Active ownership: by whom and how?

E4S White Paper
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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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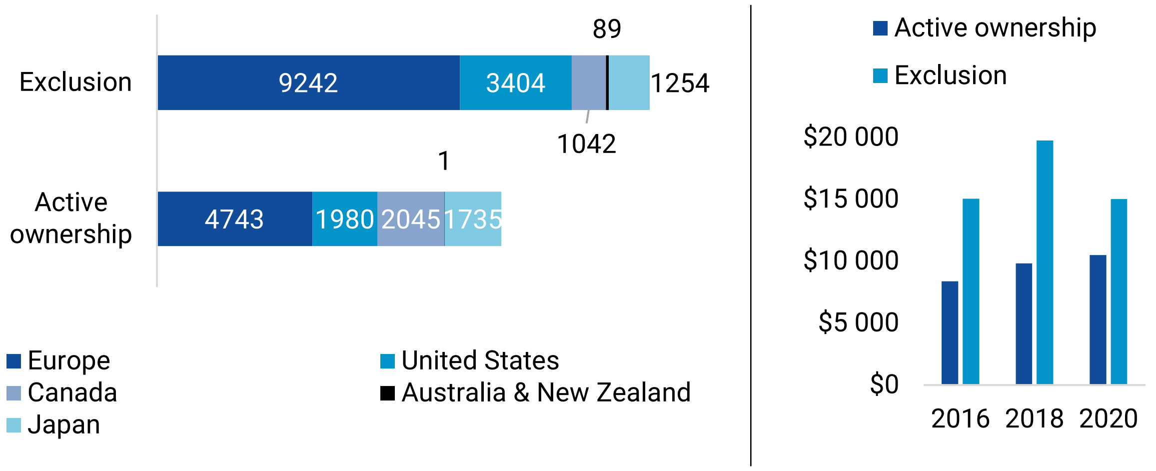
Exit vs. voice – this is the general choice that responsible shareholders face when invested in a company that behaves in a way that does not align with their values. The first option is to dissociate themselves and divest. The second is to engage in dialogue to initiate positive change. The latter strategy refers to active ownership and is the focus of this analysis.

But what is active ownership and how is it applied in practice? What is its impact on the target company and the investor engaging? What are the factors that make it successful? These key questions will be addressed throughout an E4S series. The first study of this series focuses on answering the former of these questions.

Active ownership 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. Shareholders wishing to express their opinion more than with their voting rights will engage in a direct dialogue with the company and can choose from a variety of tools to develop their strategy. Engagement can be private or public, individual or collaborative, or a combination depending on the responsiveness of the target company. If the dialogue with the company does not bear fruit after a certain period of time, investors will be more public with their engagement and, if it is not already the case, will try to convince other shareholders to join the cause in order to increase the pressure exerted.

The themes and players are diverse, and the regulations and culture around active ownership vary by region. Shareholders engage on four main themes: environmental and social issues, board management, shareholder rights and compensation structure. The active shareholder ecosystem consists of many players including

Sustainable investment per region in 2020 (left) and evolution of sustainable investment in USD billion (right)



Note: Active ownership is here defined as "employing shareholder power to influence corporate behaviour, including through direct corporate engagement, filing or co-filing shareholder proposals, and proxy voting" on ESG issues. Exclusion is here defined as "exclusion from a fund or portfolio of certain sectors, companies, countries or other issuers based on activities considered not investable". Source : Global Sustainable Investment Alliance (2021)[1] institutional and retail investors, whistleblowers such as NGOs, employees, or civil society, data providers such as rating and proxy voting agencies, as well as governments and regulators. In both Europe and Switzerland, the culture of consensus and stricter regulations favor collective and cooperative approaches, in contrast to the American modus operandi.

Engagement is increasingly extending to other asset classes such as corporate and sovereign bonds, as well as private equity. Creditors can engage both before and after securities are issued but may face limitations in their initiatives, such as the presence of diverse preferences within the creditor group and a perception of interference with the public policy of an issuing government. In the private markets, general partners, driven by demand, are increasingly engaging on ESG issues and can leverage the private equity model, which is particularly favorable to engagement, to achieve their goals.

KEY TAKEAWAYS

1. Active ownership, through engagement and voting, is growing in popularity among responsible investors and is spreading to more and more asset classes, such as corporate and sovereign bonds, as well as private equity.
2. This popularity has been amplified by the increased attention paid to environmental, social and governance issues by stakeholders and has intensified the importance of these same issues at the boardroom table.
3. Some practices, such as the lack of voting rights for exchange-traded fund shareholders or the increase in multi-class share issuance, may be a barrier to this trend.
4. But the development of investor groups and digitalization tend to favour new approaches to active ownership.

E4S SERIES ON ACTIVE OWNERSHIP

This analysis dives into the practices of active ownership. But what about its impact? In December 2021, E4S studied the impact of divestment as a responsible strategy [2]. The second analysis in the E4S series on active ownership, **Active ownership: for what impact?** applies the same approach, balancing the benefits and costs for the investor who engages and discussing 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 keys 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 [3]. The first option is to dissociate themselves and divest [2]. 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 protecting and increasing its value [4]. These are the principles on which active ownership is based.

The importance of active ownership on environmental, social and governance (ESG) issues is growing. In 2020, active ownership accounted for USD 10 504 billion of assets under management, or 35.9% of the total global assets, and was the second most used investment strategy in Japan, Europe and Canada behind ESG integration or exclusion [1]. In the same year, ESG engagement moved up to be the second most used approach by Swiss investors, overtaking exclusion. The use of engagement and voting strategies among Swiss responsible investors increased by 65% and 37% respectively, compared to a 29% increase in exclusion between 2019 and 2020 [5].

The year 2021 showed the potential of active ownership, especially in the fossil fuel industry. U.S. giant ExxonMobil saw its shareholders support three new directors, more concerned about climate issues, become board members in a frenzied proxy fight. Meanwhile, shareholders of its competitors Chevron, ConocoPhillips and Phillips 66 voted 61%, 58% and 80% respectively in favour of a proposed reduction in Scope 3 emissions [6].

