PRI Principles for Responsible Investment

TIIP THE INVESTMENT INTEGRATION PROJECT

WHY AND HOW INVESTORS CAN RESPOND TO INCOME INEQUALITY

UNEP FINANCE INITIATIVE

United Nations Global Compact

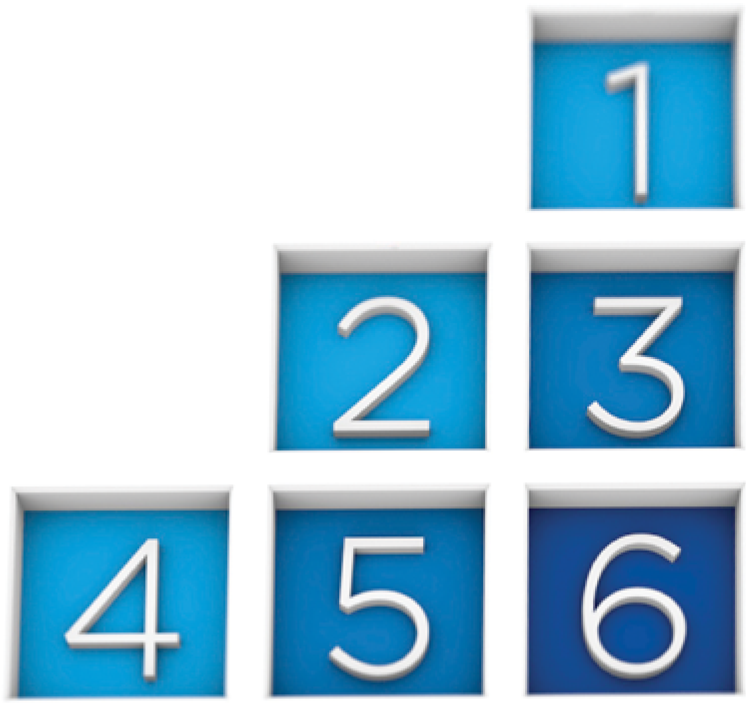
An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

THE SIX PRINCIPLES

PREAMBLE TO THE PRINCIPLES

As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society. Therefore, where consistent with our fiduciary responsibilities, we commit to the following:

1. We will incorporate ESG issues into investment analysis and decision-making processes.
2. We will be active owners and incorporate ESG issues into our ownership policies and practices.
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.
4. We will promote acceptance and implementation of the Principles within the investment industry.
5. We will work together to enhance our effectiveness in implementing the Principles.
6. We will each report on our activities and progress towards implementing the Principles.



PRI's MISSION

We believe that an economically efficient, sustainable global financial system is a necessity for long-term value creation. Such a system will reward long-term, responsible investment and benefit the environment and society as a whole.

The PRI will work to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration on their implementation; by fostering good governance, integrity and accountability; and by addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.

Support for this TIIP (The Investment Integration Project) research was provided by the Principles for Responsible Investment (PRI).

TIIP's mission is to help investors understand the feedback loops between their investments and the planet's overarching systems – be they environmental, societal or financial – that make profitable investment opportunities possible. TIIP also aims to provide these investors with the tools to manage the impacts of their investment policies and practices on these systems. The focus of this report is to help those with a long-term investment horizon more consciously visualize and articulate how systems-level considerations related to income inequality are being incorporated into daily practice.

TIIP generally relies on information that is provided by the subject entity, self-reported to third parties by subject entities, or is otherwise publicly available. Such information has not been independently verified by TIIP.

The information contained in this report should not be deemed an offer to sell or a solicitation of an offer to buy the securities or services of any of the subject entities noted, nor a recommendation concerning the merits of any such entity as an investment.

ACKNOWLEDGEMENTS

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AUTHOR INFORMATION

Steve Lydenberg. Mr. Lydenberg is TIIP's Founder and CEO. He also serves as Partner, Strategic Vision of Domini Impact Investments, where he provides strategic vision and direction to guide the firm's policies, procedures and daily practices. Mr. Lydenberg previously served as the firm's Chief Investment Officer and was a co-founder of the Domini 400 Social Index, the first index to utilise social and environmental standards. In addition, Mr. Lydenberg is the Founding Director of the Initiative for Responsible Investment (IRI) at the Kennedy School of Government at Harvard University, which was established to provide institutional support for catalytic activity for responsible investment, broadly construed, with a strong focus on creating a foundation of research activity around the field. He has published widely on responsible investment and corporate social responsibility, and is a CFA charter holder.

Michael Musuraca. Mr. Musuraca is a Strategic Advisor on ESG and Labour at Blue Wolf Capital Partners LLC. The Blue Wolf Capital Funds are a family of private equity funds that focus on transformational investments in middle-market companies. Prior to joining Blue Wolf in February 2009, Mr. Musuraca was an Assistant Director in the Department of Research and Negotiations, District Council 37, of the American Federation of State, County, and Municipal Employees (AFSCME), AFL-CIO. District Council 37 is one of the largest public-sector unions in New York City, representing 125,000 members who work for the City of New York, its covered organisations, and certain agencies of the State of New York. He worked for District Council 37 from 1988 to 2009. From 1996-2009, Mr. Musuraca was a designated trustee to the New York City Employees Retirement System (NYCERS). He also served, from 1997 until 2009, as a trustee to the Cultural Institutions Retirement System (CIRS). Mr. Musuraca was also a member of the Principles for Responsible Investment (PRI) Board and was the labour representative to the Advisory Board of the New York City Independent Budget Office. He is currently serving on the board of Sustainalytics and is co-chair of the Verite board.

William Burckart. Mr. Burckart is TIIP's President and COO. He has been at the forefront of impact investing and has contributed to the field through groundbreaking research, including leading a multiyear field building effort focused on the financial services industry in collaboration with the Money Management Institute; managing the production of (and is a contributing author to) the *New Frontiers of Philanthropy: A Guide to the New Tools and Actors that Are Reshaping Global Philanthropy and Social Investing* (Oxford University Press: 2014), and was involved in the writing of the *Status of the Social impact investing Market: A Primer* (UK Cabinet Office: 2013) that was distributed to policymakers at the inaugural G8-level forum on impact investing. Mr. Burckart is a visiting scholar of the Federal Reserve Bank of San Francisco, serves on the Global Advisory Council of Cornerstone Capital Group, and is a founder or co-founder of two impact investment advisory firms (Burckart Consulting and Impact Economy LLC).

Mackenzie Clark. Ms. Clark is a Research Associate at TIIP. She previously worked at various organisations, including the Interfaith Center on Corporate Responsibility, Principles for Responsible Investment, the United Nations Global Compact and the New York City Metropolitan Transportation Authority. Ms. Clark was a panelist at the Zofnass Program Workshop: The Business Case for Sustainable Infrastructure at Harvard University in 2017, where she presented her work on quantifying the benefits of sustainable infrastructure through a unique sustainable return on investment framework. She holds a Master of Science in Sustainability Management degree from Columbia University, and a Bachelor of Science degree in Environmental Science from Queen's University in Canada.

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FOREWORD

The widening income inequality gap is one of the most pressing challenges the world faces today, with ending poverty a key theme throughout the Sustainable Development Goals (SDGs) and an issue we all have a role in addressing. The World Economic Forum believes that widening inequality has "contributed to political polarization and erosion of social cohesion in many advanced and emerging economies," and looking at the current state of play that is certainly the case.

Although millions of people the world over have been lifted out of poverty over the past 50 years, income inequality within countries is now growing at an alarming rate, in both developed and developing countries.

Institutional investors have increasingly begun to realise that inequality has the potential to negatively impact institutional investors' portfolios, increase financial and social system-level instability; lower output and slow economic growth; and contribute to the rise of nationalistic populism and tendencies toward isolationism and protectionism. While the financial risks have become more crystallised, what is less clear is how investors can address these issues.

The PRI has been making economic inequality more of a focus with our Blueprint for responsible investment, recognising the need for investors to contribute to a more prosperous world for all. We have been tackling issues from an investor perspective on overly aggressive tax practices which can fuel inequality, along with issues such as human rights, labour rights, executive pay and fair wages and conditions for all workers.

We are excited to publish this new report, working alongside TIIP, to help investors understand the material risks around income inequality, and how they can better address this issue. Doing so is a challenging task, but investors can seize the opportunity to play a vital role in ensuring a stable and sustainable society for all.

Fiona Reynolds
CEO, PRI

FOREWORD

Economic inequality is rising in many countries and even in the countries where actual numbers suggest shrinking inequalities, perceived inequality seems to be rising.

There are no easy answers to solving the problem of income inequality. But, as long-term investors, we need to think about social instabilities that are possibly caused by income inequality and their negative impact on long term investment return.

Underlying core values of ESG are sustainability and inclusiveness. We believe sustainable, long term investment for global asset owners can only be achieved by focusing on those values at different levels throughout the portfolio, and putting corporate and governmental governance in place to support those activities by corporate executives and government representatives.

There are many positive steps that investors can employ to offset inequality risks.

Asset owners can check how their internal and external portfolio managers analyse this issue as a part of their ESG analysis. Asset owners should ask questions to asset managers how they perceive social cohesion and inclusive economic growth as investment factors or not.

So far, not many fund managers regard this as relevant, imminent risk for their portfolio. Similar to other ESG issues, it's a long term social risk and difficult for fund managers to put into their own investment decision making.

It is very important for asset owners to have discussions with their asset managers on this issue rather than just directing to act in particular ways.

We need everybody in our investment chains to buy into this not as a moral agenda, but as an investment agenda to act together to achieve our goal of a sustainable society as the foundation of sustainable capital market.

Impact investment funds can be a choice for some asset owners, depending upon their mandate. Such funds invest directly in projects that provide loans to small businesses or aid social housing or clean energy, thereby creating opportunities the local market.

Hiro Mizuno
Executive Managing Director and Chief Investment Officer, Government Pension Investment Fund (Japan)

I welcome this report from the PRI and The Investment Integration Project (TIIP) as the first step for the investment community to discuss these issues and adjust their investment strategy or practice.

Governments, corporations and investors all have roles to play in fixing the inequality problem. As the largest pension fund and a universal owner in capital markets globally, GPIF believes this is an issue to be discussed and addressed.

All of us can make a positive change in fostering economic growth that fosters inclusivity and promotes confidence in the global financial system.

EXECUTIVE SUMMARY

Institutional investors are increasingly realising that income inequality—the gap in income and wealth between the very affluent and the rest of society—has become one of the most noteworthy socioeconomic issues of our time. It has the potential to negatively impact institutional investors' portfolios as a whole; increase financial and social system-level instability, damage output and reduce economic growth, and contribute to the rise of populism, extremism, isolationism and protectionism.

The effects for investors of a massive income gap are potentially three-fold. It can:

- negatively impact long-term investment performance;
- change the risks and opportunities that affect the universe of investment opportunities;
- destabilise the financial and social systems within which investors operate.

All of these risks threaten portfolios and bottom lines, but what has been less clear is how institutional investors can manage these risks. Recognising this challenge, some investors are turning their attention to integrating considerations related to income inequality into their investment decision making.

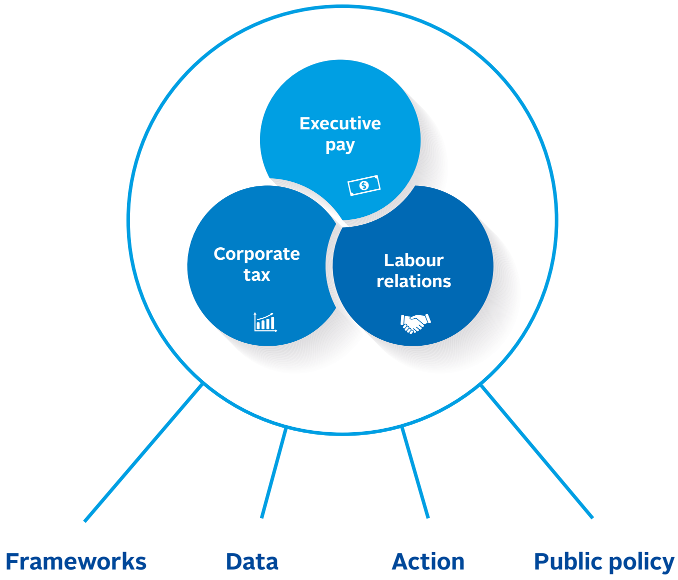
Although the causes of income inequality are many and complex, this report addresses three themes material to long-term investors:

- employee relations and the structure of labour markets;
- corporate tax policies and practices;
- levels of CEO compensation.

In all three areas, which are key leverage points relevant to income inequality and material to long-term investors, frameworks that promote maximisation of short-term profits and returns can exacerbate income inequality. These frameworks also tend to minimise considerations of external costs to society and opportunity costs for support of basic social and environmental systems, infrastructures and stakeholders.

For each of these themes, this report explores the key aspects of the current structures that are exacerbating income inequality, and looks at how investors might encourage the emergence of new frameworks that are appropriate for the 21st century. The report also suggests paths that investors might take to adopt a more balanced view of how to create value, manage system-level risks and maximise rewards while still operating profitably and enjoying competitive returns.

Figure 1: Key themes within the report and the steps investors can take to address income inequality



Across the themes of labour relations, CEO compensation and tax, the approaches explored here emphasise how investors can:

- positively and effectively influence key current system-level frameworks; and
- address concerns material to their long-term financial interests and performance.

Based on a literature review and interviews with investors, the report focuses on four basic approaches that can help:

- ensure the availability of data that allows investors to make decisions to achieve competitive long-term returns while supporting frameworks that enhance connectivity within the system;
- identify how this data can be translated into actions by investors that will effectively influence these key frameworks;
- explain how these actions can address the risks to investors of the current frameworks and create rewards; and
- examine the implications for public policy.

Through the pursuit of these practical opportunities, investors can help change existing frameworks in ways that result in greater income equity such as through improved worker wages, benefits and training; more effective unions and wider union representation; less disparity between the very wealthy and others in society; and more impactful public policies aimed at promoting these goals. Such initiatives can improve social cohesion and trust in those societal institutions that ensure the stability of financial and economic systems, which is essential for long-term investments.

Among the specific suggestions that the report explores are the following:

EMPLOYEE AND LABOUR RELATIONS

DATA

Support data-gathering efforts, such as those by the Human Capital Management Coalition and the Workforce Disclosure Initiative, that emphasise basic facts on wages, benefits, training, retention and union relations.

ACTIONS

Clarify expectations and engagement goals with corporations on their adherence to, and enforcement of, fair treatment of their direct and indirect workforce; support responsible contractor policies; publicly articulate positions on the risks of income inequality to economic growth, destabilisation of society and creation of reputational risks.

FRAMEWORKS

Contribute to a system that encourages a balance between appropriate cost controls and responsibility towards a firm's direct and indirect workforce that can promote productivity, quality and company reputation, and also strengthen the stability of society.

PUBLIC POLICY

Support public policies that mandate disclosure of material labour relations data; set reasonable standards for minimum or living wages; and acknowledge union and human rights, among other things.

CORPORATE TAXATION

DATA

Advocate the creation of a central source for comprehensive, standardised data on corporate taxation policies and practices in formats usable by investors.

