Collective impact through collaborative engagement

2° Investing Initiative

About

The 2° Investing Initiative (2DII) is an international, non-profit think tank working to align financial markets and regulations with the Paris Agreement goals.

2DII coordinates some of the world's largest research projects on climate metrics in financial markets. In order to ensure our independence and the intellectual integrity of our work, we have a multi-stakeholder governance and funding structure, with representatives from a diverse array of financial institutions, regulators, policymakers, universities and NGOs.

Author of this report:

Dr. Mickaël Mangot

Published in October 2024

FUNDING: This project was funded by the European Union LIFE program under the grant agreement LIFE18IPC/FR/000010 A.F.F.A.P and received co-funding from the Rocky Mountain Institute (RMI).

Introduction

This short briefing is extracted from 2DII's technical report "Collective investor impact in secondary markets" that provides an in-depth analysis of two collective impact mechanisms usable on public (secondary) markets that **would not be as effective if done by single investors (even the largest ones)**: price signaling and engagement.

The results are useful for investors who aim at maximizing their impact potential through collective action as well as for managers of coordination devices (ESG labels, ESG indices, proxy advisors, etc.) to improve their offering.

This practitioner's briefing presents the main ideas of the technical report on collaborative engagement only**.** We encourage the reader to access the main report to get the full narrative and retrieve academic references that support our view and recommendations.

Why discussing collaborative engagement? The ongoing shift of corporate ownership towards large (passive) institutional investors has modified the view in academia around investor stewardship. While scholars used to consider that shareholders were doomed to be rationally apathetic due to a free-rider problem, the rise of "universal owners" fed hope in "systematic stewardship". That hope rapidly turned illusory: observations of the behavior of the largest fund managers (especially the "Big Four") show that their interests do not fully align with the need for "systematic stewardship". Therefore, collaborative engagement of various investors (including fund managers, hedge funds, and asset owners) may constitute the long-searched solution.

Nevertheless, investors that aim to coordinate their engagement efforts should pay **special attention to the forming and organization of coalitions** to increase success odds and decrease the residual free-riding problems (within and outside the coalition).

ESG shareholder engagement as a major (collective) impact mechanism

Engagement and voting are classical forms of "stewardship", the act of protecting an asset owner's interests, and delivering returns and long-term value from the assets. Stewardship is the process of intervention to make sure that the value of the assets is enhanced over time, or at least does not deteriorate through neglect or mismanagement.

Given its focus on preserving and enhancing long-term value on behalf of the asset owner, engagement can encompass the full range of issues that affect the long-term value of a business, including its ESG practices.

Engagement is not restricted to equity owners. If some actions in relation to shareholder rights are, by nature, out of scope for bondholders, others are still operant. Fixed-income stewardship is getting more attention[1] and financial institutions are developing engagement strategies for corporate fixed income and, in a lesser extent, for sovereign debt[2].

Shareholder engagement to generate ESG impact is an approach that has gathered both theoretical and empirical support among academia and practitioners. First, the approach is supported by theoretic models[3] that show that in a competitive world, voice (engagement) is more effective than exit (divestment) in pushing firms to act in a socially responsible manner. Second, empirical evidence points in the direction of a positive effect of engagement actions on ESG issues if specific requirements are met.

[1] Hoepner and Schneider (2022).
[2] Responsible Investor (2022).
[3] Broccardo et al. (2020).

Several empirical studies have analyzed the extent to which companies comply with shareholder engagement requests on ESG issues. They obtain that a significant part, between 18% and 60%, achieves success. However, those high overall success rates hide a heterogeneity across requests. For instance, Barko et al. (2022) show that requests that require some form of costly reorganization have lower success rates compared with requests that entail lower costs. Bauer et al. (2022) observe in their analysis a decrease in CO2e intensity due to environmental engagements while total CO2e emissions remained unaffected highlighting the need for outcome-oriented reporting on ESG-related engagement.

