FTSE Russell’s Stewardship, Transition and Engagement Program for Change (“STEP Change”) is about helping drive better global standards in sustainable investment. As a firm, we work with corporates, NGOs and investors to improve disclosure and foster transparency for the long-term benefit of the market and ultimately the societies we all operate within.

Executive summary and introduction

Growing numbers of asset owners, asset managers and others involved in the investment chain now routinely consider stewardship and sustainability themes as core investment priorities. Around the world, they are taking action to integrate sustainability themes such as climate change into central aspects of their investments and operations.

Especially since the financial crisis, there has been widespread concern about short-termism in institutional asset management, with investment managers often trying to maximize returns over each quarter, but potentially generating sub-optimal long-term returns as a result.

There is a growing view that insights from environmental, social and governance (ESG) data, the structuring of investment mandates to incentivize a longer-term performance outcome, and strong investor stewardship and engagement with the management of investee companies will collectively help address this potential market failure, and potentially contribute to better long-term risk-adjusted returns.

FTSE Russell has a long-standing commitment to sustainable investment and has been at the forefront of this trend for nearly two decades, since the launch of the FTSE4Good Index Series in 2001. Now the momentum towards sustainability is building amongst investors globally.

For example, Larry Fink, the CEO of Blackrock, the world’s largest asset owner, said in his open letter1 this year to corporate chief executives: “To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate.”

1 https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter
In this special report we provide an in-depth look at FTSE Russell’s approach to stewardship and illustrate how we conduct dialogue with companies. This structured process often leads to improvements in disclosure and practice that could be considered akin to engagement by investors.

Our stewardship approach is based on transparent Environmental, Social and Governance (ESG) methodologies and assessments that help companies measure their own performance against that of their peers.

Listed companies have huge numbers of investors and typically each investor has a relatively small equity stake in percentage terms. This can make companies’ engagement with their shareholders a complex and time-consuming process.

By contrast, an index company with a significant market share can provide a service to a large number of investors globally, helping create a prism for corporate engagement. This service enables a form of virtual, collaborative engagement by investors, and gives a more focused opportunity for listed companies to interact.

As well as describing our sustainable investment philosophy, the role of external advisory committees and the details of our company engagement process, in the report we highlight recent developments and initiatives in the area of sustainability, including FTSE Russell’s collaborative work with international institutions and academic bodies.

Increasingly, ESG performance criteria, factors and risks are central to the everyday activities of those working in finance. FTSE Russell is committed to providing an objective framework to further this trend, by developing a comprehensive dataset based on transparent methodologies and by contributing to the formation of global standards.

We encourage the companies with which we are in regular dialogue to join us in improving standards of transparency, disclosure and sustainability.

Mark Makepeace
Group Director,
Information Services
LSEG & CEO, FTSE Russell
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29 Section 5: Looking ahead
For nearly two decades, since the launch of the FTSE4Good Index Series in 2001, FTSE Russell has been at the forefront of the accelerating trend towards sustainable investment. Our Sustainable Investment (SI) philosophy and approach are underpinned by four principles.
A commitment to sustainability

FTSE Russell has demonstrated its commitment to sustainability in a number of ways.

- We are proud to have played a key role in the creation of the Principles for Responsible Investment (PRI), which were launched in 2006. The Principles have since become a major driver of the incorporation of ESG criteria into investment and ownership decision-making. FTSE Russell was a founding PRI member and the first index provider signatory.

- We also play an active role globally in the leading sustainable and responsible investment associations, including PRI, UKSIF, EUROSIF, Japan SIF, US SIF, RIA Canada, and RIAA. For over a decade we have supported them as members, taking positions on boards and advisory committees, as well as hosting events and speaking at their seminars and conferences.

- Exchanges around the world use our expertise to create local market ESG benchmarks, facilitating the growth of new index-linked ESG investment opportunities and driving corporate engagement.

Leading the global public policy debate

We work with public policymakers around the world to encourage the creation of better regulatory frameworks to support and catalyze sustainable finance.

- We were a member of the European Commission’s (EC) 20-member High-Level Expert Group (HLEG) on Sustainable Finance (see Section 5 of this report).

