Chapter 19: Institutional Investor Activism

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ABSTRACT

Institutional investors are frequent activist shareholders on corporate governance issues, and have been for the last 25 years. A large literature of academic research has examined whether this activity is effective in influencing target firms and enhancing the performance of both target firms and activists' portfolios. The importance of this question stems from the role of institutional investors as large and influential investors in the capital markets and as financial fiduciaries who are entrusted with the assets of millions of clients and beneficiaries. This chapter examines the many parallels between the issues that institutions face today in incorporating environmental, social, and governance (ESG) criteria into their investment and activism programs, and the issues arising twenty five years ago in the context of corporate governance. In short, socially responsible activism appears to be at the early stages of gaining momentum and legitimacy among mainstream institutional investors, with a steady stream of academic research likely to follow.

INTRODUCTION

While much has been written about institutional investor activism in the corporate governance arena, much less is known about their advocacy activities in the realm of environmental and social issues. In fact, at least six survey articles have summarized the voluminous research on corporate governance shareholder activism in the United States (Black, 1997; Gillan and Starks, 1998, 2007; Karpoff, 2001; Romano, 2001; Ferri, 2011). Notably, most of the research surveyed in these articles appears in mainstream finance journals. In contrast,

only Sjostrom (2008) surveys the social responsibility shareholder activism literature; she reports that of 34 studies, only one appears in a finance journal.

Yet, there are many parallel and common issues that arise when examining the role of institutional investors in both shareholder activism arenas. Two defining features of institutional investors have important implications for their potential to be effective shareholder activists. First, the fact that institutional investors often manage pools of assets on the order of billions of dollars implies that they tend to have sizable equity ownership stakes in individual companies and in the capital markets in general. As a result, they are potentially influential shareholders able to effect change at the companies in which they invest, and influential enough to command the attention of regulators or legislators to lobby for market-wide reforms. Second, institutional investors are financial fiduciaries who invest on the behalf of others and as a result, have a legal duty to invest in the best interests of their clients or beneficiaries. This traditionally means that activism can only be justified if clients specifically authorize it, or if the enhanced investment return is greater than any additional cost. While the early studies on corporate governance shareholder activism generally failed to find measurable valuation effects on target firms or on activist portfolios, the later evidence summarized in Ferri (2011) suggests that institutional activists have enjoyed much greater success recently. Evidence on how this success translates to institutional activism in the social responsibility arena, however, is sparse.

This chapter describes how institutional investors incorporate environmental, social, and governance (ESG) criteria into their investment and activism programs. A unifying theme is that socially responsible institutional investment and activist activity is best understood through the lens of their roles as fiduciaries and large investors. We begin by first defining socially responsible investing as discussed in the literature and among practitioners. We then provide an overview of the empirical evidence on institutional social activism activities. First, in the context of prodding individual companies to make operating changes or new disclosures, we discuss common tactics such as dialogue with corporate management, submitting shareholder

proposals to the corporate proxy statement, and active and informed voting. Second, in promoting market-wide reforms, institutional activists have leveraged resources through joining investor networks to lobby the SEC and Congress for regulatory change.

Using a comprehensive database, we describe the nature of the shareholder proposals submitted by institutional investor sponsors over the 1992-2010 period, highlighting the key sponsors, the most common actions requested and proposal topics, and measures of success in achieving activist goals. We contrast the patterns we observe for institutional sponsors to that of non-institutional sponsors. Based on our analysis of historical trends and current developments, we end the chapter with a discussion of possible future directions for institutional investor social activism and for future research on their role and effectiveness.

HOW DO INSTITUTIONAL INVESTORS DEFINE SOCIALLY RESPONSIBLE INVESTMENT (SRI)?

A careful reading of the literature suggests that SRI means different things to different people. In the U.S., the SRI movement has its roots among religious investors who believed their capital should not fund companies that produce products considered immoral, such as tobacco or weapons, or that operate in unethical environments such as South Africa in the apartheid era or Sudan today. Today, this is often labeled 'ethical investing' or 'negative screening' because 'unethical companies' are excluded or screened from consideration for the portfolio. It is well known that constraining the investment universe can have negative implications for portfolio diversification and risk-adjusted performance (Geczy, Stambaugh, Levin, 2005; Renneboog, Ter Horst, and Zhang, 2008). However, some investors are willing to sacrifice financial performance to achieve their ethical objectives. According to the Social Investment Forum 2010 Report, negative screening is still a popular strategy among socially responsible asset managers. Consistent with this, Hong and Kacperczyk (2009) find that there

are enough socially conscious investors screening out "sin stocks" to negatively affect their equilibrium pricing.

An emerging variety of SRI labeled 'sustainable' or 'responsible' investing is likely more appealing to fiduciary institutions. Kerste et al (2011) define sustainable investing as "an investment approach that integrates long-term ESG criteria into investment and ownership decision-making with the objective of generating superior risk-adjusted financial returns." The purely financial motive behind the investment strategy distinguishes it from negative screening. The logic is that climate change, natural resource scarcity, public awareness and consumer sentiment, and potentially looming regulations have material economic and financial consequences for firms. Heal (2005) argues that firms that take actions to anticipate and minimize conflicts with society or stakeholders are consistent with a pure profit motive. For example, firms conflict with society when their social costs exceed their private costs, such as when their production processes pollute the air and water, or their products have long-term health consequences. Firms that can pro-actively address these issues and minimize societal conflicts can successfully deter costly regulation, mitigate litigation risk, and enhance their reputation with consumers who might consequently favor their products rather than boycott them.

In other words, responsible corporate management focused on long-term shareholder value should carefully consider these business risks. In turn, savvy investors should incorporate information on how well companies are managing these business risks, much as they would any other value-relevant information. Some label this approach 'positive screening' since investors evaluate companies on ESG criteria as part of their risk management and stock selection decision. Edmans (2011) shows that applying a positive portfolio screen incorporating employee satisfaction among a firm's workforce is associated with positive abnormal performance. His analysis shows that the market only incorporates the value of this intangible

over time, suggesting a profit opportunity for investors who are first aware of its relation to firm profitability.

Social activism can be viewed using this framework as well. Whereas activism on corporate governance issues prods firms to minimize agency conflicts, activism on social issues encourages firms to minimize societal conflicts, with both varieties potentially fully consistent with a profit motive on the part of the activist.

SHAREHOLDER PROXY PROPOSALS AS ACTIVISM TOOLS

Submitting shareholder proposals for inclusion in the corporate proxy statement is one of the most common tools used by institutional investors to push firms to make changes in policies and strategies. Rule 14a-8 of the Securities and Exchange Act of 1934 allows any shareholder owning at least $2,000 in market value or 1% of the company's securities for at least one year to include a specific request and 500-word supporting statement in the corporate proxy. Thus, shareholder proposals are included in proxy materials and sent to shareholders at company expense, a feature that makes them particularly low-cost and appealing to activists. Note, however, that ownership requirements for submitting proposals necessarily imply that this tool is incompatible with negative screening.