Table: success rates of ESG engagement campaigns

Study	# of requests	Sample period	Success rate	Type of requests
Bauer et al. (2022)	7,415	2007-2020	20%	ESG
Dimson et al. (2021)	1,654	2008-2018	53%	ESG
Barko et al. (2022)	847	2005-2014	60%	ESG
Hoepner et al. (2020)	1,712	2005-2018	31%	ESG
Dyck et al. (2019)	147	2004-2013	33%	ESG
Dimson et al. (2015)	2,152	1999-2009	18%	ESG

Alongside the growing importance of institutional investors in corporate ownership, regulators and professional associations have issued stewardship codes to provide detailed frameworks supporting investor stewardship. Revisions of both the UK Stewardship Code (in 2020) and the EU Shareholder Rights Directive (in 2017) have especially targeted ESG stewardship. In the EU, the revision recognizes that "*greater involvement of shareholders in corporate governance is one of the levers that can help improve the financial and non-financial performance of companies, including as regards environmental, social and governance factors*". The 2020 iteration of the UK's Stewardship Code aims for "*long-term value … leading to sustainable benefits for the economy, environment and society*". And the trend is not stalling as very recent updates have shown. In its "Briefing on EC targeted consultation regarding SFDR Implementation" issued at end 2023, the Platform on Sustainable Finance acknowledges that "*engagement with investee companies is a vital tool for driving the transition of the real economy toward sustainability*". National sustainable finance labels are also pushing for a more transparent and more intense use of ESG shareholder engagement and voting by financial intermediaries. In its 2024 version, the French "Label ISR" (the largest sustainable finance label in Europe in terms of covered AuM) makes the ESG engagement policy (dialogue and voting) with issuers one of its four pillars for labelling.

Against this backdrop, **in recent years, there has been a growing momentum across Europe that effective, outcome-oriented ESG engagement by asset managers and institutional investors should become a common practice**.

The complex case for ESG shareholder engagement

Despite the growing multi-stakeholder momentum on the need for institutional investors to perform credible stewardship, engagement actions have been known for decades to be hindered by **a collective-action problem**.

When there is dispersed ownership, shareholders bear all of the costs of overseeing corporate managers, but enjoy only a sliver of the gains if their oversight leads to performance improvements. As a result, shareholders ignore oversight and leave corporate leaders with a great deal of discretion over how they run their firms, discretion that allows for mismanagement, abuse and neglect of long-term environmental or social issues.

Each individual shareholder rationally opts to rely on other shareholders to perform the monitoring function and bear the associated costs, in the hope that they will themselves nonetheless benefit from their engagement (**free rider problem**).

As a consequence, shareholders, especially small-size shareholders like retail investors, have been characterized as displaying a “**rational apathy**”. The same logic applies, but to a lower extent, to moderate-size blockholders.

A critical question to ask when one assesses the rational incentive for investors to perform costly ESG stewardship is the expected gains they can reap in case of success.

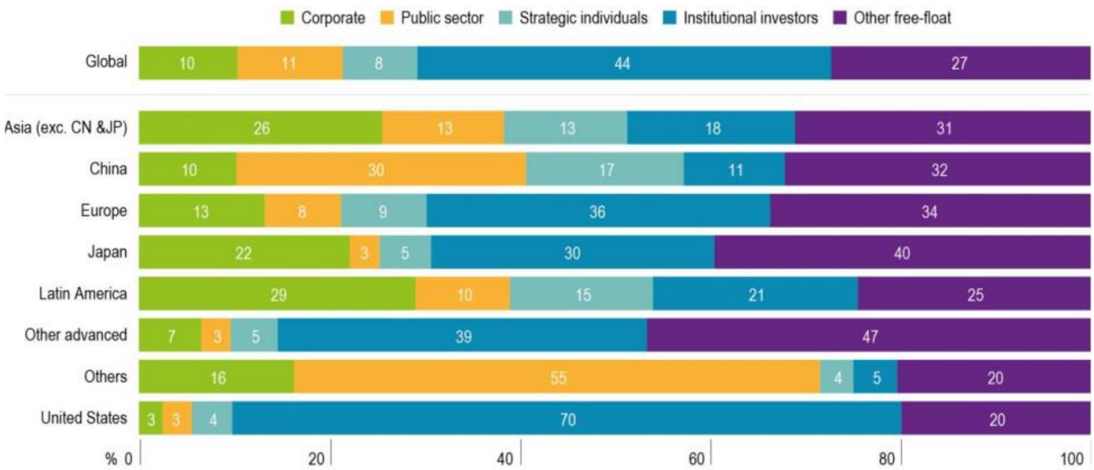
Interestingly, most studies have documented a positive effect on companies’ operating performance and stock prices in case of successful ESG engagements[4]. But the improvement in the engaged company’s valuation is far from being systematic. It especially depends on the type of subjects they are engaged in and the engagement outcome (success or failure)[5].