ACTIONS

Clarify expectation that corporations are responsible about paying taxes; engage to encourage corporate disclosure of policies and practices; endorse tax principles; promote integration of taxation issues into sustainability policies; publicly articulate how paying taxes contributes to the creation of social capital.

FRAMEWORKS

Contribute to a system in which the payment of taxes helps span the currently widening divide between the corporate/financial communities and the government.

PUBLIC POLICY

Advocate for increased disclosure; support regulations that limit tax avoidance and prevent tax evasion; promote responsible taxation principles as a model for regulation; publicly articulate considerations for managing aggressive tax planning as a risk.

CEO COMPENSATION

DATA

Support the analysis of existing CEO compensation data, including CEO-to-employee ratios.

ACTIONS

Assess the implications of the linkage between CEO remuneration and the company's stock price; develop alternative models that incorporate incentives tied to other stakeholders; support research on the implications of these alternative models.

FRAMEWORKS

Contribute to a system that appropriately rewards shareholders, while at the same time aligning with the interests of broader stakeholders and restoring the relationship between CEOs, employees and others, in ways that create long-term benefits to the corporation.

PUBLIC POLICY

Foster regulations that facilitate meaningful investor input into the design of CEO compensation packages; encourage integrated reporting of corporations' commitments to their full range of stakeholders as a means of ensuring CEO attention to these issues.

INTRODUCTION

Over the past decades, many investors have recognised that income inequality – or the gap in income and wealth between the very affluent and the rest of society – has become a defining socioeconomic issue of our time. It is inextricably linked to economic inequality, which also has significant implications for investors.

Currently, the world's richest 10% earn up to 40% of total global income. In contrast, the poorest 10% earn only between 2% and 7% of total global income. Of the increase of global income between 1988 and 2008, 44% went to the top 5% of the world population. These widening disparities require the adoption of sound policies to empower low income earners, and promote the economic inclusion of all members of society, regardless of sex, race or ethnicity.

While it can be argued that income inequality can provide an incentive to work hard, and encourage entrepreneurship, within nations, it can be detrimental to societies and economies. Greater income inequality is associated with lower economic growth and reduced educational and upward mobility opportunities for poor and middle-income people, as well as more frequent and deeper recessions[1]. Indeed, the International Monetary Fund (IMF) has found that if the share of total income of a country's wealthiest 20% increases by just 1%, GDP growth will be 0.08% lower in the subsequent five years, whereas an increase in the income share of a country's poorest 20% is associated with 0.38% higher growth[2].

The rise of nationalistic populism, trade wars and trends toward isolationism are signs of the stresses and strains of broad income and wealth inequality around the world. Such inequality has arguably influenced the outcomes of elections in the United Kingdom and the United States, and has impacted on the political climate in Austria, the Netherlands, Germany, France, Italy, Poland and Hungary[3]. Growing support for anti-establishment parties and figures reflects the gradual erosion of trust in institutions—including governments—that is crucial to the effective functioning of the global economy and financial system. It also shows the cross-country nature of income inequality as a global problem that requires global solutions. The United Nations has pointed to income inequality as a global issue, for which meaningful action is possible via the Sustainable Development Goals (SDGs) – specifically, SDG 10: Reduced Inequalities.

A growing number of investors are now recognising that the world's most pressing global and environmental challenges, including income inequality, cannot be tackled without harnessing the capital markets, engaging businesses, and ultimately shifting frameworks.

WHAT IS FISSURING?

Fissuring, in which a number of business functions—such as manufacturing of products or components, human resources services and security work—have become sub-contracted to low-cost third-party providers, has led to a loss in connectivity between long-term investors, corporations, employees and the government.

Set against a backdrop of short-termism, this has contributed to an erosion in labour standards and a rise in income inequality.

Based on David Weil's *The Fissured Workplace*

Despite the emphasis world leaders put on the importance of addressing income inequality and the diverse approaches being taken by some in the investment community, understanding how investors can address the fundamental causes of this challenge has proven elusive. This report aims to familiarise institutional investors with this complex issue, and suggests several frameworks through which they might be able to promote a more equitable system. It provides investors with the background, data and the insights needed to help consider and contend with the dimensions of income inequality material to the management of their funds, focusing on labour rights, taxes, and CEO compensation. Each issue is approached through the "fissuring" lens – seeking to increase connectivity to decrease income inequality, and the corresponding sections include descriptions of opportunities for policies or practices that can help address these issues.

It is a challenging task, but investors who can lead by example by striking a balance in their decision making can not only contribute to a rising tide of competitive investment opportunities for themselves, but also create a stable and sustainable society for all.

Currently, the world's richest 10% earn up to 40% of total global income. In contrast, the poorest 10% earn only between 2% and 7% of total global income

1 Dalio, R., Kryger, S., Rogers, J., and Davis, G. (2017). "Populism: The Phenomenon" Bridgewater Daily Observation, Bridgewater Associates. Westport, CT. March 2017. Retrieved from http://www.obela.org/system/files/Populism.pdf January 2018.

2 International Monetary Fund (IMF) (2015). *Causes and Consequences of Income Inequality: A Global Perspective*. International Monetary Fund. Washington, DC: June 2015. Retrieved from https://www.imf.org/external/pubs/ft/sdn/2015/sdn1513.pdf January 2018 (p. 7).

3 Ibid.

THE INVESTMENT CASE FOR INCOME EQUALITY

Income inequality has substantial implications for investors, with its effects being potentially three-fold. It can:

- negatively impact long-term investment performance;
- change the risks and opportunities that affect the universe of investment opportunities; and
- destabilise the financial system within which investors operate, threatening portfolios and bottom lines[4].

The benefits of considering income inequality in investment decision making include increased economic growth, improved stability in financial markets, and governmental cohesion. It can also allow investors to move from just maximising shareholder returns to a more holistic view of the outcomes of decision making. This can in turn lead to improvements in:

- employee wages, benefits and training;
- more effective unions and union representation;
- less disparity between the very wealthy and others in society; and
- more impactful public policies.

Developments such as these can result in greater social cohesion, and can enhance trust in those societal institutions that help ensure the stability of the financial and economic systems essential to long-term investments. When ignored, large systemic risks can negatively impact the long-term performance of investments. They include:

RISKS TO ECONOMIC GROWTH AND FINANCIAL STABILITY

Left unaddressed, income inequality can contribute to economic stagnation and financial crises that can affect investors' portfolios across all asset classes. Studies have argued that a prolonged period of higher income inequality in advanced economies played a role in causing the global financial crisis, by intensifying leverage and overextending credit against a backdrop of declining mortgage underwriting standards and increased financial deregulation[5].

It has been argued[6] that high levels of inequality, through its effects on the economy, reduce the pace and sustainability of economic growth. The importance of inclusive growth is highlighted by the fact that the financial crisis had significant negative repercussions on labour markets, and that the economic recovery is still weak and patchy in certain developed markets.

POLARISATION RISKS

The World Economic Forum (WEF) has stated that widening inequality has "contributed to political polarisation and erosion of social cohesion in many advanced and emerging economies.[7]" This "has led to the emergence of a worldwide consensus on the need for a more inclusive and sustainable model of growth and development that promotes high living standards for all." The WEF has also found that economic inequality "is largely driven by the unequal ownership of capital, which can be either privately or public owned."

This polarisation was illustrated by McCarty, Poole and Rosenthal in a study demonstrating the lockstep growth of inequality in the United States, as measured by its Gini coefficient, and the increased polarisation of voting in the U.S. House of Representatives from 1947 to 2011[8].

Payne attributed the tendency of inequality and political polarisation to track one another to the siloing of social classes that has resulted from the hollowing out of the middle class, which has led to more divisive politics.[9] Polarisation in government can be of concern to investors because it can lead to paralysis in the ability to address issues that are important to maintaining basic infrastructure and economic growth.

4 Wood, D. (2016). *Discussion Paper: Why and How Might Investors Respond to Economic Inequality?* Principles for Responsible Investment (PRI) and Harvard University's Initiative for Responsible Investment (IRI). London, England: November 2016. Retrieved from http://iri.hks.harvard.edu/files/iri/files/pri_inequality_discussion_paper.pdf December 2017.

5 IMF (2015) Op. cit. (p.8).

6 Cornerstone Capital Group. *Income Inequality: Market Mechanism or Market Failure?* Retrieved from https://cornerstonecapinc.com/income-inequality-market-mechanism-or-market-failure/

7 World Economic Forum (2018). *The Inclusive Summary Index 2018: Summary and Data Highlights*. World Economic Forum. Geneva, Switzerland. February 2018. Retrieved from http://www3.weforum.org/docs/WEF_Forum_IncGrwth_2018.pdf February 2018 (p. 14).

8 Gini index data from the U.S. Census Bureau (2014), taken from McCarty, N., Poole, K. and Rosenthal, H. (2016). *Polarized America: The Dance of Ideology and Unequal Riches*. MIT Press.

9 Payne, K. (2017) *The Broken Ladder: How Inequality Affects the Way we Think, Live, and Die*, Viking. New York, NY: 2017 (pp. 105-112)

INSTABILITY AND POPULISM

The rise of populism in recent years has led to disruptions in apparently stable economic systems. Examples of such disruptions include Britain's vote to exit the European Union, trade wars initiated by the United States, and the election of authoritarian leaders in countries such as Hungary and the Philippines.

Stiglitz, in *The Price of Inequality: How Today's Divided Society Endangers Our Future*, pointed out that drastic inequality is not just an economic threat and a challenge to stability, it also undermines the foundations of our national purpose. "We are, in fact, paying a high price for our growing and outsize inequality: not only lower growth and lower GDP, but even more instability. And this is not to say anything about the other prices we are paying: a weakened democracy, a diminishing sense of fairness and justice, and even, as I have suggested, a questioning of our sense of identity.[10]"

The effects of these long-term trends on investment patterns is hard to predict with any certainty, but trade wars and geopolitical instability are not prospects that long-term investors would welcome.

10 Stiglitz, J. E. (2012). *The Price of Inequality: How Today's Divided Society Endangers Our Future*. W.W. Norton & Company. New York, NY: June 2012 (p. liii).

AREAS FOR INVESTOR ACTION ON INCOME INEQUALITY

Investors considering taking action on income inequality face two challenges. Firstly, the causes of extreme inequality are many and complex, and include the impacts of globalisation, climate change, discrimination of various kinds, unaffordable healthcare and education, and the digital economy. Secondly, the proposed solutions often rely on public policy and regulatory measures, such as changes in labour law and more effective enforcement.

This paper focuses on three issues that have important implications for companies' long-term profitability and governance structure, and which can affect their stock valuation:

- employee relations and labour rights;
- corporate taxation; and
- CEO compensation.

By addressing these issues, long-term investors can help change the frameworks underlying current investment practice in ways that are likely to promote equity in income as a consistent outcome.

Various long-term institutional investors already consider the above issues material to the long-term profitability of their funds. The next step for investors is to determine how to adopt policies and practices that can address these issues.

EMPLOYEE RELATIONS AND LABOUR RIGHTS

Over the past four decades, large global corporations in developed economies have increasingly outsourced manufacturing, as well as services such as human resources, customer service calls, security, and janitorial work, to low-cost contractors.

This so-called 'fissuring' has created a gap between companies and their workforce, and has contributed to the erosion of labour standards and a rise in income inequality[11]. Although outsourcing of this kind has helped raise millions of people from extreme poverty in the developing world, it has also created conditions in which modern-day slavery and forced or child labour have become prevalent.

International labour standards, local laws and voluntary industry codes of conduct have sought to address such abuses, but enforcing them has been and remains challenging, and significant work is still needed.

Institutional investors such as Norges Bank Investment Management, Aviva and ABN AMRO, have made the promotion of human rights by corporations a prime consideration. Others, such as the California Public Employees Retirement System and AutralianSuper, have supported responsible contracting programmes for their investments in real estate and infrastructure. Investor coalitions such as the Investor Alliance for Human Rights and the Human Capital Management Coalition also offer investors opportunities to engage on these and similar labour-related issues.

TAXATION

Debates about whether tax burdens should be shouldered mainly by corporations or the rest of society raise serious questions about concentrations of wealth and income inequality throughout society. Corporations have become increasingly sophisticated in their use of transfer pricing, tax havens and tax breaks to reduce their overall tax burden. Figures cited by the Center on Budget and Policy Priorities show that "corporate taxes averaged 2% of GDP in the 1990s. That represented only about two-fifths of their share of GDP in the 1950s, half of their share in the 1960s, and three-quarters of their share in the 1970s.[12]" By 2003, this figure had fallen to 1.2%.

Corporate tax avoidance[13] denies governments much-needed revenue, upon which both companies and societies at large depend for many basic services, such as infrastructure, the judicial system, and national and international security. Long-term investors should therefore encourage a rebalancing of the tax burden, whereby corporations pay more appropriate amounts of tax so that crucial governmental services can be funded without excessive borrowing.

11 Washington Center for Equitable Growth (2017). "Equitable Growth in Conversation." Weil, D. (2017). "Income Inequality, Wage Determination, and the Fissured Workplace," chapter 9, in Boushey, H., DeLong, B. J. and Steinbum, M. (eds.) (2017). After Piketty: The Agenda for Economics and Inequality. Harvard University Press. Cambridge, MA: May 2017.

12 Friedman, J. (2003). *The Decline of Corporate Income Tax Revenues*. The Center on Budget and Policy Priorities. Washington, DC: October 2003. Retrieved from https://www.cbpp.org/archiveSite/10-16-03tax.pdf July 2017.

13 Tax avoidance is the arrangement of a taxpayer's affairs in a way that is intended to reduce his or her tax liability through legal methods (although often in contradiction with the intent of the law it purports to follow). Tax evasion refers to the illegal arrangements where the liability to tax is hidden or ignored. This implies that the taxpayer pays less tax than he or she is legally obligated to pay by hiding income or information from the tax authorities. https://www.unpri.org/download?ac=4536

CEO COMPENSATION

CEO compensation levels and the culture surrounding executive pay within the financial community are highly visible signals of the disparity between the very wealthy and the rest of society. Over recent decades, linking CEO compensation to stock performance has become standard practice, and is seen as an essential way to increase shareholder value. As a result, stock price inflation and share buybacks have led to skyrocketing CEO pay packages.

In fact, a study by Kiatpongsan and Norton found that the average American thought the ratio between their pay and average CEO pay was about 30x, and that 'fair' would be around 7x[14]. When measuring CEO compensation, the authors pointed out that "the ratio has increased from 20x in 1965 to a peak of 383x in 2000, and today sits somewhere just short of 300x"[15].

Investors concerned with this increasing pay gap have won the right to express their opinion on proposed CEO compensations packages ("say on pay"), and a provision in the 2010 Dodd Frank Act has, as of 2018, resulted in the compulsory disclosure of the ratio of CEO compensation to companies' median employee pay. Because this disclosure suggests that CEO interest can be aligned with that of stakeholders other than stockowners, it has the potential to create a model that incentivises those who are ultimately responsible for the health of a corporation in the long run to balance the interests of their stockowners with those of other stakeholders in a way that can generate long-term value for the enterprise.