But what is active ownership and how is it applied in practice? What is its impact on the target company and the investor engaging? What are the factors that make it successful? These key questions will be addressed throughout an E4S study series. This first study focuses on answering the former of these questions. It explores the components of active ownership (Section 3), the historical and regulatory developments as well as engagement themes and the role of players in the ecosystem (Section 4). The last section will focus on the application of active ownership on other asset classes than equities (Section 5).

3 TWO COMPONENTS: VOTING AND ENGAGEMENT

Active ownership 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.

3.1 VOTING, THE FIRST STEP TO TAKING A POSITION

Every shareholder has the fundamental right and responsibility to vote on the topics included in the company proxy ballot. This right gives the opportunity to show approval or disapproval to the board and executive committee as well as to influence the company's strategic agenda. Votes at shareholders' annual general meetings (AGM) usually include nominations for the board of directors, issues relating to compensation plans and proposals submitted by other shareholders. At special general meetings, votes tend to focus on pressing and structural issues, such as takeover bids. Only a small proportion of shareholders vote in person at AGM: most votes are exercised by proxy.

Voting against management proposals or supporting just-vote-no campaigns can play an important role in implementing best practices[1]**.** When governance or strategic practices are inadequate, both approaches signal shareholder concerns to the company and the financial markets and can thus facilitate the implementation of activist demands.

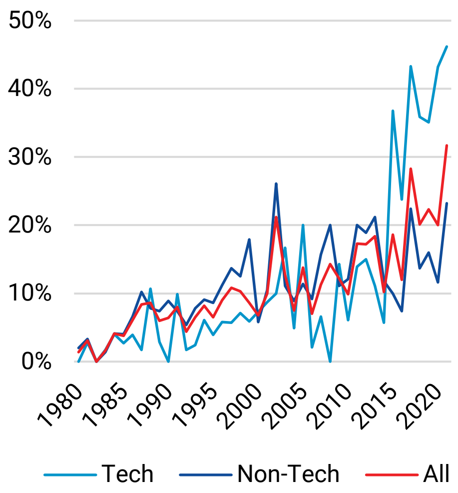
Yet some asset managers do not exercise this right delegated by their clients, particularly when concerning environmental and social (E&S) issues. In 2021, the NGO ShareAction identified seven managers that had voted for less than 60% of the E&S resolutions submitted to the companies they owned[2][7]. For three of them, this percentage lowered to 20% or less. This would be justified by their voting policies: these managers do not vote in companies that are active in certain markets or for which their stock holding is below a certain threshold. However, this sends a signal to companies about shareholder views of E&S issues and creates doubt about the role of proxy voting in an asset manager's fiduciary duty.

Additionally, more and more listed companies have a multi-class shareholder structure. This means that some shares, usually those of founders or executives, have stronger voting rights and thus have more potential to impact strategic decisions – resulting in the diminished influence of other common stock shareholders. Since 1980, the percentage of multi-class share issuance has increased by 30 percentage points in the US market (Figure 1). This trend is particularly notable in the tech sector, where nearly half of the newly listed companies have adopted this unequally weighted structure, discarding the "one share, one vote" system.

1 Just-vote-no campaigns are usually aimed at ousting certain directors.

2 These seven asset managers are signatories to the UN Principles for Responsible Investment (UN PRI) and are all based in Europe [7].

Figure 1: U.S. multi-class equity issuance by sector



Source: Ritter (2021)[8]

3.2 Engagement, to go even further

A shareholder wishing to interact more than just with their voting rights can engagement and initiate dialogue with the company on relevant issues, e.g. strategy, performance, governance or capital structure.

Although the investor often initiates the engagement, it can be beneficial for a company to open up dialogue. It creates an opportunity for management to hear other perspectives on the risks the company faces[3]. Management does not have to wait for the AGM to find out that its shareholders approve or disapprove the company's strategic direction. Engagement could thus facilitate communication, prevent disagreements and provide insight into the opinion of its shareholders concerning the implementation of long-term strategies – ultimately helping mitigate the threat of activism [9]. This analysis focuses primarily on shareholder-initiated engagement.

Shareholders can choose from a variety of tools to initiate and develop an engagement strategy. Public or private, collaborative or individual, the type of engagement will depend on the investor's objectives and escalation process.

3.2.1 Air dirty laundry behind closed doors or in public

As a first step, an investor may choose to engage privately, meeting with management behind closed doors and entering into direct negotiations. Large asset managers generally prefer private engagement (Section 4.3). This approach, based on long-term relationship building and consensus, can make the firm more receptive to shareholder requests, as it avoids public embarrassment and reputational damage. However, private engagement is not unanimously supported. On the one hand, this silent diplomacy lacks transparency, resulting in an absence of measurable results. On the other hand, if the issues raised during private engagement are not communicated to the rest of the shareholder base, it can lead to situations of information asymmetry in which engaged investors have an advantage over other investors [10].

The investor may also opt for a public engagement strategy from the beginning or when private engagement has not been successful. Adopting a public strategy shifts the focus from building consensus to achieving investors' objectives. The tools available for public engagement include shareholder resolutions, public letters or media campaigns. Note that shareholder resolutions are generally advisory in nature and not legally binding, even when they receive a majority of votes.

Responsible investors seem to prefer private engagement. Entering into discussions with companies appears to be the

3 Given the thousands of securities held in investors' portfolios, it is not always easy for companies to initiate dialogue and obtain an interview with shareholders or proxy voting advisory firms. They usually set requirements, e.g. in terms of size, for companies that are eligible for an interview.