The (over)promise of universal stewardship

Collaborative engagement by institutional investors might be facilitated by profound changes in the ownership structures of publicly traded corporations in numerous jurisdictions.

First, most countries have experienced an **increasing concentration of share ownership among institutional investors** since the 1980s at the latest. As a consequence, institutional shareholdings are now the dominant form of equity ownership worldwide; according to OECD calculations, institutional investors currently hold 44% of the global market capitalization of listed companies[6], and up to 70% in the US and UK.

Figure: ownership structure of listed companies



Source: OECD (2023)

A second major trend is the **increasing concentration in the asset management industry**, led by the American Big Three (BlackRock, Vanguard, State Street) or Big Four (adding Fidelity). The percentage held by the Big Three and the Big Four in the Euro Stoxx 50 companies amounts to 8.31% and 9.40%, respectively[7].

Finally, a third major movement in corporate ownership has been the **shift from active to passive management** by institutional investors. Morningstar data shows that as of December 31, 2023, 26.7% of total assets under management in Europe were attributable to passive strategies that replicate a benchmark (the

[4] For instance, Barko et al. (2021) and Flammer et al. (2021).
[5] Bauer et al. (2023).
[6] OECD (2023).
[7] Enriques and Strampelli (2024).

universe considered includes open-ended funds and ETFs, while excluding money market funds and funds of funds), a proportion that has doubled over 10 years.

Some of the largest institutional investors or fund managers are often classified as "**too big to be passive**".[8] This view can be supported by several arguments. First, when investors are invested in virtually every firm in the market, they are less concerned with the performance of individual portfolio companies, and more interested in the state of whole economies, if not the world economy. Second, a growing number of long-term institutional investors like pension funds recognized that sustainability (both of their portfolio companies and of society more generally) is a precondition for being able to honor their pension promises which would be due decades into the future. Therefore, assumably they should be more inclined to taking a long-term view of their holdings[9]. And third, stewardship expenses should not be a problem for large asset managers or institutional investors.

All of this provides hope that the large (passive) asset managers on behalf of institutional investors might provide the management oversight that was lacking when retail investors dominated the market.
Following the "**portfolio primacy**" theory, the goal of index funds should not be to maximize the value of individual companies (shareholder primacy) but rather to maximize the value of their entire investment portfolio (portfolio primacy). Large asset managers should behave as "**universal owners**" and conduct a "**systematic stewardship**", addressing systematic risk as opposed to idiosyncratic, firm-level risk.

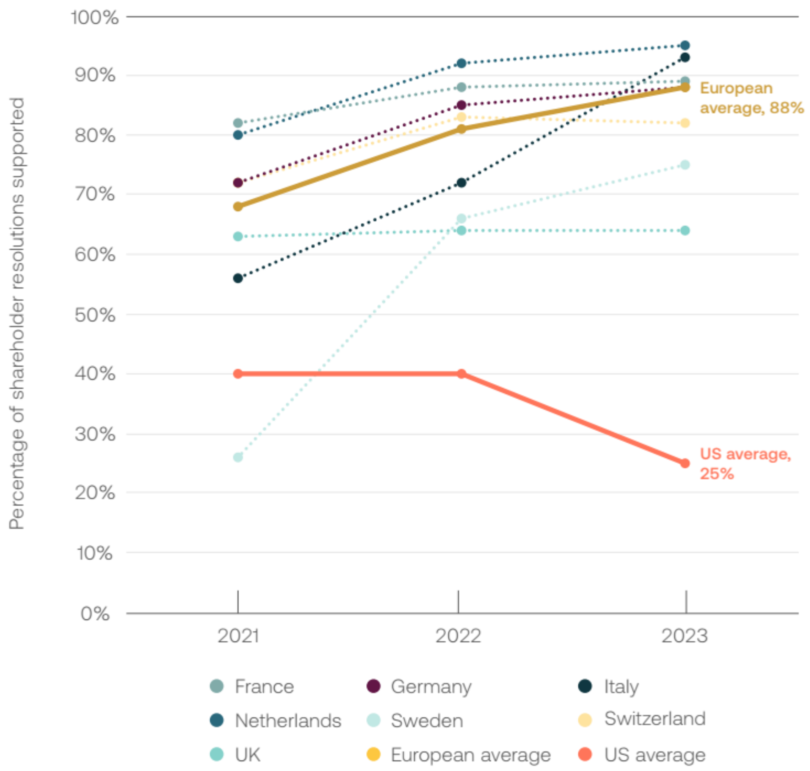
Researchers have thus produced several compelling arguments to suggest that "systematic stewardship" could become a new normal for large and universal institutional investors. Unfortunately, existing evidence fails to support that they have already conducted an overhaul of their engagement practices.