14 Kiatpongsan, S. and Norton, M. (2014). *How Much (More) Should CEOs Make? A Universal Desire for More Equal Pay*. Perspectives on Psychological Science, volume 9. Thousand Oaks, CA: November 2014. Retrieved from http://journals.sagepub.com/doi/abs/10.1177/1745691614549773 March 2018 (p. 587) (as cited by Montier, J. and Pilkington, P. (2017), "The Deep Causes of Secular Stagnation and the Rise of Populism." *Advisor Perspectives*. Lexington, MA: March 2017. Retrieved from https://www.advisorperspectives.com/commentaries/2017/03/27/the-deep-causes-of-secular-stagnation-and-the-rise-of-populism February 2018, pp. 11–12).

15 Montier, J. and Pilkington, P. (2017). "The Deep Causes of Secular Stagnation and the Rise of Populism." *Advisor Perspectives*. Lexington, MA: March 2017. Retrieved from https://www.advisorperspectives.com/commentaries/2017/03/27/the-deep-causes-of-secular-stagnation-and-the-rise-of-populism February 2018 (pp. 11–12).

OPPORTUNITIES FOR INVESTOR ACTION

In the following chapters, we highlight the opportunities for action in the three areas we have identified as potential leverage points. Focusing on these leverage points can influence the underlying frameworks currently generating increased income inequality, and its adverse implications for long-term institutional investors. These opportunities:

- have the potential to positively influence current systems-level frameworks;
- can address the material financial concerns of long-term investors;
- provide investors with a platform to exercise substantial, effective influence.

By pursuing these opportunities, investors can help change frameworks in ways that can result in greater income equity, and therefore connectivity with the system, thereby opening the path to long-term value creation and stewardship of assets. For each area, the next step is to influence frameworks so that connectivity is enhanced and can thus address the gaps that have emerged between the goals of financial and corporate leaders, average members of society, and the governments that represent them.

The three sections of the report that follow—employee and labour relations, CEO compensation, and taxation—address these opportunities in turn. The first area tackles questions related to the appropriate type and use of data:

- What kind of data can investors use most effectively to influence new frameworks that enable connectivity?
- Why does this data have the potential to be put to effective use?
- How much of this data is already available, and what are the sources?
- What can investors do to promote the adequate availability and analysis of this data?

The second section provides examples of actions that investors can take, or are already taking, that can potentially influence current frameworks in each area. These actions fall into two broad categories:

- the creation of models for behaviour, such as principles or standards that provide system-level guidelines, that tilt complex systems towards generating income equity;
- practical steps that put these models into action.

The third section clarifies how these actions can shift frameworks:

- from previous models that are exacerbating income inequality and therefore creating risks for long-term investors;
- to frameworks that can encourage income equity in ways that reduce these risks and open up new opportunities for investments with competitive returns.

The fourth section highlights public policy initiatives, and specifies:

- the types of issues that can put framework shifts towards income equity into action;
- actions that investors can take to encourage such public policy initiatives.

We view these actions as long-term investments in modelling resilient frameworks that can ultimately generate profound benefits for investors as a whole across all asset classes.

INVESTOR ACTION: EMPLOYEE RELATIONS AND LABOUR RIGHTS

The management of a company's workforce can directly affect a company's viability, profitability and attractiveness for investment. While investors accept that wage and benefit levels cannot be set without consideration of their effect on the profitability of the company, they also understand that cost-cutting must not lead to a deterioration in work standards, poor remuneration and unsafe working conditions. The widespread failure to balance these considerations can be costly not only to companies and their investors, but also in terms of stability and social cohesion.

Long-term investors can promote a framework that sets an appropriate balance between these extremes. To do so, they will need a database that is sufficiently rich to enable an understanding of companies' policies and practices in relation to the management of their workforce.

DATA

SUMMARY

A number of initiatives are already underway to address the need to provide long-term investors access to comprehensive, standardised data on employee relations and labour rights, including:

- the Workforce Disclosure Initiative;
- the Human Capital Management Coalition's petition to the US Securities and Exchange Commission;
- the Committee on Workers' Capital's *Guidelines for the Evaluation of Workers' Human Rights and Labour Standards*; and
- France's bilan social, or 'social balance sheet,' among others.

The ready availability of such data in a user-friendly format would allow investors to better evaluate those aspects of employee relations that contribute to firms' long-term value creation.

It is often difficult for investors to gauge how companies manage their workforce, or which departments are responsible for doing so. Several recent initiatives have begun to grapple with the need for more robust public reporting. Examples of such action include investor coalitions, new guidelines and regulation, and reporting and disclosure initiatives.

The Workforce Disclosure Initiative (WDI)

The WDI aims to have companies produce more standardised and detailed reporting across the whole of their employment footprint, including on how they navigate and identify risks in both their direct operations and throughout their supply chains. The initiative also asks companies to document how they use their leverage in business relationships to create decent work standards, and to meet expectations relating to the payment of living wages, adequate training, and robust occupational safety and health conditions, among other things[16].

The Human Capital Management Coalition (HCMC)

A coalition of 25 institutional investors managing over US$2.8 trillion in funds, HCMC has petitioned the US Securities and Exchange Commission to mandate the disclosure by companies of their human capital management practices and performance. Although the petition does not contain specific reporting metrics, it highlights nine categories which the HCMC regards as crucial for investors to analyse — workforce demographics, staff retention, composition, skills and capabilities, culture and empowerment, health and safety, productivity, human rights, and compensation and incentives[17]. Specific metrics are to be developed during the regulatory rule-making process.

The Committee on Workers' Capital (CWC)

An international labour union network promoting dialogue and action on the investment of workers' capital, the CWC has produced guidelines on workers' human rights and work standards that improve investors' understanding of such issues in the investment process, and help them engage with companies on these matters[18].

Bilan social

Since the late 1970s, French law has required companies with more than 300 employees to fill out a bilan social, or 'social balance sheet,' that describes employee relations and is separate from any voluntary corporate social responsibility reports. This statement of their policies towards their staff is available to employees, to trade unions and, in the case of publicly-listed firms, to shareholders. It is also, therefore, available to institutional and private investors to use in formulating analyses and in decision making[19].

16 For a full description of the Workforce Disclosure Initiative, see Share Action, Workforce Disclosure Initiative, https://shareaction.org/wdi/.

17 See the Human Capital Management Coalition website for further details at: www.uawtrust.org/hcmc.

18 See https://www.workerscapital.org/IMG/pdf/cwc_guidelines-workers_human_rights_and_labour_standards_final_may17.pdf for specific guidelines. Last visited June 27, 2018.

19 For background on the Bilan Social see: Gautier, J. and La France Social and Economic Council (1999). *The Social Balance Sheet*. Official Journal of the French Republic, opinions and reports of the Economic and Social Council. Paris, France: June 1999. Retrieved from http://www.ladocumentationfrancaise.fr/rapports-publics/994000977/index.shtml May 2018.

Such initiatives reflect the need for useable employee-related data, which can be useful both in the short-term, for valuation purposes and as an insight into companies' quality of management, and in the longer run for improving understanding of firms' prospects for viability and value generation, as well as for assessing broad trends in employee relations that have implications for social stability.

ACTIONS

SUMMARY

Long-term investors can take numerous courses of action to address inadequate work standards, including:

- incorporating expectations that corporate management is obliged to give fair treatment to its direct and indirect workforce;
- engaging with publicly listed corporations on their responsibilities as regards existing public policies and voluntary codes concerning relations in their supply chains;
- developing and implementing responsible contractor policies;
- acknowledging and publicly articulating the position that extreme levels of income inequality hinder economic growth, destabilise society and are unethical; and
- supporting public policy setting on issues that address income inequality, such as the right of workers to freely associate and engage in collective bargaining with employers, and the passage of minimum and living wage legislation.

Incorporate expectations of fair labour practices

Financial professionals recognise employee relations as important to company valuations. The limited data available suggests that integrating these considerations can be key to sound investment decision making.

Theory and practice suggest that investors can be rewarded by incorporating data on employee relations into stock selection. In a 2011 study, Edmans found that companies with a reputation for good employee relations—those in Fortune magazine's annual list of the best companies to work for—had statistically significant stock outperformance in the period from 1984 to 2009. He theorised that this was due to two phenomena. Firstly, satisfied employees add more value because of high job motivation and retention levels. Secondly, since the impact of employee relations on company earnings is difficult to quantify and is therefore not included in most analysts' models, firms with good employee relations have more 'earnings surprises' and outperform the market[20].

Investors can also create funds that use employee relations as a primary ESG factor[21]. The Parnassus Endeavor Fund, for example, combines employee relations as a primary investment factor with a value approach to company selection. It has generated annualised returns of 12.17%, compared to 8.85% for the S&P 500, since its inception in 2005 through early 2018[22].

Outperformance relative to the market depends on these factors remaining unrecognised by others, as they currently are. As more investors recognise and incorporate employee relations as a tangible factor, the likelihood of this factor generating general outperformance would likely diminish. It would, nevertheless, remain relevant to evaluations of individual companies in particular circumstances.

Engage with corporations

By engaging with companies to urge compliance with existing legal and regulatory frameworks, investors can minimise risks to their assets, as well as address issues of income inequality and the social instability that can follow in its wake.

Since preserving the legitimacy of the for-profit corporate model – i.e. a license to operate – is fundamental to the current global economic system, both hard and soft legal frameworks have emerged that set standards for corporations' practices as regards human rights and labour relations. These initiatives provide investors with the incentives, frameworks, and means to engage with corporations.

Regulatory initiatives include:

- the 2015 Modern Slavery Act, passed by the United Kingdom, making it a punishable offense for companies to knowingly engage in modern slavery or forced labour in the UK;

20 Edmans, A. (2011). "Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices." *Journal of Financial Economics*. Elsevier. Rochester, NY: March 2011. Retrieved from http://faculty.london.edu/aedmans/Rowe.pdf February 2018 (pp. 621–640).

21 Using employee relations as a determining factor for identifying investable opportunities is what TIIP would consider the use of the tool of Standards Setting. Standards Setting is applied to an investor's holdings-related activities, and is most commonly realised through an investor's adoption of a fundamental standard or a general principle that overrides all others, or when an investor identifies a threshold that if a company does not cross, it is excluded, despite any other positives. In this case, a threshold would reflect certain labour or employee-relations-related criteria.

22 Parnassus Investments (2018). https://www.parnassus.com/parnassus-mutual-funds/endeavor/investor-shares/performance. "Parnassus Endeavor Fund: Investor Shares." Retrieved on April 25, 2018.

- the 2015 rule-making guidelines produced by the Obama administration for its executive order "Strengthening Protections against Trafficking in Persons in Federal Contracts,[23]" requiring zero-tolerance for human trafficking and forced labour in companies' supply chains (companies must proactively implement certain policies before signing contracts worth over $500,000 to ensure that no such abuses are taking place or will take place);
- the California Transparency in Supply Chains Act, in effect since 2012, that aims to provide consumers with information on the status of labour relations amongst firms' vendors, and requires website disclosure of five corporate policies on human trafficking in companies' supply chains — verification, audit, certification, internal accountability and training (California has also provided a model for such disclosures);[24] and
- resources developed by several groups, such as Transparency One, Sourcemap, and Supply Shift, to aid companies in tracking the compliance records of their supply chains[25].

Investor-related initiatives include:

- the Corporate Human Rights Benchmark, which assessed and ranked the human rights performance of 100 large firms in the agriculture, apparel and extractive industries, and found that "large, listed companies are, in general, failing to demonstrate their respect for human rights in their operations.[26]" Amongst the project's goals is "enabling the investment community to begin making better decisions relating to human rights.[27]" The British insurance company Aviva has taken a leading role in this effort, with Nordea and APG Asset Management amongst other investors providing financial support. In 2017, Boston Common Asset Management coordinated the drafting of a letter to benchmarked companies from a coalition of 85 investors that endorsed the CHRB at its launch.
- the 2016 human rights report issued by Dutch firm ABN AMRO, the first major financial services firm to do so, based on the United Nations Guiding Principles on Business and Human Rights, which encourage investors to formally incorporate human rights in their policies and practices[28].
- in September 2018, The Liechtenstein Initiative for a Financial Sector Commission on Modern Slavery and Human Trafficking was launched with the aim to put the financial sector at the heart of global efforts to end modern slavery and human trafficking. The Commission will discuss the finance sector's approach to anti-slavery and anti-trafficking compliance; responsible investment and lending practices; and financial sector innovation to address modern slavery and human trafficking and consider a concrete roadmap to accelerate action to address modern slavery and human trafficking."

Apart from abuses, such as forced labour and modern slavery, there are also issues relating to compensation, benefits, workplace safety and hours of employment, amongst others. The challenge for both corporations and investors is to acknowledge their legal responsibilities and voluntary opportunities to address these challenges.

Government must play a crucial role in this process. In 2016, Subway entered into a voluntary agreement with the US Labor Department's Wage and Hour Division to ensure its compliance with work standards across the full range of its franchisees. It agreed, among other things, to "provid[e] compliance assistance and training materials," "develo[p] compliance support for franchisees through data sharing and technology," "commi[t] to regular meetings to share information, evaluate compliance trends, and solve problems," "communicat[e] about responsibilities to comply with the investigative process," and "emphasize consequences for [Fair Labor Standards Act] compliance.[29]"

Implement responsible contractor policies

By developing and participating in the implementation of responsible contractor policies, investors can proactively work to change how markets operate regarding labour within the real estate and other industries.

These programmes bear a resemblance to existing sustainability-oriented procurement policies. In the United States, for example, since the 1970s many companies, as well as government agencies, have had policies that promote contracting with women and minority-owned businesses. In 1993, the Environmental Protection Agency implemented its 'Environmentally Preferable Purchasing' programme, one among many in place across countries, cities, non-profit organisations and academic institutions around the world.

23 The White House, Office of the Press Secretary (2012). "Strengthening Protections against Trafficking in Persons in Federal Contracts." The White House. Executive Order. Washington, DC: September 2012. Retrieved from https://obamawhitehouse.archives.gov/the-press-office/2012/09/25/executive-order-strengthening-protections-against-trafficking-persons-fe June 2018.

24 Harris, K. D. (2015). *The California Transparency in Supply Chains Act: A Resource Guide*. California Department of Justice. Sacramento, California: California Department of Justice: 2015. Retrieved from https://oag.ca.gov/sites/all/files/agweb/pdfs/sb657/resource-guide.pdf June 2018.

25 For more information see the following: Transparency-One https://www.transparency-one.com/; Sourcemap http://www.sourcemap.com/; and SupplyShift https://www.supplyshift.net/.

26 Corporate Human Rights Benchmark Ltd. *Corporate Human Rights Benchmark Report: April 2018*. Corporate Human Rights Benchmark Ltd. London, England: April 2018. Retrieved from https://www.corporatebenchmark.org/sites/default/files/CHRB%202018%20Progress%20Report%20Web.pdf June 2018. Page 6.

27 Ibid. Page 2.

28 Press release (2016). "ABN AMRO Publishes First Human Rights Report." *ABM AMRO*. Amsterdam, Netherlands: December 16, 2016. Retrieved from https://www.abnamro.com/en/newsroom/press-releases/2016/abn-amro-publishes-first-human-rights-report.html April 2018.