Upon receiving a shareholder proposal, corporate managers have three options: petition the SEC to allow the proposal to be omitted from the proxy, implement the requested action to the satisfaction of the activist so that they voluntarily withdraw the submitted proposal, or include the proposal to be voted on by shareholders at the annual meeting. By law, even proposals that receive a majority of shareholder vote support are only advisory and need not be implemented by the board of directors. Critics have pointed to the non-binding nature of shareholder proposals as a reason to be skeptical about their effectiveness in eliciting companies to change. However, even the early corporate governance activism literature that failed to find valuation effects recognized the potential for this tool to begin productive dialogues between targeted

firms and investors, raise awareness of issues of broad importance, and possibly lead to spillover effects on non-targeted firms that pro-actively adopt policies to avoid future scrutiny from activists. These ancillary effects are, of course, much harder to measure.

In about 10 to 20% of submitted proposals, companies are successful in convincing the SEC to issue a "no-action letter," which allows them to omit a proposal from the proxy statement. By far the most common reason for omission is that the subject of the proposal involves an 'ordinary business' decision relating to the company's day-to-day operations, which are allowed to remain under managers' discretion. An important exception is if the proposal topic is of broad public policy importance or, in the language of the SEC, the issue "transcends day-to-day business matters". Brown (2011) argues that the particular topics that constitute public policy importance are subject to SEC staff interpretation and, as a result, evolves over time as the political climate changes. For example, shareholder proposals calling for shareholder approval of equity executive compensation plans were considered ordinary business and thereby excludable prior to 2002, but allowed thereafter on the grounds that the issue was the subject of widespread public debate (SEC Staff Legal Bulletin No. 14A 7/12/02). Similarly, the SEC changed its stance on proposals requesting that a company assess the risk they face from significant environmental and public health issues, no longer considering this topic 'ordinary business' after October 2009 (SEC Staff Legal Bulletin No. 14E 10/27/09). Not surprisingly, SEC no-action letter trends affect the observed trends in proposal topics that come to a vote. For example, Ertimur, Ferri, and Muslu (2011) show a jump in compensation-related shareholder proposals after 2002.

The focus of this chapter is confined to activity in the United States. However, Cziraki, Renneboog, and Szilagyi (2010) report that shareholder proposals are not a significant tool in other countries. They find that corporate governance shareholder proposals in the United Kingdom and in Continental Europe are rare, and even rarer on social issues; they identify only 21 social responsibility proposals across 43 country-years.

SOCIAL RESPONSIBILITY PROPOSALS SUBMITTED BY INSTITUTIONAL INVESTORS

Historical Background on Social Responsibility Shareholder Proposals

While Gillan and Starks (2007) trace the earliest shareholder proposals in the United States to the 1940s, social responsibility proposals did not become an important tool for activists until the 1970s. From the 1940s through the 1980s, sponsoring shareholder proposals was the nearly exclusive realm of "gadflies", individual investors such as the Gilbert brothers and Evelyn Davis, who each sponsored hundreds of proposals at target firms. Not until the 1980s did institutional investors, such as CalPERS and other public pension funds, begin to increasingly use the shareholder proposal tool.

Glac (2010) provides a historical account of the important early victories for social activists in both the court room and the board room against two of the largest corporations of the day. First, a landmark 1970 federal appeals court decision ruled in favor of activists that Dow Chemical must include on their proxy a proposal calling for them to cease manufacturing napalm (*Medical Committee for Human Rights v. SEC*). This decision, along with a flurry of social proposal submissions, prompted the SEC to broaden the scope of allowed proposal topics. Second, a group of lawyers organized the "Project for Corporate Responsibility" and sponsored nine social issue proposals, two of which were voted on at General Motor's 1970 annual meeting. While both proposals received less than 3% vote support, the campaign received enormous publicity, including over 100 reporters covering GM's annual meeting. Despite the low vote support, GM ultimately complied with the requests in the two proposals.

Proffitt and Spicer (2006) provide a detailed analysis of the early use of social shareholder proposals on issues of labor and human rights (e.g., apartheid in South Africa). Using a comprehensive sample from 1969 to 2003, they report that religious groups, such as the Interfaith Council on Corporate Responsibility (ICCR), were early adopters and innovators in the use of proposals as a tool for social change, as well as the most dominant sponsor type, accounting for nearly all proposals on human and labor rights prior to 1984. Public pension

funds enter the scene in 1984 and, as we show in the following sections, remain one of the dominant champions of social issues to this day.

Data Source

Our social responsibility shareholder proposal sample is originally from the Investor Responsibility Research Center (IRRC), now available through RiskMetrics. We obtain details of shareholder proposals that are omitted, withdrawn, or voted on at the annual meetings from 1992 through 2010, including target firm name, proposal topic, and sponsor name(s). The database also contains the reason for omission for omitted proposals (e.g., ordinary business, sponsor did not meet ownership requirements, etc.) and the vote outcome for proposals that came to a vote. The 1992 through 1996 sample is from Tkac (2006), as the RiskMetrics sample begins in 1997.

We identify 5,818 social responsibility proposals over this nineteen year period, of which 2,149 or 37% are sponsored by institutional investors. Not included in these totals are 86 proposals that we classify as “anti-socially responsible” and therefore exclude. For example, we exclude proposals sponsored by the Free Enterprise Action fund, which states that their mission is to challenge companies that support social causes. In generating proposal counts, we adjust for co-sponsored proposals to avoid double-counting. Exhibit 20.1 shows the time trend of proposal submissions by institutional versus non-institutional sponsors. While the individuals and religious organizations that comprise the majority of non-institutional sponsors have been prolific throughout, institutional investor activity began in earnest in 2001 and even exceeds that of non-institutional sponsors in recent years. In the next section, we provide more details about these sponsors.

[Insert Exhibit 20.1 here]

Key Institutional Investor Players and Their Motivations for Activism

The sponsors of social policy shareholder proposals can be categorized into four distinct institutional investor categories: public pension funds, union pension funds, socially responsible mutual funds, and investment advisers; and three non-institutional investor categories: individuals, religious organizations, and non-governmental organizations (e.g., Sierra Club). While some religious organizations might be categorized as institutional because they are investing pension or endowment assets, we include them in the non-institutional category for two reasons. First, the corporate governance activism literature has categorized them either separately or pooled with individuals (Gillan and Starks, 2000). Second, our interest is in understanding the activism of institutional investors whose primary focus is presumably on financial performance, rather than on investors with an a priori focus on non-financial goals. Readers interested in social activism by religious groups can refer to Proffitt and Spicer (2006), Tkac (2006), and Logsdon and Van Buren (2008, 2009). For the remainder of this chapter, we focus on the institutional sponsors.

Exhibit 20.2 lists the number of proposals over the 1992-2000 and the 2001-2010 periods for each of the four institutional investor types, as well as the names and number of proposals for the top three sponsors within each type. Two patterns quickly emerge: proposal activity has increased dramatically over time for each of the four sponsor types, and only a few sponsors are responsible for the bulk of this activity. A comparison of columns two and three shows that the most dramatic increase in proposal activity is for the socially responsible mutual funds, where there is an 8-fold increase in the more recent period.

Proposal activity is highly concentrated; in three of the four types, the top three sponsors account for between 74% and 96% of all proposals. Notably the New York City Pension funds account for 86% of all activity among public pension funds and the Calvert Family of Funds account for 48% of all SRI mutual fund activity. By comparison, the labor union pension fund category is less concentrated. The top sponsor, the AFL-CIO, accounts for only 21% of all labor

union proposals, and the top three accounts for only 50%. Consistent with this, there are only 10 unique public pension fund sponsors over the nineteen year period, and 28 unique labor union pension funds.