Looking at the voting behavior of institutional investors, one can only provide mixed support for the theory of "portfolio primacy" or "universal stewardship".

For instance, ShareAction recently analysed how 69 of the world's largest asset managers voted on 257 shareholder resolutions aimed at improving companies' impacts on some of the most pressing social and environmental issues.[10] They observed an overall poor support for shareholder resolutions on environmental or social issues and highlighted obvious stewardship deficiencies from major asset managers. Overall support for shareholder resolutions peaked in 2021, falling in 2022 and 2023. US asset managers show particularly poor performance. Asset managers in the US supported just a quarter of resolutions, on average. It is at odds with the support from European asset managers that reaches an average of 88%.

[8] Mülbert and Sajnovits (2022).
[9] Sautner and Starks (2021).
[10] ShareAction (2023).

Figure: percentage of shareholder resolutions supported by large asset managers



Source: ShareAction (2023)

It also appears that ESG stewardship performed by passive investors lags stewardship by active investors[11] and that passive investors are overall more pro-management. The pro-management bias is especially salient when looking at the voting records of the Big Four.[12]

The absence of beta stewardship reasonably questions the "portfolio primacy" narrative. Several observations suggest it was far too optimistic.

In particular, the case for profitability is highly theoretical. It assumes that i) the stewardship activity leads to real-life changes in corporate behavior, ii) actual changes in corporate behavior is perceived by the market as mitigating market climate risk and climate risk is priced into the market, iii) any loss to an invested company from adopting more sustainable practices, is made up by the gains to other invested firms and iv) associated gains (in the form of additional fees) are substantial for asset managers. For some of those (necessary) assumptions, there is so far, at best, limited evidence suggesting that they hold true.

Moreover, the free-riding problem does not magically vanish with the rise of universal owners. Because of the overlapping ownership across universal owners, there is only a competitive advantage for stewardship when asset management firms own proportionally more shares in the target firm than their competitors.

The rise of hedge fund ESG activism

Another group of investors involved in the disciplining of companies are hedge funds. Because they are not subject to regulation that governs mutual funds and pension funds, hedge funds can hold highly concentrated positions in small numbers of companies, and use leverage and derivatives to extend their reach. Therefore,

[11] Heath et al. (2022); Bubb and Catan (2022).
[12] Brav et al. (2024).

they are more interested in any share price increase (or decrease when they have built short positions) in case of engagement success.

The strategies activists employ constantly evolve as more enter the market and seek to differentiate themselves. Fewer activists are agitating purely for balance sheet optimization as a standalone thesis, in part because the large institutional investors that dominate today's shareholder bases are less receptive to this.

Instead, funds have evolved their approaches. One approach is including arguments involving environmental, social and governance factors (ESG) into campaigns by pointing to an insufficient ESG strategy or unaddressed exposure to ESG risks.

Hedge fund activists can use the full array of options, including the most confrontational ones to obtain desired changes at targeted companies. Those include the filing of shareholder resolutions, proxy contests and, less frequently, litigation. Such methods contrast with collaborative engagement preferred by more conventional institutional investors (pension funds, insurers, mutual funds, etc.).