29 "Voluntary agreement between the US Department of Labor's Wage and Hour Division and Subway." *Department of Labor*. Washington, DC: July 2016. Retrieved from https://www.dol.gov/WHD/flsa/SubwayAgreement.pdf April 2018 (pp. 1–3).

Additionally, several institutional investors in the United States have adopted "responsible contractor policies" (RCPs). RCPs typically stipulate that for real estate and infrastructure projects in which it is a majority owner, the investor favours the use of contractors and subcontractors that provide fair wages and benefits (usually defined in the context of local circumstances) and adequate training, assuming they offer competitive bids. These policies often favour unionised contractors as well. Among the long-term investors with formal RCPs in place are the California Public Employees Retirement System, the New York State Common Retirement Fund and various New York City retirement systems.

Since 2013, institutional investors in Australia—including AustralianSuper and AMP Capital—have supported the Cleaning Accountability Framework (CAF). The CAF is a multi-stakeholder coalition of investors, unions, real estate developers, facility managers, academic institutions and the Australian government's Fair Work Ombudsman department. It promotes responsible contracting policies that protect the rights of workers providing cleaning services to properties owned by institutional investors. In doing so, it has established "fair contracting principles by property owners and the provision of decent labour standards by cleaning contractors in the property services supply chain[30]." The CAF provides its members with a Code of Conduct and a procurement toolkit with industry and market-specific pricing and quality-of-service benchmarks. These tools are intended to ensure compliance with labour standards, taxation and retirement responsibilities, as well as disclosure and worker health and safety standards[31]. It has also developed a three-star rating system for the certification of properties' cleaning services, which it intends to expand to include more rigorous four-star and five-star ratings.

The CAF and RCPs illustrate how long-term institutional investors can support initiatives to change market preconceptions that can directly impact income inequality, both by setting standards[32] and by participating in their implementation[33].

Attribute value to income equity

Although investors are increasingly understanding the dangers of income and economic inequality, few actively assign a value to income equity, however qualitative that might be. Among the system-level risks investors can address are those of economic stagnation and disruptions to democracy posed by the hollowing out of the middle class. To avert this, the value of a social dialogue on the value of a thriving middle class as an avenue to risk mitigation needs to be more clearly understood in order to strengthen the case for investor action.

Economic stagnation

Montier and Pilkington, of the Boston-based asset management firm GMO, argued in *The Deep Causes of Secular Stagnation and the Rise of Populism* that the current economic system is broken and cannot sustain healthy economic growth due to four policies that gained traction in the 1970s:

> [T]he abandonment of full employment as a desirable policy goal and its replacement with inflation targeting; an increase in the globalization of the flows of people, capital and trade; a focus at a firm level on shareholder value maximization rather than investment and growth; and the pursuit of flexible labor markets and the disruption of trade unions and workers' organizations[34].

These four factors have produced a stagnant economy, characterised by "lower inflation; lower growth rates; lower investment rates; lower productivity growth; [and] increasing income and wealth inequality." As "too much income accumulates in too few hands—due to low wages relative to the productive capacity of the economy—then there will be shortfall of demand for the output of the economy because richer people consume less out of their income than less rich people[35]."

30 Cleaning Accountability Framework (2016). *Cleaning Accountability Framework: Code of Conduct*. Cleaning Accountability Framework. Melbourne, Australia: August 2016. Retrieved from https://d3n8a8pro7vhmx.cloudfront.net/cleaningaccountability/pages/1/attachments/original/1482122597/20161219-CAF-CodeOfConduct-web1.pdf?1482122597 March 2018 (p. 1).

31 Cleaning Accountability Framework (2018). https://www.cleaningaccountability.org.au/how_caf_works. "How CAF works." Accessed March 2018.

32 Establishing the principles of a preferential purchasing programme is what TIIP would consider the use of the tool of Standards Setting. Standards Setting is applied to an investor's holdings-related activities, and is most commonly realised through an investor's adoption of fundamental standards or general principles that override others, or identifies a red line that if crossed, triggers exclusion. In this case, adopting the principles of a preferential purchasing programme explicitly indicates the basic criteria that a company must meet in order for an investor to consider it a viable investment opportunity.

33 Intentionally deciding to allocate resources to the creation of organisations that can help address system-related considerations and strengthen the overall resilience of the financial system is what TIIP considers the use of the tool of Self-Organization. Investors use this tool when they commit substantial resources to creation or maintenance of an organisation that can help address system-level risks or maximize rewards at a system level or has played a prominent role in its leadership.

34 Montier, J. and Pilkington, P. (2017). "The Deep Causes of Secular Stagnation and the Rise of Populism." *Advisor Perspectives*. Lexington, MA: March 2017. Retrieved from https://www.advisorperspectives.com/commentaries/2017/03/27/the-deep-causes-of-secular-stagnation-and-the-rise-of-populism March 2018 (p. 1).

35 Ibid. Page 18.

Since economies are driven primarily by consumer spending, extreme income inequality can lead to significantly slower economic growth, unless of course consumers take on massive amounts of debt. If they primarily hold low-income jobs, however, excessive consumer debt can lead to the bursting of economic bubbles when that debt can no longer be sustained.

Threats to democracy

Sitaraman is among those who see a threat to democratic institutions arising from widening income inequality and the accompanying decline of the middle classes. In *The Crisis of the Middle-Class Constitution*, he asserts that "[t]he number one threat to American constitutional government today is the collapse of the middle class[36]."He argues that from the founding days of the country, the US and its Constitution were built on "a robust and strong belief that a truly republican form of government was only possible in a society with relative economic equality[37]."

At present, however, that relative equality, which persisted in the country from its founding through to the late 19th century, and was then re-established in the wake of World War II, is being eroded.

> The result is a downward spiral, a vicious circle in which economic inequality and the capture of the political system reinforce each other. This dynamic makes it more and more likely with each passing day that modern America is losing its character as a republic[38].

Simply put, a strong middle class is important for sustainable economic growth and macroeconomic stability, as it "promotes the development of human capital and a well-educated population . . . creates a stable source of demand for goods and services . . . incubates the next generation of entrepreneurs [and] supports inclusive political and economic institutions[39]."

Long-term institutional investors can embed a conviction about the fundamental value of employee and labour relations in their investment belief or policy statements. The California State Public Employees Retirement System (CalPERS), for example, includes among its ten beliefs about financial markets its understanding that "[l]ong-term value creation requires effective management of three forms of capital: financial, physical and human," and attention to these forms of capital "increases the likelihood that companies will perform over the long-term and manage risk effectively[40]." Included in CalPERS' definition of human capital are labour practices, health and safety, responsible contracting and diversity.

One effort to bridge the growing disconnect between management and labour is the Global Deal for Decent Work and Inclusive Growth. It promotes dialogue among corporations, labour organisations, civil society and governments to "foster decent work, quality jobs, and increased productivity—and by extension greater equality and inclusive growth[41]."

Through improved social dialogue on industrial relations, the Global Deal seeks to:

- improve workers' conditions and rights, placing a particular emphasis on the right to collective bargaining;
- create jobs that benefit individuals and society and lead to macro-economic stability;
- reduce inequalities and promote inclusive growth and social cohesion[42].

36 Sitaraman, G. (2017). *The Crisis of the Middle-Class Constitution: Why Economic Inequality Threatens Our Republic*. Alfred A Knopf. New York: March 2017 (p. 1).

37 Ibid. Page 9.

38 Ibid. Page 224.

39 Boushey, H., DeLong, B. J. and Steinbum, M. (eds.) (2017). *After Piketty: The Agenda for Economics and Inequality*. Harvard University Press. Cambridge, MA: May 2017.

40 California State Public Employees Retirement System (2015). *CalPERS Beliefs: Our Views Guiding Us into the Future*. California State Public Employees Retirement System. Sacramento, California: May 2015. Retrieved from https://www.calpers.ca.gov/docs/board-agendas/201702/pension/item7-01.pdf May 2018 (p. 7).

41 *Building Trust in a Changing World of Work: The Global Deal for Decent Work and Inclusive Growth 2018 Flagship Report*. Global Deal for Decent Work and Inclusive Growth. 2018. Retrieved from http://www.theglobaldeal.com/app/uploads/2018/05/GLOBAL-DEAL-FLAGSHIP-REPORT-2018.pdf June 2018 (p. 10).

42 Ibid. Page 11.

SUPPORT PUBLIC POLICY

Institutional investors can play an active role in influencing public policy, and so address societal fragmentation and geopolitical risks material to their portfolios. Public policy plays a particularly important role in supporting fair practices in the workplace — for example, by setting minimum or living wages.

Although investors and corporations do not have the power to mandate minimum or living-wage policies, they can support voluntary efforts to do so, which in turn can serve as model for legislative initiatives. In 2017, for example, institutional investors filed shareholders' resolutions calling for the development of "principles for minimum wage reform," at

- Amazon (filed by Zevin Asset Management);
- CVS Health (multiple filers);
- Chipotle Mexican Grill (Trillium Asset Management);
- Home Depot (Trillium Asset Management and Zevin Asset Management);
- and TJX Companies (Trillium Asset Management and Zevin Asset Management)[43].

When a corporation of the size of Walmart raises its minimum wage for its US hourly workers to $11/hour, as it did in in 2018, it not only puts pressure on other leading companies to do the same, but it also provides a potential model for local and national legislation[44].

FRAMEWORKS

SUMMARY

The current framework encourages corporate managers to outsource services, with labour treated as a cost to be controlled or offloaded. This model contributes both to income inequality within society and to a precariousness of job security that undercuts social cohesion and increases instability[45].

A system that encourages a balance between appropriate cost controls and responsibility towards the workforce can contribute to a corporation's productivity, quality and reputation in the consumer and job marketplaces, and also strengthen the stability and resilience of society.

- **Corporations** — Investors can benefit when management balances the need to control costs with investments in its workforce that increase employee motivation and productivity, and improve employment retention.
- **Investors** — Investors can benefit when management ensures the wellbeing and job skills of its employees in ways that reduce reputational risks in the consumer and job marketplace.
- **Society** — Investors can benefit from the increased societal stability of a framework in which management assumes responsibility for its direct and indirect workforce.

43 Interfaith Center on Corporate Responsibility (2017). *2017 Proxy Resolutions and Voting Guide*. Interfaith Center on Corporate Responsibility. New York, NY: 2017. Retrieved from https://www.iccr.org/sites/default/files/2017iccrproxyresolutionsandvotingguidefinal3.pdf June 2018 (p. 135).

44 Gensler, L. (2018). "Walmart Is Raising its Minimum Wage to $11 an hour after Sweeping Tax Reform." *Forbes*. January 2018. Retrieved from https://www.forbes.com/sites/laurengensler/2018/01/11/walmart-raises-minimum-wage-after-tax-reform/#49f47f5b73c9 June 2018.

45 Weil, D. (2014). *The Fissured Workplace: Why Work Became So Bad for So Many and What Can Be Done to Improve It*. Harvard University Press. Cambridge, MA: February 2014 (pp. 49–51).

A framework that encourages management to consider the workers it depends on for its products and services as less than core to its operations, and hence easily marginalised or off-loaded, runs the risk of destabilisation not only of the individual enterprise but of society at large.

The current framework breaks the connection of shared interests between the management and the employees for whom they are responsible. It runs the risk of adversely impacting productivity and the quality of services, allocating capital in ways that overemphasise the rewards to stockowners while underinvesting in the workforce, and threatening not only the viability of individual enterprises but also social cohesion, which can translate into a rise in protectionism, nationalism, trade wars and geopolitical instability.

The political landscape of the 1970s and 1980s shifted focus on to the political power of unions and the perceived inefficiency of governments, and led to a global trend towards privatisation of state-owned enterprises and deregulation of key industries. At the same time, the globalisation of manufacturing, along with advances in transportation, technology and communications, made outsourcing production to developing countries feasible, and transformed the business models of companies operating in developed markets.

What was once the backbone of many developed economies—domestic middle-class workers—was now replaced by low-cost labour or technology, as well as a shift to a more service-oriented economy. The bargaining power of the workforce declined, and unions waned. According to the Economic Policy Institute, net productivity in the US increased by approximately 144% between 1973 and 2015, whereas real hourly compensation only increased by approximately 21%[46].

These factors combined to hollow out the middle class in developed economies, increase insecurity in employment, boost returns to the wealthy (most of the stockowners), and ultimately promote a framework that generates income and economic inequality.

Corporations

Investors can benefit when management balances investments in its workforce with the need to control cost controls in ways that increase employee motivation, productivity and quality, and improve employee retention. A 2012 article in the *Harvard Business Review* noted that while there is a perception that there is "a trade-off between investing in employees and offering the lowest prices," investing in people and processes can also drive quality up and costs down[47].

Regulatory action and employee strikes can follow when basic issues of salary and benefits are ignored. For example, from 2015 to 2018 McDonalds faced protests and strikes by workers at its franchisees in the US and the UK, related to the 'Fight for a $15 minimum wage' campaign, and also over unionising efforts[48]. Since productivity can be damaged by strike action, investors need to be mindful of the wage practices of the companies they invest in.

Investors

Investors can benefit from the increased societal stability of a framework that directs management towards assuming reasonable responsibility for its direct and indirect workforce. An excessive focus on short-term cost-cutting can lead to costly crises and reputational damage. Among the most highly publicised of such cases was the 2013 Rana Plaza disaster in Bangladesh. The cutting of corners and lack of oversight by the government and the multinational companies sourcing from this factory led to its collapse, which killed over 1,100 people and left many more injured[49].

For this reason, the Ethical Council, which manages corporate engagement activities for Swedish AP national pension funds, has made human rights and labour relations a focus in recent years. It reported, for example, that of its over 300 dialogues with companies in 2016, 89 related to human rights and 123 to labour law. Among issues that it addressed were forced labour in Thailand's fishing industry, debt bondage in the construction industry in Qatar, child labour in the cocoa supply chain, and labour relations in China's toy industry[50].

Scandals and crises of these sorts can not only harm the prospects of individual companies, but also damage the reputations of whole industries, and potentially the trustworthiness of the financial and economic systems themselves.

46 Economic Policy Institute (2016). "Cumulative change in total economy productivity and real hourly compensation of production/nonsupervisory workers, 1948–2015." EPI analysis of unpublished Total Economy Productivity data from the Bureau of Labor Statistics Labor Productivity and Costs program, wage data from BLS Current Employment Statistics, and Bureau of Economic Analysis National Income and Product Accounts. Washington, DC: August 2016. Retrieved from http://stateofworkingamerica.org/chart/swa-wages-figure-4u-change-total-economy/ March 2018.

47 Ton, Z. (2012). "Why 'Good Jobs' Are Good for Retailers." *Harvard Business Review*. January-February Issue, 2012. Cambridge, MA: 2012. Retrieved from https://hbr.org/2012/01/why-good-jobs-are-good-for-retailers June 2018.

48 Scheiber, N. (2018). "Push to Settle McDonald's Case, a Threat to Franchise Model." *New York Times*. New York, NY: March 2018. Retrieved from https://www.nytimes.com/2018/03/19/business/economy/mcdonalds-labor.html June 2018 (p. B1).