- The HLEG was asked by the EC to provide recommendations to enable sustainability to be “hard-wired” into the regulation of European capital markets, and these recommendations formed the basis of the EC’s Sustainable Finance Action Plan.
• We were also an active member of the UK Government’s Green Finance Taskforce, playing a leading role across both the Capital Markets and Institutional Investment work streams. We also contribute to and engage in important public policy consultations and discussions on sustainability and corporate governance around the world. Recently we have submitted papers to the FSB’s Task Force on Climate-Related Financial Disclosure, to the US SEC and to IOSCO on the topic of developing consistent global climate and ESG frameworks. David Harris presented evidence to the UK Parliament Environmental Audit Committee alongside UK authorities (Bank of England, FCA) as part of a Green Finance Inquiry. We are members of the Principles for Responsible Investment (PRI) Global Policy Reference Group.

Facilitating dialogue

FTSE Russell plays a central role in a number of initiatives designed to promote dialogue between issuers, investors, policymakers and academics.

• Together with other divisions of the London Stock Exchange Group (LSEG), we are an active member of the United Nations Sustainable Stock Exchange (SSE) initiative. We chaired the SSE working group to develop model guidance on ESG Reporting for exchanges globally.

• Separately, we launched our own LSEG ESG reporting guidance for issuers, helping improve the flow of investment-grade ESG data to investors from those issuing securities.

• We help the marketplace work towards the continuous improvement of global ESG standards by drawing on the most established frameworks for ESG reporting and incorporating these into our own ESG methodologies.

• We catalyze discussions between investors and companies on ESG strategies and performance, notably by supporting the Transition Pathway Initiative (TPI—see Section 5), which brings together asset owners, asset managers and academics. The TPI provides an overall engagement framework for the transition to a low-carbon economy.
Enabling sustainable investment

FTSE Russell has pioneered the integration of sustainability into institutions’ and individuals’ investment strategies and their engagement and stewardship programs.

- Since we launched the FTSE4Good Index Series in 2001, we have launched a growing range of sustainable investment index series, including the FTSE Environmental Opportunities, FTSE Environmental Technology, FTSE ESG, FTSE Climate, FTSE Ex-Fossil Fuel, FTSE Climate Balanced Factor and FTSE Green Revenues index families. We have also pioneered the practice of “Smart Sustainability” which brings together the concepts of smart beta and sustainable investment.

- Exchanges around the world use our expertise to create local market ESG benchmarks, facilitating the growth of new index-linked ESG investment opportunities and driving corporate engagement; this has included Bursa Malaysia, the Johannesburg Stock Exchange, Borsa Madrid, and the ASEAN group of exchanges.

- In recent years a growing trend has been to integrate ESG into institutional passive portfolios at scale and FTSE Russell has been supporting asset owners to achieve this. This has been occurring around the world: in Asia for example, multi-billion dollar passive asset management mandates have recently been awarded by the Japanese Government Pension Investment Fund (GPIF) and the Taiwan Labour Bureau, based on FTSE Russell ESG indexes.

- We have collaborated with a leading global asset manager and the pension fund of the UK’s largest bank to create a new “Smart Sustainability” index that combines risk premia and climate parameters with a goal of delivering improved long-term risk adjusted returns by managing the investment risks associated with climate change. The HSBC Bank UK Pension Scheme has invested 100% of its defined contribution default equity fund into Legal & General’s Future World Fund, which tracks the new FTSE All-World ex CW Climate Balanced Factor Index.
Championing transparency

FTSE Russell is committed to transparency in ESG investment. Our approach helps foster wider access to and the improved quality of the ESG data available to market participants.

- As a company, we are committed to transparent and objective sustainable index methodologies and we strive to lead the industry in best practice standards for index governance. Our governance process incorporates independent Advisory Committees and Sub-Committees (see Section 3 of this report), which help to establish the criteria for our index rules.

- Through the FTSE4Good Index Series, we have engaged with companies for nearly two decades to help improve ESG disclosure standards. Academic studies from Edinburgh and Nottingham Universities have helped show the effectiveness of this engagement approach (see Section 4 of this report).

- Globally, we are in regular contact with over 4000 companies, encouraging them to publicly disclose ESG data and to check the information we collect on them. For the purpose of our ESG Ratings we only utilize publicly disclosed data, rather than potentially less reliable and less objective private, survey-based data. We also give additional credit when information disclosed is independently verified. This commitment to open-source information also encourages corporate transparency.
The role of FTSE Russell’s Advisory Committees

External advisory committees play a pivotal role in the oversight of FTSE Russell’s index families and rating systems. They help ensure that FTSE Russell indexes and their methodologies meet the requirements of financial market practitioners, and operate independently and under a transparent and consistent governance framework.