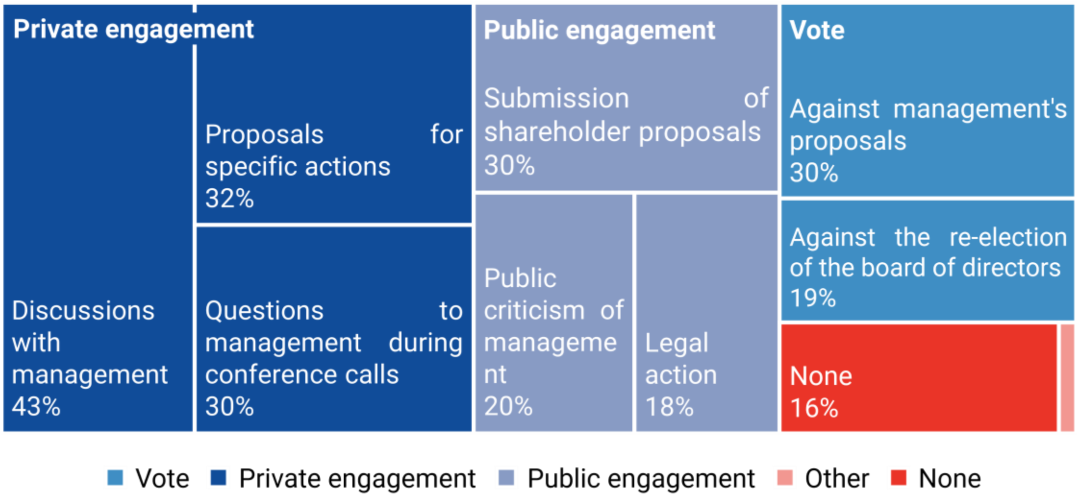
most used channel in managing climate [11] (Figure 2) and governance risks[4][12].

3.2.2 Playing solo or as a team

As the terminology suggests, individual engagement involves unilateral interaction with the company. This approach is particularly beneficial when quick action is needed or if the shareholder has a good relationship with the company. It is also often used by individual investors. Between 2005 and 2018, nearly 38.5% of shareholder proposals submitted to S&P 1500 companies were initiated by six corporate gadflies[5] and other individual investors, a proportion that exceeds those submitted by more established investors such as pension funds and investment groups [13].

Like-minded investors can pool their resources and start a collaborative engagement initiative. This trend has been driven by the creation of various collaborative groups addressing, for example, greenhouse gas emissions reduction (Climate Action 100+, IIGCC), plastic pollution (As You Sow), or human rights abuse (Investors for Human Rights). The advantages of collaborative engagement are its efficiency, its influential power and a diversified pool of knowledge. Collaborative engagement reduces the high costs associated with duplicating research efforts and responsibilities, e.g. when filing shareholder resolutions. A diverse group of shareholders also has more clout and sometimes a better understanding of the company's environment, increasing the chance of success where failure would normally occur for individual attempts. However, collaborative engagement is more complex and involves other costs such as the time needed to coordinate, build consensus, or keep all teams informed of the progress.

Figure 2: Active ownership strategies used to address climate risk



Note: This chart reports the percentage of investors surveyed who have used a particular active ownership approach to climate risk management over the past five years. Survey responses are not mutually exclusive. n=406. Source: Krueger et al. (2019)[11].

4 In a survey targeting institutional investors, McCahery et al. (2016) find that 63% have held discussions with management on governance topics in the past five years. Similar analysis by Krueger et al. (2019) focusing on climate risk shows that 43% have used this channel (Figure 2)[11], [12].

5 Corporate gadflies are individual investors actively engaged with companies and particularly fond of shareholder resolutions.

3.3 Escalation process: what to do when the company is not responsive

If the dialogue with the company does not bear fruit after a certain period, the investors engaged can escalate in their strategy to achieve their goals.

In escalation processes, investors will make their engagement increasingly public and, if not already done, will try to convince other investors to join the cause to help increase pressure on the company (Figure 3). Investors will start by exercising their voting rights and raising their concerns with management privately or at the annual AGM. If this fails, increasingly aggressive measures may be employed, such as filing shareholder resolutions, seeking legal remedies, or ultimately threatening the company with divestment [4].

In practice, engaged investors respond in counter-intuitive ways to resistance or lack of response to their engagement. In their international analysis of climate-related engagement, Krueger et al. (2019) showed that nearly 40% of investors surveyed take no further action if the first attempt at engagement fails (Figure 4). Only one in five investors initiate the next step of the escalation process. This may be explained by the costs involved in implementing more aggressive measures [14].

Figure 3: Example of an escalation process

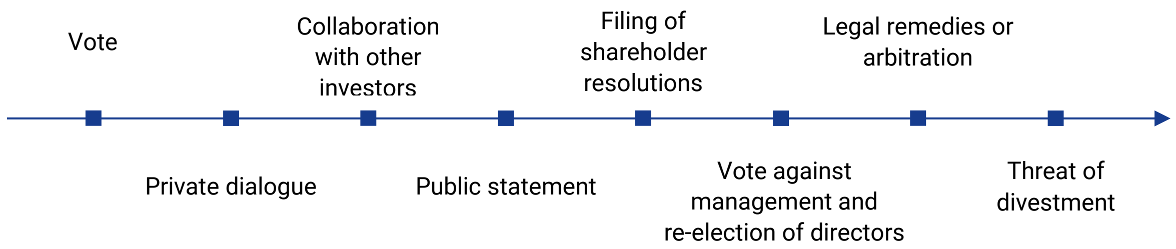
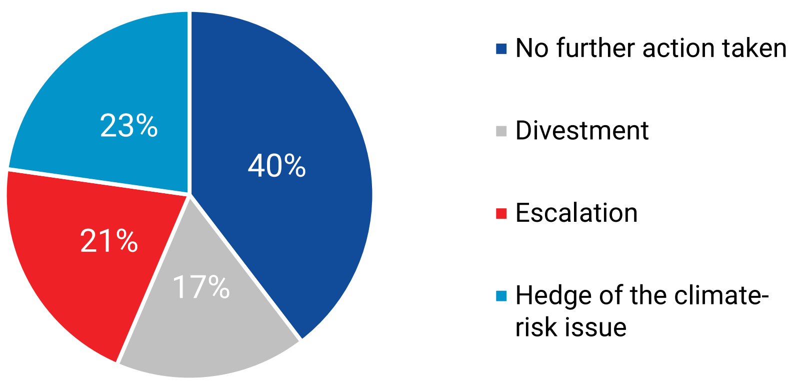


Figure 4: Investor responses to climate engagement failure



Note: This graph represents investor responses in the case where the target company fails to respond or shows resistance to climate-related shareholder engagement. n=143. Source: Krueger et al. (2019)[11].