49 Sobhan, R. (2018). *Lessons from Rana Plaza*. Centre for Policy Dialogue (CPD). Dhaka, Bangladesh: August 2013. Retrieved from http://cpd.org.bd/wp-content/uploads/2013/08/Lessons-from-Rana-Plaza.pdf April 2018 (p. 2).

50 *The Ethical Council of AP Funds Annual Report 2016: Sustainable Ownership through Dialogue and Engagement*. Ethical Council, Swedish National Pension Funds. Stockholm, Sweden: 2017. Retrieved from http://media.etikradet.se/2017/04/AnnualReport_AP_EthicalCouncil_2016_ENG.pdf June 2018 (p. 3).

PUBLIC POLICY IMPLICATIONS

SUMMARY

Public policy measures can play a crucial role in addressing income inequality and poor labour relations. Paradoxically, many of the laws necessary to help ensure equity in income and a thriving middle class are already in place, but the will to enforce them and realise their underlying purpose appears to be lacking. Investors do not need to identify new measures so much as to support the already-existing ones.

Given that many necessary laws are in place, investors can be highly influential in enforcing these standards by holding their investees accountable.

In particular, investors can:

- support existing data transparency initiatives that advocate greater disclosure of employee-related data;
- formalise in their investment belief statements and policies the recognition that employee and labour relations are material to overall success;
- ensure that companies they invest in are complying with existing legislation and regulations; and,
- formulate models for public procurement policies that favour suppliers with a history of equitable and compliant employee and labour relations.

DATA

Given the investment community's growing recognition of the materiality of employee relations to corporations' success, it is surprising how little data companies are currently required to disclose. To remedy this situation, investors can support calls by groups such as the Human Capital Management Coalition for the Securities and Exchange Commission to require that better data be provided by companies. Moreover, by developing a comprehensive database of such information through projects such as the voluntary Workforce Disclosure Initiative, investors can demonstrate the importance of a single reliable source, and can test out a model for even wider mandatory disclosures in the future.

ACTIONS

Alongside courses of action already described in this report, investors can also take various steps to encourage a formalisation of, and compliance with, public policies. Among other things, they can:

- specify in their investment belief or policy statements their conviction that employee and labour relations are factors material to the success of a business (doing so will clarify that their fiduciary duty includes assessing these issues);
- urge companies to comply with existing legislation and regulations, pointing out their potential legal exposure, and engaging actively on supply chain and related issues;
- create models for public procurement policies that favour strong employee and labour relations, by encouraging responsible contracting by both corporations and governments.

FRAMEWORKS

The underlying goal of such action is to foster a societal framework in which income equity and the fair treatment of employees and labour become the norm, and help build a thriving and resilient middle class. Since equity and the fair treatment of workers are already largely embodied in laws and legislation, investors have the opportunity to take a public stand and urge their active enforcement when they are abused, along with their preservation when they are challenged.

By acknowledging the importance of public policies in ensuring the fair treatment of employees and labour, investors can help mend the gaps that currently exist between management and the workforce, and help tackle the challenges of income inequality.

INVESTOR ACTION: TAXATION

The approach that corporations adopt in relation to taxation impacts their bottom line, and hence their attractiveness as an investment. However, it also has implications for the ability of national and local governments to maintain the services that are necessary for a healthy and sustainable society. These two considerations can pull investors in opposite directions — on the one hand, they do not want companies paying higher levels of taxes than they legally have to, and on the other it is not desirable for governments to be starved of taxation revenue, leading to excessive public borrowing or collapsing public services.

Without concrete efforts to balance the inevitable tensions between paying and avoiding taxes, changing corporate policies, together with unpredictable political developments, can cause confusion over the relative benefits to companies and society alike of the various approaches to taxation.

Long-term investors can promote a framework that sets expectations for an appropriate balance between these two extremes. In doing so, they need sufficient data to understand specific companies' policies and practices, as well as the principles, or frameworks, that can drive their tax-related philosophies and daily operations.

DATA

SUMMARY

Long-term investors lack sufficiently comprehensive, standardised data on the tax policies and practices of corporations, including those of the financial services industry.

- The Principles for Responsible Investment (PRI) has made specific recommendations in relation to tax-related disclosures.
- An increasing number of investors have endorsed such disclosures.

Companies should be encouraged to enhance transparency on taxes paid and make this information available to institutional investors in a user-friendly format. To address the relative scarcity of tax-related data on the policies and practices of major corporations around the world, investors and their companies have recently called for increased disclosure.

In May 2018, the PRI published *Investors' recommendations on corporate income tax disclosure*. Believing that investors would benefit from more tax-related disclosures by companies, the PRI's list of 20 recommendations included nine for tax policies, five for governance and risk management, and six for performance. Amongst its recommendations for corporate disclosures were:

- board-level policies on taxation and how their approach is aligned with business and sustainability strategies;
- tax-related governance policies, including those for training and risk management; and
- country-level reporting on tax allocations and the management of the risks entailed[51].

Tax-related data disclosure has also become a priority in engagement and proxy voting for several investors, including:

- ERAFP, the French national pension fund, which in 2017 made "combatting aggressive tax optimization, in particular by promoting greater transparency in financial reporting by multinational groups" one of its four priorities for corporate engagement[52]; and
- the Local Authority Pension Fund Forum, an investor engagement organisation representing 72 local and public pension funds in the UK, which has adopted proxy-voting guidelines calling for companies to "report fully on their tax strategies and payments, including a country-by-country breakdown of tax payments in each jurisdiction in which they operate[53]."

Investment decision making can benefit from the availability of a centralised, standardised data source on the tax policies and practices of corporations. Better data can help investors manage regulatory and reputational risks that can arise from the perception that companies are aggressively planning their taxes, and can help reduce distrust of corporations and governments that are supposed to regulate them. By managing these risks, investors can strengthen the resilience of the underlying drivers of value creation, increasing investment opportunities and enhancing governmental and societal stability.

51 Principles for Responsible Investment (2018). *Investors' Recommendations on Corporate Income Tax Disclosure*. Principles for Responsible Investment. London, England: May 2018. Retrieved from https://www.unpri.org/download?ac=1877 June 2018.

52 Établissement de Retraite Additionnelle de la Fonction Publique (2016). *Guidelines for ERAFP's Shareholder Engagement: 2017 Version*. Retraite Additionelle de le Fonction Publique. Paris, France: April 2016. Retrieved from https://www.rafp.fr/en/sites/rafp_en/files/publication/file/rafp-lignes_directrices-2017-uk_1.pdf April 2018 (p. 17).

53 Local Authorities Pension Fund Forum (2016). *Policy Guide on Environmental, Social and Corporate Governance Issues*. Local Authorities Pension Fund Forum. London, England: 2016. Retrieved from http://www.lapfforum.org/wp-content/about-us/2016_LAPFF_Policies_Full_Version.pdf June 2018 (p. 19).

ACTIONS

SUMMARY

Institutional investors can take various courses of action to promote responsible approaches towards taxation. Such action can include:

- clarifying that investors expect corporations to pay their share of taxes;
- engaging with corporations, including financial services firms, to promote the disclosure of tax practices;
- publicly endorsing and putting into action tax principles themselves, and encouraging corporations to do the same;
- promoting the integration of tax policies into corporate social responsibility efforts, creating a mutual understanding of the complexity of the issues surrounding corporate taxation and CSR functions; and
- understanding and publicly articulating how paying tax is a vital component of the social capital that supports long-term investments.

CLARIFICATION OF TAX EXPECTATION

In 2017, Norges Bank Investment Management (NBIM), a unit of the Norwegian central bank and manager of Norway's Government Pension Fund Global, with US$1.034 trillion in assets under management, issued a position paper on taxation. It noted that "[r]epresentatives of the investment community have . . . not generally issued expectations as to how businesses should govern and conduct their tax affairs. This may be one reason why companies and business commentators often assert that companies, through their directors, owe a fiduciary duty to their shareholders to minimise taxes[54]."

Essentially, NBIM was highlighting the fact that an excessive short-term emphasis on maximising profits for shareholders may not be in companies' or investors' best interests, noting that "[m]anaging long-term value does not require aggressive tax behaviour[55]." It also expressed hope that boards of directors will "discourage the pursuit of aggressive tax avoidance not in shareholders' long-term interest[56]."

Echoing this sentiment, Amundi, the large European asset manager with assets under management totalling €1.4 trillion[57], asserted in a May 2018 report that "[a]ggressive tax optimisation practices are not without consequences and involve various reactions that could represent a financial risk for companies." It also stated that "[o]ur fiduciary responsibility as an investor requires us to include these risks[58]."

ENGAGEMENT ON TAX POLICIES AND PRACTICES

In 2018, the PRI published a report to encourage investors to engage companies on transparency on tax policies, risk management and governance, and reporting. The report identified four primary reasons why these concerns are material to investors:

- the amount of tax paid is relevant to profitability;
- tax avoidance exposes a company to regulatory and reputational risks;
- tax management is important to firms' ability to contend with regulatory changes;
- tax revenues are key to governments' ability to provide tangible and intangible services that "enable long-term business sustainability[59]."

The report found that regulation was the primary driver of current tax disclosure, and that disclosures adequate to investors' purposes were lacking in the vast majority of cases. For example, it found little serious discussion of reputational risks; generally, no discussion of why companies were operating "in low tax jurisdictions where business operations may not be apparent;" and no disclosure of lobbying or advocacy on tax issues[60].

Through engagement with corporations on issues such as these, investors can encourage a new framework where honouring the principle of responsible tax practices is recognised by all as a fundamental element in maintaining governmental, societal and financial stability.

Among institutional investors making tax an engagement priority are Ilmarinen in Finland, Bâtirente in Quebec and the Avon Pension Fund in the United Kingdom.

54 Norges Bank Investment Management (2017). *Tax and Transparency: Expectations toward Companies*. Norges Bank Investment Management. Oslo, Norway: April 2017. Retrieved from https://www.nbim.no/contentassets/48b3ea4218e44caab5f2a1f56992f67e/expectations-document---tax-and-transparency---norges-bank-investment-management.pdf June 2018 (p. 2).

55 Ibid. Page 3.

56 Ibid. Page 2.

57 Amundi Asset Management (2018). *Aggressive Tax Optimization: What Is the Best ESG Approach?* Amundi Asset Management. Paris, France: March 2018. Retrieved from http://research-center.amundi.com/page/Publications/Discussion-Paper/2018/Aggressive-tax-optimisation-what-is-the-best-ESG-approach June 2018 (p. 2).

58 Ibid. Page 16.

59 The PRI (2018). *Evaluating and engaging on corporate tax transparency: an investor guide*, London, England: May 2018. Retrieved from https://www.unpri.org/Uploads/t/r/l/PRI_Evaluating-and-engaging-on-corporate-tax-transparency_Investor-guide.pdf May 2018.

60 Ibid. Page 8.

ENDORSEMENT OF TAX PRINCIPLES

The B Team—a coalition of business leaders who aim to ensure that business becomes a force for social, environmental and economic benefit—launched a set of principles for corporations on tax-related policies and practices. The principles include accountability for and governance of tax policies overseen at the board level; compliance with tax laws, including paying the right amount of tax at the right time in the countries where value is created; and business structures that include, among other things, not using tax havens[61].

Tax principles such as these can become a key component in a framework where companies share the tax burden, enriching the value of societies through their tax payments. Investors endorsing principles such as these signal their fundamental belief that long-term value creation and stewardship are not to be forgone in the name of short-term profit maximisation.

UNDERSTANDING TAX AS CORPORATE SOCIAL RESPONSIBILITY

Currently, tax departments and managers charged with promoting sustainability or corporate social responsibility (CSR) within organisations operate in their respective silos, with mandates that have little or nothing to do with one another. Long-term institutional investors have an opportunity to promote a new framework based on a deeper understanding of the relationship between sustainability and tax matters.

This issue is essentially a cultural one within corporations. On the one hand, tax minimisation is typically rewarded by corporate management, with adverse consequences for society. On the other hand, companies speak of their responsibility towards society and their willingness to pay their share of taxes.

With clear direction from top management, a pathway for achieving a reasonably balanced tax policy can help address the cultural disconnect between tax departments and sustainability staff.

ARTICULATION OF TAX AS SOCIAL CAPITAL

Articulating the value of paying corporate income tax as a form of 'social capital' is a step towards shifting the framework under which the corporate and financial communities currently operate. Several investors have begun to incorporate the concepts of social, natural and human capital into their investment practices. These difficult-to-value concepts emphasise the long-term value of a healthy, stable, natural environment and an empowered workforce, and are helpful in addressing the excessive emphasis on stockowner returns, which can lead to a short-term perspective in the financial community. As the authors of *What They Do with Your Money* point out, a "focus on share price creates a focus on short-term trading rather than long-term value creation[62]," part of a phenomenon that they term "economic attention disorder hyperactivity[63]."

By clearly stating their commitment to the importance of social capital for their long-term investment, investors can help address current concerns about corporate policies and practices in relation to taxation. Similar arguments apply to the benefits of such a shift in framework to address concerns about tax avoidance by the wealthy.

61 The B Team (2018). *A New Bar for Responsible Tax: The B Team Responsible Tax Principles*. The B Team. New York, NY: February 2018. Retrieved from http://bteam.org/wp-content/uploads/2018/02/A-New-Bar-For-Responsible-Tax.pdf April 2018.

62 Davis, S., Lukomnik, J. and Pitt-Watson, D. (2016). *What they Do with Your Money: How the Financial System Fails Us and How to Fix It*. Yale University Press: New haven, CT: May 2016 (p. 148).

63 Ibid. Page 63.

FRAMEWORKS

SUMMARY

A framework that encourages minimal tax payments to governments runs the risk of creating a downward spiral of increasing income inequality and declining trust in government, ultimately undercutting governments' ability to provide the security and infrastructure that support long-term investments.

A framework that discourages the pursuit of overly aggressive tax planning practices can benefit corporations, investors and society alike, and help build bridges to span the currently widening divide between the corporate/financial community and governments.

- **Corporations** — Investors can benefit if the corporations in which they invest do not face regulatory or reputational risks from avoiding or evading taxes, practices which contribute to income inequality;
- **Investors** — Investors can benefit from investments in countries where governments can rely on adequate funding, in part from income taxes, for the maintenance of basic infrastructure, such as efficient transportation and communication systems, internal and external security, basic scientific research, a reliable judicial system and a stable economy;
- **Society** — Investors can benefit from societies with a thriving middle class fuelling a consumer-based economy. When economies fracture into a division between low-wage and highly-compensated work, social instability incompatible with democratic governance can result, with the potential for financial and economic disruption.

A framework under which corporations and the very wealthy avoid or even evade taxes widens income inequality. Such a framework can lead to a decline in governments' ability to maintain basic infrastructure, resulting in an erosion of trust.

In the mid-20th century in the United States, corporate taxes accounted for approximately 30% of the federal government's revenues, reaching a high of 32% in 1952 and declining steadily through the second half of the century to the 8% range in the 1980s, rising again to 10.6% in 2015[64].

