



# Corporate Engagement by Institutional Shareholders

## A Summary of the Research by the European Centre for Corporate Engagement

Corporations increasingly face a new type of shareholder: the shareholder activist. These shareholders use their voting rights to influence the outcomes of management proposals. The rise of shareholder activism suggests that engagement with companies can be an effective approach to socially responsible investing.

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## Several ways of investing responsibly

Shareholder engagement can be seen as an alternative way of investing responsibly, alongside the two basic approaches of exclusion and inclusion.

Under the exclusion approach, certain companies are excluded from the investment universe because their activities are not consistent with the beliefs, values or moral standards of the investor. In other words, exclusion is based on non-financial information. This approach is usually applied to so-called sin industries like tobacco, gambling, or arms.

Inclusion investment approaches are based on extra-financial information, which in this case means additional facts about the environmental, social, and governance (ESG) performance of companies. Through a screening methodology, the investor selects the best-in-class firms in terms of ESG standards.

At the start of the 21st century, researchers found that firms with superior governance outperformed those with inferior governance on a statistically significant basis (see, for example, Gompers, Ishii, and Metrick, 2003). However, more recent studies show that the positive effect of incorporating extra-financial information in the investment process has disappeared, and abnormal returns cannot be earned by investing in superior ESG firms (see, for example, Bebchuk, Cohen, and Wang, 2010).

## Shareholder engagement is key

Shareholders – especially institutional investors – have many different tools at their disposal to influence corporate and managerial behavior, including:

- Shareholder resolutions at Annual General Meetings (AGMs)
- Class-action lawsuits
- Media campaigns
- Private negotiations between shareholders and management teams

Shareholders may use several of these engagement tactics, sometimes simultaneously. This article focuses on shareholder proposals – both voted on and withdrawn – as well as on private dialogue between institutional shareholders and investee firms.

Earlier this year, shareholders appeared to be stepping up their activism, a movement that became known as the Shareholder Spring<sup>1</sup>. A prominent example was the lost advisory vote on executive pay at Aviva, the big UK-based insurance company. As the Financial Times reported, at the AGM almost 60% of all votes (against and withheld) did not support the company's executive pay proposal, reflecting shareholders' discontent with the firm's poor performance in recent years.<sup>2</sup> Even though the vote was non-binding, Aviva's CEO Andrew Moss stepped down because of the widespread opposition to his remuneration. There were many more examples of shareholder opposition to management plans in early 2012.

<sup>1</sup> See: <http://www.bloomberg.com/news/2012-05-21/welcome-shareholder-spring-that-holds-bosses-to-account.html>

<sup>2</sup> See: <http://www.ft.com/intl/cms/s/0/ec52a760-9522-11e1-ad72-00144feab49a.html#axzz22BrNLsFX>

## A simplified model of the engagement process

To illustrate approaches to shareholder engagement, a hypothetical engagement process is depicted in figure 1.

Shareholders wanting to engage via voice with investee firms essentially have two options: to engage publicly or privately. The upper part of figure 1 depicts the engagement route that starts with the public filing of a shareholder resolution, though note that this may be followed by private negotiations between management teams and shareholders. The lower part of the Figure presents the engagement route that starts with private dialogue; this may turn into public engagement later on.

