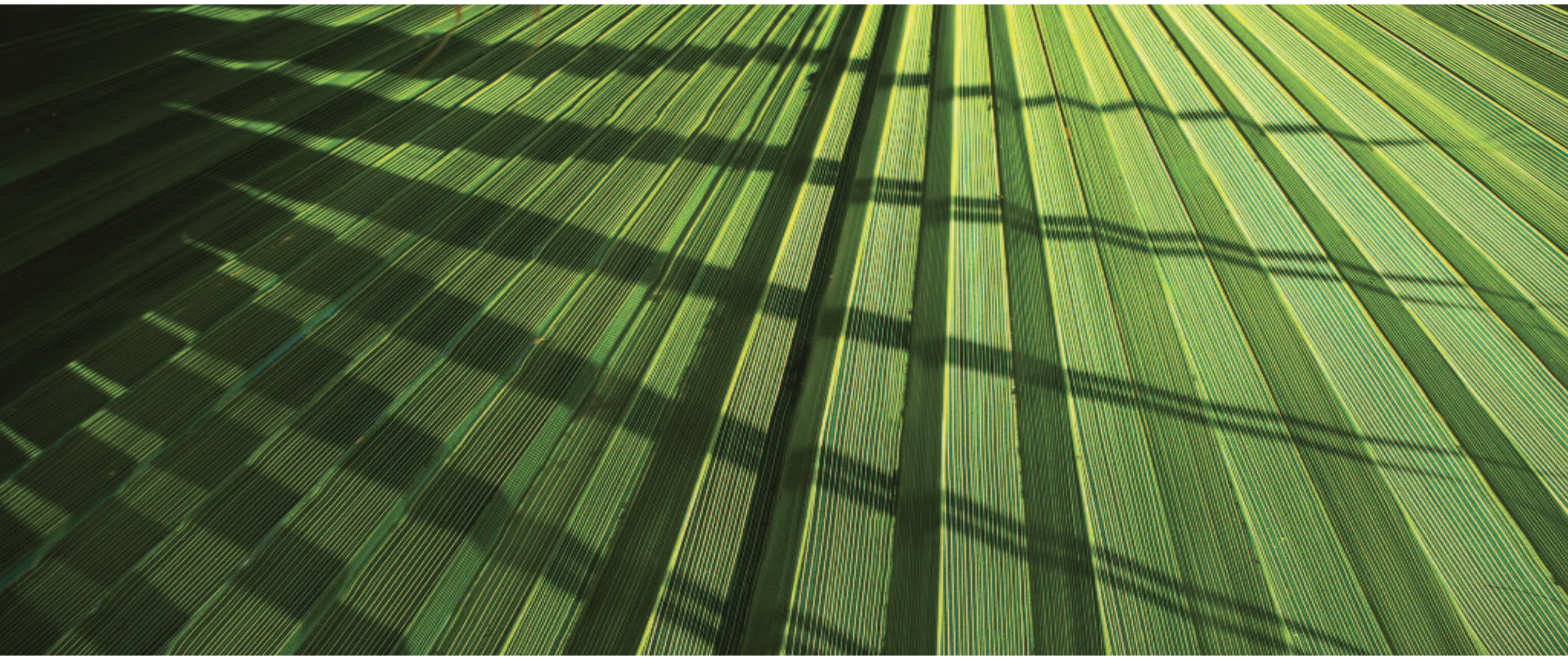
Engagement:
box-ticking or catalyzing sustainability?



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Engagement:
box-ticking or catalyzing sustainability?

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(VBDO) Dutch Association of Investors for Sustainable Development.

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Triodos Investment Management

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AXA INVESTMENT MANAGERS
redefining / investment solutions

FOREWORD

Triodos Investment Management

Triodos Bank invests in companies that deliver long-term financial, social and environmental value. We believe in building a relationship with the companies we invest in and we therefore hold investment portfolios for the longer term. This investment philosophy provides an excellent basis for our engagement strategy. Constructive dialogue is conducted with companies to stimulate improved sustainability performance and therefore long-term financial performance as well in our view. We see it as our responsibility to act as a responsible shareholder in companies on behalf of our clients.

As all practitioners of engagement will confirm, engagement takes time, knowledge and experience. Therefore it is in our best interest to continuously improve the effectiveness of our engagement efforts. Engagement practices have been subject to a lot of research and much has been written about it, but almost exclusively based on the views and recommendations of institutional investors. This study sets itself apart from others by being the first study that actively seeks feedback from the investee companies themselves. How do they perceive the engagement efforts of investors and what recommendations do they have for us? We are grateful to the VBDO for having carried out this research and it is our pleasure to be one of the sponsors of this important publication.

Michael Jongeneel
MD Triodos Investment Management

FOREWORD

ASR Nederland N.V.

The aim of this research, providing insights into effective Engagement, fits perfectly into a.s.r.'s commitment to invest responsibly and with integrity, a capability that we constantly strive to improve.

An essential part of this commitment is reflected in the constructive dialogue, engagement, with the companies we invest in about relevant Environment, Social and Governance practices conform to the standards outlined in our policy for Socially Responsible Investment (SRI). This policy has been formally in place since 2007, allowing ASR Nederland N.V. to pursue a responsible and sustainable approach, and it has been extended over time to capture the progress of the market and the changes in society. Within this spirit of improvement, ASR Nederland N.V. is proud to participate in this Engagement research, bringing forward the feedback of the companies on the engagement efforts of the investors and presenting recommendations both to equity and corporate bondholders.

As co-sponsor of this research, we are grateful to the VBDO for their hard work in putting this inspirational report together.

Jack Julicher
CIO Financial Markets ASR Nederland N.V.

FOREWORD

AXA IM Netherlands

Engagement: Ticking a box or catalysing sustainability?

'Engagement' is a means for an investor to influence, shape and shift a company's behaviour. Beyond simply excluding a company from an investment portfolio, engagement is an active strategy to improve the performance of a company, including management of critical ESG issues.

Initially, AXA IM's activities in engagement services are focused at specific company targets for engagement activities. Today, a key element around engagement for example, is to focus on fewer engagement cases as this displays focus and can gain respect by the targeted companies. We typically make use of specific milestones which are tracked over time with reporting. AXA IM will when developing an engagement strategy review carefully the prospect on success likelihood and determine together if the project should move forward through the remaining stages.

As mentioned, the goal of the engagement process is to see change in a company's behaviour. Some shifts in behaviour will be clear (new appointments, policy changes, codes, industry initiatives), while others may be verbal in nature and noted in more subtle business practice changes over time.

We will review in this process the potential to influence company behaviour through engagement in respect of (i) Positive factors which highlight shareholder ability to influence company behaviour through engagement, (ii) Challenges which may impede the ability to engage and provide (iii) a clear recommendation on whether or not to proceed with engagement.

Engagement is considered successful for our clients and AXA IM when milestones are reached (such as presence at meetings, transparency improvement). More indirect engagement success is accepted if considered steps have been taken to influence a company even if all goals have not been reached.

We full heartedly welcome in this respect the report "Engagement: ticking a box or catalysing sustainability?" which aim is to provide more transparency and structure to assessing the organization as well the effectiveness of investors engaging with companies.

To singlehandedly change a company would be quite a challenge. The goal is to use engagement to influence and monitor changes over time. Transparency in company behaviours is the most frequent success goal to be achieved from engagement.

Hanneke Veringa
Country Manager AXA IM Netherlands

FOREWORD

VBDO

Engagement is one of the key elements of Sustainable and Responsible Investment. It gets increasingly attention from institutional investors, and with reason. Several codes indicate the responsibility of shareholders to ensure the right strategy and proper behaviour of the companies they partially own. It also makes sense for investors to discuss with investees way to increase long term profitability and reduce risks, as this has a direct effect on investment returns. But what do the companies that are at the other side of the table think of all this? Little research has been done as to their perspective.

The VBDO was established 19 years ago with the aim of engaging with companies on behalf of investors. In our case the vocal power always has been more important than the very limited voting power we have. In all these years we have learned that in general companies tend to appreciate our engagement, mainly because it is long term oriented, done from a business perspective and because it is fact-based and in a constructive way. Above all, it works because of the personal contact and because we are seen as a loyal shareholder.

This research examines the opinion of a broad selection of companies. In general companies indicate the importance of direct contacts of high quality, focusing on material issues, and most of all, by loyal and long term investors. We hope this research helps to improve the quality and the relations between investors and investees, beneficial to both parties.

Finally I would like to thank our sponsors Triodos IM, ASR Nederland N.V. en AXA IM wholeheartedly. Without them this study would not have been possible.

Giuseppe van der Helm
Executive Director VBDO, The Netherlands

SUMMARY

Engagement is a method within Responsible Investment which is practiced more and more by institutional investors in Europe. In the Netherlands, 82% of the pension funds and 34% of the insurance companies practice engagement. The quality and quantity of the engagement, however, vary considerably within these groups. 60% of the pension funds report on engagement and achieve demonstrable results, compared to 17% of the insurance companies (VBDO, 2013a; VBDO, 2013b).

