless of their ESG practices or expertise (Figure 1).

3.1 MATURITY AND VISIBILITY

ESG active ownership usually targets mature, high-profile companies. In fact, companies with high market share and lower sales growth and earnings volatility than their industry peers are more likely to be subject to ESG engagement. Although hedge funds generally target small and mid-cap companies [5], industrial giants with a large market capitalization and a high proportion of sales made abroad are subject to increased public and responsible investor scrutiny [6]–[8]. In addition, companies targeted for environmental and social engagement would also be more concerned about their reputation: they are have more media coverage and greater advertising resources than their peers [7].

Targeting large companies would have several advantages for engaging shareholders. It would increase the chances of attracting public and media support and attention, increase the possibility of spill over into other industry peers, or strengthen the identity of the group of engaged shareholders [2]. However, large companies are more difficult for shareholders to control effectively and, by implication, more exposed to agency problem [9].

3.2 ESG EXPERTISE

Activist investors tend to target companies with more room for improvement in ESG practices, particularly governance practices Based on the data of a European asset manager, Barko et al (2018) found that a one-standard deviation decrease in ESG score – of the order of 23.8% - is associated with an increase of 2.45% in the probability of being engaged. Targeting companies that need to improve their governance practices can result in a board that is more independent of management, minimizing agency problems. Additionally, an independent board may be more responsive to ESG demands from investors [9].

In the case of collaborative engagements, the trend appears to be the opposite. Shareholder groups would focus more on industry leaders with proven ESG expertise who wish to avoid an ESG rating downgrade. Similarly, firms operating in countries where CSR policies[1] are more present, such as France, Scandinavia, or Germany, would be more likely to be targeted and to meet environmental and social engagement demands [8].[2]

3.3 FINANCIAL PERFORMANCE AND DISCRETIONARY SPENDING

Engagement would be more likely in the presence of financial constraints. Compared to their peers, targeted companies would have higher leverage and less liquidity [5], [7], [8]. A company under financial pressure might be more likely to accept the activists' demands. However, this result needs to be contrasted in the case of environmental reform demands where investors tend to focus on targets with higher liquidity [7].

[1]1 Corporate Social Responsibility
2 Dimson et al. (2021) notent que l'environnement juridique de l'entreprise seraient corrélé à son score ESG.

The importance of discretionary spending in the engagement decision varies. Some investors prefer companies with low capital expenditures because they have more room to invest capital for reform [7]. Others see more potential for success in high-spending companies: if they pay high dividends, it means they are able to implement better ESG practices by reallocating capital; if they have high capital expenditure, it may mean they have already made ESG investments and are better able to respond to shareholder demands again [8].

3.4 Market performance

ESG engagement is not limited to companies that perform poorly on financial markets. In traditional hedge fund engagement, targets are often companies with lower returns than their peers: by engaging them, the activist can hope to unlock value and benefit from the changes they initiate [5], [7]. However, a good stock performance, suggesting a positive attitude towards process improvement, is sometimes linked to a higher probability of engagement, especially when ESG issues are concerned [6]. Some collaborative engagement targets also have a mixed financial performance with low returns but high ROA compared to the industry [8].

3.5 Shareholder structure

Target firms are more attractive to responsible investors. Although in absolute terms they may only hold a small percentage of the equity, socially conscious investors, such as responsible pension funds, UN PRI signatories or SRI funds, have larger stakes in the target companies than in the targets' peers [7], [8].

Companies with significant management shareholdings are less attractive targets. Managers owning a high stake in the company – and the associated voting rights – are expected to bear a greater responsibility for their decisions. Because of their potential to resist ESG proposals from external investors, companies with high insider ownership are less likely to attract shareholder engagement [8], [9]

Figure 1: Summary of target characteristics and impact on engagement likelihood

Factor	Impact
Maturity & visibility	+
ESG expertise	
For collaborative engagements	+
For governance engagements	-
Financial performance	
Financial constraints	+
Discretionary spending	?
Market performance	
For traditional hedge fund activism	-
For ESG activism	+
Shareholder structure	
Presence of responsible investors	+
Presence of management	-

Box 1 : How to define success?

Successful shareholder engagement occurs when the company is receptive to the suggestions and views of engaged investors and takes concrete steps to implement them. Success can be measured in a number of ways. Two notable examples are the shareholder proposal's acceptance and withdrawal rates. Other measures specific to shareholder initiatives are also used.