[Insert Exhibit 20.2 here]

Public and Labor Union Pension Funds

Given their sheer size, pension funds are important players in the capital markets. According to the U.S. Census Bureau, the 100 largest public pension funds have $2.7 trillion in assets as of March 2011, including $896 billion in domestic equities. Private pension funds control another $4.7 trillion, including $2 trillion in defined-benefit plans (U. S. Department of Labor *2008 Private Pension Plan Bulletin*). Pension funds are also important from the standpoint that they represent the retirement assets of millions of beneficiaries who rely on the prudent investment of those assets for their future security and well-being. A traditional defined-benefit pension plan places the decision-making power with the pension trustees, who are charged with a fiduciary duty to invest the pension assets prudently and in the best interests of the beneficiaries. Private pension plans are governed by the Employee Retirement Income Security Act (ERISA), while public pension plans are governed by state or local law, although fiduciary standards for trustees of both types tend to be similar.

A long-standing legal issue is which investment practices are consistent with prudent investments in the best interests of plan beneficiaries. Whether socially responsible investment and activism is consistent with properly fulfilling fiduciary duties is currently an open question. There does not appear to be a clear consensus on whether trustees can incorporate ESG factors into their investment decisions if doing so is detrimental to financial performance. The Department of Labor in the 1998 “Calvert Letter” has taken the view that trustees can consider ‘collateral benefits’ such as in a SRI, but the investment return must still be “commensurate to alternative investments having similar risk.” Given the legal uncertainty surrounding whether

SRI is compatible with fiduciary duties, and given the size of the asset pool affected by these legal issues, it is not surprising that advocates have formed at least two working groups in 2005 and 2009 to study and report on these matters (see the publications of the United Nations Principles for Responsible Investment).

If SRI could reliably be justified on a risk-adjusted return basis, ESG considerations would not conflict with beneficiaries' best interests. However, the empirical link between financial performance and SRI by either firms or portfolio managers is weak, and therefore remains an open question, as the surveys by Margolis, Elfenbein, and Walsh (2009), Renneboog, Ter Horst, and Zhang (2008), and Capelle-Blancard and Monjon (2011) attest. Absent a purely financial justification, Barber (2007) and Richardson (2010) suggest that SRI may still be appropriate for pension plans if it reflects the preferences of the beneficiaries (although see Richardson for a discussion of practical obstacles to implementation, such as how exactly to assess beneficiary preferences and what to do if not all beneficiaries agree on a policy).

In our sample of social proposal sponsors, private pension plans are notably absent. Instead, public pension funds and union pension funds dominate the list of social proposal sponsors, much like they dominate the list of corporate governance proposal sponsors. The literature has hypothesized reasons for this that can apply to the SR context as well (see Hess (2007) for a summary of these arguments). Some argue that activism is most suited to these two types because they tend to passively index more than other institutional investors and therefore cannot simply sell stocks that they believe are poorly managed or have governance problems. A related point is that these types tend to be "universal owners" that naturally internalize society-wide (market-wide) issues because they are long-term investors who own highly diversified portfolios. Others point to the fact that these two types are unconcerned with antagonizing corporate management through activism because they do not provide financial services to corporations, unlike banks, investment banks, insurance companies, and investment

advisers. Similarly, corporate pension fund trustees may be reluctant to antagonize their fellow corporate managers.

An alternative view is that public and union pension funds pursue activism because their trustees have personal or political motives, and the nature of defined-benefit plans with dispersed uninformed beneficiaries allows trustees to place their own preferences ahead of beneficiaries (Romano, 1993, 2001; Woidtke, 2002). For example, populist CEO-bashing or advocating a hot-button social issue such as diversity may not lead to performance improvements for the fund, but it may lead to media attention for an activist who has an eye toward a future run at political office. A similar argument holds for union pension funds. They may place current union member collective bargaining goals ahead of beneficiary interests.

In our sample, we find the NYC pension funds to be by far the most prolific sponsor of social proposals throughout the 1992-2010 period. The NYC pension funds are headed by the NYC Comptroller, an elected city official, and governed by a board of trustees that has a majority of political appointees rather than beneficiary-elected representatives. Interestingly, all of the former NYC Comptrollers since the 1970s have gone on to run for either NYC mayor or for the U.S. Senate. Romano argues that a board dominated by political appointees infuses politics into pension fund management, and empirically shows that public pension plan performance is inversely related to the percentage of political appointees on pension boards. Barber (2007) makes a similar argument and points to CalPERS' divestment of tobacco stocks in 2000 as politically motivated and inconsistent with maximizing beneficiary wealth. In sum, while the literature has discussed many possible motives behind labor and union pension fund activism, it is inherently difficult to definitively empirically assess true motives.

Investment Advisers and Mutual Funds (Asset Managers)

Investment advisers and mutual funds share the feature that they provide portfolio management services to clients who have the ability to hire and fire them at will, as well as to

mandate any special investment considerations. For example, the client can specify that the manager can only invest in small-capitalization growth stocks. Or, the client can mandate that no investments can be made in companies that manufacture tobacco products or weapons. Clients with millions of dollars to invest, such as a wealthy individual or pension plan, can hire an investment adviser and contractually stipulate specific investment guidelines. Small investors can identify a mutual fund or ETF that states in their prospectus the investment principles that match their own preferences or values. (The SEC monitors whether funds comply with the investment policies stated in their prospectuses. In 2008, Pax World paid a $500,000 penalty for purchasing stocks of companies that manufacture alcohol, tobacco, and gambling products, in violation of their prospectus (SEC Administrative Proceeding No. IA-2761)).

Unlike the case for pension plan trustees, there is no legal ambiguity for investment managers to incorporate ESG principles into their investment decisions, as long as their clients approve of the strategy. This effectively means that expected superior investment returns are not a necessary condition for pursuing ESG principles or activism strategies. Some investors are perfectly willing to accept lower financial returns for advancing positive social changes or better aligning their personal values with their investment choices. Thus, from the perspective of asset managers, SRI investing is inherently client driven. Survey and anecdotal evidence certainly support this view. For example, in a 2010 survey of 107 managers conducted by the Social Investment Forum, 85% listed ‘client demand’ as the reason for incorporating ESG factors into their investment strategy, while 60% stated a desire to bring about societal benefits. Wen (2009) reports a similar finding in a survey of European asset managers.

Sponsoring shareholder proposals could serve as a credible signal to investors that the manager is firmly committed to ESG principles, and therefore could help market their services to their target clientele. Using our comprehensive sample of social proposals, we identify 23 unique investment manager sponsors. Using each manager’s website to gather background

information on their investment strategy, we find that all 23 of the proposal sponsors market themselves as specializing in SRI. We find no social proposals sponsored by conventional asset managers. However, they rarely sponsor corporate governance shareholder proposals either.

The absence of mainstream investment managers among proposal sponsors is consistent with a motivation among SRI managers that this activity will attract assets from a clientele with social concerns, rather than by a belief that activism will enhance portfolio returns. Some argue, however, that the real reason investment managers avoid activism is that they do not want to alienate target companies that might potentially hire them to invest their defined-benefit pension assets or 401(k) plans. Along these same lines, mainstream investment advisers may avoid activism because it is not an activity rewarded by their target clientele. Overall, we find that the same types of institutional investors are important advocates for both corporate governance and social issues, suggesting that similar forces spur their activism in both arenas.