Despite the fact that more and more institutional investors worldwide practice engagement, some questions still remain unanswered;

1. How do the companies experience engagement?
2. When is engagement effective in inducing changes in corporate policies?
3. What are the factors that make engagement effective?
4. What are the recommendations for asset owners on preparing, implementing, measuring and evaluating engagement?

To answer these questions several literature searches were performed and 13 qualitative interviews were conducted with companies that had been engaged.

HOW DO COMPANIES PERCEIVE ENGAGEMENT?

Most companies see engagement as making a positive contribution. Several examples were brought forward where companies showed that they had made policy changes due to engagement or that they had received new information on and insights into ESG-related topics. But maybe even more important is that engagement is used by companies for gaining a better understanding of the ESG issues that are relevant, material and on the societal agenda.

However, companies do not see all forms of engagement as positive or constructive. They consider that some forms are too superficial, a way to inform the investors rather than the other way around. Several suggestions can be made towards investors to ensure that engagement can provide a more positive contribution and nudge the company to improve its CSR policies. In general, four main topics were brought forward by the interviewees:

- The quality of the engagement and preparation is more important than the quantity of engagement cases.
- Bring forward issues which are in line with or strengthen the strategy of a company.
- A long-term relation creates a sense of trust and therefore strengthens the dialogue.
- The engagement process should be evaluated both in the end and periodically and adapted when necessary.

RECOMMENDATIONS

The literature research and the results from the interviews have led to the following recommendations for institutional investors.

WHICH COMPANY TO ENGAGE?

Focus efforts on companies with a high esg-score
The interviews and literature have shown that companies with a low ESG score are on average less open towards engagement requests. When engaging with a company with a low ESG score, it might be useful to investigate whether this company will be open and benevolent towards engagement.

Use your home advantage

One point that was put forward by the interviewees is that it makes a difference if the engaged company knows an investor. Therefore it is an advantage when companies in the same country or region are engaged or when co-operation is sought with an investor who is well known to the company.

It also helps when the engager understands or is aligned with the corporate governance culture of the company. Several companies stated that it helps to know the context and corporate governance culture so that engagement can be more effective.

Large holdings no major factor for influencing the type and effectiveness of engagement

Interviewees stated that all investors, disregarding their size or type, are welcome for engagement. In general the size of the investment is not seen as a major factor influencing the type and effectiveness of engagement. The exception to this is when direct access to the board is sought.

WHICH TOPICS TO PICK FOR ENGAGEMENT?

Make engagement more sector and market specific

According to most of the interviewees it will be more effective to make engagement questions sector and/or market specific. Companies now often receive general questions that do not apply to their specific market or sector, and are therefore not effective.

Focus on topics with materiality

A number of interviewees brought forward that engagement on ESG issues is sometimes disconnected from engagement on financial issues. They brought forward that an integration of financial and ESG performance and a focus on materiality will strengthen the engagement. They also noticed that companies are sometimes engaged by two separate departments of the same institutional investor.

Engagement on ad hoc controversies not the right way to foster the effectiveness

Interviewees stated that when the media report on a certain topic they see an increase in the engagement questions asked on this topic by institutional investors. But is this also more effective? Most interviewees stated that they do not gain any new insights because of media hypes and therefore they are rarely triggered to change their policy. Furthermore, basing engagement requests ad hoc on media is at odds with trying to stay focused on specific themes to improve the quality of engagement.

Focus on topics in line with the corporate policy

Focus on issues that are not at odds with the strategic policies of a corporation. If this is nevertheless, the case, focus on operational changes instead of expecting to change strategic policies.

HOW TO PRACTICE ENGAGEMENT?

Preparing the engagement

- *Quality is more important than quantity*

It was brought forward by interviewees that it can be useful to increase the focus on engagement. However, as resources for engagement may be limited, it can be wise to focus more on increasing the quality of engagement than on the quantity of engagement cases.

- *Know when it is necessary to reach the board*

When preparing the engagement it is important to ask the question whether it is necessary that the topic reaches the board. If so, it is important to prepare the engagement accordingly. In this case it helps when significant holdings are backing the engagement, so co-operation may be important. It also helps when senior representatives pass on the message to the company or when the issue is also brought forward at the annual shareholder meeting.

Most engagement processes are initially targeted on the investor relations departments. This can be a logical entrance, although for several topics colleagues from other departments need to be called in. It is in any case important to consider if the counterparts have the authority to agree on the demands, or have the salience to be in direct contact with the decision maker.

Ways to engage

- *Co-operate when necessary*

An important question to address in the preparation of engagement is whether co-operation with other investors should be sought. Co-operation can be a useful tool to share knowledge, share resources and represent a larger number of shares towards the company. However, co-operation can be time-consuming when preferences of a diverse group of investors have to be accommodated. Therefore it is recommended to co-operate with investors:

- With whom a working relation is already established
- With whom goals and views are shared
- With whom information and research can be shared
- Whose number is not too high to facilitate an effective co-operation

Forms and instruments for implementing the engagement

- *Focus on direct dialogue*

Engagement can take several forms, from sending letters to having dialogues. In general, interviewees have a preference for direct dialogue, possibly preceded by a letter, and it is preferable that the questions for such a meeting are sent beforehand.

- *Focus on a long-term relationship with a company*

A long-term relationship between investor and company during an engagement process has several advantages: you build a relationship of trust and at the same time you increase your knowledge. This ensures a higher quality and efficiency of the engagement process.

FOLLOW-UP AFTER THE ENGAGEMENT

Measure and evaluate the engagement process

It is important that an evaluation is carried out to assess why an engagement was or was not successful. The outcome of engagement is, however, hard to measure. When changes occur, there could be a myriad of reasons why engagement has been effective. Therefore it is important to evaluate the engagement to pinpoint why the engagement process was, or was not, successful.

Reacting on the results of engagement

When engagement has been effective it can be logical to publicly congratulate the company with this step and to inform consumers or participants on the positive steps made, which will strengthen the support for engagement as well as nudge the company to stay involved in taking more positive steps in the future. When engagement has failed several actions can be taken:

- The company can be excluded from the portfolio
- Voting policies can be changed accordingly
- A new engagement process can be started. Depending on the reason for failure it may be preferable to do this in co-operation with other institutional investors.
- Publicity can be given to the failure of engagement.

Be transparent

Engagement is an important topic to report on towards customers and participants. Engagement is particularly a method that is easy to explain to shareholders and can help to inform them on responsible investment. This increases the transparency but also gives legitimacy to engagement activities, and it can be a positive selling point.

Engagement in relation to other RI instruments

To improve the success, it is important to investigate how engagement is linked to other responsible investment instruments. For example, the insights gained by practicing ESG integration provide a suitable basis for selecting and preparing engagement cases, and making a link with exclusion can improve the bargaining power of an investor in engagement. It is recommended to integrate the different RI instruments into the responsible investment policy, as well as the organisation and implementation of responsible investment.

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1. INTRODUCTION

1.1 INTRODUCTION TO ENGAGEMENT

Responsible Investment (RI) is practiced by a wide range of institutional investors and can take many forms. Common types are exclusion, ESG integration, voting, impact investment and engagement. Engagement differs from the other methods in that it focuses on direct contact between shareholders or corporate bondholders and companies in order to obtain information and influence behaviour. Engagement is mainly practiced for public equity and, to a lesser extent, for corporate bonds. It is the crucial link between owners and managers that leads to better investment management, improved company behaviour and enhanced shareholder relations (Eurosif, 2013 p. 11).

Engagement can be practiced on many different subjects, though when linked to Responsible Investment it is specifically focused on corporate policies regarding environmental, social or governance issues. A wide range of topics can be discussed such as CO2 emissions, remuneration, human rights and involvement in weapon production or sales. The rationale for engagement comes from the classic principal-agent theory, which describes the need for investors (the principal) to ensure that company board and management (the agent) are acting in the best interests of shareholders (Eurosif, 2013 p. 14).

Especially institutional investors are important for engagement because they have the power and incentives to monitor the firm and also to promote changes if necessary, due to their large (potential) stake in the firm (Bauer et al., 2013 p. 5).

1.2 MOTIVATION FOR THIS RESEARCH PROJECT

Engagement is a method within Responsible Investment, which is practiced more and more by institutional investors in Europe (Figure 1).

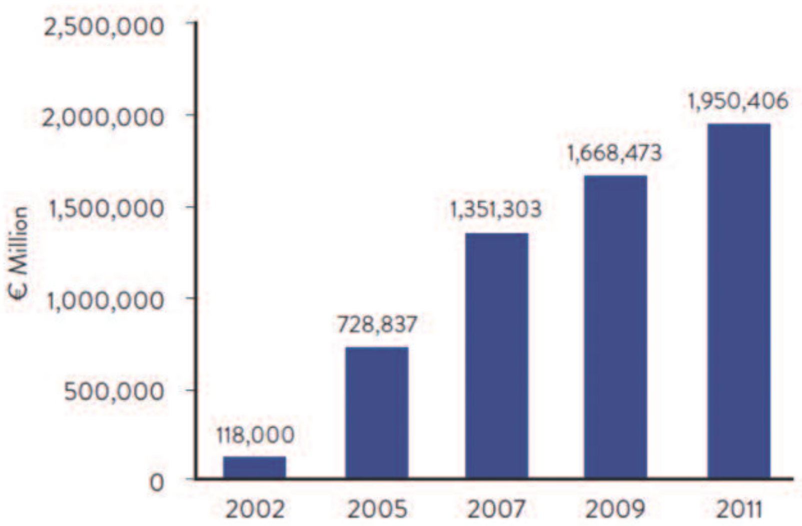

Figure 1: ***ESG Engagement Assets in Europe (Eurosif, 2012).***

82% of the pension funds and 34% of the insurance companies practice engagement in the Netherlands. The quality and quantity of the engagement however vary within these groups. 60% of the pension funds report on engagement and achieve demonstrable results, compared to 17% of the insurance companies (VBDO, 2013a; VBDO, 2013b).