4 ACTIVE OWNERSHIP IN PRACTICE

Active ownership has developed drastically in the last century and even more so in recent years with the increased awareness of pressing climate and social issues. It relies on a variety of players (Figure 7) and its practices change from one jurisdiction to another.

4.1 HISTORICAL CONTEXT: FROM FINANCIAL TO ESG ENGAGEMENT

The landscape of shareholder activism has evolved remarkably, and a majority of these changes have originated in the United States over the past century. The first-time opportunity for American shareholders to suggest changes in their company's activities came with the adoption of Rule 14a-8 by the Securities and Exchange Commission (SEC) in 1942. This required shareholder resolutions to be included on the ballot at the discretion of the company[6]. Shareholder engagement at the time focused on financial and governance issues. However, regulatory developments and the emergence of social activism gradually changed this. In the United States, all social issues were ineligible for the formal proxy process until 1970. But under pressure from the U.S. Supreme Court, the SEC decided to reinterpret Rule 14a-8 by allowing social resolutions raising important political issues to be allowed. This change opened the door to social, environmental and political activism [13].

As a new strand of shareholder activism, it explores stakeholder issues, such as a company's environmental impact and social performance, and stems from the civil rights movement of the 1960s. At the same time, the rise of agency theory and institutional shareholding propelled financial activism. Although it can be seen as antithetical to social activism, financial activism is based on principles of good governance and seeks to improve organizational structures and make managers more accountable to shareholders [10].

The last twenty years have particularly highlighted the shortcomings of the current system and the essential role of ESG engagement. The United Nations Climate Change conference (COP) as well as the first publication by the Intergovernmental Panel on Climate Change (IPCC) in the late 1990s alerted to the climatic consequences of human activities and the responsibility of companies in climate change. The collapse of the Rana Plaza in 2013 and, more recently, the Covid-19 pandemic have brought social issues, particularly those related to employees in the globalized world, into the spotlight like never before. Finally, the Enron and WorldCom accounting frauds of the 2000s and the subsequent financial crisis of 2007 highlighted the passivity of institutional investors and a lack of shareholder oversight, and similarly the importance of and need for good corporate governance [15].

4.2 THEMES AND OBJECTIVES OF ACTIVE OWNERSHIP

Investors engage with their portfolio companies to create value. Through their engagement, they commonly seek to increase, or at least maintain, the company's market value and thus their stake on their investment horizon, sometimes while trying to have a positive impact on society at large.

6 Specifically, it still indicates today that a shareholder with voting rights at the AGM is allowed to submit a shareholder proposal and that the company's management may thereafter choose to (i) publish and distribute it for the AGM, (ii) negotiate with the engaging shareholder to withdraw the proposal, or (iii) omit the proposal with the authorization of the SEC.

Shareholder objectives can be separated into four themes:

1. **Environmental and social issues** – dealing with the company's behaviour and transparency regarding these issues
2. **Management and governance** – defining the company's operations and strategy
3. **General shareholder rights** – aiming at maintaining or improving shareholder rights
4. **Compensation structure** for shareholders, board of directors and management

Figure 6 presents a non-exhaustive list of objectives that investors might wish to achieve through active ownership, categorized under the four themes mentioned above. Today in Switzerland, the most prominent engagement theme for responsible shareholders is climate change, followed by corporate governance and social factors (Figure 5) [5].

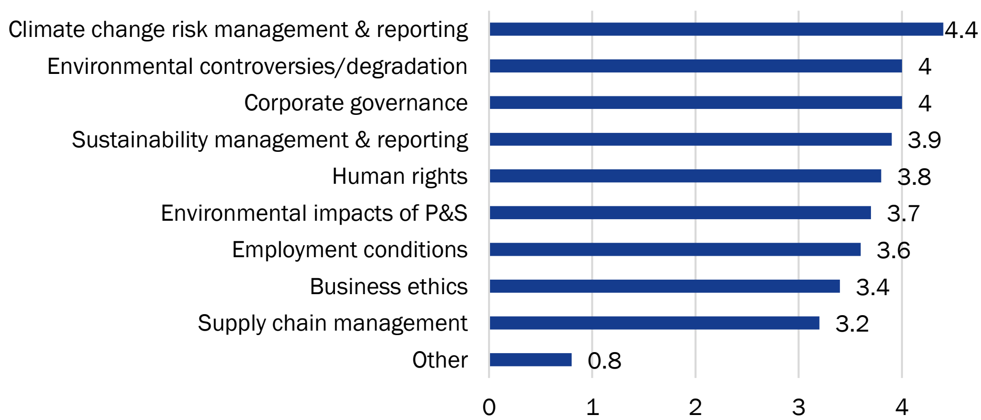
4.3 PLAYERS OF THE ECOSYSTEM

4.3.1 Institutional investors

Institutional investors include different categories, from the more traditional ones such as pension funds to the more alternative ones such as hedge funds or exchange-traded funds (ETF). An institutional investor's business model, including its investment horizon and strategy, as well as the presence of political and social incentives or legal requirements, will influence its degree of shareholder engagement [16].

Pension funds tend to take a reactive approach to engagement, supporting - rather than leading - engagement or implementing voting policies. This is due to the characteristics of their investments, which are rather passive, diversified and long-term, and the political and social pressures and regulatory requirements to which they are subject [16]. Pension funds thus prefer to support an initiative launched by another institution such as an activist hedge fund - as was the case for New York's and California's CalSTRS with Engine No. 1 shareholder resolution at the 2021 ExxonMobil AGM [17]. Pension funds also use proxy voting advisory services to support their decisions. In Switzerland, the Ethos Foundation provides such services. It specializes in socially responsible investment and comprises of 237 members – the vast majority of which are pension funds.

Figure 5: Main ESG engagement themes in Switzerland in 2020 (in average level of importance for investors)



Note: With zero considered not important and 5 very important. n=56. Source: Swiss Sustainable Finance (2021)[5].

Figure 6: Examples of objectives that the investor wishes to achieve through active ownership, classified by theme.