- **Shareholder proposal acceptance rate**

The acceptance rate of a resolution indicates the shareholders' opinion. The outcome of an engagement strategy can be used as an indicator of success, but positive results do not necessarily translate into concrete corporate action. Despite their sometimes-consultative nature, a shareholder proposal that has received a majority vote is not legally binding. Therefore, acceptance of a proposal does not imply implementation, and rejection of a proposal does not imply non-implementation. Implementation rates are still higher for proposals that receive a majority of votes than those that do not [10].[3]

- **Shareholder proposal withdrawals**

Shareholder proposal withdrawals can indicate the success of a private engagement action. The mere filing of shareholder proposals, particularly on environmental and social issues, can serve as a starting point for dialogue and ultimately improve the company's performance on these issues [11]. A positive outcome to these discussions usually results in the shareholder proposal being withdrawn. In fact, it appears that withdrawn proposals would have a greater impact on company practices, e.g. regarding management remuneration, than proposals submitted for voting and which received relatively few votes ex-post [12]. In spring 2021, for example, the Ethos Foundation and seven Swiss pension funds submitted a shareholder resolution to the Nestlé AGM that called for a "Say on Climate" vote.[4] Soon after the resolution was tabled, Nestlé's Board of Directors announced it would put its climate strategy to a vote, causing the Ethos Foundation to withdraw its resolution [13].

- **Measures specific to the shareholder initiative**

Private engagement remains a preferred method for investors and is often used prior to a resolution filing [2]. As it must be done in the context of negotiations and on a case-by-case basis, depending on the industry, the company, or the theme, the assessment of success will tend to be qualitative and non-binary. In some institutions, success is measured based on the project and type of engagement. In its collaborative engagement platform, UN PRI compares the metrics for each target company for the pre- and post-engagement periods [8]. Some engagement projects will be considered successful if the company signs up to an initiative (e.g., the CEO Water Mandate), sets targets (e.g., GHG emission reductions), or makes progress toward achieving these targets. Scorecards are also frequently used.

3 The analysis by Ertimur et al (2010) focuses on proposals related to corporate governance issues and filled between 1997 and 2004. The probability of implementation of the proposal increases with the percentage of votes in favour of the proposal and the weight of the shareholders who submitted it and support it.
4 Say on Climate votes allow investors to assess a company's climate strategy and associated risk management, and to increase shareholder pressure when measures taken are insufficient.

4 Shareholder Action Success Factors

As with any type of negotiation, its success will depend on a variety of factors (Box 1). These can be divided into three categories for ESG active ownership: the target firm's profile, the engaging investors' profile, and the engagement characteristics.

4.1 Profile of the Target Firm

Engagement results can be influenced by the firm's maturity, ESG expertise, financial stability and performance, and shareholder structure. Companies that are mature and ESG-conscious are more likely to comply with shareholder demands (Figure 2).

4.1.1 Maturity and visibility

In reality, mature companies appear to be more receptive to engagement and more likely to meet ESG demands: receptive companies have low sales growth and have already passed the expansion stage [6]–[8]. In part, this is due to their greater investment capacity and fear of bad press, as well as because responding to engagement can have operational benefits [14].

4.1.2 ESG expertise

The probability of successful shareholder engagement is positively impacted by the ESG expertise of the target company [6], [8]. A strong track record and expertise in ESG matters would make it easier for the company to comply, given the small gap between demands and existing practices. ESG expertise also shows how much importance a company attaches to these issues. Yet, the potential impact of engagement is lower than if it were targeted at companies that lag behind their peers.

4.1.3 Financial stability and discretionary spending

Financial constraints can undermine the success of environmental engagements. High liquidities as well as lower leverage, R&D and capital expenditure, would facilitate the implementation of better environmental practices, which are generally more expensive than those related to corporate governance [7].

Figure 2: Company profile and impact on the likelihood of successful engagement

Factor	Impact
Maturity & visibility	+
ESG expertise	+
Financial performance	
Financial constraints and high cost of reform	-
Financial constraints and dependence on external funding	+
Market performance	**No impact**
Shareholder structure	
Presence of responsible investors	**No impact**
Presence of lead coordinating investors	+
Presence of managers	-
Presence of index fund managers	+

Financial constraints seem to favour successful engagement in other cases. Companies without a cash cushion are more dependent on external financing and, therefore, more interested in maintaining good relations with investors and meeting their demands [6].

