WALTER SCOTT

BNY MELLON | INVESTMENT MANAGEMENT

FROM PIGS TO COTTON – THE RISE OF THE SHAREHOLDER PROPOSAL

FIRST PUBLISHED FEBRUARY 2023

Few stories typified the trend towards purpose-driven shareholder proposals in 2022 than Carl Icahn's unsuccessful attempt to force McDonald's to improve its treatment of pigs. When one of the world's most feared activist investors, and the man said to be the inspiration for the character of Gordon Gekko in the film 'Wall Street', believes it to be his responsibility to "help rectify glaring injustices" it is probably no exaggeration to suggest that we are in a new era. Proxy season is increasingly defined as much by corporate purpose as it is by corporate profit.

ALAN EDINGTON
Investment Manager – Responsible Investment

Reflecting this change, in the second quarter of 2022 alone, Walter Scott's Investment Stewardship Committee considered more shareholder proposals than in the whole of 2021. In many ways, we welcome this increased level of shareholder scrutiny; an engaged shareholder base has a valuable role to play in holding management to account and protecting shareholder interests. Too often, however, what can appear a reasonable objective on paper fails to withstand closer inspection, particularly in this era of impact investing and politically motivated shareholder activism. Nuance is not always much in evidence and too often, a good understanding of the business in question is lacking.

When considering a shareholder proposal, our starting point is simple: is the proposal in the best long-term interests of shareholders? Answering that question is not always quite as straightforward, however. Due consideration must be given to myriad factors. We will look at materiality and direction of travel. Is a company already making positive progress on the issue in question (by voting in favour do we risk making the perfect the enemy of the good)? While a proposal may be desirable, are there other more pressing matters on which management should be focusing (even the most well-run companies cannot do everything at once)?

> *"When considering a shareholder proposal, our starting point is simple: is the proposal in the best long-term interests of shareholders?"*

To help us crystallise our thoughts, we frequently engage with management in advance of voting. Not only does this help us to better understand their position but it also provides us with the opportunity to communicate our thinking on the proposal in question. In our experience, we find management teams can respond more positively to constructive recommendations from long-term investors than the often-blunt instrument of shareholder proposals. The former rather than the latter is, in our view, typically the most effective tool for achieving positive change.

> *"It is extremely difficult for any company of significant scale to ensure 100% compliance within its supply chain"*

One proposal concerning an emotive topic during 2022 related to Nike and requested that that company "adopt a policy to pause sourcing of cotton and other raw materials from China until the U.S. government Business Advisory is lifted or rescinded." Few would disagree that companies should be taking the steps necessary to try and ensure they are not using materials produced under conditions of forced labour. But it is also important to understand the limitations on what can be achieved and acknowledge when a company is working hard to adhere to best practice.

Our initial reaction to the proposal was that its fundamental objective – do no business with China – was unrealistic, given the country is integral to Nike's necessarily Asia-focused sourcing model. A deep understanding of the issues involved and Nike's approach to sustainability helped to inform our decision.

Supply chain and sourcing risk is an area into which we have conducted significant research in recent years, and it remains an ongoing focus for our Research team. In 2019, two members of the team undertook an extensive trip to Vietnam and Bangladesh to better understand the Asian supply chain for the global apparel industry. It was clear from our conversations with industry participants that the international brands were driving a consolidation around best-in-class suppliers but that risks, particularly in relation to second-tier suppliers, remained. As investors, we think this necessitates a pragmatic approach: we expect our investee companies to be fully committed to upholding high standards in their supply chains, while understanding that it is unrealistic to expect them to eliminate risk completely.

Viewed through this lens, Nike is a market leader, with an approach that continues to improve and evolve. We know from many years of engagement that this is a business that takes its sustainability responsibilities very seriously. While the company does not own or operate the factories which manufacture its products, it does implement a supplier code of conduct to which all facilities must adhere. This policy prohibits any type of forced labour, and regular evaluation, including announced and unannounced third-party monitoring, is conducted in a bid to identify non-compliance. Furthermore, 100% of Nike's materials are expected to come from facilities that meet its sourcing criteria by 2025. Several initiatives aimed at improving the traceability and mapping of raw material sources, including DNA testing, are also in place.

> *"The year ahead will likely be another busy one for shareholder proposals"*

It is important to bear in mind, however, that this work is conducted on a 'best efforts' basis – it is extremely difficult for any company of significant scale to ensure 100% compliance within its supply chain.

Nike understands that this leaves the business open to a degree of risk but works hard to mitigate this and wherever possible to promote best practice and positive change. It should be supported in its efforts where it is already a clear industry leader.

The year ahead will likely be another busy one for shareholder proposals. In the words of The Economist "annual meetings are the new frontline in the battle over corporate purpose." Thoughtful analysis and upholding our fiduciary duty will continue to define our approach.

WALTER SCOTT & PARTNERS LIMITED, ONE CHARLOTTE SQUARE, EDINBURGH EH2 4DR
TEL: +44 (0)131 225 1357 · FAX: +44 (0)131 225 7997
WWW.WALTERSCOTT.COM

Registered in Scotland 93685. Registered Office as above. Authorised and regulated by the Financial Conduct Authority.
FCA Head Office: 12 Endeavour Square, London E20 1JN · www.fca.org.uk