Contents of the Proposals

Heal (2005) provides a useful framework for understanding economic motivations behind social responsibility activism. He views corporate social responsibility as important whenever there are inherent conflicts between the firm and society, which he argues arise under two conditions: when the firm's social costs exceed private costs (e.g., pollution), or when there are disagreements over what is fair (e.g., sweatshop labor conditions). As mentioned earlier, firms that successfully minimize these conflicts with society can reap benefits that enhance performance. Thus, profit-minded investors can prod firms to pay more attention to addressing these conflicts, avoiding a future landmine. We now examine the issues and specific requests of activists using shareholder proposals, and analyze whether they focus on minimizing conflicts between firms and society.

Issues Addressed and Actions Requested in the Proposals

We place each shareholder proposal topic into one of thirteen issue categories and provide a summary of the number of proposals in each category sponsored by institutional investors and non-institutions in Exhibit 20.3. The top two issues of institutional sponsors are energy and environment and anti-discrimination, both consistent with institutions prodding firms to pay greater attention to potential business risks. Climate change can lead to significant disruptions to company operations, and discriminatory practices have the potential for costly lawsuits. While institutional investors and non-institutional investors share an interest in sponsoring proposals on energy and environmental matters, the second most popular issue for non-institutional sponsors is controversial business (e.g., tobacco, firearms). This issue, which is related to the production of unethical products that some socially responsible investors use as negative screens, ranks only tenth in the list of issues advocated by institutional investors.

[Insert Exhibit 20.3 here]

We place the actions requested in social policy proposals into five categories and summarize them in Exhibit 20.4. Across both institutional and non-institutional sponsors, the most common action requested is to issue a report or disclose information to investors. Also similar across both investor types is a request for firms to adopt a policy not significantly affecting their operations, which is primarily anti-discrimination proposals asking companies to adopt sexual orientation anti-bias policies or to implement the MacBride principles (which encourage fair treatment for minority employees). Institutions differ substantially from non-institutional sponsors regarding proposals requesting firms to make significant changes to operations. A common example for this request is under the topic of workplace standards, where sponsors typically ask firms to implement the International Labor Organization standards and use third-party monitoring. Finally, a category where institutions differ from non-institutions is under proposals that request that the firm stop supporting certain named groups (e.g.,

abortion providers, political campaigns). There are 140 such requests from non-institutional sponsors, but not a single request from an institution.

[Insert Exhibit 20.4 here]

Success Rate of the Proposals

An old question in the shareholder activism literature is how to measure success. A variety of definitions have been applied by both researchers and activists alike, and no broad consensus has emerged. At the opposite extreme, most agree that a clear failure is when a company successfully petitions the SEC to omit the shareholder proposal from its proxy statement.

In this section, we discuss the definitions of success from the literature and apply them to our sample of proposals. We begin with a measure relevant for proposals that come to a vote at the annual meeting, the percentage of votes cast in favor. Beyond the obvious show of support that significant votes convey, vote support is important because SEC rules stipulate thresholds for a proposal to be re-submitted in subsequent years. In the first year, a proposal must receive at least 3% of votes in favor in order to be resubmitted the next year. The minimum threshold increases with subsequent submissions, eventually to the level of 10% in the third year and beyond. Gaining enough support for resubmission is considered a success for many shareholder activists, as it allows them to keep the issues alive and raise shareholder awareness. We find that only 10% of submitted proposals are omitted because vote thresholds are not met (although this does not capture the proposals not submitted because the sponsor is aware that they did not meet the SEC thresholds).

Over our sample period, we find increasing vote support in favor of social proposals, especially for those sponsored by institutional investors. Exhibit 20.5 shows the time trend in average vote support for proposals sponsored by institutions vs non-institutions. For institution-sponsored proposals, the average support is 9.9% in 1992 and 25.8% in 2010. Not surprisingly,

a comparison to corporate governance proposals reveals that social proposals garner much lower shareholder support. While we find average vote support for social proposals of 10.5% in 2001, Renneboog and Szilagyi (2010) report an average level of vote support three-times higher (32.2%) for corporate governance shareholder proposals that same year. Similarly, while Renneboog and Szilagyi (2010) report that 27% of corporate governance shareholder proposals in 1996-2005 received majority vote support, we find that less than 1% of social proposals do so, no matter which sample or sub-sample period we examine.

[Insert Exhibit 20.5 here]

Another common definition of success is if the target firm makes the desired changes or at least some changes that move toward the activists' goals. Because proposals are non-binding on the board of directors, proposals that pass with high vote support need not be implemented. However, several studies of corporate governance proposals find that majority vote support is associated with a significantly higher implementation rate (Thomas and Cotter, 2007, Ertimur, Ferri, and Stubben, 2010, and Renneboog and Szilalgyi, 2010). All three studies find that implementation rates have risen over time, suggesting that target firms are increasingly responsive to shareholder concerns. We find that of the 20 social proposals that receive a majority of vote support, 14 (70%) are implemented by the board of directors within one year of the annual meeting. This compares with a 32.5% implementation rate from 1996-2005 reported by Renneboog and Szilagyi (2010).

Although it is much more difficult for researchers to precisely determine the outcome, proposals that are not voted on but are instead withdrawn by the proposal sponsor are potentially highly successful. An activist may withdraw their proposal when the target firm demonstrates to their satisfaction that it will take the necessary actions to address the issues raised in the proposal. Thus, issues may get resolved well before the annual meeting through private dialogue, prompting observers to label proposals that make it to the proxy statement as "failed negotiations." However, it is also possible that activists voluntarily withdraw their

proposals because they anticipate an SEC omission or very low vote support. Thus, withdrawn proposals are not necessarily unqualified successes. Tkac (2006) investigates the outcomes of withdrawn proposals from 1992-2002, and is only able to obtain information on the outcomes of 35% of these proposals. Out of this smaller sample, 79% resulted in a concrete action by the target firm, and 19% led to a dialogue between the firm and the shareholder activist but no commitment to action. Given the high degree of target firm actions associated with these withdrawn proposals, Tkac argues that the percentage of withdrawn proposals across all proposals is a good measure of activist success, and reports a 30% success rate.

Rojas et al. (2009) question the relatively high success rate reported by Tkac (2006). They classify a withdrawn social proposal as a "success" only if they find an announcement by any party claiming that the proposal will be implemented. Of 657 withdrawn proposals from 1997 to 2004, they report that only 36% fall in this category, and most withdrawn proposals are due to activists conceding that their proposal is unlikely to survive SEC scrutiny or gain support from shareholders. Overall, the authors report that a success rate of 10% of all submitted social policy proposals better reflects proposals that are both withdrawn and implemented.

Although we do not have information on whether the withdrawn proposals were implemented by target firms, we can use the percentage of withdrawn and omitted proposals in our sample as rough estimates of activist success and failure. Not surprisingly, we find substantial differences in these rates across sponsor types suggesting that institutional sponsors enjoy greater success as activists. For institutional sponsors, 40.2% of all proposals are withdrawn and 11.0% are omitted. In contrast, for non-institutional sponsors, 27.7% of all proposals are withdrawn and 19.1% are omitted. Exhibit 20.6 summarizes the breakdown of omitted, withdrawn, and voted-on proposals by sponsor type. By this measure, SRI mutual funds are the most successful type, with the highest rate of withdrawal and the lowest rate of omission, while investment managers and public pension funds are not far behind. Union pension funds and non-institutional investors are least successful by this measure. Rojas et al

report a similar pattern in that SR mutual funds and public pension funds have a success rate of about 25%, versus 10% for the full sample.