4.1.4 Market performance

Stock market performance would not affect ESG engagement success. Although underperforming companies may find investor concerns more relevant and want to avoid more aggressive action, their stock returns would not influence their response to shareholder demands [6] unlike their operational efficiency [7].

4.1.5 Shareholder structure

It seems that the presence of responsible investors does not particularly encourage companies to comply with corporate governance demands [7]. When they work together in collaborative engagements, however results seem to be more positive [8].

The presence of a lead investor coordinator in ESG collaborative engagements, on the other hand, would play a catalytic role in improving company practices. The lead investor generally demonstrates a strong engagement to sustainability and has a greater potential for influence on a company's environmental and social performance than less involved institutional investors. Despite having a relatively small equity stake, the lead investor seems to be associated with higher social and environmental scores [15].

When management represents a significant portion of the equity, it is difficult for engaged investors to achieve their goals without collaboration or consensus. And escalation is not always a solution in itself. If the more confrontational route of the shareholder proposal were to be taken, management would be more inclined to let the proposals be voted on rather than compromise and to limit the reputational damage of confrontation [12].

The inclusion of index fund managers in the company's shareholder group would increase success of private engagement but not necessarily of public engagement. Indeed, the amount of shares held by index fund managers would increase the likelihood of a proposal withdrawal or reduce the company's CO_2 emissions [12], [16][5,6]. On the other hand, large asset managers are the least likely to vote in support of social and environmental proposals [17] (Focus 1).

Focus 1 : Engagement of index fund managers

The role of index fund managers **is often questioned.** In 2017, BlackRock, Vanguard, and State Street, also known as the Big Three, held on average 25% of the votes of S&P500 companies. As their market grows and competition increases, this could rise to almost 40% by 2038 [18]. Yet, despite their strong position and the public signal their voice would send, they often underuse their voting power and vote more conservatively than proxy voting agencies on environmental and social issues [17], [19]. In 2021, they voted in favour 26% to 40% of the time compared to 75% for ISS and 44% for Glass Lewis. In the same year, 18 E&S resolutions would have won a majority if one or more of the Big Three had been less

5 A one standard deviation increase in the amount of shares held by index fund managers would increase the probability of a withdrawal by 13.9 percentage points [12].
6 A one standard deviation increase in the Big Three's shareholding would be associated with a 2 percentage points reduction in the company's CO2 emissions. This trend is particularly present when their shareholdings are large [16].

conservative and voted in favour (Figure 3) [19].

In theory, however, it would be in the interest of the Big Three to engage more actively on ESG issues. First, for large holdings, they can achieve economies of scale in implementing and monitoring engagement and in active voting and would capture a greater share of the value generated by practice improvements. Second, in a market where fees are uniformly low and competitors follow similar investment strategies, more active engagement could be used as a differentiator. This strategy is already being used by medium-sized funds, which could encourage the Big Three to get more involved [17]. Finally, index fund managers are exposed to risks that they cannot diversify beyond the indices they track. As a result, they are positioning themselves as new universal investors and have a stake in addressing long-term risks [20].