FTSE Russell has a long history of collaborating with independent practitioner committees to assist in performing these oversight duties: the company’s first external advisory committee was set up in 1984 to oversee the management of the FTSE 100 index of UK large-cap stocks.

What is the role of the advisory committees?

The ESG Advisory Committee and the Environmental Markets Advisory Committee consist of senior market practitioners, who are representative of the global investment community, and representatives with specific ESG and environmental markets expertise, drawn from companies, unions, NGOs and academic institutions.

The committees’ responsibilities include:

• providing guidance on the development of the methods, criteria and taxonomies for the construction of FTSE Russell’s ESG Ratings and Environmental Markets indexes;
• commenting on the index reviews for the FTSE4Good and Environmental Markets indexes;
• periodically reviewing the ground rules and inclusion criteria for the indexes;
• providing feedback on options and proposals for changes to the ground rules and inclusion criteria. Any final significant changes must also then be approved by the internal governance committee.


“The ESG Criteria Advisory Group provides a forum for consideration of how the ESG methodologies and the index eligibility criteria should evolve to reflect international standards to effectively capture ESG Themes.”
Raising the bar for global ESG standards

The ESG Criteria Advisory Group provides a forum for consideration of how the ESG methodologies and the index eligibility criteria should evolve to reflect international standards to effectively capture ESG Themes. They also provide guidance on the development and prioritization of possible new criteria, or updates to existing criteria. In this way the Committee plays an important role in setting and raising the bar for global ESG standards.

The BMS Marketing Advisory Group provides a specialist forum to consider the approach and criteria for infant food and nutrition companies in relation to breast milk substitutes (BMS) marketing. Please see Section 4 third case study for more details on this important issue.
FTSE Russell’s transparent ESG evaluation methodology has been developed over many years, taking into account the views of financial market participants and drawing on the responses provided to market consultations. The underlying criteria are drawn from over 40 leading global standards, including thematic and broad ESG frameworks. These include the Global Reporting Initiative (GRI), the Carbon Disclosure Project (CDP), the OECD’s Guidelines on Corporate Governance, and Transparency International’s Business Principles for Countering Bribery.

The methodology is based on a concept of materiality and seeks to overweight sector-specific and quantitative performance measures. FTSE Russell categorizes companies’ exposure to each of 14 ESG Themes on a scale between 0 (negligible or not applicable) and 3 (high).

For companies with exposure in a particular Theme, clear rules are used to award each company a score between 0 and 5. These scores aggregate into scores for the three ESG “Pillars” (Environmental, Social and Governance) and these are then used to calculate an overall ESG Rating. This overall rating reflects the materiality of each company’s ESG exposures.
FTSE Russell’s ESG Model

Source: FTSE Russell
A structured stewardship and engagement process

Each year, FTSE Russell’s ESG analysts communicate with over 4000 companies in 47 countries and we conduct two-way dialogue with over 1000 companies. In the case of a more focused group of up to a few hundred companies, who are facing potential deletion from the FTSE4Good Index Series or trying to improve their ESG practices, we become involved in detailed communication and dialogue.

FTSE Russell follows a structured engagement process to ensure companies are given adequate notice when they face deletion from the FTSE4Good Index Series, so they can address shortfalls in their ESG Ratings if they wish to try to retain index inclusion.

For example, a company from a Developed market with an ESG Rating of below 2.7 at the June 2018 index review would receive a minimum of three notifications: a first notification in June, a second in the form of a letter to the company’s CEO in September and a third in November/December.
When communicating with companies, FTSE Russell follows four key principles:

- We enable all companies to review the information we have collected, as an additional data check mechanism;
- We aim to ensure companies are treated and assessed fairly and transparently;
- We take on board corporate feedback on the ESG Ratings criteria to improve and refine our methodology over time;
- And we aim to catalyze improvements in corporate disclosure, practice and performance, while giving constituents adequate time to respond to queries.

Although companies are deleted from our indexes for not keeping pace with the increased thresholds for inclusion, this is counterbalanced by others moving to meet our standards and gaining inclusion in our indexes. In each calendar year since 2011, with the support of our engagement program, the number of constituents added to the FTSE4Good Developed Index has exceeded the number of constituents deleted from the index, with additions to the index between 2011-2017 totaling 575 and deletions from the index over the same period totaling 243.