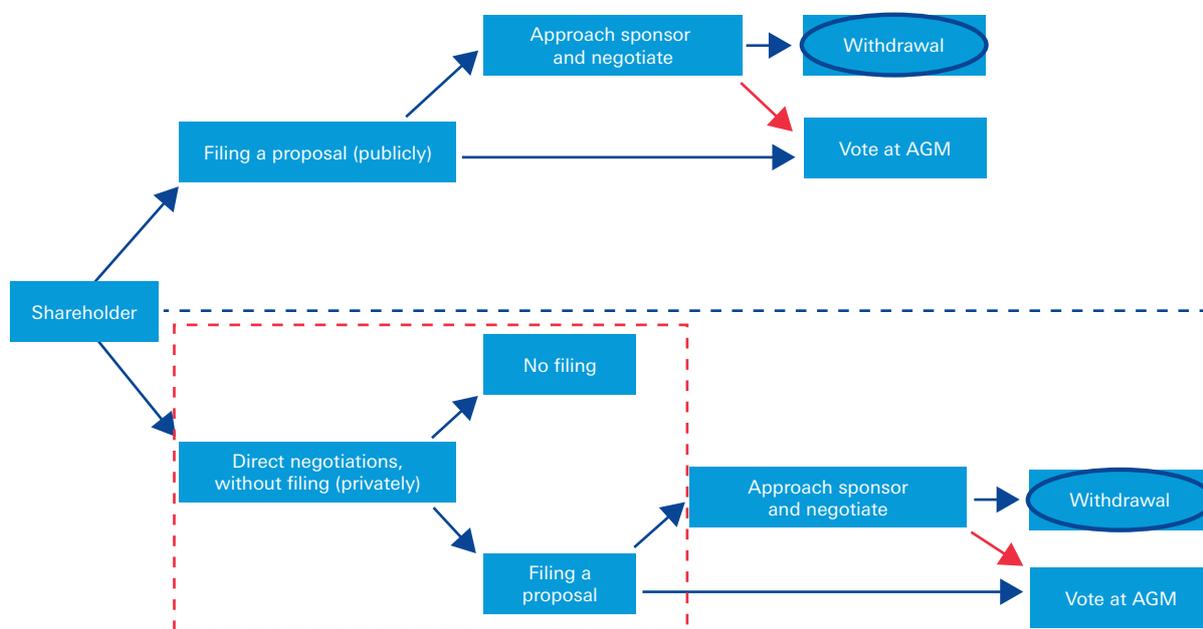
## Public shareholder engagement: The filing and voting of shareholder resolutions

In the public engagement route, a shareholder starts by filing a resolution. In the U.S., shareholder resolutions are often used to monitor corporations' ESG policies and many firms are exposed to resolutions filed by discontented shareholders. Usually, proposals go directly to a vote at the AGM, provided they meet the regulatory requirements of the Securities and Exchange Commission.

Large companies like General Electric, General Motors and ExxonMobil tend to receive many shareholder resolutions. For example, ExxonMobil received more than 200 resolutions between 1997 and 2009, an average of 15 per year.

Figure 1: A simplified model of the typical engagement process of shareholders

This figure presents the underlying theoretical framework we use to describe the withdrawal and engagement process. The dashed line in the middle of the graph separates the two different options a shareholder has when he wants to adopt voice engagement to promote changes at corporations. The upper part of the figure represents the route when the shareholder starts with the filing of a shareholder proposal. The lower part depicts the voice engagement route that starts with private engagement. The dashed rectangle in the lower part represents the unobservable part in the engagement process: private pre-negotiations before a filing of a proposal takes place. It is this part that we cannot observe from our data.



© by Bauer, Moers, and Viehs (2011, p. 40): The determinants of withdrawn shareholder proposals.

These ranged from corporate governance proposals asking for the separation of the chairman and CEO roles, to corporate social responsibility proposals requesting the introduction of greenhouse gas emissions reduction targets. More than half of the resolutions filed over the period went to a vote at ExxonMobil's AGM.

It is important to remember that shareholder resolutions are non-binding; management teams are not obliged to implement them even if they receive more than 50% of the votes. However, the power of these resolutions should not be underestimated, even when they receive as little as 30% or less of the votes. During the Shareholder Spring, a number of executives stepped down in the face of opposition to executive pay deals.

Most of the time, shareholders target poorly governed companies. Firms are significantly more likely to receive shareholder proposals in the absence of industry competition and in the presence of anti-takeover measures; in other words, where firms have the potential for managerial entrenchment. Additionally, poorly performing firms are much more likely to receive shareholder proposals. Voting patterns reveal that corporate insiders (i.e. executives and board members) sometimes vote against shareholder proposals, thus influencing outcomes in their favor.