More and more institutional investors practice engagement worldwide. Studies have been done on engagement by different parties, but always based on the experience and recommendations of investors. Hardly any study took the perspective of the engaged company into account. However, only this perspective can provide an answer to the question on how engagement is perceived and handled by the companies which are engaged. Do companies indeed gain new insights or change their policies due to engagement, or is it just a time-consuming activity for both parties?

Important questions are key to improving the effectiveness of engagement for the institutional investor as well as the companies that face engagement. Therefore the VBDO started this research project, in co-operation with Triodos Investment Management, ASR Nederland N.V. and AXA Investment Management, with the aim of providing valuable new insights and recommendations on how engagement can be practiced.

2 METHODOLOGY

2.1 MAIN RESEARCH QUESTIONS

There are four main questions that we address in this project:

1. How do the companies experience engagement?
2. When is engagement effective in inducing changes in corporate policies?
3. What are the factors that make engagement effective?
4. What are the recommendations for asset owners on preparing, implementing, measuring and evaluating engagement?

2.2 SCOPE AND DEFINITIONS USED:

SCOPE

- The research focuses on the engagement activities of Dutch institutional investors both on local and international level, representing the international scope of their engagement activities.
- In this research project we focus specifically on engagement linked to public equity and corporate bonds. In this report the term 'shareholders' is used when discussing the recommendations made. These recommendations, however, also apply to corporate bondholders, unless stated otherwise. Also, some of the recommendations could be valuable to engagement in other asset classes as well.
- In this study, voting on annual shareholder meetings is not seen as part of the engagement process as such, although the link between voting and engagement will be discussed, for example in relation to the effectiveness of engagement. Voting does not apply to corporate bondholders.

DEFINITIONS

Responsible Investment: "Combines investors' financial objectives with their concerns about social, environmental, ethical and corporate governance issues" (Eurosif, 2013).

Engagement: Eurosif (2013) defines engagement as "activities and active ownership through voting of shares and engagement with companies on ESG matters. This is a long-term process seeking to influence behaviour or increase disclosure" (Eurosif, 2013). In this report we use this definition, but we focus on the dialogue process and the voting policies separately.

Voting: Shareholders can use their voting rights or file proposals in (annual) shareholder meetings to pressure companies to report on and improve their environmental and social performance. Filing proposals is common among a wide range of shareholders, such as pension funds, unions, religious organisations, social organisations and SRI consumer funds (TKAC, 2006; Wagemans et al., 2013). Voting as an instrument can be related to engagement in three ways:

- Voting or filing a proposal can be done when engagement fails.
- Announcing to file a proposal or to vote for or against a proposal can be used to gain access to the management of a company and to start engagement.
- Engagement can sometimes take place as a follow-up after a proposal has been filed or a vote has been cast.

Exclusion: "An approach that excludes specific investments or classes of investment from the investible universe such as companies, sectors, or countries" (Eursosif, 2013).

ESG integration: "The explicit inclusion by asset managers of ESG risks and opportunities into traditional financial analyses and investment decisions based on a systematic process and appropriate research sources" (Eurosif, 2013).

2.3 LITERATURE RESEARCH

The literature research was performed with the use of generally known scientific databases such as “web of science” and “Scopus”. Besides scientific literature, relevant practitioners-based literature available at the PRI, Eumedion and Triodos Investment Management, AXA-IM, ASR Nederland N.V. and the VBDO was used.

2.4 INTERVIEWS

The study was conducted using qualitative interviews. This method was chosen in order to gain in-depth insights into the perception and activities of companies related to engagement. A semi-structured questionnaire was used to guide the interviews, but there was also room to discuss points in more detail when brought forward by the interviewees. In total, 13 interviews were held with engaged companies.

The companies that were approached with the request to be interviewed were selected with the use of the following criteria:

- The selection comprised a variety of companies concerning location, sector and level of CSR.
- Companies were engaged or were under consideration to be engaged by Triodos IM, ASR Nederland N.V. or AXA IM.
- Relevant background information was available on the engagement process.
- The interviews were chosen such that the selection was representative by selecting a balanced group with regard to the following criteria:
    - National versus international companies
    - Successful versus unsuccessful engagement
    - Companies from different sectors

In total, 16 companies were approached to be interviewed. 3 of them declined and responded that they had to decline due to time constraints. 13 companies accepted the interview request. This number and the depth of the interviews are sufficient to be able to analyse patterns and relevant criteria that have to be taken into account within the engagement process. However, it is important to note that it is difficult to make quantitative and statistically verified statements when using qualitative interviews. Therefore this has only been done in this report when based on quantitative studies found in the literature research.

Figure 2 below shows an overview of the 13 interviewed companies. Besides these interviews, the VBDO asked a few German and British companies about their experiences with engagement after the engagement talks the VBDO had with them, in order to verify and enrich the findings of the interviews. All interviews were conducted confidentially to ensure respondents were able to talk freely, and the results presented in this report are processed anonymously.

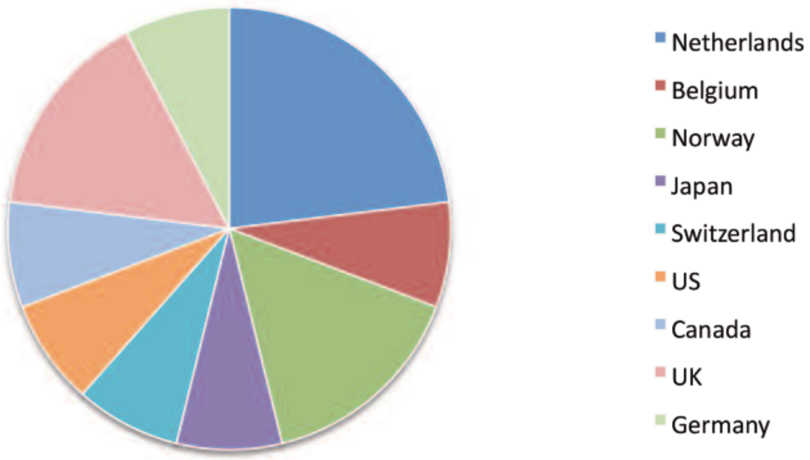

Figure 2: ***Countries in which the interviewed companies are based***

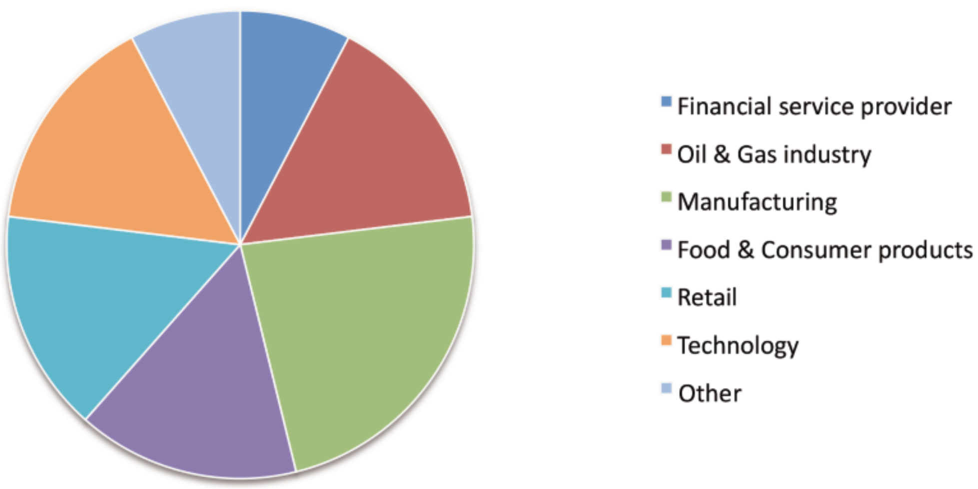

Figure 3: ***Sectors of the interviewed companies***

3 BACKGROUND

3.1 WHAT TYPES OF, MOTIVATIONS FOR AND POLICIES OF ENGAGEMENT EXIST?

TYPES AND INTENSITY OF ENGAGEMENT

Engagement can take several forms, and these forms can differ in intensity. PRI classifies their engagement intensity as basic, moderate or extensive:

Level of engagement	Definition
Extensive	Multiple instances of focused interaction with a company on issues identified, with a view to changing the company's behaviour. The engagements were systematic and began with a clear goal in mind.
Moderate	More than one interaction with a company on issues identified. The engagement was somewhat systematic but the specific desired outcome may not have been clear at the outset.
Basic	Direct contact with companies but engagement tended to be ad hoc and reactive. May not have pursued the issue beyond the initial contact with the company and includes signing on to letters authored by others.