### Additions and deletions to the FTSE4Good Developed index by calendar year

<table>
<thead>
<tr>
<th>Year</th>
<th>Constituents added</th>
<th>Constituents removed</th>
<th>Total constituents*</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>88</td>
<td>20</td>
<td>719</td>
</tr>
<tr>
<td>2012</td>
<td>43</td>
<td>18</td>
<td>735</td>
</tr>
<tr>
<td>2013</td>
<td>45</td>
<td>29</td>
<td>749</td>
</tr>
<tr>
<td>2014</td>
<td>50</td>
<td>12</td>
<td>782</td>
</tr>
<tr>
<td>2015</td>
<td>82</td>
<td>36</td>
<td>801</td>
</tr>
<tr>
<td>2016</td>
<td>124</td>
<td>53</td>
<td>830</td>
</tr>
<tr>
<td>2017</td>
<td>143</td>
<td>75</td>
<td>879</td>
</tr>
<tr>
<td>Total</td>
<td>575</td>
<td>243</td>
<td>N/A</td>
</tr>
</tbody>
</table>

* Total constituents is reduced by corporate actions and changes to benchmark indexes

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*This relates to constituents in the FTSE4Good Index Series and the FTSE Blossom Japan Index*
**FTSE Russell’s pioneering role in ESG investing**

“When the FTSE4Good Index Series was launched in 2001, the idea of benchmarking sustainable investing via an ESG index was relatively new. At the time it was a part of the market dominated by ethical, socially responsible investment funds. There was little understanding of how corporate governance and social and environmental issues could constitute sources of risk and return.

“The index generated an immediate reaction from some of the companies that were not included. One CEO got in touch immediately and asked, ‘what do we need to do to get in?’ There was a competitive race to the top in terms of wanting to meet the disclosure criteria.

“The major success of the FTSE4Good Index Series has been in generating that sense of momentum and change in some of the world’s leading companies.”

*Will Oulton*
Director of Responsible Investment, First State Investments; previously Deputy Chief Executive, FTSE

**Our engagement in practice**

To illustrate how engagement works in practice, we provide three case studies: one that follows the introduction of the new FTSE Russell ESG model, which resulted in more challenging index inclusion requirements for companies; a second showing the recent process of engagement in Japan, where FTSE Russell launched the FTSE Blossom Japan Index in 2017 which was selected for an important passive mandate by the Japanese Government Pension Investment Fund (GPIF); and a third describing FTSE Russell’s influence in catalyzing improvements in the infant food and nutrition industry with respect to responsible marketing practices.
In 2014 FTSE Russell introduced a new ESG model for the FTSE4Good Index Series, resulting in more challenging index inclusion requirements for companies.

This resulted in over two hundred companies failing to meet the standards for index inclusion, and therefore becoming at risk of deletion.

The country and sector make-up of these companies, as well as the index turnover threatened by the deletion of such a large number of constituents, presented risks for users of the FTSE4Good Index Series.

Typically, companies at risk of deletion from the FTSE4Good Index Series receive a 10-12-month grace period. During this time FTSE Russell communicates with the CEO or Chairman of each company, along with the relevant sustainability practitioner, where possible. Where companies are responsive, FTSE Russell provides support in understanding the criteria and the steps that the company would need to take to meet the thresholds for inclusion in the index.

The companies at risk of deletion displayed clear sector and country characteristics, with companies in the financial sector and Japan overrepresented. In Japan, it was clear that some companies were finding it difficult to meet the new, stricter indicators within the governance pillar, particularly as some of these standards were not yet widely adopted in Japan. The scale of the challenge can be seen in the table below, where 107 of the 212 companies at risk of deletion from the FTSE4Good Index Series were from Japan.
After the financial crisis, the FTSE Russell ESG Advisory Committee had assembled a working group to look specifically at how to develop additional sector specific criteria for financial institutions within FTSE Russell’s ESG model. Following the working group’s review from 2014, 57 new indicators were introduced. The affected companies in the financial sector initially found the inclusion criteria more difficult to meet; 76\* of the 212 companies at risk of deletion were from the financial sector (see the table below).