As the influence of corporate and private wealth over the political process grows, the potential increases for governments to weaken themselves through tax policies that favour powerful corporate forces but erode the revenues needed to maintain crucial services.

CORPORATIONS

Investors can benefit if the corporations in which they invest do not face regulatory or reputational risks from the avoiding or evading of income taxes, which contribute to income inequality.

In 2017, the European Union was contemplating regulations aimed at increasing taxation on corporations such as Amazon, and directed Ireland to collect US$14.5 billion in back taxes from Apple[65]. In 2013, Apple was called to testify before Congress amid public reports that it was not paying enough taxes. Although the company argues that it is the largest taxpayer in the world, having paid US$35 billion in income taxes globally in three years from 2014–2016[66], a public perception that the company is still not paying its fair share persists.[67]

Meanwhile, financial services firms can pay heavily for tax-related abuses. The Swiss bank UBS has been repeatedly fined for its involvement in tax irregularities, paying US$780 million to settle tax evasion charges in the US in 2009 and €300 million to settle similar charges in Germany in 2014, while in France it faces potential penalties of €1.1 billion for facilitating tax evasion.[68]

64 Individual income taxes accounted for 42.2% of federal revenues in 1952 and 47.4% in 2015. During that period, revenues from individual and corporate payments to social insurance and retirement (Social Security, Medicare and Medicaid) rose from 9.2% in 1952 to 32.8% in 2015. The Office of Management and Budget (2018). "Percentage Composition of Receipts by Source 1934–2021." The White House. Washington, DC: 2018. Retrieved from https://www.whitehouse.gov/omb/historical-tables/ March April 2018.

65 Kanter, J. (2017). "European Union Renews Offensive on Silicon Valley on Tax Reforms." *New York Times*. New York, NY: September 2017. Retrieved from https://www.nytimes.com/2017/09/20/business/eu-tech-tax.html April 2018.

66 "The Facts about Apple's Tax Payments." *Apple Inc.* Cupertino, CA: November 6, 2017. Retrieved from https://www.apple.com/newsroom/2017/11/the-facts-about-apple-tax-payments/ April 2018.

67 Hoxie, J. (2018). "Commentary: Apple Avoided $40 Billion in Taxes: Now It Wants a Gold Star." *Fortune Magazine*. New York, NY: January 2018. Retrieved from http://fortune.com/2018/01/18/apple-bonuses-money-us-350-billion-taxes-trump/ April 2018.

68 Browning, L. (2009). "Settlement Reached in UBS Tax Case." *New York Times*. New York, NY: July 2009. Retrieved from https://www.nytimes.com/2009/08/01/business/01ubs.html on April 10, 2018.

INVESTORS

Investors can benefit from investments in countries where governments can rely on adequate funding—in substantial part from income taxes—for the maintenance of basic infrastructure, such as efficient transportation and communication systems, internal and external security, basic scientific research, a reliable judicial system and a stable economy. In addition, these governments can help redress income inequalities that may result from the workings of market economies. Furthermore, government at various levels can play an important role in providing basic services, such as education and healthcare, that are key components of an equitable and wealthy society.

A society in which taxes are reduced or evaded becomes one where the mechanisms for addressing income inequality is, at best, passed from the relatively certain hands of government to the relatively uncertain workings of the markets. In times of financial or economic instability, however, when markets fail or charity dries up, a vicious cycle can result — a growing urgency to limit income inequality falls on an underfunded government which, unable to adequately address the issue, cannot prevent greater instability that further exacerbates these needs.

SOCIETY

The growing polarisation of income drives deep divides in our social structure, widening the gap between corporate managers and their workforce, CEOs and stakeholders other than shareholders, and corporations and governments.

Long-term investors have an interest in advocating for responsible tax practices by corporations and the wealthy. This can create a framework that encourages social cohesion and a growing middle class.

PUBLIC POLICY IMPLICATIONS

SUMMARY

Long-term investor action can encourage public taxation policies that play a crucial role in addressing income inequality. More specifically, investors can:

- advocate for increased mandatory disclosures on key tax-related data;
- endorse government policies that minimise tax avoidance and prevent tax evasion;
- promote tax principles as models for government regulation;
- evaluate new proposals for tax reforms to understand which might be most effective; and
- make their views known on their consideration of tax policies and practices as investment risk factors.

DATA

Long-term investors could advocate for increased mandatory disclosures on key tax-related data.

In addition, voluntary efforts have the potential to demonstrate the demand and need for such data, and can provide models for its mandated disclosure at a national level, just as investors' calls for voluntary climate-related disclosure served as a precursor to France's Article 173 mandating a variety of such disclosures.

ACTION

Investors' endorsement of and advocacy for the adoption of tax-related principles can serve as a model for public policy initiatives that address avoidance or evasion schemes. Moreover, investors can and should support the initiatives by policy makers currently underway to tackle these issues, such as those by the OECD set to come into force in the coming years[69].

In addition, long-term investors should consider proposals by various independent scholars and public policy experts for further reform. Zucman, for example, has advocated the creation of an international registry of financial holdings of stocks, bonds, mutual funds and other financial products, much like ones already maintained at various regional levels, which would permit the tracking of tax avoidance schemes in general. As he puts it, "[a] financial registry is a concrete embodiment of the notion of financial transparency." Furthermore, he has proposed that corporations be taxed on their global consolidated profits, which cannot be manipulated through transfer pricing[70]. Policies such as these can boost transparency and help create a framework in which corporations cannot but pay their share of taxes.

FRAMEWORKS

Long-term investors can lend their voice to influence the development of tax regulations by making their views known on tax related risks that may affect investment decisions.

69 "OECD peer reviews on BEPS Action 13 Country-by-Country reporting initiative show strong progress for global roll-out in June." *OECD*. Paris, France: May 2018.

70 Zucman, G. (2015). *The Hidden Wealth of Nations: The Scourge of Tax Havens*. Chicago University Press. Chicago, IL: September 2015 (pp. 112–113).

INVESTOR ACTION: CEO COMPENSATION

At the end of the 20th century, a shift took place in the compensation of chief executive officers. From 1980 to 2014, according to Edmans et al., the median pay of CEOs in the S&P 500 increased six-fold, while during the same period compensation for "the average worker has risen much more slowly[71]."

Although numerous factors contributed to this shift, the shareholder value maximisation model played an important role. Tying CEO remuneration to the stock price can lead to capital allocation decisions that boost the share price without incentivising investments in other aspects of the business. Stock buybacks, for example, increase the share price in the short term, but create income disparities by concentrating wealth in stockowners' hands, and contribute to a growing dichotomy between the interests of executives and the average employee, as well as other stakeholders in the corporation.

Widening the compensation gap between senior executives and lower-level employees can impact long-term investors to the extent that it has implications for employee motivation, retention and overall productivity. In addition, skyrocketing CEO compensation can become a highly visible symbol of the disconnect between the corporate, as well as the financial community, and other members of society, eroding the trust in these institutions, the loss of which can lead to social and financial disruptions.

The disclosure of new data on the ratio of CEO compensation to that of the median employee opens an important avenue to addressing income inequality.

DATA

SUMMARY

Long-term investors already have access to data on CEO compensation policies and the practices of corporations. As stockowners, they are obliged to consider and vote annually on how appropriate these policies are.

The availability of pay ratios, however, introduces a new perspective for consideration in these evaluations, raising questions about disparities in compensation and the consequences of incentivising CEOs primarily through stock price appreciation.

With the mandatory disclosure of the ratio of CEO compensation to that of average employees that came into effect in the US in January 2018 under the Dodd–Frank Act of 2010, long-term investors now have access to a powerful new data set. These ratios suggest that a corporate stakeholder—in this case employees—other than stockowners might also be considered in incentivising CEO decision making. Since such data has the power to reveal the stark discrepancies in pay levels within companies, its analysis can help in understanding the destabilising effects of income inequality, and can provide alternative approaches.

Établissement de Retraite Additionnelle de la Fonction Publique (ERAFP) is, for example, an institutional investor that has set strict standards for such ratios. ERAFP—the asset manager for France's public services and other pension plans—assesses the ratios' effect on "social cohesion."[72] To "keep differences in remuneration between managers and employees at levels that do not negatively affect the company's business or the motivation of its teams," ERAFP has set a "socially acceptable maximum amount of total remuneration," inclusive of salary, benefits, options, bonus shares and top-up pension plan contributions,[73] at "100 times the minimum salary in force in the country in which the company's registered office is located, which in France corresponds to the national minimum wage (SMIC)[74]."

This dataset is likely to prompt analysis and debate about what constitutes appropriate and fair CEO remuneration. In doing so, it has the potential to bring about a reframing of the current model for incentivising CEO decision making primarily through stock performance, which can be short-term and volatile. Alternative incentives could be designed to reward employees and other stakeholders in ways that contribute to the long-term value of the firm, which would also be in stockowners' interests.

71 Edmans, A., Gabaix, X. and Jenter, D. (2017). *Executive Compensation: A Survey of Theory and Evidence*. The National Bureau of Economic Research. Working Paper 23596. Cambridge, MA: July 2017. Retrieved from http://www.nber.org/papers/w23596 May 2018.

72 Établissement de Retraite Additionnelle de la Fonction Publique (ERAFP) (2018). *Guidelines for ERAFP's Shareholder Engagement 2018 Version*. Retraite Additionelle de le Fonction Publique. Paris, France: January 2018. Retrieved from https://www.rafp.fr/en/sites/rafp_en/files/publication/file/rafp-lignes_directrices-2018-uk-planches.pdf March 2018 (p. 34).

73 Ibid. Page 35.

74 Ibid. Page 35.

ACTIONS

SUMMARY

Institutional investors can take various courses of action to bring about a fairer system of remuneration for top management. These can include:

- assessing the short and long-term effects of the current model of tying CEO compensation to stock price appreciation;
- developing alternative models that balance the rewards to stockowners with making investments in employees and other stakeholders that enhance the value of the corporation; and
- conducting, funding or encouraging research into the short and long-term implications of such alternative incentivisation models.

Through a variety of action, investors can use their influence as shareholders to reframe how CEO compensation is incentivised, better integrate available data into their investment decision making, and establish a framework that enhances income equity.

ASSESSING THE REWARDS TO SHAREHOLDERS

A disproportionate focus on the stock price and other financial indicators raises the question of whether there is any level at which CEO compensation becomes "excessive," regardless of performance. An increasing proportion of investors are beginning to vote against compensation packages even when companies have successful financial track records. According to As You Sow's report *The 100 Most Overpaid CEOs in 2018*, "ISS [Institutional Shareholder Services Inc.] recommended voting against 10% of the CEO pay packages at S&P 500 companies," and against 38 of the 100 companies it identified as having the most overpaid CEOs.[75] Because its recommendations are widely followed, a 'no' from ISS "reduces shareholder support for Say on Pay [proposals among S&P 500 companies] by 20-30% ... depending on a company's shareholder base[76]."

Moreover, CEOs that leave due to poor financial performance are often rewarded with golden pay parachutes[77].

Investors identified by As You Sow as actively voting against CEO pay proposals included:

- Allianz, which was the most likely non-US mutual fund to vote against excessive CEO packages, voting against 79 % of CEO pay resolutions at the top 100 "most overpaid" companies[78]; and
- the Florida State Board of Administration, which voted against CEO pay packages at 41% of S&P 500 companies, and 73% of the "100 most overpaid" companies, and provided a relatively granular explanation for these votes.

Voting against excessive pay proposals offers a tool that investors can use to intervene when proposed compensation appears out of line with their interests or with a sense of appropriateness. Though still focused on shareholders' interests, rather than on the interests of other stakeholders, including employees more broadly, votes of this kind can contribute to a questioning of unrestrained compensation rewards and of the efficacy of the current model.

DEVELOPING ALTERNATIVE LONG-TERM INCENTIVISATION MODELS

As long-term stockowners, institutional investors have an opportunity to evaluate and potentially advocate for the adoption of a multi-stakeholder approach to compensation incentives — that is, an approach that links CEO compensation not just to specific stock price targets or financial goals, but also to benchmarks related to employee relations or other stakeholder considerations, especially where the latter could positively impact the former.

The PRI published a report in 2016 providing guidance on integrating ESG metrics into executive pay decisions. Surveying 70 large firms in the utility and extractive sectors, the study found that 20% linked executive compensation to certain environmental or social factors and disclosed these factors and their targets. The PRI suggested that industry-specific metrics can offer a useful starting point in aligning executive compensation with long-term value creation, with companies developing "their own definition of sustainable value creation[79]." It identified, among the material ESG issues to which CEO compensation might be tied in these sectors, "employee satisfaction, safety, water quality, emissions, and spill prevention[80]." It also noted that most of the issues identified as material in the firms' sustainability reports were not included in CEO compensation metrics.

75 Ibid. Page 6

76 Bannon, L. (2000). "Mattel Proxy Says Barad Received Severance Package Near $50 Million." *The Wall Street Journal*. New York, NY: May 2000. Retrieved from https://www.wsj.com/articles/SB957134092545259551 March 2018.

77 Weaver, R. L. (2018). *The 100 Most Overpaid CEOs: Are Fund Managers Asleep at the Wheel?* As You Sow. Oakland, CA: March 2018. Retrieved from https://www.asyousow.org/reports/the-100-most-overpaid-ceos-2018-are-fund-managers-asleep-at-the-wheel March 2018 (p. 7).

78 Weaver, R. L. (2018). *The 100 Most Overpaid CEOs: Are Fund Managers Asleep at the Wheel?* As You Sow. Oakland, CA: March 2018

79 Ibid. Page 6.

80 Ibid. Page 7.

‘Focusing Capital for the Long-Term,’ a global initiative created by the Canadian Pension Plan Investment Board and McKinsey & Company, in partnership with BlackRock, the Dow Chemical Company and Tata Sons, among others, has highlighted the inherent contradiction in setting short-term equity rewards for CEOs when most capital is long-term. Its report *A Roadmap for Focusing Capital on the Long Term* includes aligning compensation with long-term performance as key to “reorienting the portfolio strategy and management of institutional investors[81].” To the extent that strong employee relations can have benefits in reduced turnover, increased productivity and enhanced brand recognition, they can be viewed as generating benefits for the firms targeted by long-term investors.

Similarly, one of the implications of the work of the International Integrated Reporting Council (IIRC) is that by including material data on social and environmental issues in determining pay, executive management’s attention is directed to key drivers of long-term prosperity. IIRC’s ultimate vision is to “align capital allocation and corporate behaviour to wider goals of financial stability and sustainable development,” a goal that can be accomplished through the seamless integration of material financial and non-financial data in corporations’ public reporting[82].

Investors calling for integrated reporting can take the next logical step of advocating that CEO compensation be formally tied to a combination of these two factors.

CONDUCTING, FUNDING OR ENCOURAGING RESEARCH STEMMING FROM THE DISCLOSURE OF CEO PAY RATIOS

CEO pay ratios can serve as the starting point for better understanding the implications that drastic wage gaps can have on company or industry-specific stability; help identify a range of CEO-to-worker ratios that stimulate employee productivity or other positives in employee relations; or provide a basis for whether certain specific social or environmental benchmarks for CEOs, for example those called out by the Sustainability Standards Accounting Board, can be meaningfully tied to various degrees of financial performance.

