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Investors Exercise Rights, Obligations and Influence Through Voting on Key ESG Issues of Enterprises at the General Meeting of Shareholders

ESG & Sustainability Transformation

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As we have discussed in previous articles, shareholders have voting rights at AGMs and EGMs, and in some markets, occasionally at other investor meetings. In most cases, voting rights are proportional to the percentage of shares owned in the company, and resolutions are usually passed when more than half of those voting are in favour. In some cases, special resolutions require the support of 75% of the votes cast, and there are unusual cases where the number of votes cast exceeds a threshold in terms of total share capital (and more rarely where the number of shareholders is significant). Institutional investors typically vote in favour or against, although in many markets there is also scope for conscious abstention (for example, in the UK these votes are collated although they are not legally considered votes). This is considered a positive decision rather than simply an absence from a vote. Abstaining can sometimes be a useful engagement tool when investors do not have a fixed position on an issue, particularly ESG-related issues such as waste management or worker safety, but investors certainly do not want to be in a position where they may later be prevented from criticizing an action that they have actually supported through their vote.

Due to the public nature of general meetings of companies, where the results are announced publicly by the company and the events themselves are often open to the media, voting decisions are often the most visible element of the investment management role (stewardship) and interaction. As a result, they attract disproportionate media attention and large negative votes often attract significant media scrutiny. As a result, fund managers are often held accountable, both to the public and to their clients, for individual voting decisions.

As we have discussed, due to the huge resource requirements required to interact with a large portfolio of companies receiving capital, voting is often referred to as "proxy voting" because institutional investors rarely attend the meeting where the vote is held in person, but instead appoint an individual to act as a proxy to vote on their behalf (in most cases, this will be the company chairman, although anyone present at the meeting can be appointed). The vote belongs to the legal owner of the shares, which may be a custodian or a trustee or some other intermediary, meaning that even an institutional investor will often need various formal paperwork to attend the meeting and vote, not least identifying the individual who is directly representing the investor at the meeting.

With large corporate portfolios and AGMs often occurring within short timeframes (months in some markets, notably Japan, where thousands of AGMs are held in just a few days), resources are a particular issue when it comes to voting. Institutional investors often rely on proxy firms to help process their votes and advise on them. Globally, there are two dominant players in this market:

- ISS, with around 80% of the market; and
- Glass Lewis, which accounts for much of the remaining 20%; along with
- A number of much smaller players, which have some market share, particularly in some local markets.

Proxy advisers are often criticized by investee companies for taking seemingly narrow approaches, for being inflexible in their voting, and for not facilitating the "accountability" aspect of "comply/apply or account." But most investors would argue that the role of advisers is less flexible and more focused on general guidance, and that investors should demonstrate a deeper understanding of individual companies and respond appropriately to representations. The extent to which investors actually use their own judgment and avoid relying on their proxy advisers varies, especially with smaller stocks outside their home markets.

Active and constructive participation at AGMs is one of the most important activities of an active investor engagement program or active ownership strategy.

Active ownership is the use of ownership rights and positions by investors to influence the activities or behavior of investee companies. This investment method uses a number of different shareholder strategies to promote positive change in the way a company is governed and managed. In fact, it takes the opposite approach to negative screening investment strategies, as it sees the mere act of divestment as incapable of mobilizing and directing investors to create positive change in the recipient company.

Active ownership can foster direct engagement between investors and investee company management, collective engagement where investors collectively push for change, submit shareholder proposals and resolutions, and proxy voting strategies driven by a clear agenda, to:

- Encourage greater disclosure;
- Enhance transparency; and
- Raise strong awareness of ESG issues.

Companies/stocks that are trading at a large discount (low price) to their industry peers or have distressed debt/loans often have poor ESG metrics. By influencing the behavior of companies to improve key ESG metrics, this strategy is based on the theory that there is a link between improvements in a company's ESG metrics and rerating/repricing its equity or credit through a lower discount.

Voting is an important tool for the activist investor and any voting decisions should be consistent with the investment thesis for the holding and any stewardship agenda the organisation has in relation to the company. So, for example,

- If there are concerns about the capital structure and financial strength of the business, investors should pay close attention to votes relating to dividends, share buybacks, equity issues or the scope for additional debt.
- If there are concerns about the effectiveness or diversity of the board (S&G), this should be reflected in voting decisions on the re-election of directors (and in particular in relation to members of the nominations committee).
- Concerns about the independence or effectiveness of the audit process (G) should be taken into account when voting on auditor reappointment, auditor remuneration and reappointment of audit committee members.

Given the level of interest in executive remuneration, it is perhaps unsurprising that investors are particularly interested in remuneration resolutions (G). In many markets, there are both non-binding annual resolutions to approve pay for the year and binding votes

on forward-looking policies and any new remuneration plans. These are in addition to votes on the appointment of remuneration committee members.

Investors will also often reflect concerns about the Financial Statements or sustainability or ESG issues in their votes approving the Report and Accounts. In most markets, this is a largely symbolic resolution, but the message sent by voting against it can still be important. It is important to remember that although most resolutions are considered to be purely governance – G matters (e.g. approving accounts and dividends, electing directors, related party transactions, appointing auditors and deciding on capital structure—issuing shares and authorising share buybacks), there is no reason why investors' decisions on such resolutions should be driven solely by G considerations.

This can be seen, for example, in the recent debate about the inclusion of climate change issues in the Financial Statements (the Financial Statements are located in the back of the Annual Report, rather than the Narrative Report in the front half). In September 2020, investor groups representing over $100 trillion in assets published an open letter calling on companies to follow guidance from the International Accounting Standards Board (IASB) and include material climate change issues in their Financial Statements, and to fully disclose the assumptions involved. The investor groups also called on auditors to play their part in ensuring this was done, and said they expected the assumptions used to be compatible with the objectives of the Paris Agreement. Some investors are considering how their voting patterns might respond to any failure to heed this call from investors. In particular, some institutional investors are likely to vote against reports and accounts that do not make it clear that climate change has been factored in or assumptions have not been disclosed. Some are considering voting against auditors of climate-sensitive companies that do not include climate as a material audit matter in their Audit Reports. And others are expected to vote against key directors of companies that are not sufficiently climate-aware when they face major risks.

Any vote itself is rarely meaningful because there may be many reasons why an investor votes in a particular way. Therefore, institutional investors often have active programs to communicate to companies why they are voting in particular ways, either in writing or through dialogue. Many investors seek to engage in active discussions with companies as they work toward their voting decisions (helping them tailor their decisions to the particular circumstances of their investee company) and use this as an opportunity to explain the thought process behind any decision-making. This dialogue is a form of low-level interaction but will have only limited impact.

Although institutional investors are unlikely to attend shareholder meetings in person, investment managers should perhaps consider this opportunity more actively. Particularly in small and medium-sized companies, AGM attendance may be small or negligible, allowing investors direct access to many directors at once, with ample opportunity for informal conversations. Furthermore, since the entire board typically attends most AGMs, these meetings can provide investors with unusual insight into board dynamics and the degree of affinity within the board. Shareholder meetings often provide an opportunity for many board members to be formally questioned on any material ESG issue (typically, all committee chairs will answer the same questions directly as the chairman and CEO; in some cases, the audit partner will also attend and may answer relevant questions), and this formal questioning can provide scope for both insight and influence. But many will find that the informal insights gained from actually participating in general meetings are equally valuable.

To learn more about ESG and sustainability-related models, please contact **YTT Consulting**!