<table>
<thead>
<tr>
<th>Country</th>
<th>Pre-engagement</th>
<th>Post-engagement</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number of companies that failed to meet the new higher standards for inclusion</td>
<td>Number of companies who failed to meet the higher inclusion standards and were deleted from the index</td>
<td>Number of companies who moved to meet the higher standards and were retained in the index</td>
</tr>
<tr>
<td>Australia</td>
<td>15</td>
<td>3</td>
<td>12</td>
</tr>
<tr>
<td>Canada</td>
<td>2</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>France</td>
<td>4</td>
<td>1</td>
<td>3</td>
</tr>
<tr>
<td>Germany</td>
<td>1</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Ireland</td>
<td>1</td>
<td></td>
<td>1</td>
</tr>
<tr>
<td>Israel</td>
<td>6</td>
<td>4</td>
<td>2</td>
</tr>
<tr>
<td>Italy</td>
<td>1</td>
<td></td>
<td>1</td>
</tr>
<tr>
<td>Japan</td>
<td>107</td>
<td>48</td>
<td>59</td>
</tr>
<tr>
<td>South Korea</td>
<td>11</td>
<td>6</td>
<td>5</td>
</tr>
<tr>
<td>New Zealand</td>
<td>4</td>
<td>1</td>
<td>3</td>
</tr>
<tr>
<td>Austria</td>
<td>1</td>
<td></td>
<td>1</td>
</tr>
<tr>
<td>Singapore</td>
<td>1</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Spain</td>
<td>1</td>
<td></td>
<td>1</td>
</tr>
<tr>
<td>Sweden</td>
<td>1</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Switzerland</td>
<td>4</td>
<td>3</td>
<td>1</td>
</tr>
<tr>
<td>UK</td>
<td>9</td>
<td>2</td>
<td>7</td>
</tr>
<tr>
<td>USA</td>
<td>43</td>
<td>25</td>
<td>18</td>
</tr>
<tr>
<td><strong>Grand Total</strong></td>
<td><strong>212</strong></td>
<td><strong>98</strong></td>
<td><strong>114</strong></td>
</tr>
</tbody>
</table>

\* Note: The number 76 is an approximation and may not reflect the exact figure.
The phased deadlines and accompanying communication and management process that followed the 2014 changes to the FTSE4Good Index Series inclusion criteria was completed in 2017. A majority (59 of 107) of Japanese corporates moved to meet the new criteria and have maintained their place in the index, as did a significant portion of the companies in the financial services sector (48 of 76). Across countries and sectors, more companies improved their ESG standards and stayed in the index series than failed to meet the more challenging criteria and were deleted (out of 212 companies at risk of deletion from the index, 114 stayed and 98 departed). Please also see the academic studies on p27 that sets out the academic research on whether and how FTSE4Good and FTSE Russell’s ESG Model influences corporate behavior.
The challenge: Raise local ESG standards

In 2014 Japan introduced a new Stewardship Code, to which the Government Pension Investment Fund (GPIF), the largest pension fund in the world, committed itself, together with many Japanese asset managers. The Stewardship Code encourages dialogue between investors and investee companies to support the long-term growth of companies and investments.

The emphasis on long-term growth has helped incentivize investors to incorporate ESG-related performance and risk into their portfolio construction processes and their engagement with investee companies. As signatories to the Japanese Stewardship Code, investors needed a tool to examine the ESG performance of Japanese corporate issuers, as well as to track the impact of the engagement activities conducted by market participants.

“GPIF wants to incentivize Japanese corporates to perform better on environmental, social, and governance issues, and allocate more to corporates and managers that took such issues seriously.”

Mr. Hiromichi Mizuno
Chief Investment Officer of the Government Pension Investment Fund

Source: IPE article, 7 June 2017

In 2015 Japan also introduced a new Corporate Governance Code, with Shinzo Abe, the country’s Prime Minister, placing improved governance at the center of his economic reform efforts.

These very public commitments by Japanese politicians and savings institutions to improved corporate stewardship have marked a sea change in domestic Japanese practices and have had an impact across the whole Asian region.

Only a few years ago, it was largely foreign investors who were raising concerns over ESG standards in Japanese companies. Now, this form of engagement is coming from both domestic and international investors, who sometimes collaborate in their engagement efforts.