Table 1: ***Intensity of engagement*** (PRI, 2013)

TYPES OF CO-OPERATION

Some institutional investors pool their engagement issues with other engagers to increase the impact and power of their action (and cutting costs at the same time). This is called collaborative engagement; their influence increases because of the higher number of participants and proportion of assets they put together (Novethic Research, 2011).

It is important to note that there are two main forms of co-operation:

- *Through an engagement service provider*
  Institutional investors can hire an engagement service provider. Commonly this service provider represents several of their clients towards the engaged companies.

- *Through collaboration of institutional investors*
  Institutional investors themselves can work together on certain topics or regarding certain companies.

An example of collaborative engagement is the PRI Clearinghouse. This is a unique global platform for collaborative engagement initiatives. It provides PRI signatories with a private forum to pool resources, share information, enhance influence and engage with companies, stakeholders, shareholders, policymakers and other actors in the investment value chain on environmental, social and corporate governance (ESG) issues across different sectors and regions. The vision of the Clearinghouse is to foster sustainable long-term value creation through collaboration, benefiting the environment and society as a whole. All PRI signatories can be involved in engagement activities, thereby increasing their power and legitimacy when exercising their ownership rights to promote responsible business and long-term value creation (PRI, 2014).

MOTIVATIONS TO PRACTICE ENGAGEMENT

Novethic Research (2011) states that institutional investors are motivated in different ways to practice engagement:

- *Optimising long-term value*

For many institutional investors and investment managers, the primary objective of engagement is to preserve or improve the company's long-term value. Its purpose is to correct existing problems, prevent future risks or enable the company to seize future opportunities.

- *Managing reputational risk*

Some investors, mainly institutional investors, practise engagement to protect against reputational risks. In this case, engagement can be an extension of a norms-based approach, which identifies the companies that are accused of violating treaties or international standards, such as the ILO conventions.

- *Activist engagement*

NGOs and organisations take more of an "activist" engagement approach. Engagement provides an additional means to accomplish their broader mission: defending human rights, protecting the environment, reducing poverty. But also institutional investor can take an activist approach although this is not quite common (Novethic Research, 2011).

FOUNDATIONS FOR POLICY ON ENGAGEMENT

To practice engagement it is important to have a general policy in which is explained why engagement is practiced, what the main goal is and on which issues is focused. This can be a specific engagement policy, but it can also be integrated in the general responsible investment policy. From the benchmark Pension funds (VBDO, 2013a) three (combinations of) foundations for developing a policy regarding engagement can be derived:

- *A policy based on (international) guidelines*

This is a policy that is based on international guidelines such as the UN Global Compact or the OECD guidelines. A responsible investment policy based on guidelines focuses especially on addressing breaches of these guidelines.

- *A policy based on stakeholder preferences*

Besides international guidelines an institutional investor can also develop a policy on the basis of preferences of its stakeholders, such as customers, participants or employees. A pension fund can for example consult its participants on their preferences regarding responsible investment and engagement in particular.

Only 22% of the Dutch pension funds consult their participants on their responsible investment policies. Few institutional investors choose to focus their engagement on specific issues. An example is the pension fund Bedrijfstakpensioenfonds Mode- Interieur- Tapijt- en Textielindustrie which focuses its engagement on labour condition in the textile industry (Omni online, 2014).

- *A policy based on increasing long-term shareholder value by focusing on improving ESG ratings*

Institutional investors can also focus on increasing long-term returns by using engagement to improve ESG ratings and therefore corporate performance in the long run.

Most institutional investors in the Netherlands have a policy regarding responsible investment; 100% of the 50 largest pension funds and 76% of the 30 largest insurance companies (VBDO, 2013a; 2013b). In these policies most institutional investors rely on international guidelines such as the UN Global Compact, PRI and OECD guidelines. In general the international guidelines are used as the standard for the engagement policies.

3.2 WHICH GUIDELINES ARE AVAILABLE FOR ENGAGEMENT?

EUMEDION BEST PRACTICES

Eumedion (2011) identified in its report ten best practices for their participants for engaged share ownership.

Eumedion participants should:

- Monitor their Dutch investee companies.
- Have clear policies with regard to the exercise of their shareholders' rights, which may include entering into dialogue with Dutch investee companies and other engagement activities.
- Have clear policies for dealing with situations in which it does not prove possible to convince the board of the Dutch investee company of their stances and differences of opinion between the board of the investee company in question and the shareholders remain unsolved.
- Be willing to deal collectively with other Eumedion participants and other investors where appropriate.
- Take steps to mitigate conflicts of interest arising from the different roles an institutional investor can have.
- Have a clear policy on voting and publicly disclose this policy.
- Cast informed votes on all the shares they hold in Dutch companies at the general meeting of these investee companies.
- Publicly disclose at least once in a quarter how they voted the shares in Dutch investee companies.
- Take aspects relating to environmental and social policy and to governance into account in their policies on the exercise of their shareholder rights, which may include entering into dialogue with listed companies and other engagement activities.
- Not borrow shares solely for the purpose of exercising voting rights on these shares.

UK STEWARDSHIP CODE

The UK Stewardship Code aims to “enhance the quality of engagement between asset managers and companies to help improve long-term risk-adjusted returns to shareholders.” This code also provides some guidance that may be useful to institutional investors to protect the value and the level of engagement. Therefore, it sets out a number of areas of good practice to which the Financial Reporting Council (FRI) believes institutional investors should aspire on (FRI, 2014). The Stewardship code aims to promote “the long-term success of companies in such a way that the ultimate providers of capital also prosper” because effective stewardship will benefit companies, investors and the economy as a whole. (FRI, 2014)

The seven principles of the code are as follows. Institutional investors should:

- Publicly disclose their policy on how they will discharge their stewardship responsibilities.
- Have a robust policy on managing conflicts of interest in relation to stewardship and this policy should be publicly disclosed.
- Monitor their investee companies.
- Establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value.
- Be willing to act collectively with other investors where appropriate.
- Have a clear policy on voting and disclosure of voting activity.
- Report periodically on their stewardship and voting activities.

PRINCIPLES FROM EFAMA

Another code providing guidelines for institutional investors is the code from the European Fund and Asset Management Association (EFAMA). In this code several principles for the exercise of ownership rights in companies are identified (EFAMA, 2011):

Principle 1: the investment management company should have a documented policy available to the public on whether, and if so how, they exercise their ownership responsibilities.

Principle 2: the investment management company should monitor their investee companies.

Principle 3: the investment management company should establish clear guidelines on when and how they will intervene with investee companies to protect and enhance value.

Principle 4: the investment management company should consider cooperating with other investors, where appropriate, having due regard to applicable rules on acting in concert.

Principle 5: the investment management company should exercise their voting rights in a considered way.

Principle 6: the investment management company should report on their exercise of ownership rights and voting activities and have a policy on external governance disclosure.

PHASES OF ENGAGEMENT

Eurosif identifies several phases of the engagement process (figure 4).

Phase 1:
Define engagement policy; Communicate stewardship expectations.

Phase 2:
Monitor portfolio companies; Identify risks and opportunities; Select targets.

Phase 3:
Decide on achievable objectives and success criteria; Initiate engagement.

Phase 4:
Evaluate outcome of first engagement; Assess the need for escalation.

Phase 5:
Measure impact/ value creation; Communicate outcome to beneficiaries.

Figure 4: ***the different phases of engagement*** (Eurosif, 2013).

These phases will be explained in more detail below:

Define: The first phase of the engagement process thus concerns the establishment of an engagement policy, including purpose and aim, and the communication of this policy to companies and beneficiaries. This phase can be characterized as involving both internal and external resources, and is periodical in the sense that policy and expectations should be reassessed regularly (for example annually) (Eurosif, 2013 p. 26).

Monitor: The second phase of the engagement process focuses on the monitoring of the portfolio for potential targets for engagement, and analysing the identified companies. This phase can be characterized as involving mainly internal resources, and is continuous in the sense that monitoring is an on-going effort (Eurosif, 2013 p. 29).

Prepare: The third phase of the engagement process is about setting success criteria and milestones for engagement and selecting the method(s) for engagement. Several instruments can be used while implementing engagement:

- Sending letters/questionnaires to a company
- Meeting with representatives of the engaged company
- Asking questions at shareholder meetings

A central question in this phase is whether co-operation is sought with other investors. This can for example be done through initiatives such as the PRI clearing house, national platforms (such as Eumedion or Hermes) or on an informal basis (Eurosif, 2013 p. 34). In this phase the dialogue with the company is initiated. This can take the form of attending meetings, having informal conversations, sending e-mails and sending questionnaires.

Evaluate: The fifth phase of the engagement process is the time for investors to react to the company's response from the engagement. In the event the first engagement effort is successful, this can be a short phase, consisting of reconciling the outcome with initial aims. This can lead to further engagement (escalation) either in collaboration with other investors or not. It is in this phase that the connection with the exclusion policy, ESG integration or voting policies can be made. It can for example lead to shareholder proposals to the company, or ultimately to exclusion of the company from the investment universe (Eurosif, 2013 p. 36-37).