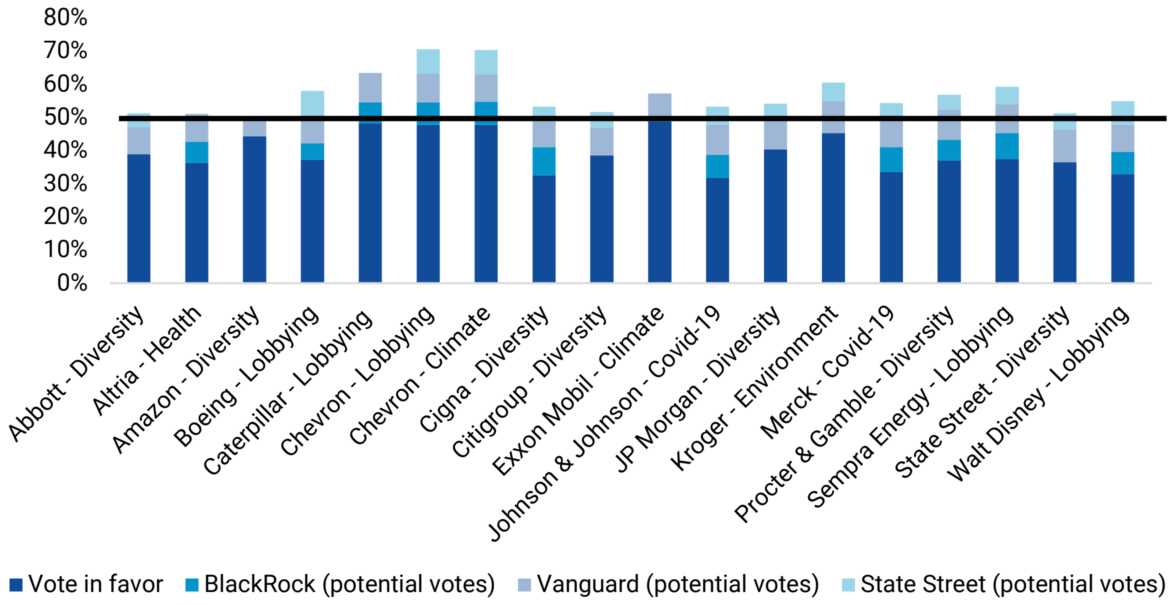
This non-interventionism can be explained by the growing influence of the Big Three and their difficulty representing the heterogeneous preferences of their investor base. The Big Three could provoke strong public reactions by stating their opinions more forcefully [20]. The proxy period for 2021 has nonetheless demonstrated that rapid improvements are possible. As an example, BlackRock voted in favour of E&S resolutions in 40% of cases compared to 12% in 2020, an increase of 28 percentage points. BlackRock also appears to have new ambitions: from 2022 on, the largest asset manager would like to give its clients the option of participating more actively in voting decisions, where that is legally and operationally feasible [21].

The Big Three therefore prefer private engagement to find nuanced solutions to complex ESG issues[7]; particularly with companies in which they have large stakes [16]. Engagement here requires building long-term relationships which are equally costly. The use of voting against management might jeopardize the progress made in discussions, so it would only be used as a last resort. Despite this, since engaging behind closed doors is difficult and costly, managers would generally be more likely to underinvest in their engagement strategy and defer to the company's management [20].

More transparency is therefore needed to assess the influence of private engagement by index fund managers. Bebchuk & Hirst (2020) suggest that privately engaged investors should share more information about engagement initiatives[8], and that disclosure should be more frequent and carried out not only through an annual management report published off-line from their engagement results[9]. This would allow all investors to have access to material information on their voting decisions and to better assess the effectiveness of these private engagements.

7 Between 2017 and 2019, the Big Three conducted private engagements on approximately 7.5% of their portfolio companies, which in relative terms seems small but in absolute terms represents hundreds of companies. [18]
8 Such as the number of conversations, the party that initiated them, changes requested by the engaging investor, or information that could be important to voting decisions.
9 Note that more transparency can also be counterproductive: companies may be less responsive in private if their communications are subsequently disclosed.

Figure 3: Resolutions that could have obtained a majority if one or more of the Big Three had voted in favour



Source: Sood et al. (2021)

4.2 Profile of engaging investors

The investor's profile, including its location, influence, and type of activity, play an essential role in to achieving the engagement objectives. Local institutional investors who have a history of successful engagement with the company are more likely to achieve their objectives (Figure 4).

4.2.1 Location

The location of both parties affects the choice of target and the success of the investor's engagement. Investors are more concerned with local environmental issues and local businesses. In collaborative engagements, it is mainly the location of the lead investor that matters. Investors supporting – rather than leading – shareholder actions do not necessarily have a preference for local companies as long as leading investors are local. For example, Ethos Foundation based in Geneva handles the dialogue with Nestlé and LafargeHolcim, the two Swiss giants involved in the Climate Action 100+ (CA 100+) collaborative initiative. An indeed, having a coordinating investor in the same country as the target increases the probability of success by 16 to 25%. Efficiency is gained through geographic proximity, cultural similarities, and language advantages [8].

4.2.2 Investor influence and credibility

Many people believe that the influence of the shareholder or shareholder group involved, and therefore the outcome of the initiative, is determined by the size of the shareholding and the interests at stake ex ante. A strong shareholder group would have a better chance of success if the engagement escalates to resolution filling, thanks to its strong rallying and negotiating power. In ESG collaborative engagements, especially those led by a lead investor, the shareholding value would play a particularly important role, even if it is not decisive in deciding the engagement decision [8].