### The most powerful proposal type: Withdrawn shareholder proposals

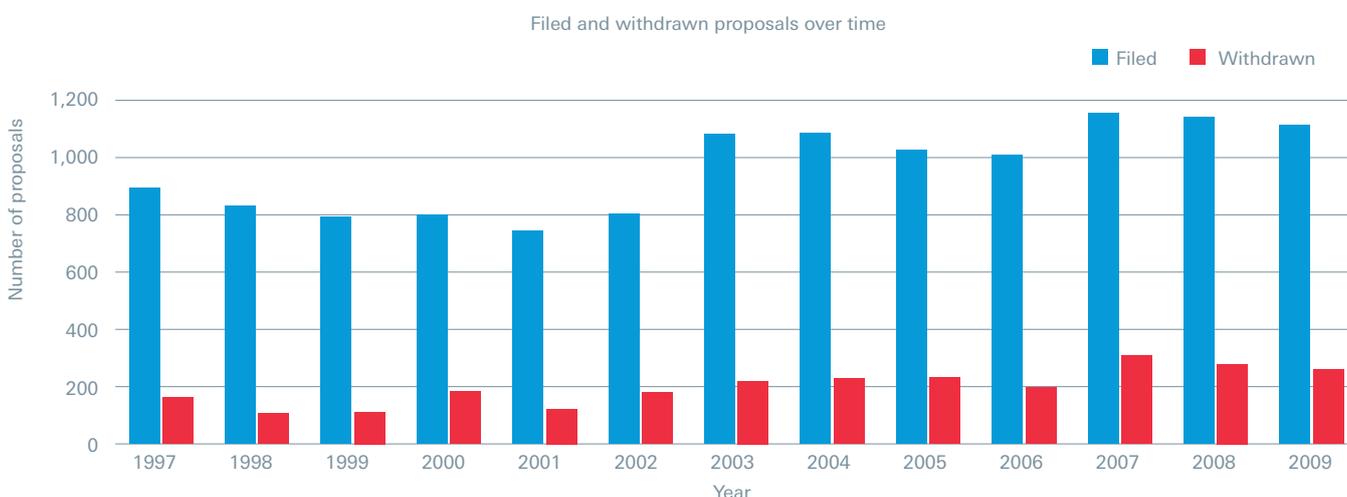
Subsequent to the filing of a proposal, companies may invite sponsoring shareholders to take part in private nego-

tiations to discuss withdrawing it (depicted in figure 1 as 'Approach sponsor and negotiate'). This typically occurs when the management team wants to avoid negative publicity or an adverse vote result at the AGM. If a satisfactory agreement is reached during private negotiations, the shareholder withdraws the proposal and no vote is held. Hence, a withdrawn proposal reflects a success for shareholders because their request has been partially or fully implemented. If no agreement is reached, a vote will be held. Most of the time, these negotiations take place behind closed doors and no information about them is revealed to the general public.

To assess the importance of withdrawn shareholder resolutions as a governance mechanism, a sample of shareholder proposals at S&P1500 companies from 1997 – 2009 was analyzed. The results indicate that:

- Shareholders frequently use the proposal mechanism
- A significant number of proposals are withdrawn (approximately 20% each year; as indicated by red bars). Figure 2 shows that more than 1,000 shareholder resolutions have been filed with S&P1500 firms every year since 2003
- Institutional investors have the most bargaining power because they generally own a bigger proportion of a firm's outstanding shares. When negotiations fail, the institution may threaten to sell its stake. This would lead to a stock price decrease if the ownership position is large, and therefore could adversely affect executive compensation, much of which is today paid out in the form of stock options

Figure 2: Evolution of withdrawn shareholder proposals (S&P1500)



© by Bauer, Moers, and Viehs (2011, p. 41): The determinants of withdrawn shareholder proposals.

Figure 3: Withdrawn proposals by sponsorship and coarse sub-categories

	Institutional Investors			Individual Investors			Coordinated Activism			Unions		
	Filed	Withdrawn	%	Filed	Withdrawn	%	Filed	Withdrawn	%	Filed	Withdrawn	%
Corporate Governance	1,115	277	24.8%	4,189	166	4.0%	555	102	18.4%	2,588	904	34.9%
Corporate Social Responsibility	1,244	527	42.4%	473	21	4.4%	1,684	522	31.0%	97	32	33.0%
Other	33	6	18.2%	162	6	3.7%	36	6	16.7%	41	8	19.5%
<b>Total</b>	<b>2,392</b>	<b>810</b>	<b>33.9%</b>	<b>4,824</b>	<b>193</b>	<b>4.0%</b>	<b>2,275</b>	<b>630</b>	<b>27.7%</b>	<b>2,726</b>	<b>944</b>	<b>34.6%</b>

© by Bauer, Moers, and Viehs (2011, p. 48): The determinants of withdrawn shareholder proposals.

Figure 3 illustrates that institutional investors filed 2,392 proposals in total over the sample period. Of these, 810 or 33.9% were withdrawn before the AGM. Labor unions submitted 2,726 resolutions, of which 34.6% were withdrawn. Individual (private) investors submitted substantially more proposals but were on average not as successful as institutional shareholders or labor unions when it came to private negotiations.

Furthermore, institutional investors filed more corporate social responsibility (CSR) proposals, which deal with environmental and social issues, than corporate governance proposals (1,244 vs. 1,115). Institutions were also more successful in negotiations on CSR proposals (42.4% withdrawal rate) than on corporate governance proposals (24.8%). Hence, institutional investors appear able to promote changes in corporate behavior pertaining to ESG issues.