Communicate: The sixth and final phase of the engagement process involves measuring outcomes against the success criteria set, communicating the results, and learning from the experience for future engagements (Eurosif, 2013 p. 39).

One important drawback of this scheme is that there is no 'Implementation' phase added in this model that focuses on the actual engagement process. And it is precisely this phase that is important for finding out how engagement is perceived by the company that is engaged.

3.3 SCIENTIFIC THEORY ON THE EFFECTIVENESS OF ENGAGEMENT

SHAREHOLDER SALIENCE

To review the impact of engagement it is important to distinguish the different factors that determine if the engager has salience. In a research performed by Gifford (2010) on shareholder engagement in the UK the theory of stakeholder salience is translated to engagement by institutional investors. Gifford used the different components 'power', 'legitimacy' and 'urgency' in translated form to be applicable for shareholder engagement. An adapted overview of the results is shown in Figure 5:

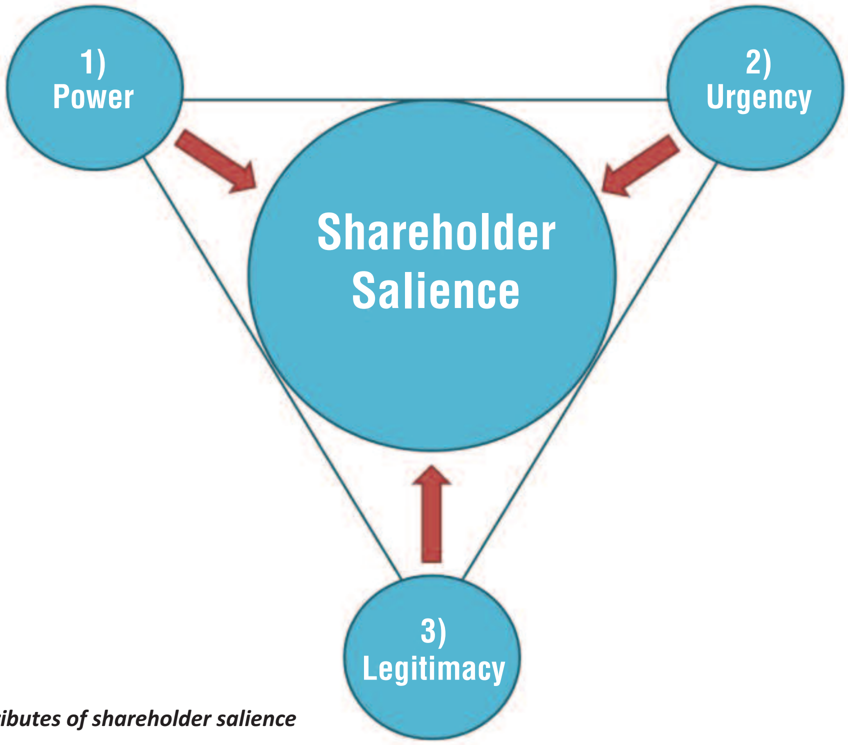

Figure 5: ***Attributes of shareholder salience***

Power

Power is categorised into coercive power (through the use of formal shareholder governance powers), *utilitarian power* (the power to reward or punish through financial means) and *normative power* (expressed through actions that affect a target company's reputation). The key sources of this power relevant to shareholder engagement are:

Coercive:

- Use of formal shareholder rights through resolutions.
- Replacement of directors or CEOs.
- Legal proceedings to enforce shareholder rights.
- Successful lobbying for regulation.

Utilitarian:

- Provision or withdrawal of capital or other resources from companies (investment, divestment).

Normative:

- Public or private statements, shareholder resolutions or other activities that affect the company's or individual managers' reputations. (Gifford, 2010)

Legitimacy

Legitimacy is divided into individual legitimacy (relating to the credibility of the engagement practitioners meeting with the target companies on behalf of the shareholder) *organisational legitimacy* (driven by the credibility of the shareholder organisation in the market) *societal legitimacy* (based on the legitimacy of the issue in the eyes of the community) and *pragmatic legitimacy* (focusing on the legitimacy of the shareholder's argument from the perspective of the company).

Put together, these four sources of legitimacy provide a complete and appropriate sub-categorisation of legitimacy within the shareholder engagement context. Proposed sources of legitimacy that may contribute towards shareholder salience are:

Individual:

- Credibility, expertise, experience and status of the individuals engaging with the company.

Organisational:

- Legitimate claim on the company (e.g. large shareholding, high-risk stake).
- Alignment between shareholders' interests and those of the company (shareholder has the best interests of the company at heart).
- Perception that the shareholder organisation is a credible and respected member of the investment community.
- Consistency of messaging from different parts of the shareholder organisation.

Societal:

- The shareholder embodies or reflects a position widely accepted in society.
- Existence of norms or codes of conduct.
- Supportive political and policy environment.

Pragmatic:

- The shareholder has a strong argument for why the proposed action is in the interests of the company.
- The shareholder provides new information to the company.

Urgency

Urgency represents the 'degree to which a shareholder claims to call for immediate attention.' Stated is that urgency exists only when a relationship or claim is of a time-sensitive nature and when that relationship or claim is important or critical to the shareholder. The sources of shareholder urgency that can contribute to shareholder salience are:

Time-sensitivity:

- Shareholder resolutions at AGMs.
- Benchmarks with deadlines for response.
- Use of other forms of deadline to create time pressure.

Criticality:

- Assertiveness of tone.
- Persistence.
- Willingness to apply resources.

Relevance for corporate bondholders

The research of Gifford focuses specifically on shareholders. We will now discuss if and how the three attributes of shareholder salience are applicable to corporate bondholders.

Power is the attribute that plays out differently for shareholders and corporate bondholders. Corporate bondholders do not have the formal rights that shareholders have, though corporate bondholders are more able to provide capital to or withdraw capital from a company, as corporate bonds mature and new corporate bonds are introduced, while shares are fixed provisions of capital that can only be withdrawn when the company buys back its own shares.

Legitimacy seems to be applicable to shareholders as well as corporate bondholders as this is mainly focused on the expertise of the investor instead of the (different) rights associated with corporate bonds and shares. Urgency can also be applied to corporate bondholders as well as shareholders, except when time-sensitivity of engagement is related to proposals for the AGM where corporate bondholders do not have any formal rights.

4 RESULTS: WHICH COMPANY TO ENGAGE?

4.1 FOCUS EFFORTS ON COMPANIES WITH A HIGH ESG-SCORE

Eurosif (2013) identifies a low ESG score as an important factor in determining whether a company will be engaged: *Companies within the portfolio that exhibit very low ESG absolute or relative scores or the lowest ranked will be selected for further analysis, which may lead to engagement* (Eurosif, 2013).

Having a lower ESG score can indeed be a logical criterion to start engagement. It seems, however, that it is important to look into the reason why the ESG scores are low.

One point brought forward in the literature is that a low ESG score is also the indicator of a company that is not open to society. Therefore these companies and the board specifically, are not able to not welcome ideas from shareholders or other stakeholders. This was also discussed in an article of David et al. (2007) that proves a causal relationship between the number of proposals on the agenda of shareholder meetings and the willingness of corporate management to address the concerns of shareholders. Although difficult to prove quantitatively, this was also something that came forward in the interviews, with the companies with a low ESG score being less susceptible to sustainability themes. Therefore, when using ESG scores, the openness of a company should also be taken into account when selecting engagement cases where institutional investors can be successful.

4.2 ENGAGING LARGE VERSUS SMALL FIRMS

Bauer et al. performed a study looking at the global corporate engagement activities of a large UK-based asset manager from 2006 to 2011. Several findings were identified related to engagement and its effectiveness:

- Larger and more visible firms are maybe more responsive towards shareholder engagement.
- Larger and more visible firms are simply more often included in the institutional clients' portfolios, and hence also more likely to be frequently targeted.
- Firm size is an important driver of the engagement intensity, especially in the UK and the US. This effect is less pronounced in Continental Europe and all other countries.
- Firm size increases the success ratios of social and environmental engagements but not for corporate governance engagements (Bauer et al., 2013).

4.3 USE YOUR HOME ADVANTAGE

Eurosif (2013) identifies that a company will be engaged sooner when it is located in the local market: *Engaging primarily on the local/domestic market is common in the beginning of implementing an engagement strategy. This is also a convenient place to start, since domestic holdings tend to be a dominant part of the portfolio, the asset manager is more familiar with the market specificities, and there are no language barriers* (Eurosif, 2013).

One thing that the respondents pointed out is that it indeed makes a difference if the engaged company knows the investor. Therefore it is an advantage when companies in the same country or region are engaged or when co-operation is sought with an investor who is well known, being it to the size or to the location, to the company. This was also brought forward by Driscoll and Starik (2004) who identify 'proximity' as an additional attribute of salience, focusing on the proximity of the actors from a network point of view.