The shareholders' credibility is more important to the engagement success than their shareholdings. The decision to engage on environmental and social issues seems to be independent of the responsible investor's shareholdings in the first place [6]. Individual investors have demonstrated this well. FollowThis, which now pools more than 8 000 shareholders, votes and engages on their behalf at the AGM. In 2021, it proposed two resolutions to set emission reduction targets at ConocoPhillips and Phillips 66, which were approved by 58% and 80% of shareholders, respectively [22], [23].[10] When a shareholder initiates a unilateral engagement, the value of his or her shareholding is not relevant to the outcome of the initiative [7], but the credibility of the shareholder with respect to gaining support from other shareholders is [24]. The market would be more likely to react positively to an engagement by a shareholder with an activism history [25].

If the investor has a history of successful engagement with the company, it is more likely to adapt to new ESG demands [6], [7]. This may be a result of the trust relationship already established between the investor and the company, or the company's desire not to have its ESG profile downgraded. It may also be less expensive to improve practices because the most important investments have already been made.

4.2.3 Types of investors

Institutional investors are more likely to win private engagements and are generally more successful in negotiating with management than some retail investors. Bauer et al. (2015) estimate institutional investors withdraw shareholder proposals in 33.9% of cases, compared to 4% for retail investors. Large volumes of assets under management and the existence of internally developed engagement processes are characteristics that favour successful shareholder actions and are widely shared by institutional investors [8]. Moreover, their resources and ability to gain the support of other shareholders encourage compromise in order to avoid a vote.

Figure 4: Profile of the engaged investor and impact on the probability of successful engagement

Factor	Impact
Location	
Coordinating investor based in the same country	+
Influence and credibility	
Shareholder participation in a collaborative engagement	+
Shareholder participation in a unilateral engagement	**No impact**
Engagement history	+
Type of investors	
Institutional investors	+
Pension funds as leads in collaborative initiatives	-
Pension funds as supporters in collaborative initiatives	+

10 A few months after the resolution was approved, Phillips 66 became the first major US oil company to set an ambition to reduce the carbon intensity of its products (Scope 3 emissions) by 15% by 2030 [23].

Among institutional investors, pension funds are less successful in leading engagement and prefer to support rather than lead collaborative initiatives. The reason for this is that they have fewer resources to support the responsibilities of the lead investor and may be subject to political constraints or conflicts of interest. Investors who support collaborative engagement would be less likely to join those led by pension funds. On the contrary, success rates are improved when the proportion of pension funds in an investor coalition is higher [8].

4.3 Engagement characteristics

The type, theme and degree of disagreement will influence the outcome of the engagement. Engagements that involve multiple levels of collaboration, corporate governance, or an aggressive approach seem to be more successful (Figure 5).

4.3.1 Types of engagement

Collaborative engagements seem to be more successful than individual engagements, especially when they address environmental and social issues. In their study focusing on US corporate engagements, Dimson et al (2015) estimate that the success rate of collaborative engagements is 32.8% compared to 11% without collaboration. These percentages decrease to 28.3% and 2.8% respectively for environmental and social themes.

The designation of a lead investor would also increase the likelihood of a successful collaboration. Engagement would be more effective if there was a multi-tiered structure and a clearer picture of the roles of the participants. The empirical study by Dimson et al (2021) estimates that this would increase the probability of success by at least 26%. Additionally, they found that when a structured engagement strategy is implemented, the role of company-specific characteristics in engagement is limited.

4.3.2 Engagement themes and costs of reform

Requests with environmental or social criteria are less often accepted. While environmental and social projects are beneficial to other stakeholders, it is more difficult to convince management to implement them. Dimson et al (2015) found that environmental and social engagements have an average success rate of 13% compared to 24% for corporate governance engagements.

The chances of successful engagement are lower for large-scale reforms. In their study focusing on the engagement performance of a European investor, Barko et al (2018) show restructuring requests are 17% less likely to be implemented. A request for transparency or disclosure will indeed require less effort and cost. The impact of success in transparency cases is questionable compared to restructuring requests. While the latter is a more complex management decisions, they are more likely to have a greater impact on the real economy.

