The role of shareholders and institutional investors: responsible investing and shareholder engagement as a vector of corporate governance?

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Given the weight of their votes, the way in which institutional shareholders use their power to influence the standards of corporate governance is of fundamental importance.
The Cadbury Report, 1992

The crisis of confidence caused by the financial scandals of the last 20 years has prompted some organizations to conduct a critical examination of their practices (Currie, Knights, & Starkey, 2010; Pfeffer & Fong, 2004). These scandals have forced many players, including civil society and investors, to reconsider organizations' quality of governance (Abid & Ahmed, 2014; Cohan, 2002). Moreover, many investment firms and financial institutions have had to rethink and revise their investment strategies (Majoch et al., 2017; Woods & Urwin, 2010). Like organizations (Elkington, 1993; Hart, 1995; Milne, Tregidga, & Walton, 2009), investors and managers now face pressures from various stakeholders. In addition, some are questioning their organizational management as well as the inclusion of environmental, social and governance (ESG) factors in their management methods (Majoch et al., 2017). This is why researchers and professionals in the field are showing greater interest in shareholder engagement strategies.

Responsible investing

For many years now, responsible investing (RI) has been an area of interest worldwide in both academic and entrepreneurial circles. In 2003, RI achieved international recognition with the emergence of the United Nations Principles for Responsible Investment (UNPRI). RI differs from traditional funds, or "mainstreams," by applying various strategies for observing and promoting ESG issues. Between 2013 and 2015, the Canadian RI industry grew by 48% (Responsible Investment Association, 2017). RI may be defined as "an investment approach that includes environmental, social and governance criteria in the selection and management of placements and investments" (Desjardins, 2018). These strategies may focus on the application of negative filters (e.g., sin stocks) or positive filters (e.g., benchmarking) in stock selection and may extend to shareholder engagement, or activism.

Shareholder engagement is based on four strategies: dialogue, submission of shareholder resolutions, disinvestment, and proxy voting (Éthiquette, 2014). These four strategies are independent of one another, though some investors may apply more than one of them concurrently. For example, following a dialogue with an organization, investors may submit a shareholder resolution at the annual general meeting (AGM) and rally other investors as part of a campaign to encourage them to vote for the resolution when conducting a proxy vote. To take a specific example, Trillium Asset Management, along with four public investment funds, submitted a shareholder resolution to the 2019 Facebook AGM to replace Mark Zuckerberg as chair of the board of directors. These investors stated that this resolution was motivated by a desire for more independent oversight. They had also submitted a shareholder resolution to the 2018 AGM regarding establishment of a risk management committee (Bernard, 2018).

The shareholders' role

Although boards are often perceived as guardians of sound governance, they do not have sole responsibility. Indeed, shareholders can play a major decision-making role, through RI among other means. Shareholders' position in institutional governance is complex, however (Solomon & Solomon, 2004). In the section of the Cadbury report (1992) devoted to shareholders' rights and responsibilities, institutional governance was refocused not only on companies and the effectiveness of their boards but also on the role that shareholders should play. The report emphasized proxy voting as a shareholder strategy, suggesting that shareholders should use their voting rights at general meetings. In a sense, they represent another institutional governance mechanism that can substantially control and influence the management of organizations as well as aligning the interests of management with those of the shareholder group.

My own research does not attempt to draw a parallel or signal a contradiction between so-called "mainstream" investment financial instruments and RI, but many reports have indicated that weak corporate governance was responsible for a great majority of financial crises (e.g., the Canadian Association for Socially Responsible Investment (CASRI), 2009). According to CASRI (2009), corporate governance – which includes points such as the strengthening of shareholders' rights and the diversity and independence of directors – is a central concern of RI. Corporate governance (CASRI, 2009), which also includes shareholder engagement as a governance mechanism, has failed to prevent some companies from operating recklessly (e.g., BP). This has potentially eroded the trust of stakeholders, giving them the impression that they were voiceless in the face of disarray at some companies, with a fairly direct impact on the lives of many individuals.

Yet shareholders can make their voices heard and may sometimes have impacts on corporate governance. This brings to mind Volkswagen shareholders, who decided to take concrete action against the carmaker. DSW, a federation representing more than 25,000 German shareholders, mobilized following the "dieselgate" scandal, which drew attention starting in September 2015 when several journalists exposed problematic data involving some of the German company's vehicles. U.S. authorities revealed then that about "482,000 Volkswagen and Audi vehicles, built between 2009 and 2015 and sold in the United States, were equipped with software that could automatically detect anti-pollution measurement tests and falsify the results" (Peard, 2015). Across the Atlantic, the European Commission had to respond to allegations from the *Financial Times* stating that it knew carmakers were rigging engines to falsify anti-pollution tests as early as 2013 (Brunsden & Olivier, 2015).

On May 30, 2016, DSW submitted a shareholder resolution. Germany's biggest private investors' association was seeking a special audit of the actions of company management with respect to "dieselgate." What was the role of the auditor sought by the shareholders, according to the resolution submitted by DSW? In accordance with German corporate law, and following adoption of the resolution at a general meeting, the auditor was in charge of verifying the directors' role, more specifically whether they had violated their legal obligations and voluntarily caused harm. The auditor was also tasked with examining whether the company's risk management and compliance provisions had been adequately reviewed and corrected.

In addition, Volkswagen hired the law firm Jones Day to conduct an internal investigation into the legal duties of directors and executives regarding the disclosure of fraudulent data (Manifest, 2016). However, DSW wanted the firm Baker Tilly Roelfs AG Wirtschaftsprüfungsgesellschaft to conduct this investigation independently (Manifest, 2016). “When you have an independent investigation, you can be sure that the findings will be publicized. With internal investigations, you do not know whether everything has been made transparent,” DSW spokesperson Jürgen Kurz said (Manifest, 2016).

The shareholders’ resolution was not enough on it own, however. Institutional investors (for example, the Norwegian fund Hermes Equity Ownership Services) signed on to the resolution for it to obtain a majority of votes. Proxy voting must go hand-in-hand with the other forms of shareholder engagement to be a vector of effective corporate governance. With the many lawsuits the carmaker was facing, it was interesting to see shareholder strength rallying for sounder corporate governance. For these reasons, among others, shareholder engagement and RI may not serve only as governance mechanisms but can also promote sound governance.

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