[Insert Exhibit 20.6 here]

Using withdrawn proposals as a metric for success suggests that shareholders with sizeable ownership stakes are much more likely to gain the attention of management and reach a compromise. Alternatively, the success of SR mutual funds and public pension funds may be due to their policy of publicizing the outcome of their advocacy and dialogue with target firms. For example, the NYC pension funds, which sponsor 86% of public pension fund proposals in our sample, post a report on their website every proxy season summarizing the topic and outcome of their proposals. Calvert Funds, which sponsors almost half of all SR mutual fund proposals, also regularly provides similar details on their website. Companies may be more responsive to these sponsors to avoid negative publicity, as they both regularly publish the names of the leaders and the laggards among their target firms. As Del Guercio, Seery, and Woidtke (2008) and Ertimur, Ferri, and Muslu (2011) find for corporate governance activism, public shame can be a powerful tool.

David, Bloom, and Hillman (2007) argue that a withdrawn proposal, whether or not implemented by the firm, is only a symbolic victory for activists who care about true social change. They find that a composite summary score on the firm's corporate social performance (CSP) is negatively associated with social responsibility shareholder proposals that were either omitted or withdrawn the previous year. One interpretation is that target firms may expend resources to resist external pressure from activists, lowering resources available for performance improvement on other dimensions. Neubaum and Zahra (2006) address a similar question and use a similar composite score to measure a firm's CSP. Instead of proposal submission, however, they create a measure of institutional activist activity by compiling news stories on incidents of activism by 421 institutional investors. They find that institutional ownership by long-term institutional investors (public pension funds) is positively correlated with

CSP three years later, while ownership by short-term institutional investors (mutual funds and investment advisers) is not. In addition, while their measure of activism is unrelated to CSP, an interaction term of activism with long-term institutional ownership is significantly positively related to CSP.

Finally, the measure of success of greatest interest to researchers and investors alike is whether this activity leads to improvements in financial performance. Gillan and Starks (2007) and Ferri (2011) provide a thorough review of the corporate governance literature's findings and limitations in answering this question. While there is little evidence of a relation between shareholder activism and positive share price effects or improved operating performance, standard assessment methods are fraught with measurement problems. For example, short-term stock price reactions to shareholder proposals are difficult to interpret because they could either reveal the valuation consequences of activist intervention or a failed negotiation between the activist and the firm. In addition, it is notoriously difficult for researchers to accurately time when the market learned about the activists' efforts. In short, while evidence consistent with positive valuation effects of corporate governance activism is more common in the recent literature, this remains an open question. We could not find any research on the valuation effects of social responsibility activism, suggesting it is a ripe area for future research.

VOTING AS AN ACTIVISM TOOL

Besides filing shareholder proposals, institutional investors can also exercise their influence by actively voting their shares. Because properly researching the issues and deciding how to vote requires substantial time and effort, many institutions hire proxy consultants, such as ISS or Glass Lewis, to advise them or facilitate voting. According to the Council of Institutional Investors' primer on proxy voting (2011), most institutions historically delegated their voting authority to external managers, who tended to vote with company management. In 1988, in its famous letter to Avon Products' retirement plan, the Department of Labor ruled that under

ERISA, proxy voting rights are considered pension plan assets and therefore trustees have a fiduciary duty to vote in the best interests of beneficiaries. The Department continued to issue interpretative bulletins, encouraging pension funds to develop written proxy voting guidelines and to exert their influence on corporate management when the benefits of doing so exceed the costs.

In 2002, mutual funds came under SEC scrutiny due to a perceived conflict of interest in voting their proxies in the interests of fund shareholders. Critics argued that funds routinely vote with corporate management out of a desire to gain investment management business from corporate 401(k) plans. In 2003, the SEC adopted new rules requiring mutual funds to disclose their voting policies as well as a full listing of their votes at individual companies. Despite the common view that disclosure would prompt funds to vote against management more often, Cremers and Romano (2011) find no evidence of a decline in support for management proposals due to the rule change, and instead find an increase in support.

Morgan et al. (2011) analyze mutual fund voting patterns on shareholder proposals from 2003 to 2005, including separate statistics on social proposals and on voting by socially responsible funds. They find that funds vote in favor of corporate governance shareholder proposals 49% of the time, but only 5% of the time for environmental and social proposals. ISS recommended a vote in favor 75% of the time for corporate governance proposals, but only 11% of the time for social proposals. They find socially responsible funds to be 31% more likely to vote in favor of a shareholder proposal than conventional funds. Finally, they find that mutual fund vote support is strongly positively related to the likelihood of a proposal's passage and subsequent implementation of the activist's request, suggesting that mutual funds are influential shareholders.

Morgan et al's finding that social funds vote differently is unsurprising in light of our finding that only social funds sponsor social proposals, which we attribute to their incentive to market their social advocacy to their target clientele. Presumably, socially-minded investors

would like to verify that their funds are investing and voting according to their stated principles. Two free websites use official votes disclosed on SEC N-PX filings to aggregate mutual fund voting on management and shareholder proposals (fundvotes.com and proxydemocracy.org), providing investors with summary information to compare across funds. For example, using the "Overall Activism Score" that proxydemocracy.org assigns to funds based on how often they vote against management, we find that the socially responsible fund sponsors in our sample range from the 85th percentile (Pax World) to the 98th percentile (Calvert Group) of all mutual funds. In contrast, the two largest fund families, Fidelity and Vanguard, are at the 48th and 13th percentiles respectively. Thus, socially responsible funds appear to have internally consistent voting and advocacy programs.

COLLECTIVE EFFORTS TO PROMOTE MARKET-WIDE CORPORATE REFORMS

Similar to the group of institutions that co-founded the Council of Institutional Investors in 1985 in order to pool resources and more cost-effectively influence corporate governance practices, several investor networks on social issues have recently formed. For example, 100 institutional investors with $10 trillion in assets are part of the Investor Network on Climate Risk, a project initiated by Ceres, a non-governmental organization. In 2007 this network petitioned the SEC to require companies to disclose details about their exposure to climate change risk, and in February 2010 the SEC issued an interpretative release outlining new disclosure requirements for all public companies.

In 2006, groups within the United Nations set a goal of having institutional investors sign on as signatories to the Principles for Responsible Investment (UN PRI), which means they agree to incorporate six principles of integrating ESG and of active ownership into their investment processes, ultimately aligning the objectives of investors with society at large. The number of institutional investor signatories world-wide has gone from 73 in May 2006 to 910 in September 2011. Notably, U.S. signatories include mainstream asset managers such as

BlackRock, Capital Group, and T. Rowe Price in addition to the traditional SRI asset managers such as Calvert and Domini.