It also helps when the engager understands or is aligned with its corporate governance culture. Several companies stated that it helps to know the context and corporate governance culture so that engagement can be more effective. Habits regarding engagement processes can vary per country or region, and the interviewees gave a few examples of differences they noticed:

"Sometimes engagement questions are very adapted to the context of a specific country and do not take another cultural context into account."

"There is a big difference between continental and American investors. On the continent it is much more critical, for example the bonus policy. Especially for Dutch investors this topic and sustainability in general are seen as an important commitment. Then comes the rest of the continent and the UK and only after that the U.S."

"Negotiating is better regarding Dutch companies; the use of power can be more effective regarding companies from the US."

According to Bauer et al. relative to firms originating from the UK, firms from the U.S. and Continental Europe have significantly more successful engagement (Bauer et al., 2013 p. 5). Also the geographic location of priority firms is an important determinant of engagement success (Bauer et al., 2013 p. 35).

4.4 LARGE HOLDINGS NO MAJOR FACTOR FOR INFLUENCING THE TYPE AND EFFECTIVENESS OF ENGAGEMENT

Eurosif (2013) identifies that many asset managers choose to focus their engagement on the largest holding in their portfolio. This brings forward the question if it matters how much is invested and if the investments are in corporate bonds or shares.

Interviewees stated that all investors, disregarding their size or type, are welcome for engagement. In general the size of the investment is also not seen as a major influence regarding the type and effectiveness of engagement. However, the size of investments can matter when direct access to the board is sought, instead of access through the investor relations department. And a lot of interviewees also stated that no distinction is made between the shareholders, though the power of a shareholder is indirectly still of importance, as can be seen in the following quotes:

"When it is an important shareholder more effort is put into it, we cannot put the same effort in every questionnaire."

"We respond to everybody. But of course you sometimes have to listen if a shareholder for example holds 20% of the company."

4.5 ENGAGEMENT BEFORE POSSIBLE INCLUSION IN THE INVESTMENT PORTFOLIO

Several institutional investors screen companies before they include them in their investment universe. There are also several sustainability indices such as the Dow Jones sustainability index.

Engagement with these companies can take place when inclusion is likely and/or when improvements still have to be made. It is important to add that in this situation, though engagement takes place, the engaging institutional investors still do not own any shares or corporate bonds . In research by Oekom (2013) 87.9% of the surveyed companies stated that inclusion in such an index or portfolio was seen by them as very important.

5 RESULTS: WHICH TOPICS TO PICK FOR ENGAGEMENT?

5.1 MAKE ENGAGEMENT MORE SECTOR AND MARKET SPECIFIC

Interviewees mentioned that specific knowledge of investors on their sector is sometimes limited:

"When engagement takes place the person engaging should have enough knowledge of the sector and the topics and also has to listen to the company."

The advice companies give to investors is to focus on specific issues and sectors so that knowledge of these topics is solid and can be increased, and investors can make comparisons with other companies. They also advise investors to choose such a focus on a specific sector or theme for a time period of several years.

"I recommend to make engagement requests sector specific; more sector specific engagement will result in deeper engagement conversations."

"It might help if engagement questions were on only one sector, or that each year another sector would be in the spotlights. Then questionnaires could, for example, be more to the point, and slightly less within a certain standard framework."

5.2 FOCUS ON TOPICS WITH MATERIALITY

Interviewees stated that they especially value engagement when it makes a good business case and when it is material, thus being the identification of new opportunities as well as identifying risks. This makes this criterion valuable for picking engagement cases, especially when combined with a specific sector or theme on which the investor can develop specific knowledge. In that way both the company and the investor are benefiting and investors appreciate engagement more:

"Institutional investors do not need to put a lot of pressure on us like some NGOs do; they are fairly reasonable because they want a win-win situation and want the company to thrive."

5.3 ENGAGEMENT ON AD HOC CONTROVERSIES

Interviewees stated that when the media report on a certain topic they see an increase in the questions asked on this topic by institutional investors. But is this also more effective? It is at odds with the focus on specific issues, especially when an investor informs itself on the topic based on public sources only. Interviewees stated that engagement solely based on media reports does not provide them with new insights or stimulate them in changing their policies:

"Media is mostly very superficial; they put forward a lot of very general information."

"There are a lot of reports and media. We would like to see less use of media reports by investors in engagement and more use of research reports that are confirmed by us as a company."

Also Vandekerckhove et al. (2007) state that although ad hoc controversies can be a starting point for engagement, it is important to quickly move beyond the ad hoc controversy towards a conversation on policy formulation and implementation.

Having said that, it might be that when focusing on ad hoc controversies, the combination of pressure from media, NGOs and the engagement of institutional investors provide more leverage than the engagement of institutional investors alone. There were however insufficient data to provide evidence for this assumption.

5.4 FOCUS ON TOPICS IN LINE WITH CORPORATE POLICY

A few interviewees stated that it is highly unlikely that a company will take over an issue that runs contrary to its corporate policies or business model:

“An investor can in engagement exert more influence on operational themes within engagement than on strategic ones.”

“This is our business model, so when the agenda of the investor is not in line with the agenda of our company you have no chance. You cannot change the core business model of our firm with engagement.”

For example, demanding a stop of exploitation of tar sands would run contrary to the core corporate strategy of an oil company. That also means that picking this topic and company is unlikely to be successful. However, if the question is focused on a more operational level, for example on how the specific company could diminish the environmental and social impact of this exploitation, it might have a better chance. Summarised, engagement focused on changing the business model or core corporate policy is less likely to be successful than engagement focused on changing the way the business is run. If the investor is fundamentally opposed to the business model and/or core corporate policy, exclusion of the company would be a more logical step than engagement.

Nevertheless, it is not impossible to change corporate policy. But only when there is well-founded evidence to convince them, a change of corporate policies is justified.

"We are willing to change our policy if we find the engagement question well founded. You sometimes have to recognize your responsibility, even if you are a small pivot in a supply chain. You have to contribute to society as a company. "

6 RESULTS: HOW TO PRACTICE ENGAGEMENT?

6.1 PREPARING THE ENGAGEMENT

QUALITY AND PREPARING ENGAGEMENT

It was brought forward by the interviewees that several engagement cases are too general because of the wide range of companies and issues on which institutional investors focus. This can result in questions of too low quality, of which the following quote is an example:

“General engagement questions are of low quality, because some questions have nothing to do with us.”

“I want parties to do good research, they mostly do it rudimentary. Some do not even look at our press releases. They just read their normal newspaper and use that as the basis to respond on, they rarely visit our website.”

The interviewees brought forward that questions or requests of a low quality were answered, but that they were not seriously considered or communicated to the board. In general the quality of engagement should be raised, according to the interviewees and also according to a report of ICSA (2012).

WHO TO TARGET: BOARD, INVESTOR RELATIONS OR THE SUSTAINABILITY DEPARTMENT

When preparing the engagement it is important to ask the question if it is necessary that the topic reaches the board. In specific cases, such as questions or requests on operational issues, there is no immediate need to. With themes related to the core strategy or business model of the company it can be important to bring the message across effectively. If so, it is crucial to prepare the engagement accordingly and then it might help when significant holdings are backing the engagement (collaborative engagement can be useful to accomplish that).

It also helps when senior representatives bring the message to the company or when the issue is also brought forward at the annual shareholder meeting. The interviewees confirmed that the seniority and the power of the investor play a role in the communication towards higher management. Furthermore, they noted that the management is mostly not informed with the exact details but only with the highlights:

“We have an overview of the main questionnaires we answered, but we do not usually use that info internally. Some of the results of the evaluations and some key points are noted, but not in a systematic way towards de management. They know we are answering engagement requests, but not the exact details.”

"Some lines to management are short, some longer. It also depends on the topic and its importance. Also, it is important who has deposited the engagement question. We link certain themes (such as remuneration) back to the management but little things are handled by local management."

Most engagement requests are initially targeted on the investor relations departments. This can be a logical entrance, although for several topics colleagues from other departments need to be called in. It is in any case important to consider if the counterparts have the authority to agree on the demands, or have the salience to be in direct contact with the decision maker.

A number of interviewees brought forward that engagement on ESG issues is sometimes disconnected from engagement on financial issues. Or in other words; the company is engaged on financial issues and ESG issues by separate departments of the same institutional investor. Companies bring forward that an integration of the engagement on financial and ESG performance will strengthen engagement.

"I think it is best to create a team where both sustainability aspects and financial aspects are integrated. However, that can be tricky as it sometimes creates a mismatch because the sustainability specialist knows nothing about finance and vice versa. Besides that they often have a very different focus and ambition."

6.2 WAYS TO ENGAGE

CO-OPERATION

An important question to address is whether co-operation with other investors improves the effectiveness of engagement. Co-operation can be a useful tool to share knowledge, share resources and represent a larger number of shares towards the company.

The interviewees also indicated the importance of co-operation:

"We generally experience collaborative engagement as pleasant. By exchanging more views you get to a collaboration that is stronger and more constructive. "

“Engagement would be more effective if there was a European initiative; as a big super tank company you need something a bit more substantial.”

“Sometimes it can also help investors to work together in a coalition; that increases your chance of success.”