In last resort, ESG activist hedge funds can go to court. Indeed, ESG litigations are on the rise. ESG litigation refers to legal action that is taken against companies for alleged violations of related laws, regulations or standards. It is increasingly seen by investors as the sharp end of escalated engagement. "*A successful litigation, where a legal judgement confirms specific wrongdoing, is one of the most effective ways of forcing a company to act, given its legally binding nature*," says Emmet McNamee, Head of Stewardship at the UN-convened Principles for Responsible Investment (PRI)[13].

Litigation is already a well-established escalation strategy for shareholders in the US but has been little used in Europe. Litigation has been seen as potentially running counter to the UK and European approach to engagement, which has valued process and good, long-term, enduring relationships between companies and their investors. It is nevertheless mentioned as one of the available techniques in some stewardship codes, like IIGCC's Net Zero Stewardship Toolkit.

To maximize their chance of obtaining from targets the expected change, hedge funds are used to operating within "**wolf packs**". The tactic involves multiple hedge funds or other activist investors congregating around a target, with one acting as a "lead" activist and others as peripheral activists. Wolf pack activity appears to be ostensibly uncoordinated—i.e., no formal coalition is formed—a fact that is usually attributed to an attempt by the funds to circumvent the requirement for group filing (under Regulation 13D in the US) when governance activities are coalitional. Second, wolf packs appear to form dynamically. The market's knowledge of the formation of a wolf pack (either through word of mouth or public announcement of by the lead activist) often leads to additional activist funds entering the fray against the target corporation, resulting in a rapid change in composition of the target's shareholder base. Researchers find that wolf packs are associated with a greater probability of successful engagement[14] and that hedge funds often partner with institutional investors who can provide support through their "behind-the-scenes" engagements[15]. This partnership lowers coordination costs in achieving the desired intervention outcome.

Collaborative engagement as the solution?

Whatever the type of investor studied, collective engagement is often the most resource-efficient method for engagement as every investor is inevitably resource-constrained and pooling those limited resources should enable greater efficiency. Such efficiency carries a benefit for the corporate recipient too because it reduces the weight of messages received, which in some cases can feel like a broad spectrum of conflicting opinions of which it is difficult to make much sense.

[13] ESG Investor (2023).
[14] Other papers include, for instance, Artiga Gonzalez and Caluzzo (2019) and Brav et al. (2019).
[15] Brav et al. (2019) and Levit (2019).

As defined by PRI, "*collaborative shareholder engagement occurs when a group of institutional investors come together to engage in dialogue with companies on environmental, social and governance (ESG) issues*." Collaborative engagement implies coordination among participants. Therefore, we distinguish collaborative behavior from mere (coincidentally) simultaneous behavior as well as from imitative behavior without active cooperation or any kind of consultation between the parties.

Collaboration between shareholders is, on a theoretical level at least, a way to overcome or mitigate some of the disincentives for engagement previously explained. This is because (i) chances of success are increased as voting rights and the associated informal influence can be bundled through collaborative interaction, (ii) collaboration can reduce information and implementation costs by sharing resources, skills, and expertise and by attributing roles among participants, and (iii) collaboration also contributes to risk sharing among participants. An additional systemic benefit of collaboration is that it may decrease engagement and questionnaire fatigue among companies when they must only respond to one coherent set of requests instead of multiple (and potentially conflicting) ones.

The evidence on the effectiveness of implicit coordination among engaging shareholders is mostly positive. The pioneering study by Gillan and Starks (2000) dealing with the corporate governance role of institutional investors shows that "*proposals sponsored by institutions or through coordinated activities receive significantly more favorable votes than those sponsored by independent individuals or religious organizations.*" In the last ten years, a series of studies have confirmed this initial result.[16]

Aside of the empirical evidence, collaborative engagement may also benefit from an institutional support in the form of stewardship codes emphasizing its beneficial effects or coordination tools developed by international initiatives.

A clear reference to collective engagement is contained in the EFAMA Stewardship Code. In its current version, EFAMA Principle 4 recommends that asset managers "*should consider acting with other investors, where appropriate*". Emphasizing that shareholder collaboration may sometimes be "*the most effective manner in which to engage*", the Guidance to Principle 4 illustrates that collective action with individual investee companies may in particular be appropriate "*at times of significant corporate or wider economic stress, or when the risks posed threaten to destroy significant value or the ability of the company to continue in operation*". In addition, the Code also welcomes ongoing collective engagements concerning policy issues[17].