THE FUTURE OF ESG-FOCUSED INVESTMENT AND ACTIVISM STRATEGIES BY INSTITUTIONAL INVESTORS

Institutional investment manager behavior and strategies is inherently driven by client demand. By several measures, client demand for socially responsible investment and incorporation of ESG factors is growing rapidly. For example, according to the Social Investment Forum, both the number and assets of exchange traded funds (ETFs) incorporating ESG criteria grew from only 8 with $2.3 billion in assets in 2007 to 26 ETFs with $4.0 billion in assets in 2009, a 74% increase over just two years. Similarly, companies are beginning to provide a SR fund option in their 401(k) plans, presumably due to plan participant interest. Mercer's 2009 Global Defined Contribution Survey reports that 12% of surveyed plans currently offer a SRI option. States have been adding SRI options to 529 College Savings Plans as well. Currently, California, Illinois, Oregon, Pennsylvania, Virginia, and the District of Columbia offer SRI options in their 529 plans. These trends suggest that small investors are gaining interest in ESG issues, which could presage sufficient interest from beneficiaries to ultimately induce their defined-benefit pension plan trustees to consider SRI as well. In a 2009 survey of investment consultants to pension plans conducted jointly by the Social Investment Forum and *Pensions & Investments*, 88% of surveyed respondents stated that client interest in ESG strategies is likely to grow over the next three years. None of the respondents believed client interest would decrease.

A major obstacle for SRI to emerge from its current status as a market niche to the mainstream of institutional investments, however, is the fiduciary duty of pension plans to invest in the best interests of beneficiaries. The massive scale of global pension plan assets has drawn the attention of ESG advocates as a resource to harness toward achieving their goals. If

incorporating ESG gains widespread acceptance among pension funds, this will have profound consequences for the external asset managers they hire as well. Efforts by the UN PRI toward studying the legal and practical issues fiduciaries face in justifying a sustainable investment focus is an important move in this direction. One leading indicator of increased acceptance by pension funds is CalPERS' recent website announcement that they plan to "integrate ESG factors into the Pension Fund's investment process in order to enhance risk management (August 15, 2011)." After commissioning Mercer Consulting to study the issue, they are reportedly ready to launch their "comprehensive plan to implement ESG across all asset classes." Given CalPERS' track record as a pioneer of corporate governance activism, this appears to be a significant development.

CONCLUSION

The predominant perception in the academic finance literature is that socially responsible investing and activism is an activity in the realm of the gadflies and financial fringe. For example, Starks (2009) concludes that "…a minority of investors believe that social responsibility issues have important implications for a firm's actions and value (p. 467)." In a similar vein, Thomas and Cotter (2007) conclude that "shareholders view corporate governance proposals as connected to firm value and therefore worthy of support, whereas their beliefs about social responsibility proposals are precisely the opposite (p. 389)."

After 25 years of institutional investor advocacy regarding corporate governance issues, once radical notions (e.g., a majority of the board and key committees should be independent of management) are mainstream today. Reviewing the current institutional social activist activity and trends, we predict a similar sea change in investor attitudes toward social issues. If practitioner interest is a leading indicator, we are also likely to see much more research on the understudied economic and financial impact of social issues in the future.

DISCUSSION QUESTIONS

1. Contrast a pension plan trustee's decision to invest according to ESG principles compared to a mutual fund manager's decision. Is there any difference in the factors that should drive each decision?
2. From the perspective of an activist, what are the advantages and disadvantages of submitting shareholder proposals to the corporate proxy as a tool for activism?
3. Compare and contrast socially responsible shareholder proposals with corporate governance proposals in terms of success rates, proposal sponsors, sponsor motivations, etc.
4. Do you think socially responsible activism among institutional investors will increase, decrease, or stay the same in the next ten years? Explain the reasoning behind your prediction.

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Exhibit 20.1 Socially Responsible Shareholder Proposal Submissions

This exhibit provides an annual count of all socially responsible SEC Rule 14a-8 shareholder proposals from the 1992 to 2010 proxy seasons. The totals include all proposals submitted to target firms for placement on the proxy, including proposals that were subsequently omitted due to an SEC rule violation or withdrawn by the proposal sponsor. In generating proposal counts, we adjust for co-sponsored proposals to avoid double-counting. Institutional investor sponsors include public pension funds, union pension funds, socially responsible mutual funds, and investment advisers. Non-institutional investors include individuals, religious organizations, and non-governmental organizations (e.g., Sierra Club). The data from 1997 to 2010 is from RiskMetrics (originally from the Investor Responsibility Research Center), while the 1992-1996 sample is from Tkac (2006).

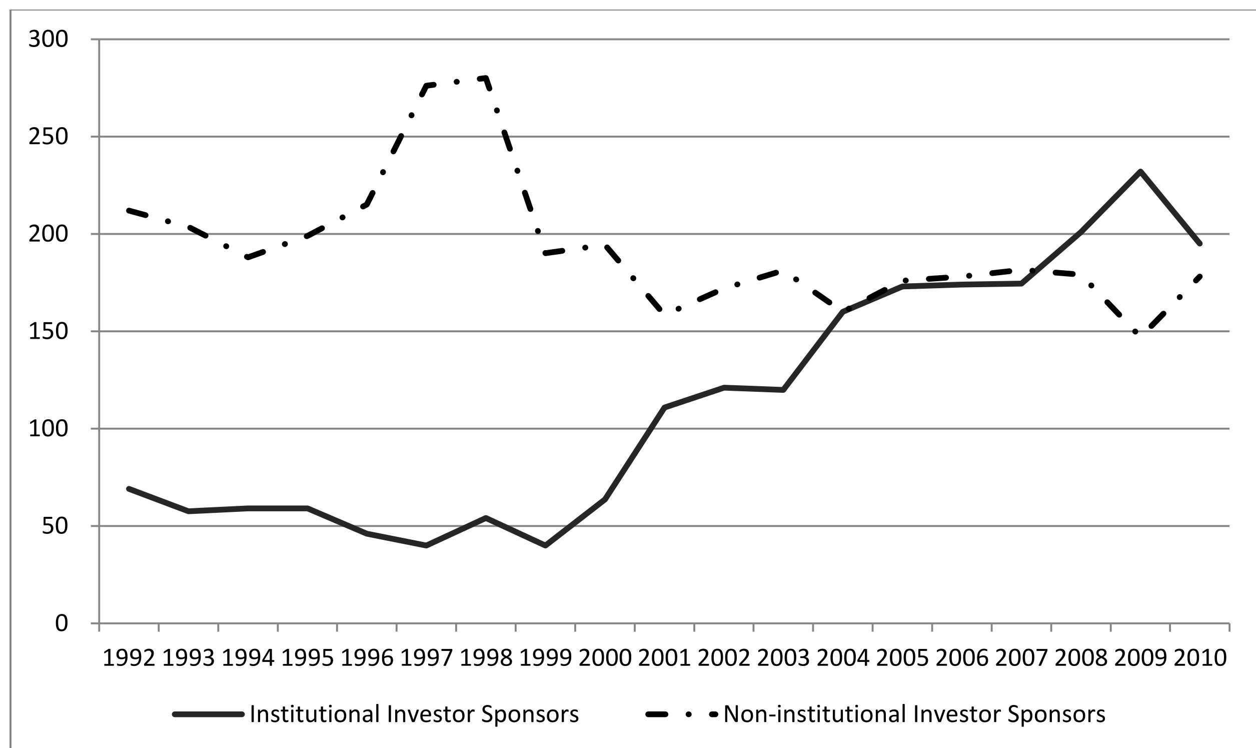

Exhibit 20.2 Number of Socially Responsible Shareholder Proposals by Sponsor (1992 – 2010)

This exhibit summarizes submitted proposals by sponsor and time period for four institutional investor sponsor types. In each sponsor type category, we provide summary information in addition to a listing of the top three individual sponsors. The final column provides the percentage of all proposals in that sponsor-type category represented by the sponsor in that row. For this exhibit, we do not adjust for co-sponsored proposals. In the case of a co-sponsored proposal, we count the proposal for each co-sponsor.