So co-operation can be useful. However, co-operation can also be time-consuming when preferences of a diverse group of investors have to be accommodated. Therefore it is recommended to co-operate with investors:

- With whom a working relation is already established
- With whom goals and views are shared
- With whom information and research can be shared
- Whose number is not too high to facilitate an effective co-operation

THE USE OF SPECIALISED FIRMS TO PREPARE AND IMPLEMENT ENGAGEMENT

Engagement can be time-consuming, especially for smaller institutional investors. Therefore several Dutch institutional investors make use of specialised engagement service providers. Interviewees see these firms as knowledgeable and stated that the engagement with them is of high quality. Some interviewees, however, stated that they prefer to have contact with the actual investors instead of through a specialised engagement firm. One reason is that through this proxy it is not clear for a company whether the topics are indeed on the agenda of a specific investor or only at the agenda of the engagement service provider. Therefore it can be recommended that the actual conversation and contacts are held by the institutional investor, and facilitated with the expertise of the engagement service providers, instead of fully executed by the engagement service providers.

6.3 FORMS AND INSTRUMENTS FOR IMPLEMENTING THE ENGAGEMENT

Engagement can take several forms: from sending letters to having dialogues. In general interviewees have a preference for direct dialogue, possibly preceded by a letter, and it is preferable that the questions for such a meeting are sent beforehand.

"For us a real conversation is best to see through nuances and fully understand each other. That is a better way to engage than by written communication. The limitation of conversations however, is that you cannot speak to everyone due to time constraints."

Regarding questionnaires interviewees stated that they receive yearly several questionnaires from ESG service providers and as a preparation for engagement. The views on these questionnaires differ. Some companies stated that too many questionnaires are sent, that these questionnaires are not specific enough for their company and that a large number of questions can be answered by using the annual report. Other institutional investors stated that the number of questionnaires and the quality is fine.

What companies recommend is that ESG Service providers or institutional investors should join their questionnaires or share their information and by doing so reduce the workload.

TONE OF VOICE: FOCUS ON ALIGNMENT OF INTEREST

Interviewees stated that it is positive that the interests of investors and companies are aligned, which makes the engagement constructive:

"Institutional investors do not need to put a lot of pressure on us like some NGOs; they are fairly reasonable because they want a win-win situation."

Therefore it is recommended to choose topics and tone of voices that emphasise the joint interest of the investor and the company.

DURATION OF THE ENGAGEMENT

Interviewees all prefer long-term contact over a single contact. They stated that a certain level of trust can be established and that the engager can be more familiar and knowledgeable on the company and the sector. This improves the contact and increases the quality and usefulness of engagement for the company.
"A long-term relationship between an institutional investor and a company is needed for better engagement; we miss them when they do not come back."

"The dialogue definitely becomes better when engagement is taking place regularly; it also makes it easier to understand the business and that improves the quality of the dialogue."

Also Bauer et al. (2013) confirms that a successful corporate engagement by institutional investors heavily depends on the relationship that the institution has established with the target firm in the past: continuous engagement and long-term relationship building leads to milestones and drives engagement (Bauer et al., 2013 p. 4/ 36).

7 RESULTS: FOLLOW-UP AFTER THE ENGAGEMENT

7.1 MEASURE AND EVALUATE THE ENGAGEMENT PROCES

It is important that an evaluation is carried out to assess why an engagement was or was not successful. The outcome of engagement is however hard to measure. During the interviews it became clear that when changes occur, there could be a myriad of reasons why engagement is effective.

Although it is not common practice among institutional investors, it is important to evaluate engagement and to improve engagement practices. It is recommended to evaluate with a select number of companies in a meeting or teleconference on how they have perceived engagement and which follow-up they have undertaken due to the engagement.

Questions that can be addressed are:

- o Why did you / did you not take over the demands?
- o Are these reasons internally or externally driven?
- o Has this engagement provided the company with new information or insights?
    - If so; which ones?
- o Are the demands communicated to the decision makers, high-level management or the board?
    - If so, why? / If not, why not?
- o How much time and effort did you invest in responding to these requests?

7.2 REACTING ON THE RESULTS OF ENGAGEMENT

When engagement has been effective it can be logical to congratulate the company with this step and to inform consumers or participants on the positive steps made, strengthening the support for engagement as well as nudging the company involved to make more positive steps in the future.

When engagement has failed, several options can be taken:

- o The company can be excluded from the portfolio
- o Voting policies can be changed accordingly
- o A new engagement process can be started. Depending on the reason for failure it may be preferable to do this in co-operation with other institutional investors.
- o Publicity can be given to the failure of engagement.

7.3 ENGAGEMENT IN RELATION TO OTHER RI INSTRUMENTS

To react to the results of engagement, but also in the preparation, it is important to link engagement with other methods of responsible policy. In Figure 6 Eurosif shows how often other instruments of responsible investment are linked to the policy and implementation of engagement.

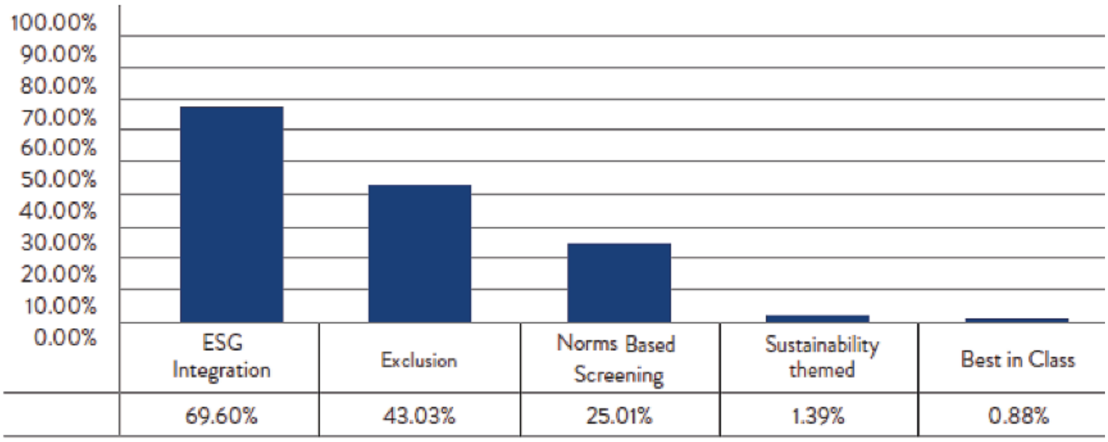

Figure 6: ***Engagement combined with ESGmethods*** (Eurosif, 2013)

There are several advantages of linking engagement to other methods of responsible investment. According to Bauer et al. firms are significantly more likely to honour engagement of any kind as firms receive both shareholder proposals and are engaged by the institutional investor at the same time (Bauer et al., 2013 p. 3).

Mackenzie et al. performed a study that investigates the impact of a responsible investment index on environmental management practices. The study suggests that engagement via a responsible investment index reinforced by the threat of public expulsion from the index provides an effective route for large-scale collaborative investor engagement on corporate social responsibility issues targeting large and internationally diverse firms (Mackenzie et al., 2013). Firms subject to engagement by index were more likely to meet environmental management criteria introduced in 2002, according to Mackenzie et al.

8 CONCLUSIONS AND RECOMMENDATIONS

8.1 ENGAGEMENT TODAY

Engagement as an instrument of responsible investment is rapidly growing in the Netherlands, but also in Europe and the rest of the world.

Not only the way in which the contact takes place, but also the engagement policy, the way in which the engagement cases are selected, prepared, and monitored, and the way engagement is evaluated are critical parts of the engagement process. This process is handled in very different ways by different types of institutional investors. Some investors handle it themselves, others outsource it. Some practice engagement on material ESG issues, and some practice engagement to diminish reputation risks. There are still little practical guidelines on how engagement should be practiced to be most effective.

8.2 HOW IS ENGAGEMENT PERCEIVED BY COMPANIES?

Most companies see engagement as making a positive contribution and that the intensity of engagement is increasing. Several examples were brought forward where companies showed that they had made policy changes due to engagement or that they had received new information and insights on ESG-related topics. But maybe even more important is that engagement is used by companies for gaining a better understanding of the ESG issues that are relevant, material and on the societal agenda.

However, companies do not see all forms of engagement as positive or constructive. They consider that some forms are too superficial, a way to inform the investors rather than the other way around. By and large, several suggestions can be made towards investors to ensure that engagement can provide a more positive contribution and nudge the company to improve its CSR policies. In general, four main topics were brought forward by the interviewees:

- The quality of the engagement and preparation is more important than the quantity of engagement cases.
- It brings forward issues which are in line with or strengthen the strategy of a company.
- A long-term relation, a sense of trust and a sense dialogue are established.
- The engagement process is evaluated both in the end and periodically, and adapted when necessary.

These general issues have been processed into a set of recommendations for institutional investors set out in the upcoming paragraphs, which can be used in the different phases of engagement.