Environmental and social issues	**Define improvement objectives on these themes**, e.g. reduce direct carbon emissions, divest from fossil fuels, ensure respect for human rights in the supply chain. These objectives can then be translated into an action plan to allow the company and its shareholders to monitor performance over time. **Improve non-financial reporting**, filling in gaps and creating more transparency with additional disclosures.
Management and governance	**Introduce new board members who are more aligned with the views** of the proposing shareholder and/or more knowledgeable on certain issues. **Change the board structure**, e.g., rules, size, to improve its effectiveness and representativeness. **Fundamentally change the structure of the company**. A shareholder may e.g. propose a restructuring or the creation of new business areas to increase the efficiency and profitability of the company.
General shareholder rights	**Change the voting system**, e.g. from a multi-class shareholder structure, where the maximum percentage of voting rights per shareholder is limited, to a "one share, one vote" system.
Compensation	**Align executive compensation with corporate objectives**. Paying executives based on key performance indicators - potentially a mix of financial and non-financial indicators - can encourage decisions that are consistent with objectives related to e.g. ESG performance. **Increase dividends or initiate share buyback programs** to compensate shareholders.

Note: The objectives listed above may belong to several themes.

Hedge funds are more proactive in their engagement. The themes of hedge fund engagement are varied, ranging from corporate governance and capital structure to growth strategy, and can be accomplished through a variety of active investment strategies. The ultimate goal is to increase the value of the company over the investment horizon and thereby achieve financial returns over market benchmarks. The engagement is typically conducted with small equity investments, possibly supplemented by derivatives and by actively seeking support from other investors to back their demands [16]. The shareholder engagement imitated by Bluebell Capital Partners –

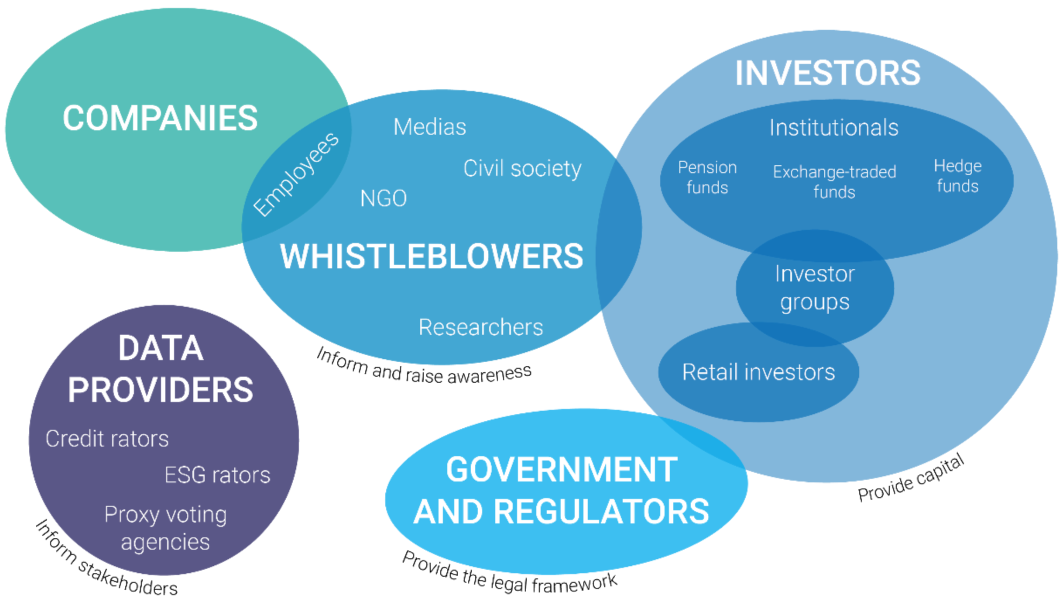
backed by the pension fund Artisan Partners – with Danone is a good example. In January 2021, the London-based hedge fund, which at the time held stakes of less than 5%, challenged the French food giant about its governance structure as well as its financial performance, which was inferior to that of its competitors Nestlé and Unilever. The initiative resulted in the departure of the CEO and chairman of the board, Emmanuel Faber [18].

Exchange-traded funds have significant power to influence. The largest players, i.e. BlackRock, Vanguard and State Street also known as the Big Three[7] use this power in private engagements. The latter held on average 25% of the votes of S&P500 companies at the end of 2017. However, they vote less often in favour of environmental and social shareholder resolutions than proxy voting advisory firms [7], [19]. It seems the Big Three prefer private engagement to find nuanced solutions to ESG issues[8], especially with companies in which they have large stakes [20]. Engagement here means building a long-term relationship and voting against management could jeopardize the progress made during discussions. However, new ambitions seem to be emerging to restore voting rights to ETF shareholders: from 2022 onwards, BlackRock wants to give its clients the possibility to participate more actively in voting decisions where legally and operationally viable [21].

4.3.2 Individual investors

Although institutional investors more often draw attention, individual investors also have an important role. Until the 1970s, they were the main players in the U.S. shareholder engagement scene, although their actions were often seen as subverting the AGM and wasting management's time and corporate resources [10],

Figure 7: Active ownership ecosystem



7 When an institutional or retail investor invests in an ETF, he or she owns a share of that ETF, but it is the ETF itself, or rather its manager, that holds the underlying securities and benefits from the rights attached to them – such as voting rights

8 Between 2017 and 2019, the Big Three conducted private engagements on 7.5% of the companies in their portfolios on average [19], which in relative terms seems small but in absolute terms represents hundreds of companies.

[13]. In Europe, they account for a significant share of equity investments: households held nearly 23%, 21% and 19% of listed shares in Austria, Belgium and Germany respectively in 2019 [22]. Also, corporate governance proposals from individual investors frequently garner support from other investors, contradicting some critics who suggest that they have different interests than diversified investors. Between 2005 and 2018, 26% of resolutions submitted to S&P 1500 companies by corporate gadflies received a majority of shareholder votes [13].

The engagement of these investors is likely to increase due to new technologies and their appetite for sustainable investments. Indeed, innovative new initiatives are democratizing active ownership practices. For example, the U.S. platform Say Technologies, acquired in August 2021 by the retail investor trading app Robinhood, is making it easier for shareholders to exercise their rights [23]. Tulipshare, a U.K. activist investment platform that allows client-shareholders to pool their rights, has also proven itself with the filing of four resolutions since its inception in July 2021 [24]. In Switzerland, the startup Inyova, dedicated to impacting investing, is setting up a service to facilitate online voting [25].

