GOVERNANCE & ACCOUNTABILITY INSTITUTE'S

TO THE POINT!™

Timely Insights & Perspectives on Corporate Sustainability, Responsibility & Citizenship

EXTRA BACKGROUND

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1.10 Tracking ESG Ratings Players Influencing the Capital Markets

Governance & Accountability Institute shares timely news, insights and perspectives with corporate managers in key topic areas: *corporate citizenship; corporate responsibility; corporate sustainability; community affairs; sustainable investing.*

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BACKGROUND INFORMATION FOR YOU ABOUT SOME KEY ESG THIRD PARTY PLAYERS AND IMPORTANT TRENDS...THE LONG WAVE

Today, as many more asset owners and their managers -- key fiduciaries -- adopt policies, practices and methodologies for guiding their portfolio construction, the terms coming into vogue include *sustainable investing; sustainable & responsible investing; impact investing; ethical investing; faith-based or values-based investing*, and "ESG" for a range of activities, starting with performance analysis.

Here is some background that we think will be helpful for you in understanding where we have come from over the past three or more decades, and who the key players are.

Here's where we came from over the past two decades...

SETTING THE STAGE FOR DRAMATIC *LONG-WAVE CHANGES* IN THE CAPITAL MARKETS

Some of the early analytics firms started with a clear focus on corporate governance (the "G" in ESG), and over time broadened their perspectives to include E and S.

A number of key institutional investors still remain clearly focused on the G. And some sustainable investors are expanding the view of "G" to include the *governance of* the total ESG performance of a company, and expanded definition of corporate governance.

As explained in an accompanying commentary, the journey toward today's broadening adoption of *sustainable investing* et al approaches of the 21st Century began with a relatively few investors adopting the term, "socially responsible investing" ("SRI") some three decades ago. The hub of this activity was in Boston and New England.

This term (SRI) was adopted by institutions interested in the new approach described how fiduciaries were analyzing publicly-traded companies to guide both institutional (and individual) investing beyond the traditional financials of a company.

- The first clearly-understood approach for many S&R investors was to ***screen out*** certain industries and individual companies (such as firms involved in tobacco, alcohol, gaming, weapons manufacture).

- Over time this became a more sophisticated approach with more accurate sustainability analysis being made available by third party providers -- and so selection of companies ***to be included*** *in* the asset owners' holdings (screening in) evolved.

- S&R investors also pursued more ***active engage*****ment** with corporate boards and C-suite executives to discuss the investors' concerns and attempt to persuade the company to change certain behaviors, adopt new policies, address issues of concern to investors.

- Engagement with companies to dialogue on ESG performance was another defining characteristic that evolved to move the conversation beyond governance matters alone.

- Considering a company's "ESG" profile (environmental, social and governance strategies, performance, achievements, and other factors) quickly evolved as a preferred term for many investors and their service providers.

Today, "Sustainable Investing" is another preferred term. And SRI is still very much in use as descriptive term, evolving to become "sustainable & responsible & impact" investing.

This is what we at G&A call "the sustainability journey," for both halves of the capital market; for the companies embracing sustainability, and for the institutions and individual investors adopting sustainable & responsible & impact investing guidelines and methodologies.

It's been a very *l-o-n-g* journey!

THE LONG WAVE CONTEXT FOR SRI

Background For Corporate Managers

There have been a number of attempts in the modern industrial economy (going back more than 100 years) to attempt to "regulate" and "supervise" the conduct of American corporations. The marketplace regulated small business; one could avoid doing business with an unethical entrepreneur. As the Industrial Revolution took hold and spawned giant American industries in steel, food, oil & gas, electricity generation, railroads --- the public demanded more accountability.

President Theodore Roosevelt (#26, serving 1901-1909) responded, establishing a Federal Bureau of Corporations to regulate *Big Business*. He was an early "trust-buster." TR was able to get the *Pure Food and Drug Act* passed (leading to creation of today's Food & Drug Administration).

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TR's successors, President William Taft (#27 - 1909-1913) and President Woodrow Wilson (#28 - 1913-1921) were able to put still more consumer protections in place, as well as advance Federal anti-trust, anti-monopolistic regulations. For example, the laws regarding child labor and workday conditions were adopted; there was more vigorous enforcement of the anti-trust regulations.