8.3 IS ENGAGEMENT EFFECTIVE?

The question whether engagement is effective or not is always difficult to answer for an engager. When a company makes a policy change it may be unclear if these changes are made due to the engagement, preferences of the management, pressure by NGOs, or that the policies were already planned to be changed. Combined with the fact that engagement largely takes place behind closed doors, there is little statistical data to analyse when engagement is actually effective. There is, however, a scientific theory on the effectiveness (and specifically the salience of shareholders) which states that an investor will be more effective when he improves three attributes:

- **Power:** The shareholder has direct influence due to the size of its investments and is able to use the rights associated with its shares.

- **Legitimacy:** The engager is seen by the company as legitimate, bringing a legitimate demand across and is seen as knowledgeable and well informed.
- **Urgency:** The demand is seen as relevant, pressing and timely.

However, in the interviews also other factors came forward as being relevant for the effectiveness of engagement:

- **Quality of the engagement:** how engagement is prepared and implemented.
- **Relationship:** the duration of the engagement, tone-of-voice, proximity and similar corporate governance culture.
- **The engaged company:** How open is the company towards investors (and other stakeholders) and the position of management towards ESG-issues

8.4 RECOMMENDATIONS

The research and results from the interviews have led to the following recommendation for institutional investors on how to practice engagement.

WHICH COMPANY TO ENGAGE?

Focus efforts on companies with a high esg-score

The interviews have shown that companies with a low ESG score are on average less open towards engagement requests. When engaging with a company with a low ESG score it might therefore be useful to investigate whether this company will be open and benevolent towards engagement.

Use your home advantage

One point put forward by the interviewees was that it makes a difference if the engaged company knows an investor. Therefore it is an advantage when companies in the same country or region are engaged or when co-operation is sought with an investor who is well known to the company.

It can also be beneficial when the engager understands (or is aligned with) the corporate governance culture of the company. Several companies stated that it helps to know the context and corporate governance culture so that engagement can be more effective.

Large holdings no major factor for influencing the type and effectiveness of engagement

Interviewees stated that all investors, disregarding their size or type, are welcome for engagement. In general, the size of the investment is not seen as a major factor influencing the type and effectiveness of engagement. The exception to this is when direct access to the board is sought.

WHICH TOPICS TO PICK FOR ENGAGEMENT?

Make engagement more sector and market specific

According to most of the interviewees it would be more effective to make engagement questions sector and/or market specific. Companies now often receive general questions that do not apply to their specific market or sector, and therefore are not effective.

Focus on topics with materiality

A number of interviewees brought forward that sometimes engagement on ESG issues is disconnected from engagement on financial issues. They bring forward that an integration of financial and ESG performance and a focus on materiality will strengthen the engagement. They also noticed that engagement on financial is disconnected from ESG factors and that companies are sometimes engaged by two separate departments of the same institutional investor.

Engagement on ad hoc controversies not the right way to foster the effectiveness
Interviewees stated that when the media report on a certain topic they see an increase in the questions asked on this topic by institutional investors. The question that rises is if this is also more effective. Most interviewees stated that they do not gain any new insights due to media hypes and therefore they are rarely triggered to change their policy. Furthermore, basing engagement requests on media is at odds with trying to stay focused on specific themes to improve the quality of engagement.

Focus on topics in line with the corporate policy
Focus on issues that are not at odds with the strategic policies of a corporation. If this is nevertheless the case, focus on operational changes instead of expecting to change strategic policies.

HOW TO PRACTICE ENGAGEMENT?

Preparing the engagement

- *Quality is more important than quantity*

It was brought forward by interviewees that it could be useful to put more focus on engagement. Since resources for engagement may be limited, it could be wise to focus engagement more on increasing the quality of engagement than on the quantity of engagement cases.

- *Know when it is necessary to reach the board*

In the preparation of the engagement it is important to ask the question whether it is necessary that the topic reaches the board. If so, it is important to prepare the engagement accordingly. In this case it helps when significant holdings are backing the engagement, so co-operation may be important. It also helps when senior representatives pass on the message to the company or when the issue is also brought forward at the annual shareholder meeting.

Most engagement processes are initially targeted on the investor relations departments. This can be a logical entrance, although for several topics colleagues from different departments need to be called in. It is in any case important to consider if the counterparts have the authority to agree on the demands, or have the salience to be in direct contact with the decision maker.

Ways to engage

- *Co-operate when necessary*

An important question to address in the preparation of engagement is whether co-operation with other investors should be sought. Co-operation can be a useful tool to share knowledge, share resources and represent a larger number of shares towards the company. However, co-operation can be time-consuming when preferences of a diverse group of investors have to be accommodated. Therefore it is recommended to co-operate with investors:

  - With whom a working relation is already established
  - With whom goals and views are shared
  - With whom information and research can be shared
  - Whose number is not too high to facilitate an effective co-operation

Forms and instruments for implementing the engagement

- *Focus on direct dialogue*

Engagement can take several forms, from sending letters to having dialogues. In general, interviewees have a preference for direct dialogue, possibly preceded by a letter, and it is preferable that the questions for such a meeting are sent beforehand.

- *Focus on a long-term relationship with a company*

A long-term relationship between investor and company during an engagement process has several advantages: you build a relationship of trust, and at the same time you increase your knowledge. This ensures a higher quality and efficiency of the engagement process.

FOLLOW-UP AFTER THE ENGAGEMENT

Measure and evaluate the engagement process

It is important that an evaluation is carried out, in which the (un)successful outcome of the engagement process is discussed. The outcome of engagement is, however, hard to measure. When changes occur, there could be a myriad of reasons why engagement has been effective.

Reacting on the results of engagement

When engagement has been effective it can be logical to publicly congratulate the company with this step and to inform consumers or participants on the positive steps made. This will strengthen the support for engagement and nudge the company to make more positive steps in the future. When engagement has failed several actions can be taken:

- The company can be excluded from the portfolio
- Voting policies can be changed accordingly
- A new engagement process can be started. Depending on the reason for failure it may be preferable to do this in co-operation with other institutional investors.
- Publicity can be given to the failure of engagement.

- *Be transparent*

Engagement is an important topic to report on towards customers and participants. Engagement is particularly a method that is easy to explain to shareholders and can help to inform them with responsible investment. This increases the transparency, gives legitimacy to engagement activities and can be a positive selling point.

Engagement in relation to other RI instruments

To improve the success of engagement, it is important to investigate how the method is linked to the other responsible investment instruments. For example, the insights gained by practicing ESG integration provide a suitable basis for selecting and preparing engagement cases, and making a connection with exclusion can improve the bargaining power of an investor in engagement. It is recommended to integrate the different RI instruments in the responsible investment policy, as well as in the organisation and implementation of responsible investment.

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APPENDICES

INTERVIEW QUESTIONNAIRE

Topics and questions to be discussed (semi-structured interview)

1. **How many requests for engagement do you receive on SRI issues?**
   a. By which parties;
   b. Nationalities (culture)
   c. On which themes/ topics
   d. Which topics are mainly brought forward by Dutch institutional investors?
2. **How do you prepare for an engagement meeting?**
3. **Which differences do you observe between:**
   a. Engagement of different institutional investors?
   b. The level of preparation of institutional investors?
   c. Engagement of corporate bond holders and shareholders?
   d. Engagement of NGOs and institutional investors?
4. **Which department has the responsibility in preparing and holding the meeting?**
   a. Are there other departments that play a role in the engagement process?
5. **How do you decide on which level and who you ask to participate in the engagement meetings?**
6. **Is there a follow-up after an engagement conversation has taken place?**
7. **How do you inform management on the proposals and demands brought forward in the engagement process?**
   a. How do you know if engagement demands can be met?
8. **Can you give an example of changes in policy due to engagement?**
9. **Can you give examples of unsuccessful engagement? (focus of specific case)**
   a. What was the case about?
   b. What went wrong?
   c. Did you also have successful engagement with this institutional investor?
10. **What are the reasons why the management does or does not take over actions proposed by institutional investors?**
   a. Power?
      i. What is the effect of the number of stocks owned?
      ii. Connection to voting policies/ filing a proposal?
      iii. Is divesting an option?
      iv. Is making a media statement on the topic an option?
   b. Urgency?
      i. Was the topic time-sensitive?
      ii. How critical was it, that the topic had been addressed soon?

      iii. Was it a topic on a strategic level, tactical level or operational level?
      iv. What effect did it have that the topic was or was not receiving attention in society/ the media?
      v. What effect did it have that the topic was an urgent topic for certain actors?
   c. Legitimacy?
      i. How did you rate your level of expertise on the topic in comparison with your counterparts?
      ii. How long have the investors had contact with you in the engagement process?
      iii. Who (junior, senior) did you send to the meetings?
      iv. How was their position in engagement in line with the views of other investors or the public in general?
      v. Did they have a strong business case?
      vi. Did they have a strong societal case?
      vii. Is there a supportive political environment?
   d. Other?

11. **Do you see differences between investors practicing SRI in relation to the country in which they are based?**

12. **Do you see differences and/or similarities between engagement campaigns and other campaigns (media, NGOs, labor unions) with the goals to change your corporate policies?**

13. **Which development and trends do you see in socially responsible investment and engagement in particular?**

14. **How can engagement be more efficient and successful according to you? (what could have helped to make the failed engagement conversations more successful/ which factors made the engagement case successful?)**

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