4.3.3 Groups of investors

In recent years, asset managers and owners have increased their collaboration through joint initiatives. These ESG-oriented investor groups began to develop with the creation of Ceres in the late 1980s. They involve both institutional and retail investors and focus on specific objectives. For example, institutional investors seeking to focus their efforts on achieving carbon neutrality in their investments and their advocacy can join the Institutional Investors Group on Climate Change (IIGCC) and Climate Action 100+. Individual investors seeking to do the same can directly purchase shares in fossil fuel companies through the FollowThis. This group, which currently has over 8 000 shareholders, votes and engage on their behalf at the AGM. In this case, the line between investor groups and activists is not so clear.

4.3.4 Whistleblowers

Whistleblowers reinforce the stigma around corporate behaviour and thus contribute to more effective active ownership. NGOs, media, employees, researchers and students are campaigning and informing other stakeholders through documentaries, articles or protests and thus increasing the pressure on companies.

These players are becoming increasingly daring and invest directly in the companies they stigmatize to bring about change. In 2019, for example, some 8 700 Amazon employees filed a shareholder resolution asking the American giant to publish a report detailing its strategic plan in the face of climate risks and its dependence on fossil fuels [26]. Although opposed to the resolution, Amazon had issued an initiative to eliminate carbon emissions from half of its customer deliveries by 2030. The resolution failed to win a majority but was supported by voting advisory firms ISS and Glass Lewis [27].

4.3.5 Rating agencies

ESG and credit rating agencies, which are key sources of information for investors, can be directly impacted by engagement – and the reverse is also true**.** The former measure the resilience of companies to long-term ESG risks according to their own methodology and are by extension influenced by shareholder initiatives on these terms. For example, the ESG rating agency MSCI downgraded Solvay's rating in March 2021, following the engagement of hedge fund Bluebell Capital Partners in opposing the waste management of the Belgian giant's Tuscan plant [28]. Credit rating agencies, established by financial regulators for better risk management, also include the

ESG performance of companies in their methodology [29]. It appears that shareholder activism is often associated with a credit rating action: S&P Global identified 26 actions linked to activist campaigns in 2020, and 80% of them involved a rating downgrade. These followed major mergers and acquisitions or changes in capital structure initiated by shareholders. ESG campaigns, although representing 75% of the total campaigns, only resulted in a few rating action [30].

4.3.6 Proxy voting advisory firms

Proxy voting advisory firms are key players in active ownership (Box 1). Asset managers have significant voting power through their position as agents for their clients. This power subjects them to strict regulations related to their fiduciary duty and requiring them to vote in the best interests of their clients. Given the thousands of securities held in investors' portfolios and the resources required to implement reasonable due diligence processes, many asset managers use the services of proxy voting advisory firms such as ISS and Glass Lewis [31]. On the Swiss market, the Ethos Foundation, which promotes sustainable development, is also an important player whose members currently have CHF 330 billion of assets under management [32].

4.3.7 Governments and legislators

Governments and regulatory bodies can facilitate or hinder active ownership practices. Regulations and the culture of active ownership vary from one jurisdiction to another. These differences are discussed in the following Section 4.4.

4.4 Culture of engagement and regulatory development

In Europe, regulations and the culture of consensus favour collective approaches and private discussions with companies rather than public and confrontational ones. To file a resolution, the shareholder or group of shareholders committing themselves must hold between 0.5% and 5% of the shares, depending on the country (excluding Scandinavian countries) (Figure 8). This makes filing a proposal complex for companies with a large market capitalization, which are undoubtedly those with the greatest impact on society. Also, European asset managers are more likely to vote for environmental or social resolutions than their American peers. In 2021, they voted in favour of these resolutions on average 25% more than in the USA [7]. This trend can be explained by investors' preferences for more sustainable products, as well as by the European legislative environment for sustainable finance. The European Union's Green Deal and Action Plan, as well as the Corporate Sustainability Reporting Directive, considering the TCFD framework, increase the pressure for more ESG disclosure and encourage dialogue with shareholders [33].

Box 1: Proxy voting advisory industry overview

The proxy voting advisory industry is highly concentrated and can have a significant impact on AGM voting outcomes, which can raise concerns. ISS and Glass Lewis, owned by private equity firms, together accounted for 90% of the market in 2020 [34]. In 2017, 23% of ISS clients almost completely followed its recommendations that went against management, compared to only 5% in 2007 [35]. By automatically relying solely on these recommendations, some institutional investors and asset managers would tend to create an undesirable phenomenon, called *robovoting*[9].

In response to these concerns, proxy voting advisors are expanding their product lines and regularly reviewing their policies. ISS, for example, offers a wide range of voting guidelines that can upon request be customized to meet the diverse needs of their clients. Voting guidelines are available online, vary by region and include special policies focusing on e.g. climate and sustainability [36]. The U.S. data provider ensures a yearly review of its guidelines and includes market participants in their development – based on the results of the proxy season, new empirical studies, roundtables and public surveys with customers, businesses, academics, NGOs and others [37]. ISS also gives analysed companies the opportunity to engage in pre-AGM dialogue via their platform [38].

To increase transparency in the assessment processes, regulatory bodies have also introduced new initiatives in recent years. Through its Shareholder Rights Directive II (SRD II), which went into effect in September 2020, the European Parliament is imposing transparency requirements on proxy voting advisors: they must now publicly disclose material information relating to their research process, advice and voting recommendations as well as actual or potential conflicts of interest and business relationships that may influence their research [39]. In July 2020 the SEC also issued new regulations to ensure that investment advisors, including institutional investors and the proxy voting advisory firms that assist them, act in the best interest of shareholder-clients.[10] This reinforced monitoring announced in 2019 may have already influenced robovoting practices: the number of institutional investors applying this strategy appears to have decreased by 5.8% between 2019 and 2020[11] [34].