4.3.3 Escalation process level

At times, confrontational approaches can be more effective in achieving engagement goals. According to Gantchev (2012), who studied the sequential process of active ownership, proxy fights accomplish the desired results more often (57% of the time) than board reappointments (39%), or private negotiations (7%) [26]. Although proxy fights here have a high success rate, they only account for 7% of the campaigns initiated and are extremely expensive for the parties involved.

Figure 5: Characteristics of engagement and impact on the likelihood of successful engagement

Factor	Impact
Engagement types	
Collaborative (vs. individual) engagement	+
Collaborative engagement with a lead investor	+
Engagement theme	
Environmental and social demands	-
Large-scale reforms	-
Level of escalation process	
Degree of conflict	+

5 What to do when a company does not respond?

For a higher likelihood of success, more focus should be therefore placed on collaborative engagements led by local investors, preferably large asset managers, and focused on mature, ESG-conscious companies. Even though chances of success are lower with them, smaller companies and laggards should not be ignored. Increasing engagement or collaborating with other actors can be helpful when an initial engagement does not bear fruit.

5.1 Intensifying engagement

If the dialogue with the company does not produce results after a certain period of time, engaging investors can escalate in order to achieve their goals. During an escalation process, investors make their engagement increasingly public. In the first instance, they will exercise their voting rights and raise their concerns with management privately or at the annual AGM. If this fails, increasingly aggressive measures can be employed, e.g., by filing shareholder resolutions, seeking legal remedies or, finally, threatening the company with divestment. For example, the intensified engagement of ShareAction and Ethos with Credit Suisse has already made a difference in the Swiss bank's stance on the financing of controversial industries - even if it doesn't quite meet the demands of the investor group (Box 2).

5.2 Collaborate with other actors in the ecosystem

If this is not already the case, engaging shareholders will try to win over other stakeholders such as bond investors and creditors to increase the pressure on the company.

5.2.1 Bond investors

Corporate bondholders can exert pressure alongside shareholders. Their position as creditors can encourage issuers to improve their risk management and ESG practices, and to enhance the quality of disclosure on these issues. They can join with other investors to increase their influence and when they also own shares emitted by the issuer, leverage the greater rights they confer.

Box 2 : Crédit Suisse and the resolution filed by Ethos and ShareAction

A coalition of institutional investors submitted a climate resolution to the Credit Suisse Board of Directors on 9 March 2022. The coalition consisting of 11 institutions managing EUR 2.1tn, coordinated by ShareAction and supported by Ethos Foundation and Swiss Association for Responsible Investment (ASIR), has petitioned the Swiss bank to insert a climate change financing article into its Articles of Association and to disclose additional information on its strategy to align with the Paris Agreement. The resolution will be voted on at the AGM on 29 April 2022. From the analysis of success factors in Section 4, what can be expected?

Company profile – Headquartered in Zurich, Credit Suisse is one of the world's largest asset managers with CHF 1.6tn in assets under management. In recent years, several high-profile scandals such as spying on former executives, fraud, and money laundering have weakened the company's ESG profile, thus lowering its ESG rating with several agencies [27]. Its financial performance has also suffered: its share price has fallen by almost 70% in a decade, a mixed result compared to its peers [28]. Most of Credit Suisse's shareholders are institutional investors (86%), a majority of whom are located in North America (53%) or Switzerland (20%), and are highly unconcentrated, with the largest shareholder holding around 5% of the equity – the first being Qatar Investment Authority with around 5.03% [30].

Profile of the engaging investor group – Of the 11 investors who initiated the coalition, and in addition to the two coordinators, Ethos and ASIR, 9 are Swiss asset managers or pension funds. LGPS, a British pension fund, and Amundi, a French asset manager, are the remaining two members of the coalition. ShareAction, which aims to set higher standards for responsible investment, began its engagement with Credit Suisse and other European banks in 2017 in the context of discussions on coal industry financing policies and industry-wide climate performance surveys – Credit Suisse was among the worst banks assessed [28]. Ethos has also initiated numerous ESG engagements with the bank and other Swiss companies over the years. The foundation is a founding member of the CA 100+ climate investor initiative and has carried out numerous client engagements, most recently with Nestlé and Lafarge-Holcim [31].