The solution: Incentivize improved ESG performance via an index

FTSE Russell had been actively promoting sustainable investment in Japan since 2004, when the FTSE4Good Japan Index was first launched. There has been positive engagement from Japanese companies for many years, but it has taken longer for institutional investors in Japan to become engaged. This started to change in 2014 when GPIF commissioned studies looking into global good practice in ESG and Stewardship. QUICK and FTSE Russell were selected and conducted such a study for GPIF, which involved interviewing asset owners around the world. The resulting...
In 2017 FTSE Russell introduced the FTSE Blossom Japan Index, an industry-neutral benchmark that measures the performance of Japanese companies which demonstrate strong ESG practices. The index is closely aligned with the FTSE4Good Index Series, using the same ESG Rating threshold for inclusion. This new index was then chosen along with two indexes from another provider, by GPIF as part of an important new allocation to passively managed ESG funds, totaling 1 trillion Japanese yen (c. $9.3bn).

The FTSE Blossom Japan Index incentivizes enhancements in corporate disclosure and ESG performance through a transparent index selection methodology, whereby companies need to meet good international standards to gain index inclusion.

Meeting and keeping pace with the evolving methodology can be challenging, but there are strong benefits associated with index inclusion. Not only does a company become part of the investment universe for investors following these indexes, but it also sends a powerful message to the wider market that it meets international good practice standards.

Index constituents often proudly use the FTSE Blossom Japan Index logo in their corporate literature. This helps companies promote their inclusion in the index and to communicate their achievements in ESG performance to other stakeholders and the general public.

Following the launch of the FTSE Blossom Japan Index, our engagement with Japanese companies has significantly increased. To support the launch of the index, we conducted a constituent communications program to introduce the new index and its inclusion criteria. Since the launch of the FTSE Blossom Japan Index, the number of incoming queries from Japanese companies has gone up by around 200%.

“Since the launch of the FTSE Blossom Japan Index, the number of incoming queries from Japanese companies has gone up by around 200%.”

Mr. Norihiro Takahashi  
President of the Government Pension Investment Fund

Source: GPIF statement, 3 July 2017

“GPIF expects that the selected ESG indices incentivize Japanese companies to improve their ESG evaluations and enhance enterprise values in the long term.”

Source: GPIF statement, 3 July 2017
The challenge: Address risks around infant health where there are strongly polarised positions over BMS marketing between companies and non-governmental organizations (NGOs) focused on infant health.

Breast milk substitute (BMS) marketing criteria form an important component of FTSE’s ESG framework for infant food manufacturing companies. The BMS marketing criteria are part of the Customer Responsibility Theme in our ESG Ratings methodology.

Breast milk substitutes have been a controversial topic for decades. From the 1970s onwards, certain pressure groups worldwide have urged a boycott against the manufacturers of BMS products as part of a broader initiative to support breastfeeding and healthy infant nutrition, especially in developing countries.

The main international standard on BMS marketing (the “WHO Code”), introduced in 1981, is interpreted and followed in very different ways by governments, manufacturers, NGOs and UN agencies. Many governments have only implemented small parts of the WHO Code, and some, including the United States, have not implemented it at all.

In the absence of regulations many have looked to industry to move ahead in meeting the guidance provided by the WHO Code on a voluntary basis. But differing interpretations of the WHO Code and lack of consensus on the way forward has also led to a highly confrontational stance between the industry and infant health organizations. As a result, cooperation between the food industry and NGOs on this issue has been at an impasse, and has often hindered engagement in related areas, such as partnerships focussing on the fortification of complementary foods with micronutrients.

In many ways, the challenges over BMS marketing echoed the debates of two decades ago concerning supply chain labour standards and sweat shops. In that case, progress became possible once NGOs, retailers and clothing brands started working together, for example through the Ethical Trading Initiative.

The solution: Bridge the gap via engagement and a transparent verification process

At first from 2001 to 2010 the BMS Marketing criteria were established such that no company met the requirements. As a result, they were not helping catalyze improvements in industry practices, unlike in other areas of ESG-related engagement.

In an effort to bridge the gap, in September 2010 the FTSE Russell ESG BMS Marketing Advisory Group advised FTSE Russell on the introduction of new FTSE Russell BMS marketing criteria, informed by the WHO Code, and which set minimum standards for company policies, lobbying, management systems, reporting and verification.
Initially, only one company out of the five large BMS manufacturers (Nestlé) moved to meet the criteria. To ensure independence in verifying compliance with the marketing criteria, FTSE (in consultation with a number of investors and infant health organizations) developed a verification process and then engaged an external audit firm to verify Nestlé’s practices in sample countries and at head office.