The empirical results also show that a proposal submitted to a firm with high levels of institutional ownership is more likely to be withdrawn. Moreover, CEO ownership lowers the likelihood of proposals being withdrawn, indicating a stronger resistance by management teams when insider ownership is relatively high.

### An integral part of engagement: Private engagement from the beginning

Private engagement is the route used most often by the majority of institutional investors. Nowadays, many institutions have special engagement departments that deal with the communication of concerns and complaints to portfolio firms.

The lower part of figure 1 depicts this (partially) private engagement route. Shareholders start with direct negotiations, which are assumed to take place before any public actions in the form of shareholder proposals.

Direct negotiations are often part of a continuous interaction on ESG issues between institutional shareholders and investee firms. For example, if the institutional shareholder is not satisfied with a company's environmental policies or executive compensation, it may contact the management team directly to discuss its requests and objectives. Everything in this engagement process takes place behind closed doors, as with negotiations over the withdrawal of a shareholder proposal.

However, the private engagement route does not end with private dialogue. As the lower part of figure 1 shows, either:

- Private dialogue yields successful outcomes in the eyes of the engaging shareholder and no further action is taken; that is, no public shareholder resolution is filed, or
- If investee firms decline to accommodate the requests of the shareholder, the filing of a proposal is the most likely consequence

Since most institutional investors cannot easily sell their stakes in unresponsive firms, the filing of shareholder resolutions often takes place after private talks have failed (Bauer, Moers, and Viehs, 2011).

Of course, an institutional investor's public actions are not limited to filing shareholder proposals. Often, they make their complaints public to communicate their concerns to a wider audience, including other shareholders, and to put pressure on management teams. Examples of this include the media reports in early 2012 about London-based pension fund Hermes and German corporations VW and ThyssenKrupp. Hermes' concerns about the board structures at these corporations were discussed in the press right before the AGMs took place.<sup>3</sup>

<sup>3</sup> For more information, see: <http://www.handelsblatt.com/unternehmen/industrie/hans-christoph-hirt-crommes-starke-rolle-bei-thyssen-krupp-sehen-wir-kritisch/6086672.html> and <http://www.faz.net/aktuell/wirtschaft/volkswagen-kein-unabhaengiger-mehr-im-aufsichtsrat-11684344.html>

If direct negotiations fail, shareholders can choose the public engagement route and file a shareholder proposal. This may go directly to a vote at the AGM, or the sponsor may be invited to private negotiations. As discussed before, if the talks are successful for the shareholder, the proposal will be withdrawn; otherwise, it goes to the AGM. However, it is not likely that private negotiations will re-open if they fail to yield satisfying results in the first instance. Private negotiations are an option only in cases where management is very eager to avoid a public vote.

### Implications for institutional investors

Recent anecdotal evidence on shareholder opposition to executive pay structures highlights that institutional investors are important corporate engagers who can successfully promote change at investee firms. They are able to make a difference because they are the most powerful shareholder group and can put pressure on management teams and boards.

From a socially responsible investment perspective, institutions benefit from shareholder engagement because it can help to ensure sustainability and good ESG practices at investee firms. Engagement therefore goes hand-in-hand with institutions' fiduciary duties toward their own clients and beneficiaries, such as pension funds, asset managers, or insurance companies.

### Key takeaways

- Shareholder engagement is an alternative way to invest responsibly.
- Voice engagement by institutional investors takes place either publicly (via shareholder resolutions at AGMs) or privately (via private dialogue).
- Public shareholder resolutions are frequently used by individual and institutional shareholders in the U.S.
- Many proposals (approx. 20% of all filed resolutions) are withdrawn after successful negotiations between the management and the sponsoring shareholder.
- Often, private engagement in the form of private talks takes place between institutional investors and portfolio firms.
- Failed private negotiations usually lead to public engagements through shareholder proposals or media campaigns.
- The size of the institutional ownership stake is positively related to the probability that shareholder proposals will be withdrawn.
- Research into private talks between institutional shareholders and investee firms is important and must be expanded.

### Future avenues of study

Even though a growing number of institutional investors are engaging privately with portfolio firms, there is hardly any evidence that private engagements pay off in terms of changed corporate behavior and/or improved financial performance. Therefore, more research on the private engagement activities of institutional investors is necessary to evaluate their effectiveness. Often, private engagements are unobservable because these activities mostly take place behind closed doors. It is even more difficult to observe joint private engagement by multiple institutions at the same time.

