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Hedge Funds Starting To Consider ESG Issues In Campaigns

By **Chelsea Naso**

Law360 (March 30, 2018, 5:33 PM EDT) -- Activist hedge funds better known for their financially focused campaigns are increasingly looking at public companies' environmental, social and governance profiles, as institutional investors call for an emphasis on long-term value and markets react to the political climate and corporate scandals.

The focus on environmental, social and governance, or ESG, topics is not necessarily new, but it is a relative newcomer to the playbook of economic shareholder activists as issues like environmental sustainability, climate change, sexual harassment, and board and employee diversity are affecting public companies' worth.

"People haven't really made the connection between shareholder activism and companies' ESG profiles and just assume shareholder activists are concerned with one thing and one thing only, and that's performance and value creation. But actually, it all goes together," said Andrew Freedman, co-chair of Olshan Frome Wolosky LLP's activist and equity investment practice.

"Our activist clients, they're very focused on companies' ESG profiles because they want to understand when approaching any investment what the risks are within any given company. ESG — the environmental, social and governance quotient — plays directly into that," he said.

The trend is reinforced by a growing emphasis on those topics by institutional investors, whose votes activists often have to court for a successful campaign.

BlackRock Inc., for example, made headlines in January with a letter from CEO Larry Fink to public company CEOs that described its plans to promote board diversity and encourage companies and their boards to evaluate their role in the community, impact on the environment and response to technological change.

The letter echoed a January 2017 letter to board members from State Street's Chief Operating Officer Ronald O'Hanley. In it, O'Hanley outlined the fund's plan to target "board oversight of environmental and social sustainability in areas such as climate change, water management, supply chain management, safety issues, workplace diversity and talent development," contending that those areas "can pose both risks and opportunities for long-term returns."

"It's a huge step in the philosophy behind ESG and investor activism," said Nicole Crum, head of Sullivan & Worcester LLP's corporate governance practice.

Fink's letter also hit around the same time that activist hedge fund Jana Partners issued an open letter with the California State Teachers' Retirement System, or CalSTRS, that urged Apple Inc. to address device addiction among children and teens. The pair noted at the time that they held about $2 billion worth of the tech giant's stock.

Jana's efforts highlight the shifting focus of campaigns for the more traditional shareholder activists.

"Hedge funds are becoming more aware how these two areas of 'E' and 'S' can affect the companies' bottom lines and especially their stock holdings, not just in the long term but the short term as well," said Alexandra Higgins, managing director of proxy solicitation and investor response firm Okapi Partners LLC.

"By being proactive in these campaigns, and joining forces with institutional investors in these campaigns, they are more likely to get their support should a company be unresponsive to their demands for change," she added.

One of the more common areas of focus for more traditional activists is on diversity in the boardroom, which can help a company address a range of issues like employee diversity and sexual harassment.

The effect those topics can have on public companies has also been made apparent following recent scandals. The Weinstein Co. headed into Delaware bankruptcy court earlier this month, after a series of explosive reports came out about co-founder Harvey Weinstein's alleged pattern of sexual harassment and abuse. The allegations against Weinstein energized the #MeToo movement of calling out predatory behavior by men in power and also wiped out The Weinstein Co.'s value.

"Boards are thinking about what's happening in the company in a different way. Sexual harassment, for example, is something boards are talking about. That was previously viewed as an HR issue," Crum said.

The demise of The Weinstein Co. — and at least two failed attempts to sell the company since — is making the need for a mix of different voices in the boardroom apparent.

"Different ideas resource the board on how to even talk about these issues. It can be a little intimidating to take some of these things on. And having directors with different ideas lets the board work out some of these issues in private with the benefit of a perspective they might not previously have had," Crum said.

While boardroom diversity has been a particularly hot topic, there has also been a focus on environmental changes companies can be making in an effort to curtail their impact on the planet. That has also ramped up in the last year, as companies are pushed to step up in light of a rollback of environmental regulations under President Donald Trump.

“Since Trump took office, I think it’s really ignited this institutional investor activism. Individuals and institutions feel like they need to push against a perceived tide in the country on certain issues. I would say it’s really pushed this along,” Crum said.

And it’s more than just talk. ESG issues are starting to gain traction with companies’ shareholders, not just the ESG-focused activists that are known for proposing them. Three shareholder proposals — one each at Occidental Petroleum Corp., PPL Corp. and Exxon Mobil Corp. — on environmental issues received enough votes to pass for the first time during the 2017 proxy season.

Some, however, are skeptical about the notion that the big-name economic shareholder activists are interested in the potential of long-term value creation at companies through an emphasis on ESG issues.

“It’s really, in my view, potentially an effort to be able to raise assets under management from sources that they might not ordinarily be able to raise that money from. And so it’s somewhat of a marketing-driven initiative,” said Keith Gottfried, who leads Morgan Lewis & Bockius LLP’s shareholder activism defense practice.

Gottfried sees the push as more of a way to attract funds from investors who are increasingly concerned about ESG topics.

“I don’t think the ESG funds from an economic standpoint are going to have a lot of traction," he said. "But if you’re looking to cater to millennials or looking to attract assets under management from certain pension funds or endowments that may want to show their investing with folks that have ESG as part of their focus."

--Editing by Rebecca Flanagan and Aaron Pelc.