Institutionalized investor platforms have also emerged over recent years as a force for investor empowerment, serving to coordinate investor campaigns and to share the costs of engagement. In particular, the past several years have seen an unprecedented surge in investor-led initiatives steered toward sustainability. Most climate-related investor initiatives have emerged after the 2015's Paris Agreement[18].

An example of a platform is the one provided by the United Nation's Principles for Responsible Investment (PRI). The PRI Collaboration Platform exists to help PRI signatories work together on engagements with target companies, and potentially with regulators and other actors on ESG issues across the world. Engagement begins after one or several signatories identify an issue relating to a company or sector and determine that there is a case for change. The signatories may then talk with peers and with PRI to explore the scope for engaging collaboratively. The projects are then interactively posted on the Collaboration Platform[19].

Regarding voting, a de facto coordination can also occur through the recommendations of proxy advisors. Proxy advisory firms are independent service providers who advise institutional investors on how to vote their shares and help them to execute their voting decision. Together, two firms (ISS and Glass Lewis) own a 90% share of the proxy advisor voting market[20]. Academic research has documented the influence proxy advisory firms exert on voting outcomes. Their recommendations are estimated to sway between 13-30% of

[16] For instance, Dimson et al. (2015) and Dimson et al. (2023).
[17] Balp and Strampelli (2020).
[18] McDonnell (2023).
[19] Dimson et al. (2023).
[20] Rose (2021) ; Shu (2024).

shareholder votes, depending on the type of proposal.[21] With such a clout, some investors, policymakers and observers have expressed concerns about potential conflicts of interest inherent in some proxy advisors' business models. Indeed, researchers have observed that the largest proxy advisors often simply support management and rarely follow shareholder proposals.[22] Nevertheless, it has emerged that proxy advisors such as ISS, the dominant player, has recently become more supportive of environmental and social resolutions than most traditional asset managers.[23]

Finally, some issues remain unresolved. There may still be free riding within coalitions, with some members lagging far behind others in case of defective accountability. Observations by ShareAction (2023) confirm the lack of accountability within the CA 100+ initiative by checking votes of members on resolutions flagged by the initiative in the 2023 AGM season. While CA100+ makes clear that legally they cannot require members to vote a certain way, they flag resolutions from their investor members on the website, if these are considered to be "*consistent with the goals of [CA100+]*," "*worded such that the request of management is considered reasonable and not burdensome," and "complementary to existing engagement strategy as set out by the [CA100+] collaborative engagement group for the company affected by the resolution*". Several members of the initiative (all American asset managers) voted "against" in most of the 20 CA100+ flagged shareholder resolutions.

There is also a free riding problem with non-members. The costs of collaboration and engagement are borne by a (potentially small) group of collaborating investors while other investors will equally benefit from the engagement of that group in case of success. This can provide an incentive not to participate in the collaboration in the first place.

Finally, there may be a remaining economic – and potentially also cultural – barrier to collaboration, especially between directly competing institutional investors.

How to make ESG collaborative engagement function

Work has been done by regulators, associations and researchers to identify factors that influence the success rate of engagement requests.

Looking at various guidelines and academic research on moderators of engagement effectiveness, we observed that some success factors are widely acknowledged:

- **Size:** there is evidence that engagement requests are more likely to succeed when the shareholder engaging holds a larger share of the targeted company (Dimson et al., 2015, 2021).
- **Resources:** active shareholder engagement also requires financial and human resources. Financial costs relate to information acquisition, strategy implementation and external legal counselling. Activist shareholder campaigns have been estimated to cost millions of euros[24]. For instance, the total cost of the high-profile successful Exxon campaign by Engine n°1 has been estimated for the asset management firm at around $30 million[25].
- **Access to management/board:** it has also been convincingly argued that engaging investors benefit from having a strong relationship and/or cultural awareness of the target company. The role of cultural connection has been emphasized by Dimson et al. (2021) who found that a group of investors engaging had more influence when the engagement was spearheaded by an investor who is from the same country as the company being engaged, suggesting that linguistic and cultural elements may play an important role. This is also consistent with the finding in Kim, Wan, Wang, and Yang (2019) that institutional shareholders are especially likely to commit resources to ESG engagement with companies that are located nearby.