Within the private engagement process, more research is needed on the interplay and usage of different engagement practices by institutional investors. An important issue, for example, is how institutional investors respond to unsuccessful engagements. Do they prefer to sell off stakes from unresponsive portfolio firms, do they continue engaging with firms, or do they file shareholder proposals to increase the pressure on management? These are important questions for future studies to seek answers to.

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## About the European Centre for Corporate Engagement

The European Centre for Corporate Engagement (ECCE) at Maastricht University's School of Business and Economics is the world's leading research institute on sustainable finance and responsible investing. ECCE offers high-quality research on the impact of environmental, social, and governance (ESG) standards on the pricing of assets in financial markets. Moreover, it studies the different ways investors can engage with the companies they invest in.

The mission of ECCE is to develop, communicate, and promote a thought-provoking and innovative body of knowledge concerning sustainable business and finance, through high-quality research, teaching, training, international networking, conferences, and other conventional outlets. Its core purpose is to encourage an ongoing dialogue between all parties capable of contributing to sustainable development, including capital markets investors, financial analysts, corporate managers, consultants, academic institutes, governmental bodies, and NGOs.

ECCE can be regarded as a "lab for responsible investment"; a multidisciplinary research network founded by researchers with established track records in the academic domain and in the finance industry. ECCE helps practitioners and scholars understand how businesses and financial markets can promote sustainable development by considering ESG issues.

The ECCE research group receives public endorsement from institutional investors around the world and has been awarded various prestigious research grants and prizes, such as those of the Haas School of Business at UC Berkeley (Moskowitz Prize), the United Nations Principles of Responsible Investing, the Mistra foundation (Sweden), and the French Social Investment Forum.



The report is a summary of the research activities of the European Centre for Corporate Engagement (ECCE) on the topic of shareholder engagement. Other sources are quoted where appropriate and necessary. For more information on the sources of information contained in this document, please see the references at the end of the document. The views and interpretations expressed in this report are those of the authors and do not necessarily reflect the opinion of the European Centre for Corporate Engagement (ECCE) or Deutsche Bank. Do not quote, reproduce or distribute this report without the prior written permission of the authors. Conclusions drawn in this paper are sample-specific and reflect the current status of the research projects. Hence, conclusions and results are subject to changes when the projects are continued further. Questions and remarks can be directly sent to Rob Bauer ([r.bauer@maastrichtuniversity.nl](mailto:r.bauer@maastrichtuniversity.nl)) or Michael Viehs ([m.viehs@maastrichtuniversity.nl](mailto:m.viehs@maastrichtuniversity.nl)).

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DB Advisors is a leading asset manager for demanding institutional investors, currently managing EUR 176 billion assets worldwide (as of October 2012). We are part of Deutsche Bank's asset management unit which administers a total of EUR 552 billion of assets (as of October 2012).

DB Advisors is highly committed to integrating environmental, ethical, social and corporate governance (ESG) principles into our investment analysis and decision-making processes, without compromising investment performance. ESG is an integral part of our fiduciary duty and investment process. Our investment philosophy is based on the firm belief that the underlying value of a company is determined by its long-term fundamental prospects. Corporate sustainability can be achieved by minimizing risks arising from ESG aspects, as well as proactively applying ESG principles in the way companies run their businesses.

Our ESG framework can be integrated into equity, fixed income, and multi-asset strategies, providing clients with the broadest range of solutions. It encompasses the full range of ESG factors, rather than focusing narrowly on, for example, environmental considerations. Our ESG strategies leverage DB Advisors' global research resources as well as external research. In addition, we have established an independent panel of external experts from academia and industry to oversee the ESG process and advise the investment teams.

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- EUROSIF
- International Corporate Governance Network (ICGN)
- German Corporate Governance Commission
- Carbon Disclosure Project
- The Climate Group
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- Forum Nachhaltige Geldanlagen (fng)
- Institutional Investors Group on Climate Change (IIGCC)
- The Investor Network on Climate Risk (INCR)
- International Labor Standards
- Klima-Partner
- OECD Principles for Multinational Corporations
- The Global Exchange for Social Investment
- UNEP Finance Initiative (FI)
- UN Global Compact
- Wolfsberg Principles (prevention of money laundering, elimination of financing of terrorism)
- World Bank Standards
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- World Economic Forum
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