Characteristics of the engagement – Investors engaged with the company for several years before filing a resolution. Engagement has been progressive: ShareAction has, for example, organised various meetings to assess Credit Suisse's response to climate change, has become increasingly present at its AGMs, questioning the objectives and details of its environmental policy, and notably signed an open letter with 115 other investors in July 2021 [32]. In response, Credit Suisse committed to phase out coal and increase its thresholds over time at COP26. In any case, this response, which was considered insufficient, particularly since it did not pertain to its asset management business, was insufficient, leading to further discussions and the filing of a resolution by the investor group [28].

What outcome can we expect? Credit Suisse is in a difficult reputational and financial position. It is engaged by a credible group of investors and coordinators with a history of successful environmental engagement and with whom it has been in contact for many years on these issues. In response to the resolution filling, the Board of Directors announced various measures for 2023: 1) the inclusion of the requested additional re-porting to the sustainability report and the submission of this to a vote at the 2023 AGM, 2) the introduction of new restrictions in the financing of oil sands, deep-sea mining and Arctic oil and gas, and finally 3) the intention to propose the requested changes to the Articles of Association at the 2023 AGM [33]. These steps would probably not have been taken so quickly without the resolution filing and, although more detail is needed, can be considered a first success. However, they were not sufficient to convince the engaged group to withdraw its resolution. An acceptance of the resolution could be an opportunity for the bank to show leadership and restore trust with stakeholders [28]. Despite this, the attention of shareholders on the deficiencies in the bank's management and risk control and the lack of support from proxy voting advisors (Glass Lewis and ISS) possibly due to the response already obtained by the Board of Directors could jeopardise the acceptance of the resolution [34]. Verdict on 29 April 2022.

Some instruments, such as sustainability-linked bonds, can also provide incentives for companies to meet pre-determined performance targets. Sustainability-linked bonds incorporate targets based on ESG performance indicators into the bond's issue documentation and hold the issuing companies financially accountable for their progress. The coupon of the bond is adjusted according to the achievement of the defined targets, resulting in a lower cost of capital when these are met [35]. In 2020, Novartis issued EUR 1.85 billion in sustainability bonds to expand access to its medicines and therapies in low- and middle-income countries, a first for the pharmaceutical industry. If Novartis were to miss its targets, it would see the interest rate on its bond increase by +2.5 percentage points per annum [36].

5.2.2 Creditors

Creditors can also be equally effective in engaging. Investors with a closer relationship with issuing companies can more easily engage in dialogue about ESG risks before and after a loan is issued. They are generally the most important source of financing for companies: between 2000 and 2015 bank loans were by far the most important source of capital for the oil and gas sector [37]. As a result, they have significant leverage in negotiations [38].

6 GLOSSARY

Active ownership – The strategy of exercising investor influence in order to promote the sustainable success of the company, for example through dialogue or the exercise of voting rights.

Agency problem – Principal-agent problem. Conflicts of interest in the case of information asymmetry and divergence of interest and motivation between the principal e.g., the shareholder and the agent e.g., the manager of the company.

Capital expenditure – Capital expenditures or capex. Funds used by a company in connection with physical assets and new projects.

Discretionary spending – Spending of a non-essential nature.

Economies of scale – A concept describing the relationship between cost and quantity of output. In this case, the cost per unit decreases as the quantity of output increases.

ESG integration – Inclusion of ESG risks and opportunities in traditional financial analysis and investment decisions.

Exclusion – A screening strategy that excludes certain sectors, companies or securities from its portfolio by comparing the relative ESG performance to that of peers in the sector or based on specific ESG criteria in an absolute sense.

Index fund managers – Managers of mutual funds and/or exchange-traded funds (ETFs).

Proxy fight – An action by one or more dissenting shareholders in which they solicit proxies from other shareholders to vote against or for a proposal.

Scope 3 – A company's indirect emissions, i.e., those related to the life cycle of the product outside of its direct production. For a company that extracts fossil fuels, Scope 3 emissions are those generated during combustion or during transport to the customer.

Scorecard – A tool for managing the performance of a strategy. It is used to monitor the progress of activities and their effects.

Shareholder resolution – A proposal submitted by one or more shareholders for a vote at the AGM of a company.

SRI – Socially Responsible Investment. An investment strategy that links economic performance with social and economic impact.

UN PRI – United Nations Principles for Responsible Investment. The United Nations network for the promotion of the integration of ESG issues into investment strategies.

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