Switzerland is following the European trend, both at a regulatory and thematic level. In June 2020, the Swiss parliament adopted a Corporate Law Reform, modifying the law for listed and private companies. Among other things, the conditions necessary to add an item to the agenda of the AGM were modified. Starting from its entry into force in 2022, a shareholder of a Swiss listed company wishing to make such a request will need to hold 0.5% of the company's equity or votes, compared to a value of CHF 1m until now[12] [41]. Even though this reform brings Swiss conditions

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9 Robovoting corresponds to a very strong alignment with the recommendations of a proxy voting advisory firm that goes against those of the management. Rose (2021) and Shu (2021) set this alignment threshold at 99.5% and 99.9% respectively [34], [35]. The trend towards robovoting is particularly pronounced among the smallest index funds, about 50% of which use it.

10 The new regulation will have three main impacts. First, the proxy voting advisory firm will have to provide its recommendations not only to its clients but also to the companies analysed. Second, if the company responds to the advisory firm's recommendations, the advisory firm will have to put in place a procedure to notify its clients of this response. Finally, if the client is an investment advisor, a procedure for dealing with the firm's response should be put in place [40]

11 The analysis of Rose (2021) is based on data collected after the SEC's announcement of proxy voting advisory regulation in November 2019, but before final publication of the regulation in July 2020 [33]. The author compares these results with the same data collected the previous year.

12 if the company decides to increase its thresholds to the maximum of 0.5% allowed by the new regulation.

closer to their stricter European counterparts, it could lead some companies to raise their resolution filing thresholds and worsen shareholders' rights. Also, Swiss activism is mainly focused on strategic, operational and governance issues [42]. ESG aspects have recently become more important (Figure 6) and will continue to do so. Indeed, on March 30, the Federal Council opened a consultation process on the regulation of climate issues for large Swiss companies. This provides a binding implementation of the TCFD recommendations for large Swiss companies and could increase the dialogue with shareholders. Although there is still room for improvement, Swiss investors are relatively well positioned on these issues: in the ranking of asset managers using their voting rights in favour of the environment and society, the seven Swiss managers considered are in the top 30 out of 65 [7].

In the United States, regulation is currently more liberal. The SEC requires less stringent criteria than the European legislators for submitting shareholder proposals, which probably explains their popularity (Figure 8). Once a shareholder resolution is filed, the board of directors decides whether to add it to the agenda of the AGM. SEC Rule 14a-8 allows companies to omit certain resolutions, including ESG resolutions, based on the ordinary business exception or economic relevance[13]. In November 2021, however, the U.S. regulator changed its interpretation of requests to exclude proposals. The company must now demonstrate that the proposal submitted to it and which it wishes to omit does not raise social or ethical issues that have an impact on society at large [43]. These regulatory developments could suggest an increase in ESG proposals for the 2022 proxy period, but recent announcements by the SEC chairman may in the future limit these incentives for hedge funds[14].

Figure 8: Criteria for filing a shareholder resolution in Europe and the United States

Country	Participation required to submit an item on the agenda
Austria	5%
Belgium	3%
Denmark	One share
Finland	One share
France	Between 0.5% and 5%*
Germany	5% or €500,000
Greece	5%
Ireland	3%
Italy	2.5%
Luxembourg	5%
Netherlands	3%**
Norway	One share
Portugal	2%
Spain	3%
Sweden	One share
Switzerland	0.5%
UK	5% or 100 members ***
US	USD 2 000 for <3 years USD 15 000 for <2 years USD 25 000 for <1 years

Note: The criteria are specific to publicly traded companies. (*) depending on the company's capital i.e. 5% if the company's equity is below EUR 750 000, 1% if it is between EUR 7 500 000 and EUR 15 000 000. (**) can be lowered to 1% if mentioned in the company's articles of association. (***) who are entitled to vote and who hold shares on which they have been paid on average at least GBP 100 per member.
Sources: Thomson Reuters Practical Law

13 The ordinary business exception allows the company to omit proposals dealing with matters relating to ordinary business operations. This is to leave the resolution of ordinary business issues to management and the board of directors rather than to the AGM.

14 Indeed, the SEC is currently considering a restriction on the timeframe within which hedge funds must announce the acquisition of an equity stake of more than 5%. The current 10-day deadline would already be too short and it would be more difficult for these funds to make profits if they had to disclose their strategies to the public even earlier [44].

5 ENGAGEMENT IN OTHER ASSET CLASSES

Engagement takes different forms depending on the asset class held by the investor. The analysis so far has focused on listed stocks, where investors can submit their views and concerns through voting and engagement. These two components partially extend to corporate and sovereign bonds and unlisted corporate securities. Holders of these assets can have an equally significant impact and are increasingly using engagement to deal with ESG issues.

5.1 BONDS

In recent years, creditors have increased their ESG interventions. An international survey by Russell Investment shows that between 2019 and 2021 the proportion of bond managers regularly engaging with issuers increased by seven percentage points, from 88% to 95% (Figure 9). Fixed income engagement is particularly notable for corporate securities: in 2020, 84% of non-financial corporate bonds held by UN PRI signatories were subject to engagement versus 66% for sovereign bonds [45].

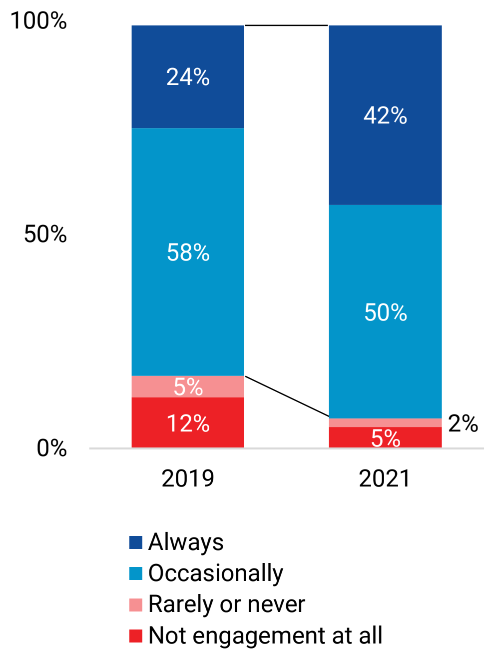
5.1.1 Corporate bonds

Corporate bondholders can exert pressure, although they are not shareholders and therefore do not have the same rights. Their position as creditors can encourage issuers to improve their risk management and ESG practices and enhance the quality of disclosure on these issues [45].