In recognition of the importance of the FTSE Russell work in achieving traction on this issue, first GAIN (the Global Alliance for Improved Nutrition), and then later the Bill & Melinda Gates Foundation have contributed technically and financially to support this verification work.

Recently Danone, after almost a decade of engagement with FTSE about BMS marketing, has followed suit and now meets the FTSE Russell criteria. Danone will, accordingly, now be subject to the same verification process as Nestlé. Further, RB, formerly Reckitt-Benckiser, following its acquisition of US BMS manufacturer, Mead Johnson, will also need to meet these criteria by the end of 2018 if it is to retain its inclusion in the FTSE4Good index. Should all three companies meet the criteria, a significant proportion of the global BMS industry would be meeting the FTSE4Good standards.

As for all other ESG criteria used for the FTSE4Good Index family the threshold will be lifted gradually over time, balancing the need to further advance standards, while ensuring that companies are positively engaged and move to meet the criteria.

To further build trust and dialogue between the parties involved in the long-standing debate over BMS marketing, FTSE Russell makes the verification reports public. In addition, multi-stakeholder workshops are hosted to consider the verification process with participants from charities, responsible investor groups, NGOs, health and children’s organizations, inter-governmental organizations, UN agencies, as well as the verified companies, the audit firm, and members of the FTSE Russell BMS Marketing Advisory Group, a subcommittee of the FTSE ESG Advisory Committee. Further, at the most recent workshop additional BMS manufacturing infant nutrition companies were also invited and participated indicating the increasing level of engagement across the market.

Playing this role can often mean facing significant criticism from both manufacturers and NGOs, but FTSE Russell’s approach has helped enable dialogue on this important issue and has facilitated a demonstrable difference in company practices globally as well as building trust.

This case study shows how a transparent approach to assessing companies against the ESG criteria built into a benchmark can support and incentivize corporate changes, influencing market norms and open the door to multi-sector collaboration.

“Once in, companies are not going to want to drop out of the FTSE4Good index. FTSE Russell will gradually raise the bar of their criteria for BMS marketing policies. FTSE Russell stepped into the fray and helped create a structured process for change.”

**Dominic Schofield**  
Senior Technical Advisor, the Global Alliance for Improved Nutrition, & President, GAIN Canada
ESG assessment and index inclusion can influence corporate behavior

Two important academic studies have focused on FTSE Russell’s corporate communication and engagement approach. The studies have shown how the process of ESG assessment and the potential inclusion of a company in an ESG index can influence corporate behavior.3

In one study, conducted by Nottingham University Business School over three years and involving over 40 corporate directors and managers, researchers found that over 30% of interviewees had personal performance objectives linked to inclusion in the FTSE4Good Index Series.

And 75% of the companies interviewed had strengthened their public commitments, their internal monitoring procedures, their implementation or external reporting frameworks in order to maintain inclusion in the index.

In a second study, conducted by Edinburgh University and involving over 1000 companies, researchers performed quantitative analysis to measure the effect of FTSE Russell ESG team’s engagement on companies’ ESG disclosure.

The researchers compared improvements in companies’ environmental management and climate change policies amongst two groups: those companies from within the FTSE4Good Index Series with which FTSE Russell was conducting an engagement program, and a control group of companies with which FTSE Russell was not engaged.

The study results showed that a significantly higher percentage of companies in the engagement group met new environmental management and climate change criteria than those in the control group (see the table).

The effect of engagement—Edinburgh University study

<table>
<thead>
<tr>
<th>FTSE4Good constituents</th>
<th>FTSE engaged with these companies</th>
<th>Control group</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>FTSE engaged with these companies</td>
<td>FTSE did not engage with these companies</td>
</tr>
<tr>
<td></td>
<td>Number of companies</td>
<td>Percent of companies met new criteria over period</td>
</tr>
<tr>
<td>FTSE4Good criteria enhancements</td>
<td>Period</td>
<td></td>
</tr>
<tr>
<td>Environment Management</td>
<td>2002-05</td>
<td>390</td>
</tr>
<tr>
<td>Climate Change</td>
<td>2007-10</td>
<td>208</td>
</tr>
</tbody>
</table>

Source: FTSE Russell

The gradual integration of ESG considerations into asset owners’ and investment institutions’ decision-making processes during the last two decades has been taking place largely behind the scenes, in what could be described as a quiet revolution.