It took a spectacular stock market crash (in October 1929) and more than 10 years of broad populace suffering in the *Great Depression* era that followed to put in place extensions of the earlier presidents' work and to convince the members of the U.S. Congress (and the American People) to enact sweeping regulations we know as the 1933 and 1934 Acts (1933 action: *Securities Act*; 1934 action: *The Securities Exchange Act).*

It was another Roosevelt -- Franklin Delano R, former governor of New York, sixth cousin of TR -- who used much of the New York State securities regulation *(The Martin Act,* passed in 1926) as model to shape what would become the Securities & Exchange Commission, which was created by the *1933 Act.*

New York Attorney General Eliot Spitzer many years later used *The Martin Act* provisions to tangle with the leading broker-dealers on financial analysis missteps.

- What is important to keep in mind today and going forward is that important legislation and regulatory rules that have been adopted in our generation were in large measure built on the historic '33 and '34 legislation.

- Two prime examples are very familiar to us: "Sarbanes-Oxley" (2002 - a/k/a "SOX" and The *Public Company Accounting and Auditing Responsibility and Transparency Act ;* and "Dodd-Frank" (passed in 2010 - *The Dodd-Frank Wall Street Reform and Consumer Protection Act).*

Sarbanes-Oxley ("SOX") was passed by the 107th Congress and signed into law by then-President George W. Bush in summer 2002 following the collapse of Enron, WorldCom, Adelphia Cable, and accounting scandals at other prominent public companies.

What Happened Next

Sarbanes-Oxley had major 11 "titles" (many containing other sub-titles for the issues they addressed) and many parts were targeted to reform "accounting," "corporate governance" and related issues. Example: Title VIII, "*Corporate and Criminal Fraud Accountability Act of 2002*."

A cottage industry of third party service providers benefitted from the passage of SOX.

In February 2003, as SOX rules were being put in place, G&A Institute Chair Hank Boerner authored a commentary for *BNA Corporate Governance Report*. Title: "Scorekeepers, Rankers, Raters Will Shape Company Reputations."

He explained: *A "cottage industry" of "scorekeepers" now analyze, judge, rate, and otherwise qualify public companies' corporate governance and accountability practices.*

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In the description of these players, there were of course were large companies -- such as Standard & Poor's (S&P), then owned by McGraw-Hill and focused on credit ratings. The company was developing a corporate governance scoring method (a new product).

And there were players to watch that had direct influence on companies through their work in the investing sector. These "watchdogs to watch," explained Boerner 14 years ago, included:

- **Institutional Shareholder Services** (ISS), which had just launched a "Corporate Governance Quotient" product for fiduciaries with scores (1-to-100) on seven major topics and 51 subsets of CG issues assigned to the Russell 3000 companies.

  2017 update: This product was available to investors for more than a decade and was retired. Corporate managers complained about the methodology and ratings. ISS became part of MSCI and then was spun off to a P/E company, Vestar. Information: https://www.issgovernance.com/

  Explained ISS VP and Director of Corporate Program Patrick McGurn in 2003: "We are seeing both revolutionary and slower-paced evolutionary moves to improve corporate governance standards and practices. [These steps] are intended to rebuild investor confidence." He predicted that boards would have an independent "lead director" and the separation of board and chair positions, or at least investors demanding this.

  Today, McGurn is Special Counsel and Head of Strategic Research and Analysis at ISS. He is a member of the Council of Institutional Investors' Markets Advisory Council.

- **Domini Social Investments** was busily leveraging the work of its Domini 400 Social Index to call attention to its investments (including the firm's equity fund). (The index work began in 1989, to look like the S&P 500 Index except holdings were based on "S' and E standards.) S&R Investors used the index; in a survey by US Social Investment Forum at that time, an estimated $1-in-$8 invested was using Domini or similar analysis for mutual fund management. The trio of founders -- Peter Kinder, Steven Lydenberg and Amy Domini -- 10 years before SOX was passed published a great encyclopedia of ESG investing: *Social Investment Almanac*.

  2017 update: Amy Domini in 2003 was the "D" in KLD Research, then a private firm that generated research and indexes and benchmarks for investors. Domini today is an independent firm -- Domini Impact Investments LLC, with three funds with $1.8 billion AUM -- and the former KLD organization is part of MSCI, which still manages the indexes.

  Today, Amy Domini is Founder and Chair of Domini. The "L" in the former KLD was co-founder Steven Lydenberg, who is Partner-Strategic Vision. Peter Kinder is not involved. The MSCI and Domini firms are not affiliated. Information: https://www.domini.com

- **FTSE4Good**, an index series from *The Financial Times* global indexes was being offered to investors. The indexes were based on corporate environmental, human rights and stakeholder engagement performance.

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2017 update: Still an influence in the capital markets, especially in Europe and the UK, where it is based. The difference between FTSE4Good and the DJSI is that the former screens out certain industries.