By requesting such information from their compensation consultants, long-term investors could also help address a knowledge gap around these factors that inform board decision making. In its 2016 study of the integration of ESG factors into executive compensation, the PRI found that “the majority of companies could not rely on their remuneration consultants to help select appropriate ESG issues and set metrics,” which suggested “a potential lack of expertise on ESG issues among remuneration consultants[83].”

A number of studies already address the connection between CEO compensation levels and financial performance. A 2016 MSCI study, for example, found that companies whose CEOs were awarded “higher equity incentives had below-median returns based on a sample of 429 large-cap US companies observed from 2006 to 2015[84].” The study also found that companies with total pay packages below sector averages delivered higher total shareholder returns on a 10-year cumulative basis than companies with above sector average pay.

81 Focusing Capital for the Long-Term (2015). *Roadmap for Focusing Capital on the Long term*. Focusing Capital on the Long-Term. Boston, MA: March 2015.

82 To learn more please see the website of the International Integrated Reporting Council at http://integratedreporting.org/the-iirc-2/. Last accessed June 27, 2018.

83 Integrating ESG Issues into Executive Pay: A Review of Global Utility and Extractive Companies. (2016) Principles for Responsible Investment.

84 Marshall, R. and Lee, L.-E. (2016). Are CEOs Paid for Performance: Evaluating the Effectiveness of Equity Incentives. MSCI. New York, NY: July 2016.

FRAMEWORKS

SUMMARY

The current framework, which focuses CEO incentives solely on benefits to stockowners, drives a wedge between corporate management and other employees that not only contributes to income inequality within the firm but that can become a highly visible symbol of that inequality more broadly in society.

A framework that appropriately rewards shareholders, and at the same time restores the connection between CEOs, employees and other stakeholders, can motivate CEOs to focus on considerations material to the long-term health of the corporation. CEOs who take a full spectrum of stakeholders into account can benefit long-term investors, as well as the company and society as a whole.

- **Corporations** — Investors can benefit when the CEO compensation model incentivises a long-term alignment of managements' interests with those of employees and other stakeholders, which in turn contributes to value creation within the firm;
- **Investors** — Investors can benefit from the increased attention to value creation that results from this alignment, through the building of a base for long-term profitability and the minimisation of CEO incentives to take shortcuts to boost the stock price, which may not survive the test of time;
- **Society** — Investors can benefit when multi-stakeholder initiatives create trust in the economic system and align corporations' long-term interests with those of society as a whole.

Tied only to stockowners' interests, incentives can become symbols of concentrations of wealth at the top and a lightning rod for the kind of discontent that can lead to financial and economic disruptions, as well as to income inequality itself.

The tying of compensation to stock prices during the 1990s bull market propelled CEO remuneration skywards, with a number of unintended consequences, including the concentration of wealth in the top 1% and an intensification of the gap between executives and average employees. Other consequences were an increased tendency to take short-term risks, and the polarising and potentially destabilising widening of the gap between compensation at the top and all others.

CORPORATIONS

Investors can benefit when a CEO compensation model incentivises a long-term alignment of managements' interests with those of employees and other stakeholders, which in turn contributes to value creation within the firm.

In an attempt to maximise shareholder value and unlock performance-based payouts, executives may engage in activities that boost the stock price and hit earnings-per-share targets in the short-term, but which can have negative effects on performance in the long-term. A recent study by Edmans et al., evaluating the effect of short-term incentives on long-term value, found that "impending vesting of equity may lead CEOs to take myopic actions that boost the short-term stock price at the expense of long-term value[85]." Such short-term action—in particular stock buybacks that boost the share price by reducing the amount of outstanding stock, and mergers and acquisitions which can inflate stock prices upon their announcement—had positive effects on share prices in the short term, but negative consequences in the long run.

Using corporate assets to purchase a company's own shares or engage in mergers and acquisitions are legitimate strategies, but they generally need to be accompanied by additional investments in the long-term value drivers of the company — the workforce, research and development, innovation, and the like.

INVESTORS

A study by Flammer and Bansal found that when "close-call" shareholder resolutions imposed long-term incentive programmes on management, they increased the firm's operating performance, "investments in long-term strategies such as innovation and stakeholder relationships," and "investments in R&D and stakeholder engagement, especially pertaining to employees and the natural environment[86]." In another study, Flammer found that, when adopted, close-call corporate social responsibility shareholder-sponsored resolutions were "value enhancing" and that "labor productivity and sales growth increase after the vote[87]."

Incentive structures that encourage CEOs to drive up the short-term stock price without attention to stakeholders other than stockowners can create an income gap and neglect approaches that align the interests of shareholders with the interests of employees. Such an alignment of interests is important because it can help counteract the distrust in the societal benefits of large corporations, while at the same time creating long-term shareholder value.

85 Edmans, A., Fang, V. W. and Huang, A. H. (2017). *The Long-term Consequences of Short-term Incentives*. Investor Responsibility Research Center Institute. New York, NY: October 2017.

86 Flammer, C. and Pritma, B. (2016). "Does a Long-term Orientation Create Value? Evidence from a Regression Discontinuity." *Strategic Management Journal*. Chicago, IL: December 2016.

87 Flammer, C. (2015). "Does Corporate Social Responsibility Lead to Superior Financial Performance: A Regression Discontinuity Approach." *Management Science*. London, Ontario: February 2015

The average tenure of an S&P 500 CEO is currently only 7.4 years[88]. Given this relatively short timeframe, and the tying of their compensation to the stock price, leaders of corporations are incentivised to take excessive risks. In a 2009 survey by KPMG, 52% of banking risk officers and professionals believed that "incentives and remuneration" were among the elements "most at fault" for the 2008 credit crisis, followed 50% who singled out "risk governance," and 48% who identified "risk culture" as a contributing factor[89].

SOCIETY

Investors can benefit when multi-stakeholder initiatives create trust in the economic system and align corporations' long-term interests with those of society as a whole. The risks of ignoring the current misalignment are considerable.

The growing disparity between CEO pay and that of other employees can be seen as a symbol of the growth in income inequality in wider society. It has found its way, along with other factors such as job precariousness, into a political dialogue that has resulted in a de-legitimisation of business in particular and a rise in protectionist nationalism[90].

As shareholders, investors can express their opinions on the relative appropriateness of current levels of CEO compensation through proxy voting. Workers, however, are not awarded the same opportunity, except to the extent that they are represented by unions. Declines in union representation and bargaining power, however, have made this more difficult.

The extent of the societal destabilisation that will stem from these trends is still unclear, but it has the potential to disrupt financial markets in ways that can severely damage long-term investors.

PUBLIC POLICY IMPLICATIONS

SUMMARY

Public policy initiatives can play an important role in shifting the current framework on CEO compensation incentives to emphasise a reasonable balance between stockowners' interests and those of other stakeholders who are crucial to the corporation's long-term success. Investors can:

- encourage public policy that is supportive of research on appropriate CEO compensation incentive schemes;
- demonstrate the need for regulations that provide meaningful investor input into the design of CEO incentives and compensation levels, particularly where they relate to the full range of stakeholders; and
- support initiatives that would require the integrated disclosure of managements' sustainability commitments to the full range of corporate stakeholders with traditional financial data.

This report has examined several courses of action by long-term investors with regards to CEO compensation incentives that can have implications, both direct and indirect, for public policy.

DATA

Public policy already requires the disclosure of substantial information on CEO compensation. Investors can make use of this data as a valuable resource for their implementation of effective investment policies and practices.

88 "CEO Tenure Has Increased Nearly One Full Year Since 2005." *Equilar*. Redwood City, CA: January 2016. Retrieved from http://www.equilar.com/blogs/59-ceo-tenure.html March 2018.

89 KPMG International (2009). *Never Again? Risk Management in Banking beyond the Credit Crisis*. KPMG International. Zurich, Switzerland: January 2009. Retrieved from http://www.alidebibliotecavirtual.com/informacion/recursos/AIS-BARCELONA/RIE/23RIE-NEVER%20AGAIN-kpmg-Risk-management-in-banking-beyond-the-credit-crisis.pdf June 2018 (p. 7).

90 Joutsenvirta, M.a (2013). "Executive Pay and Legitimacy: Changing Discursive Battles over the Morality of Excessive Manager Compensation." *Journal of Business Ethics*, volume 116. Springer. Berlin, Germany: September 2013.

ACTIONS

Current regulations require that investors vote each year on CEO compensation packages. By continuing to exercise their responsibilities to assess the appropriateness of CEO compensation through voting, investors can demonstrate the importance of meaningful input not only into the proposed levels of CEO pay, but also in the design of the public policies around pay disclosure.

FRAMEWORKS

Increased attention to commitments to broader stakeholders can foster longer-term thinking. This can be done for example, by investors supporting calls for integrated disclosures in annual reports around strategic sustainability commitments and therefore drawing CEOs' attention to these factors.

FURTHER RESEARCH

This paper leaves unanswered questions about how investors might measure the effectiveness of their investment activities in changing the systems that generate income inequality, and then report on this progress; how income inequality can be addressed through the comprehensive and intentional use of tools and key investment activities; and how this approach might be applied to other relevant themes beyond employee and labour relations, CEO compensation and taxation.

MEASUREMENT AND REPORTING

This report proposes that for investors to address the issue of income inequality, they can apply a system-level perspective on their activities and contend with various aspects of what Weil calls the "fissuring" that has occurred in corporate behaviour, thereby helping to restore the connectivity between corporations and employees, communities, customers, governments and the environment. Once investors begin addressing this challenge, though, they will face the task of measuring the effectiveness of their activities. Put another way, if they wish to be effective in the long run, investors will need to ensure that they are moving beyond generating an environmental or social impact through individual market transactions and are bringing about system-level change. They will need to answer the question *How can I measure whether I, as a long- term institutional investor, have contributed to a system-wide, enduring reduction in income inequality?*

Investors will also need to understand the implications of this form of measurement for how they report on the progress they are achieving. For example, *What is the relationship between system-level reporting and various indicator frameworks (like the SDGs)? How does such reporting relate to, or compliment, the Principles for Responsible Investment reporting format and other types of sustainability and impact reporting? How does it relate to financial performance reporting?*

INTEGRATION WITH THE TOOLS OF INTENTIONALITY AND KEY INVESTMENT ACTIVITIES

A number of system-level investing approaches, in the form of 'Tools of Intentionality" and key investment activities (KIAs), are referenced in Appendix B. Some of these tools and their related underlying activities are a natural extension of activities recognisable and widely used by investors as part of daily portfolio management and conventional investment strategies, while others reflect approaches not typically incorporated into day-to-day portfolio management. Each represents a way that investors attempt to *influence* the environment, society and the financial system through both portfolio and non-portfolio-related strategies. More research is needed to better understand how their entire toolbox and KIAs can be harnessed to help influence a framework shift in a system that is generating income inequality.

OPPORTUNITIES FOR OTHER RELEVANT THEMES

The causes of income inequality are many and complex. As noted earlier, these causes include, among others, the rapid pace of globalisation, the digital economy, automation, climate change, and unaffordable healthcare and education. Although this report focused on three issues—labour relations, CEO compensation and taxation—that are material to the management of funds, these other causes also deserve further exploration. Doing so would serve to deepen the knowledge about how investors can most effectively apply various tools at their disposal, in different contexts, to different sub-themes. It would also help to broaden the usefulness and potential of the tools generally — all towards the end of addressing the issue of income inequality and restoring connectivity.

APPENDIX A:
WORKING GROUP MEMBERS*

- **Scott Connelly**
  Assistant Secretary, Australian Council of Trade Unions (ACTU)
- **David Erickson**
  Director of Community Development, Federal Reserve Bank of San Francisco
- **Steven Godeke**
  Founder, Godeke Consulting; and Board Chair of the Jessie Smith Noyes Foundation
- **Adam Kanzer**
  Formerly Managing Director of Corporate Engagement, Domini Impact Investments; and a Vice President, Domini Funds
- **Rob Lake**
  Founder, Authentic Investor
- **Katherine Ng**
  Head of Academic Research, Principles for Responsible Investment (PRI)
- **Shannon Rohan**
  Director of Responsible Investment, Shareholder Association for Research and Education (SHARE)
- **Anna Snider**
  Managing Director and Head of Due Diligence, Global Wealth and Investment, Bank of America; Co-lead of the Impact Investing effort for Merrill Lynch Investment Management and Guidance team
- **Dan Viederman**
  Managing Director, Humanity United
- **David Wood**
  Director of the Initiative for Responsible Investment (IRI), Hauser Institute for Civil Society at Harvard's Kennedy School of Government

* Affiliations for identification purposes only. Members of the working group participated in their personal capacity only.

APPENDIX B:
KEY CONCEPTS AND FRAMEWORKS FOR SYSTEM-LEVEL INVESTING

Institutional investors—those with long-term investment horizons (e.g., pension plans) or who identify as socially responsible or impact investors—are often aware of the impact that individual investments and investment portfolios can have on the environment and society. They are also increasingly convinced that the ESG performance of the entities that they invest in has a material effect on portfolio risk and return.

Beyond contending with the effect of specific investments on the environment and society, or considering company ESG performance, a number of investors are also grappling with larger questions related to their impact on the broader environmental, societal and financial systems within which they operate, and the impact of the well-being of those systems on their investment practices. They are asking:

1. *How do things like ecosystems under stress, societies in turmoil and economic crises affect investment risk and return, given that the world is more interconnected now than ever before?*
2. *What can we do, as individual investors and as a broader finance community, to help stabilise and enhance the environment, society and financial systems such that they benefit rather than harm our investments?*

Some investors are also intentionally and proactively addressing the bigger-picture context of their investment selection and portfolio construction decisions. They are developing approaches to managing the relationship between their investment strategies and the health of the environment, society and the financial system. They are thinking beyond "What are the carbon-emissions and working-condition consequences of our investment in this enterprise or fund?" and considering "What can we do, as an individual investor and as a collective investment community, to address climate change and labour rights and, in turn, help to foster an environment and society that promotes the long-term growth and solvency of our assets?".

TIIP refers to these investors as 'system-level' investors. Generally, investors aim to maximise the returns of individual market transactions for a given level of risk, typically against a benchmark and within a specified short-term time frame. Some evaluate potential ESG risks and impacts of investments as part of these "portfolio-level" transactions (see Table 1). System-level investors incorporate these considerations into their daily investment management, while also acknowledging that their market transactions are affected by, and affect, the broader environmental, societal and financial systems within which they take place. They believe that finance and investment rely, in part, on the predictability and reliability of these systems, and that cumulative decision making by investors affects these systems' wealth-creating potential which, in turn, can impact the performance of all portfolios. They balance making profits and doing good, price and values.