Sponsor Name	**1992 - 2000**	**2001 - 2010**	**Total No.**	**% of Category**
New York City Pension Funds	196	584	780	86.0%
Minnesota State Board of Investment	25	31	56	6.2%
Connecticut Retirement Plans & Trust Funds	0	32	32	3.5%
All other public pension funds (N=7)	2	37	39	4.3%
Total public pension funds	223	684	907	100.0%
AFL-CIO	3	82	85	21.4%
LongView Collective Investment Fund	30	32	62	15.6%
International Brotherhood of Teamsters	5	48	53	13.4%
All other union pension funds (N=25)	97	100	197	49.6%
Total union pension funds	135	262	397	100.0%
Calvert Group	12	192	204	48.0%
Domini Social Investments	9	93	102	24.0%
Green Century	4	57	61	14.4%
All other SRI mutual funds (N=7)	19	39	58	13.6%
Total SRI mutual funds	44	381	425	100.0%
Walden Asset Management	11	153	164	26.5%
Trillium Asset Management	53	116	169	27.3%
Harrington Investments	22	105	127	20.5%
All other SRI investment advisers (N=10)	38	121	159	25.7%
Total SRI investment advisers	124	495	619	100.0%

Exhibit 20.3 Socially Responsible Shareholder Proposal Topics (1992 – 2010)

This exhibit shows the range of topics sponsored by institutional and non-institutional investors during our sample period. Typical proposals for each category are given in parentheses following the category name: energy and environment (issue sustainability report, endorse Ceres principles), community/charities (issue community reinvestment report, disclose charitable contributions), human rights (adopt human rights policy, no purchase of forced labor products), workplace standards (implement International Labor Organization standards and third-party monitoring), anti-discrimination (adopt sexual orientation anti-bias policy, implement MacBride principles), product (report on genetically-engineered food), corporate governance (board diversity, link executive pay to social criteria), controversial business (divest tobacco holdings, report on foreign military sales), political donations (disclose political donations), animal rights (stop animal testing), health care policy (adopt principles of health care reform), abortion (no contributions to abortion providers). For this exhibit, co-sponsored proposals are adjusted to avoid double-counting.

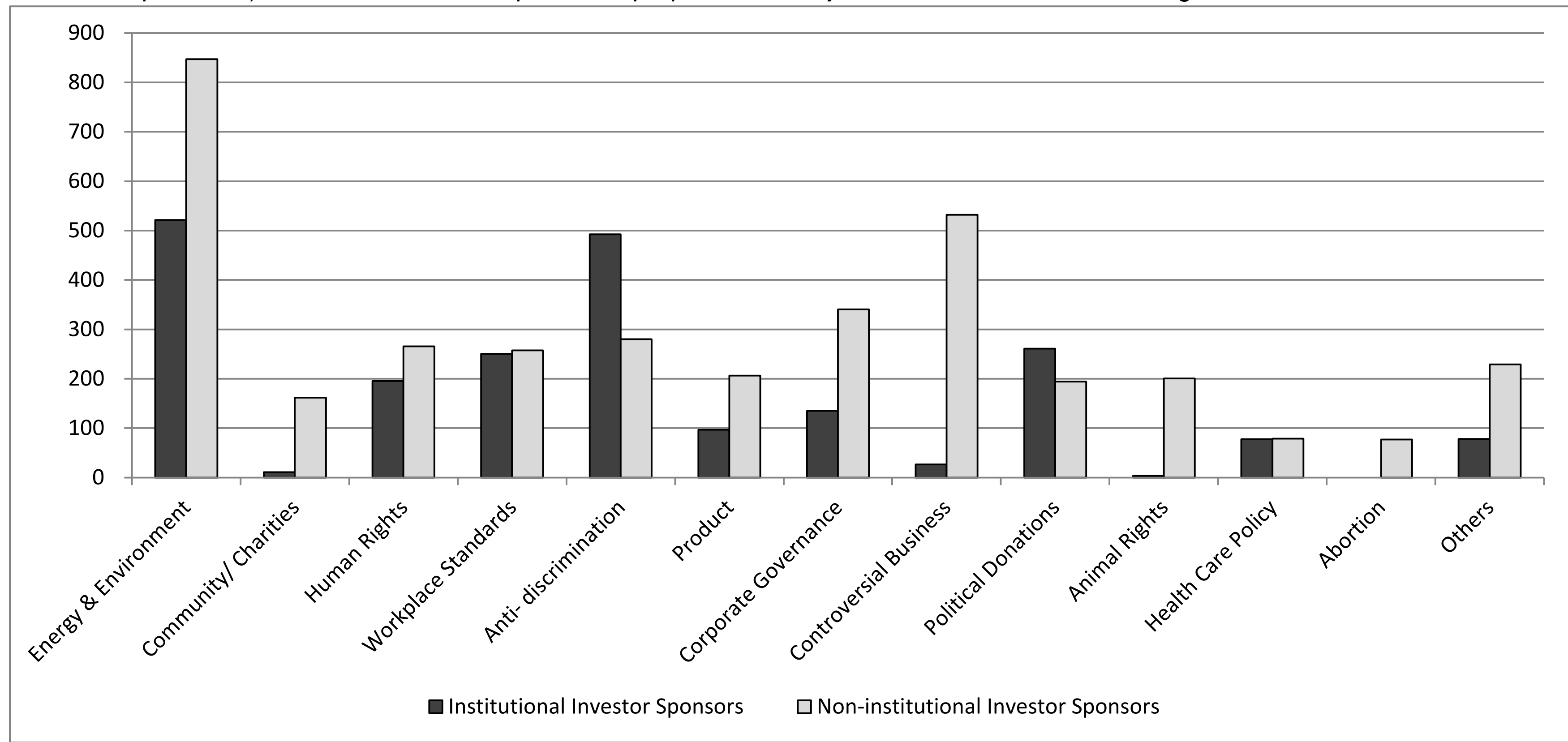

Exhibit 20.4 Actions Requested by Sponsors (1992 – 2010)

This exhibit reports the types of action requested by institutional and non-institutional investors during our sample period. Institutional investor sponsors did not submit any proposals in the category of "stop support for certain groups or make certain contributions/aid." Co-sponsored proposals are adjusted to avoid double-counting.