- **Interfaith Center on Corporate Responsibility** (ICCR), the faith-based investment coalition. The coalition was focused on energy and environment; global finance; community economic development, international health issues; militarism and violence. It was then in its 25th year of activism, headed by **Tim Smith**, who is now the major force at Walden Asset Management and within SRI circles (he was an organizer of, and chair of, Social Investment Forum/US SIF).

  2017 update: ICCR is still a major force in shaping the annual U.S. corporate proxy voting campaigns, and a leader in creating change in corporate behaviors and practices. The 300 institutional members manage $1 billion in AUM and influence many more billion's in Assets Under Management by affiliated institutions. See: http://www.iccr.org/

- **The Center for Financial Research & Analysis**, headed then by founder/CEO and former university accounting professor Howard Schilit, Ph.D., CPA. This is the organization that detected many large-cap accounting frauds and had a large following of influential investors. In 2003 it had 3,000 investment professionals at 800 institutional investing organizations as clients, and was about to launch "Diagnostic Reports," focused on the quality of earnings for every S&P 500(r) company.

  2017 update: Professor Schilit later sold his firm but continues as a forensic accounting consultant through Schilit Forensics. His book -- *Financial Shenanigans* - first published in 1993 is now in its third edition and continues to sell well. See: http://www.schilit.com/

- **AFL-CIO Office of Investment**. In 2003, the Office was circulating voting guidelines for member union fund managers and other shareholder activists.

  2017 update: This umbrella labor organization manages more than US$400 billion in AUM and is very much a shareholder activist. "We advocate for greater corporate accountability, worker-friendly corporate practices, and well-regulated capital markets," AFL CIO states. The Office keeps track of investment manager proxy votes (such as JP Morgan Chase and Alliance Bernstein) for labor's member funds. Information at: https://aflcio.org/what-unions-do/social-economic-justice/corporate-accountability

- **TIAA-CREF** (Teachers Insurance and Annuity Association - College Retirement Equities Fund), is the nation's largest retirement complex. The firm adopted corporate governance voting guidelines before the corporate scandals and was meeting with corporate managements to discuss CG improvements.

  2017 update: Now known more generally as "TIAA," the non-profit offers its beneficiary-members TIAA-CREF Social Choice Equity Retirement Fund (TRSCX) has $2.6 in AUM.

Amy Muska O'Brien, who was in 2003 helping to manage the United Church of Christ (UCC) pension boards, and was active in the ICCR activist coalition as the UCC member representative, joined TIAA (in 2005) to manage the SRI portfolio. Today she is Managing Director and Head of Responsible Investment and a member of the UN Principles for Responsible Investment's Reporting and Assessment Committee. TIAA is a *Fortune 100* financial services organization. The CEO explains that consideration of ESG factors is universal throughout the $400 billion AUM. Information at: https://www.tiaa.org

- **California Public Employees Retirement System**. The largest of the state pension fund complexes, CalPERS had adopted corporate governance policies for its investment management team. The guidelines are presented to companies with a request to consider adopting all or part.

  2017 update: CalPERS was a pioneer among large U.S. public employee retirement systems in focusing on corporate governance and developing policies for proxy voting, including introducing shareholder resolutions but more focused on active engagement with boards and managements. CalPERS, with $330 billion in AUM, invests in 10,000 companies. It has an **ESG 5-Year Strategic Plan** and **Global Governance Principles**. Over time, its original governance focus expanded to today's ESG practices and policies. For a time, CalPERS announced a watch list (portfolio companies that it wanted to see CG improvements in) but when other investors began to use the list as a sort of index for their own investing, CalPERS dropped the practice. See: https://www.calpers.ca.gov/page/investments

- **Council of Institutional Investors** (CII), the trade group for many institutional investors. CII had activist investors in the early days and put in place guidelines for its fiduciary-members including corporate governance issues.

  2017 update: The group has many public employee funds and organized labor funds in its membership and calls itself "the voice of corporate governance." Issues in focus include executive compensation; CEO succession; board diversity; also, independence of accounting standard setters is a concern. There's information for you at: http://www.cii.org/policies

All of the above organizations were in various ways putting in place stricter corporate governance policies and practices -- and influencing public companies -- leading the way a decade later to the now-familiar ESG approaches.

In 2003, BNA was the employee-owned Bureau of National Affairs in Washington DC; it was acquired by and is a part of Bloomberg LP today.

Hank Boerner's commentary is posted at:
http://www.hankboerner.com/library/bnacgr.stm