Table 1: Portfolio-level investing vs. system-level investing

INVESTMENT CONSIDERATIONS	PORTFOLIO-LEVEL INVESTING	SYSTEM-LEVEL INVESTING
Individual market transactions	✓	✓
Short-term risk/reward	✓	✓
Achieving financial returns against a benchmark	✓	✓
ESG risk/reward	✓	✓
Environmental or social impact of individual investments	✓	✓
Impact of environmental, societal or financial system context on market transactions		✓
Long-term risk/reward		✓
Investor impact and influence on broader environmental, societal and financial context		✓

System-level investors can employ a variety of what TIIP calls the Tools of Intentionality (see Table 2). Some of these tools and their related underlying activities are a natural extension of activities easily recognisable and widely used by investors as part of daily portfolio management and conventional investment strategies, while others reflect approaches not typically incorporated into day-to-day portfolio management. Each represents a way that investors attempt to influence the environment, society and the financial system through both portfolio- and non-portfolio-related strategies; that is, through strategies directly related to the management of their investments (investment belief statements, security selection and portfolio construction, corporate engagements, targeted investment programmes, and manager selection, directives and monitoring) and through additional strategies implemented above and beyond daily portfolio management (e.g., public policy advocacy, thought leadership and convening investor interest groups).

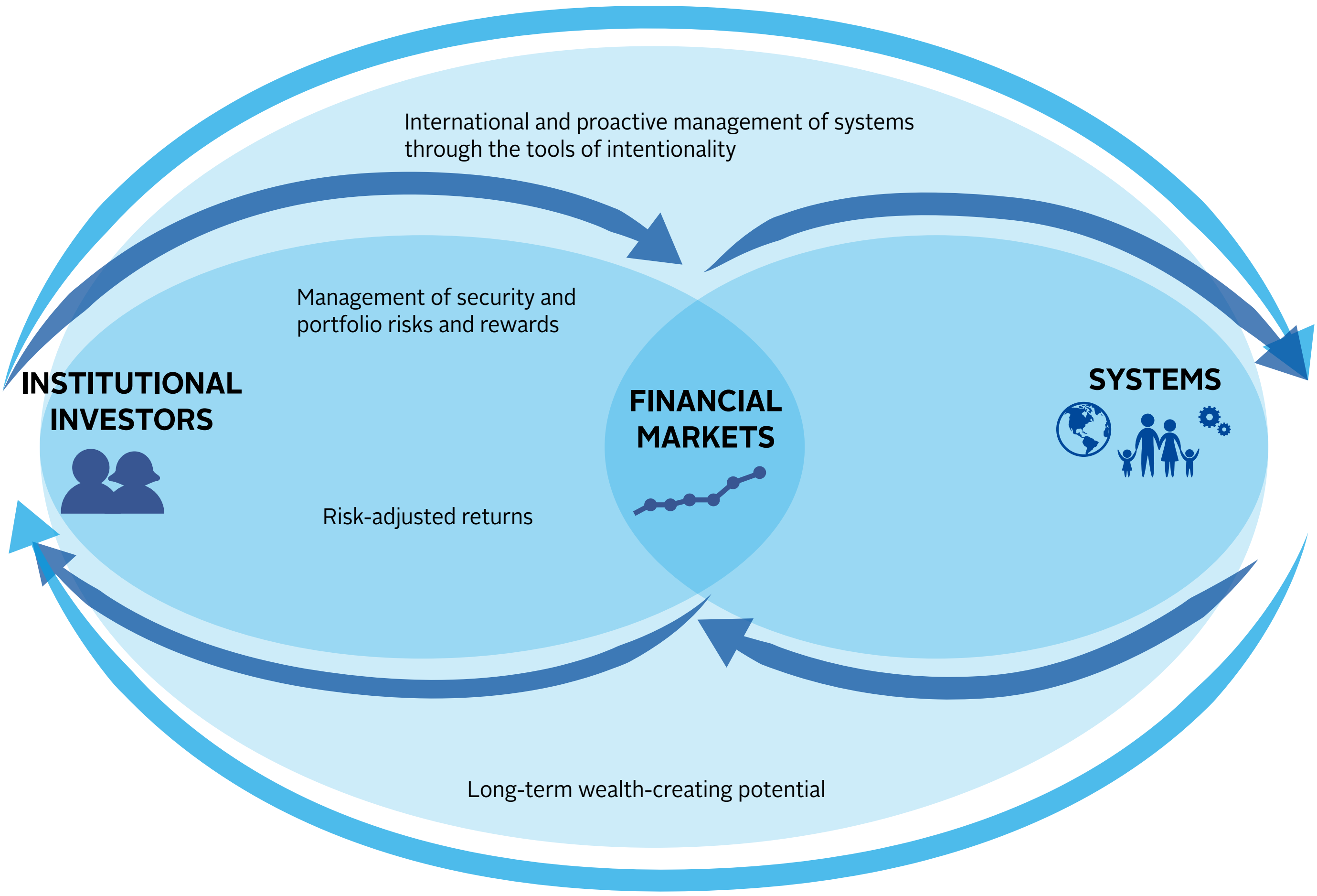
Table 2: The Tools of Intentionality

Additionality	(1) Adding to the value of the societal and environmental systems, while also creating economic value, in ways that would not otherwise be funded; (2) investing in underserved regions or populations, or; (3) funding projects that are not currently being funded by any others and are in effect breaking new ground and creating new markets.
Diversity of Approach	Developing of a diverse set of investment products or services to serve clients with differing ESG concerns (asset managers). Utilising a diverse range of investment tools to address complex system-level social or environmental concerns (asset owners and managers).
Evaluations	Valuing difficult-to-price aspects of environmental, society and financial systems that generate potential long-term investment opportunities.
Interconnectedness	Increasing the flow of information and communications about environmental, societal and financial systems among peers, clients and the public at large.
Locality	Strengthening the environmental, societal and financial systems within a geographic region—be that a city, state, region or country—with an attempt to create a series of interrelated investments that address sustainability issues and support and enhance each.
Polity	Substantially engaging in public policy debates—directly with governmental bodies and regulators or less directly through collaboration with civil society organisations or peers in the investment community—to create a stronger, more resilient financial, environmental or societal system on which long-term investment can build.
Self-Organisation	Leading the creation and management of on-going organisational structures that build the capacity of the investment community to address system-related considerations and strengthen the overall resilience of the financial system.
Solutions	Pursuing investments that resolve system-level societal and environmental challenges.
Standards Setting	(1) Setting absolute standards for the inclusion of securities (primarily public and private equities or fixed income) based on widely accepted norms or standards, or (2) leading the setting of standards for conduct by corporations in areas of social or environment concern for specific industries or issues.
Utility	Maximising the alignment of specific asset classes with the societal functions that the asset classes were designed to serve.

Figure 2 provides a summary illustration of the relationship between portfolio and system-level investing. It depicts how portfolio-level investing focuses on managing the risks and rewards of individual securities and investment portfolios towards the achievement of risk-adjusted rewards.

It also depicts how system-level investing incorporates these portfolio-level considerations while simultaneously managing investor impact on the health and well-being of the environment, society and financial system to support their contributions to long-term wealth creation.

Figure 2: Portfolio and system-level investing



APPENDIX C: FREQUENTLY ASKED QUESTIONS ABOUT SYSTEM-LEVEL INVESTING

SYSTEM-LEVEL INVESTING: FREQUENTLY ASKED QUESTIONS

WHAT IS SYSTEM-LEVEL INVESTING? WHAT IS A “SYSTEM”?

System-level investors believe that the health of the world’s overarching environmental, social and financial systems affects investment returns, and that investors’ actions positively or negatively impact the health of these systems. They believe that they must do more than achieve environmental and social impact with individual investments; they must act more broadly to enhance and preserve the well-being, reliability and predictability of the environment, society and financial system to protect the long-term solvency of their investments.

Systems consist of those common-pooled environmental, societal and financial resources on which investors depend. When healthy, systems facilitate long-term wealth creation; when unhealthy, they negatively affect long-term returns.

Environmental system	The ecosystems that make up the entirety of our natural world – for example, the oceans, the atmosphere, water, metals, minerals.
Societal system	A series of societal constructs such as equality, well-being, knowledge, theories of law and other abstract elements that serve as the foundation for society.
Financial system	The laws, contracts and technology, as well as the theoretical and political ideas around which our complicated financial systems have been built.

WHY SHOULD INVESTORS ENGAGE IN SYSTEM-LEVEL INVESTING?

Systems are important. Finance and investment are built on the predictability and reliability of the environment, society and the financial system. Stable systems promote healthy market returns; unstable systems can jeopardise market returns.

System-level factors can affect entire markets, and hence all portfolios, in substantive ways. Investors on the whole benefit from the performance of the overall markets, driven in large part by the performance of the economy. It is this market “beta”—swings in benchmark performance against which investors’ performance is often measured—that is the primary source of long-term returns, rather than the “alpha” that individual investors generate by outperforming benchmarks. Alpha is a zero-sum game, difficult for any single manager to generate consistently and impossible for more than half of all managers to claim at any one time. Market beta represents an extra advantage to investors through the creation of long-term value, and benefits them individually and collectively. Consequently, investors have a compelling reason to consider environmental, societal and financial systems-level issues as part of their investment processes, while also grappling with the integration of ESG factors in portfolio management.

Take climate change, for example. Researchers and industry organisations assert that there is a considerable range of unhedgeable—that is to say, unavoidable—consequences for portfolios of climate change under various scenarios, and that is a material sustainability performance indicator for nearly every single industry that makes up the economy. The long-term performance of investments in these industries is increasingly at risk as climate change accelerates. As one of the largest emitters of greenhouse gas, the coal industry has already paid a substantial price, with major coal mining firms having to seek bankruptcy protection. As another example, during the 2008 financial crisis, few investors understood how mortgage defaults in one country could, through collateralised debt obligations, wreak devastating effects on the global financial system. All asset classes suffered during the crisis, with losses across the board that were difficult for any investor to avoid.

HOW IS SYSTEM-LEVEL INVESTING DIFFERENT FROM IMPACT OR RESPONSIBLE INVESTING OR STRATEGIES SUCH AS ESG INTEGRATION?

An increasing number of investors integrate environmental, social and governance (ESG) considerations into their risk assessments and pricing valuation of individual securities to mitigate portfolio risks. Many socially responsible investors and impact investors understand the importance of the environmental and social consequences of their investment decisions and use various conventional investment activities to pursue related goals, while also integrating ESG considerations into portfolio risk management.

Beyond managing non-financial portfolio-level impacts and using ESG factors to manage portfolio-level risk, system-level investors take additional action to generate measurable influences on the broader environmental, societal and financial systems within which they operate; that is, to convince stakeholders that a system has a relevant impact on investment and that investors can act in discrete and tangible ways to determine that impact, or to alter prevailing financial community or societal norms in a way that promotes system health and resilience. These investors deliberately—or *intentionally*— employ a combination of conventional investment strategies and other system-level investing tools that embrace system-level investing to address big global problems or harness global trends while achieving competitive returns.

WHO IS CURRENTLY ENGAGED IN SYSTEM-LEVEL INVESTING?

Many institutional investors with long-term investment horizons are engaged in system-level investing to one degree or another. In 2016 and 2017, TIIP conducted in-depth analyses of the investing strategies of a diverse set of 100 asset owners and managers, and found that most of them integrate system-level considerations into their investment approaches to some extent. The analyses examined large and small investors of various types (e.g., pension plans, sovereign wealth funds, insurance companies, endowments, development finance institutions, diversified financial services providers, and responsible or impact investors), including boutique or lesser-known and emerging investors (e.g., Circularity Capital, Sarona Fund, Arjuna Capital) and those well-known for their leadership in a variety of arenas (e.g., Allianz, Bank of America Global Wealth and Investment Management, CalPERS and CalSTRS).

APPENDIX D: RESEARCH METHODS

In partnership with the Principles for Responsible Investment (PRI), and in collaboration with Mike Musuraca and David Wood, TIIP developed this practical guide—or 'toolkit'—to help institutional investors integrate income inequality considerations into their investment policies and practices.

To fulfil the project objectives, TIIP:

- identified and reviewed literature on investor approaches to integrating income inequality considerations into their decision making. This included examining widely-used investment frameworks; best-practice investment approaches utilised by individual investors; and other reports, websites and articles reflecting current financial community research and guidance.
- interviewed 16 individuals, including asset owners and managers, impact investment experts, academics and others, about their approaches to integrating income inequality considerations into investing; integration of the SDGs into such approaches; and prevailing best practices. Respondents mainly included high-level and executive personnel, such as vice presidents, chief executive officers, partners, directors and fellows. They represented the following organisations:

    1. AustralianSuper
    2. California Public Employees' Retirement System (CalPERS)
    3. City University of New York (CUNY)
    4. Generation Investment Management
    5. Heller School of Social Policy and Management, Brandeis University
    6. International Federation of Accountants (IFAC)
    7. MIT Sloan School of Management
    8. Moody's Analytics
    9. Norges Bank Investment Management
    10. Pension Consulting Alliance
    11. Standard Life
    12. Stichting Pensioenfonds ABP (ABP)
    13. The B Team
    14. UAW Retirees Medical Benefit Trust
    15. University of Pretoria
    16. Wespath Investment Management

TIIP staff conducted interviews using an interview guide that ensured the systematic collection of comparable information across individuals and entities, while also allowing each discussion to focus on individuals' specific expertise and experience.

We refined TIIP's institutional knowledge on system-level investing and related theoretical frameworks. TIIP integrated, referenced and built on its previous research on system-level investing to inform the roadmap presented in this report, including:

- *Portfolios and Systemic Framework Integration: Towards a Theory and Practice*;
- *System-level Considerations and the Long-Term Investor: Definitions, Examples, and Actions*;
- *Tipping Points 2016: Summary of 50 Asset Owners' and Managers' Approaches to Investing in Global Systems* (with IRRC Institute);
- *Central Bank and Development Finance Institution Approaches to Investing in Global Systems* (with IRRC Institute);
- *Effective Investing for the Long Term: Intentionality at Systems Levels* (with High Meadows Institute); and
- *Measuring Effectiveness: Roadmap for Assessing System-level and SDG Investing* (with IRRC Institute).

CREDITS

EDITOR
Ruth Wallis, PRI

DESIGN
Alessandro Boaretto, PRI

The Principles for Responsible Investment (PRI)

The PRI works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

More information: www.unpri.org

PRI Principles for Responsible Investment

The PRI is an investor initiative in partnership with UNEP Finance Initiative and the UN Global Compact.

United Nations Environment Programme Finance Initiative (UNEP FI)

UNEP FI is a unique partnership between the United Nations Environment Programme (UNEP) and the global financial sector. UNEP FI works closely with over 200 financial institutions that are signatories to the UNEP FI Statement on Sustainable Development, and a range of partner organisations, to develop and promote linkages between sustainability and financial performance. Through peer-to-peer networks, research and training, UNEP FI carries out its mission to identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations.

More information: www.unepfi.org

UNEP FINANCE INITIATIVE

United Nations Global Compact

The United Nations Global Compact is a call to companies everywhere to align their operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anti-corruption, and to take action in support of UN goals and issues embodied in the Sustainable Development Goals. The UN Global Compact is a leadership platform for the development, implementation and disclosure of responsible corporate practices. Launched in 2000, it is the largest corporate sustainability initiative in the world, with more than 8,800 companies and 4,000 non-business signatories based in over 160 countries, and more than 80 Local Networks.

More information: www.unglobalcompact.org

United Nations Global Compact