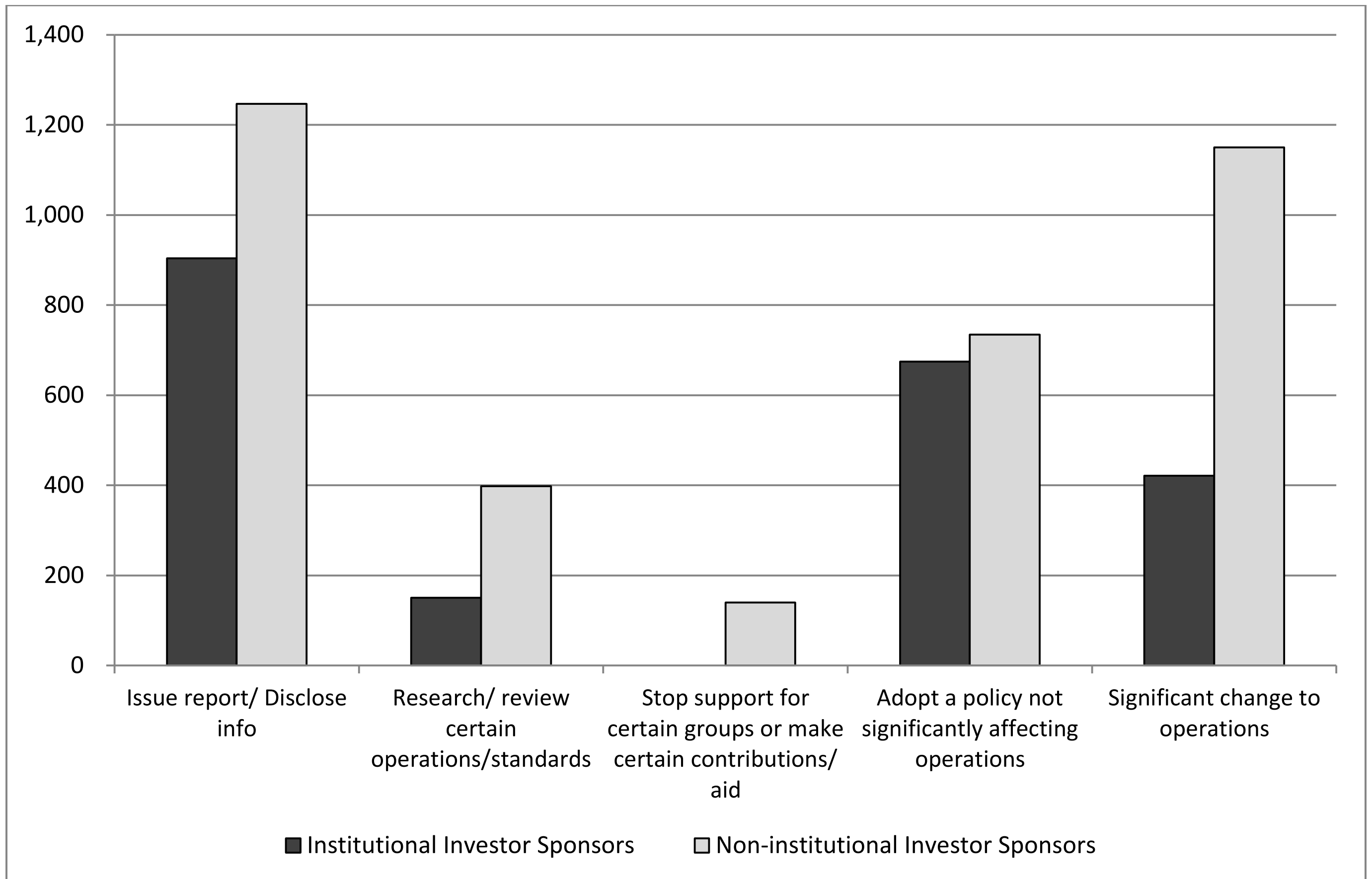

Exhibit 20.5 Average Vote Support for Socially Responsible Shareholder Proposals

This exhibit displays the trend in the average percentage of votes cast in favor of the shareholder proposal for proposals by institutional and by non-institutional investor sponsors. In computing the average percentage vote support, a co-sponsored proposal is included once for a group if it is sponsored by at least one member of the group.

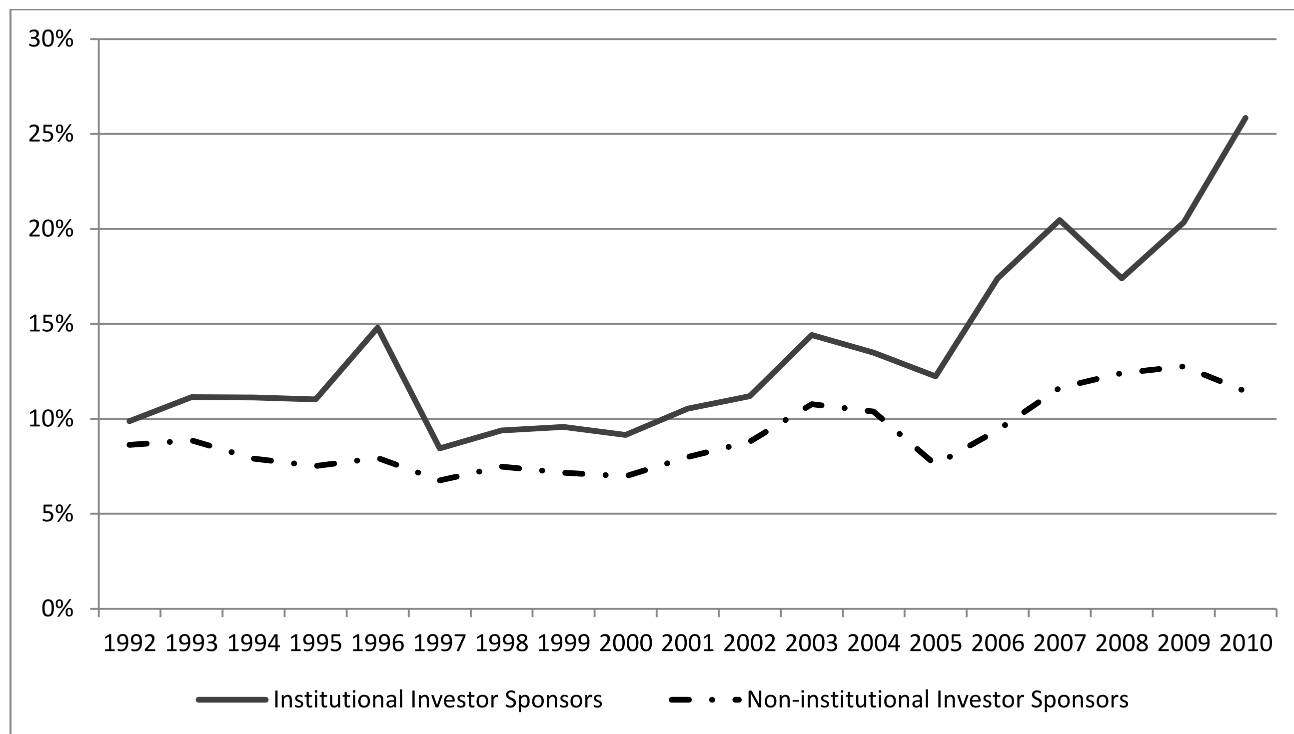

Exhibit 20.6 Distribution of Proposal Outcomes by Sponsor (1992 – 2010)

This exhibit illustrates the differences in proposal outcomes across sponsor types. For each sponsor type, we report the percentage of submitted proposals that come to a vote at the annual meeting, that are voluntarily withdrawn by the sponsor before the annual meeting and therefore do not appear on the proxy, and that are allowed to be omitted from the proxy by the SEC. There are 196 proposals or 3% of our sample with other outcomes (not in proxy, not presented, meeting cancelled, etc) that are excluded from this exhibit. Co-sponsored proposals are not adjusted for double-counting.