---

[21] Ertimur et al. (2013); Larcker et al. (2015).
[22] Cappucci (2019).
[23] Chuah et al. (2021).
[24] Gantchev (2013).
[25] Reuters (2021).

- **Specific objectives and clear milestones:** as pointed out by the Investor Forum, objectives should be specific and targeted to enable clarity around delivery and the engagement approach should be bespoke (tailored) to the target company. FinanceMap stresses that engaging investors should use a defined structure for engagement and milestones to measure progress against.
- **Detailed escalation policy:** it is also commonly admitted that engaging investors should have a detailed escalation policy. Escalation is one of the 12 principles of the 2020 UK Stewardship Code while the former UK Code set out a helpful list of escalation measures that can be considered to advance engagements.
- **Full use of shareholder authority:** to be effective, engagement escalation policies should include offensive actions to be used as credible threats in case engagement requests were ignored by engaged companies. Those offensive actions include divesting, putting the company on exclusion list, filing shareholder resolutions, driving anti-management voting campaigns at AGMs, litigation, etc.

Those success factors apply as much to single investors as to investor coalitions.

One of the Nobel Prize winner Elizabeth Ostrom's major contributions, the Institutional Analysis and Development Framework (IAD)[26], has been widely used by social scientists to study the effectiveness of collaborative governance regimes around the world. As emphasized by Miazad (2023), the IAD framework is of great use for understanding investor alliances as a new type of shared institutional infrastructure for managing climate change. Investor alliances like Climate Action 100+ provide a sophisticated and dynamic collection of rules that their members use to organize ongoing investor monitoring, engagement, and voting.

Miazad (2023) applied the IAD framework to CA 100+ to highlight strengths and limitations of the alliance. In several aspects (regarding proportional allocation of costs and benefits, monitoring and graduated sanctions), the way CA100+ conforms to the IAD principles is minimal only. Critical adjustments would be necessary to create strong incentives for members to significantly contribute and fully align with the coalition's objective.

Studies show that successful engagements by coalitions - those in which investors' ex ante engagement goals are achieved - are associated with several "success factors" that enhance the salience of an investor coalition to firms' managers[27], such as

- The coalition's size[28]
- The coalition's stake in the target firm[29]
- Local proximity between investors and target firms[30]
- Experienced coalitions are also expected to be more effective in achieving their aims as past experiences of success enable future success[31].

Practical recommendations

We build on this line of research to issue a series of **9 recommendations** regarding the forming or the functioning of investor coalitions:

1. Mix global and local investors,
2. Include "the Big Four" when possible,
3. Team up with green activist funds,
4. Align objectives across participants,
5. Adapt requests to the target,
6. Organize roles with a multi-tier system,
7. Make members accountable,

[26] Ostrom (2011).
[27] Mitchell et al. (1997); Bundy et al. (2013).
[28] Doidge et al. (2019).
[29] Gond and Piani (2013).
[30] Dimson et al. (2023).
[31] Hadani et al. (2019).

8. Make good use of advisory votes (especially Say on Climate and Say on Pay votes),
9. Exercise your full shareholder authority (by requiring votes on M&A, co-filing shareholder resolutions, initiating proxy contests, or considering litigation in last resort).

Finance ClimAct contributes to the implementation of French and Euro pean policies for sustainable finance, in line with the European Green Deal and France's National Low Carbon Strategy.

It will develop the tools, methods, and new knowledge to achieve this goal in the coming years by: (1) supporting investments in energy efficient, and low-carbon industries, (2) considering the double materiality of climate change in financial management and supervision and (3) integrating environ mental objectives into retail investors' decisions.

The project is coordinated by the French Agency for Ecological Transition, The Ministry for Ecological Transition, The Autorité des Marchés Financiers, the Autorité de contrôle prudentiel et de résolution, 2° Investing Initiative, The Institute for Climate Economics, the Institut de la Finance Durable and RMI.

Finance ClimAct is an unprecedented programme which comprises a total budget of 18 million euros, 10 million of which are provided by the European Commission.

Duration: 2019-2024

With the contribution of the European Union LIFE program