Engagement can be undertaken in a number of ways. Creditors can include ESG issues, before issuance, into the credit contractual obligations or, after issuance, during renegotiations of contractual obligations, refinancing, or bond meetings. They can also join with other investors to increase their influence and when they also own shares emitted by the issuer, leverage the greater rights they confer. Sustainability-focused debt securities, such as green bonds, are more prone to engagement, in part because investors want to mitigate the risk of greenwashing and ensure the quality of the expected positive environmental impact.

Diverse creditor preferences can constrain pre-issuance engagement actions. If constraints are too significant, issuers may turn to other funding channels. ESG issues are sometimes cumbersome to assess quantitatively, and their evaluation can be tedious. Some corporate issuers will be reluctant to include metrics that cannot be easily measured without high administrative costs in their bond contracts and will try to turn to less demanding creditors.

Figure 9: Frequency of ESG discussions between bondholders and issuers (% of total)



Source: Phillips et al. (2021)[46]

5.1.2 Sovereign bonds

While it may be more ambitious, sovereign bondholders can also engage to improve transparency and disclosure of environmental and social information or to highlight credit risks that could have a significant impact on the issuing country's long-term health. Engagement can be conducted in a variety of ways: 1) through private meetings e.g. to improve the disclosure of information relevant to credit assessment, 2) through collaborative actions, or 3) through one-off events such as the presentation of budget plans or the publication of financial stability reports [47].

This type of engagement has traditionally been linked to fiscal and monetary policy, and ESG issues have only recently begun to come to the forefront. In November 2021, for example, the Zambian government met with a dozen of creditors, including the large French asset manager Amundi, to discuss a restructuring of the country's debt and possibly include ESG targets, which if met would reduce interest fees [48]. Earlier the same year, 251 financial institutions representing USD 17 billion in assets under management signed an open letter to the Brazilian government calling on it to stop deforestation in the Amazon [49].

Sovereign investors resorting to engagement face a challenge: their actions may be mistaken for lobbying or interference with the public policy of the issuing government. Focusing on certain social or governance issues, e.g. by setting targets on political rights, may not be welcomed depending on the government's agenda and financial constraints [48].

5.2 Private Equity

Private markets are not immune to ESG-related engagement. A PwC survey (2021) revealed that in 2021 56% of private equity fund managers engaged more than once a year on ESG issues with their boards, compared to 35% in 2019 [50]. A second PwC survey (2021) estimates that nearly 75% of European players aim to increase the assets under management of their ESG private equity funds, and among them almost 40% want this increase to be at least +20% [51]. The Science-based Targets initiative guidelines for private equity published in November 2021 also show the industry's willingness to set climate targets within invested companies.

The private equity model is particularly conducive to the implementation of ESG best practices. General partners (GP) typically hold a majority or significant minority stake in the company and can use this influence, especially when ESG improvements are material to value creation. Here, active ownership is essentially a matter of post-investment monitoring. Limited partners (LP) have less influence on final investments because of the contract that binds them to the GP [52]. They can, however, formalize the ESG integration in their investments and put pressure on GP to apply more advanced ESG monitoring, by threatening to withdraw capital – which would ultimately be costly for them.

6 GLOSSARY

Active ownership – A strategy in which investors exercise their influence to promote the long-term success of the company through dialogue or voting rights.

Agency theories – Theories dealing with the consequences of the principal-agent problem and examining the asymmetry of information and the divergence of interest and motivation between the principal e.g. the shareholder and the agent e.g. the company's management.

Ceres – An organisation encompassing investors and interest groups addressing sustainability challenges and aiming to integrate sustainability in capital markets.

Credit rating decision – Any initial rating, any change i.e. downgrade or upgrade of a rating, withdrawal, affirmation or suspension of an existing rating, any credit risk monitoring action and any other rating indicator.

Corporate bonds – Debt security issued by a company to raise funds for specific purposes.

Due diligence – A set of analyses and verifications carried out by the investor before a transaction, to anticipate the risks and opportunities associated with it.

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

Exchange-traded funds or ETFs – Index funds listed on a stock exchange and tracking a particular index such as the Nasdaq or the SMI.

Exclusion – A screening strategy that excludes certain sectors, companies, or securities from the investor portfolio by comparing their relative ESG performance to that of industry peers or by relying on specific ESG criteria on an absolute basis.

General partners or GPs – Investment professionals who make the investment decisions in a private equity fund and manage it on a day-to-day basis.

Hedge fund – An actively managed investment fund whose managers use a variety of strategies, including leverage, to achieve average returns above market benchmarks.

Limited partners or LPs – Investors in a private equity fund whose losses can only mount up to their investment.

Pension fund – An investment fund that provides retirement income to taxpayers. The funds are invested in the name of the employee, and the income generated is paid out to the workers upon retirement.

Private equity – A fund that invests in the equity of a company that is not listed on a stock exchange or of a listed company that the fund wants to take private. This type of fund is managed by general partners and financed by limited partners.

Proxy ballot – A document that is provided by a company in advance of its AGM that contains the agenda and additional information about the topics to be voted on.

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.

Science-based Targets Initiative – An initiative comprised of CDP, UNGC, WRI, and WFF that promotes ambitious climate action in the private sector. It provides methods and criteria for effective climate protection and allows companies to set science-based emission reduction targets.

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

SEC – Securities and Exchange Commission. US government agency that regulates the financial markets and aims to protect investors.

Share buyback programs – An initiative by which a company buys its own shares in the market; this is done for two main reasons: 1) to reduce the influence of shareholders and prevent some of them from taking a majority stake or 2) to increase the value of its equity. The latter would signal an undervaluation of the share price by the market and the presence of sufficient liquidity to complete the transaction.

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

Sovereign bonds – Debt security issued by a sovereign issuer such as a government or a central bank.

TCFD – Task Force on Climate-Related Financial Disclosures. A group created by the G20 Financial Stability Board to provide recommendations to investors on disclosure of corporate governance and actions taken by companies to mitigate climate change risks.

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

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