However, sustainable investing is now increasingly at the center of public policy as well. FTSE Russell has consistently played a prominent role in the debate over sustainability by collaborating with key influencer organizations and by championing important new policy developments. In this section we highlight two ongoing initiatives in which FTSE Russell is closely involved.

The Transition Pathway Initiative

The Transition Pathway Initiative is an asset owner-led initiative, supported by asset managers and owners with over $6.5 trillion assets under management. The initiative assesses how companies are preparing for the transition to a low-carbon economy.

To evaluate the quality of a companies’ management of their greenhouse gas emissions associated with their businesses, TPI:

- Evaluates and tracks the quality of companies’ management of their greenhouse gas emissions and of risks and opportunities related to the low-carbon transition;
- Evaluates how companies’ future carbon performance would compare to the international targets and national pledges made as part of the Paris Agreement; and
- Publishes the results of this analysis through an online tool.

TPI reassess each company on an annual basis which enabled those using TPI to track company performance over time and with a transparent tool.

The three partner organizations to the initiative are FTSE Russell, the Principles for Responsible Investment (PRI), and the Grantham Research Institute of the London School of Economics.

FTSE Russell’s data underpins the TPI’s assessment of companies’ quality of management. Examples of the data points being used by TPI include whether or not a company has published a climate change policy, disclosed the financial costs of climate change risks, disclosed energy reduction and emission reduction targets and explained how ESG performance is integrated into executive remuneration.

The asset owners and asset managers supporting the Transition Pathway Initiative have committed to use the results in a number of different ways, including informing their investment decision-making processes, their dialogues with fund managers...
and with policy makers. TPI supporters are also using the TPI management quality assessments to structure and inform their engagement with companies. For example, some have written to companies encouraging them to publish a climate change policy, to publish data on their greenhouse gas emissions and to publish details of the targets they have set for managing their greenhouse gas emissions. A number of funds have also started to use the TPI management quality assessment to inform their voting at company AGMs.

The European Commission’s High-Level Experts Group and Action Plan on Sustainable Finance

In March 2018 the European Commission launched its ambitious and wide reaching Action Plan on Sustainable Finance, setting out its strategy for a financial system that supports the EU’s climate and sustainable development agenda.

This built on the detailed work and recommendations of a High-Level Expert Group (HLEG) on Sustainable Finance, which the Commission established over a year earlier and which set out its recommendations in a report entitled “Financing a Sustainable European Economy”.

The HLEG comprised 20 senior experts from civil society, the finance sector, academia and observers from European and international institutions. David Harris, group head of sustainable business at the London Stock Exchange Group and Head of Sustainable Investment at FTSE Russell, was appointed as one of these experts.

The HLEG was mandated to provide advice to the Commission on how to:

- steer the flow of public and private capital towards sustainable investments;
- identify the steps that financial institutions and supervisors should take to protect the stability of the financial system from risks related to the environment; and
- deploy these policies on a pan-European scale.
The UK Green Finance Taskforce

FTSE Russell was also represented in the UK’s Green Finance Taskforce, which was set up in 2017 by the UK Government to consider how the UK could fulfil its vision set out in its Clean Growth Strategy. Nikhil Rathi, chief executive of the London Stock Exchange plc, chaired one of the work streams and was supported by experts across the London Stock Exchange Group, including FTSE Russell. FTSE Russell actively participated in two key work streams, capital markets and institutional investment, and the taskforce produced a final report, called “Accelerating Green Finance”, in April 2018.

Its recommendations included boosting investment into innovative clean technologies, driving demand and supply for green lending products, setting up clean growth regeneration zones, improving climate risk management with advanced data, building a green and resilient infrastructure pipeline and the issuance of a sovereign green bond by a national government.

Our perspectives: Policy makers have a key role to play

These initiatives from the EU and the UK have had the collective effect of bringing sustainability to the forefront of financial reporting, asset management and investment.

The London Stock Exchange Group (LSEG) and FTSE Russell welcome and support these developments and share the view that sustainability and the transition to a low-carbon, more resource-efficient and circular economy are key to ensuring the long-term competitiveness of economies.

We also believe that the financial services sector has a key role to play as part of the solution towards a greener and more sustainable economy. As part of HLEG and the Green Finance Taskforce, and in our engagement in the wider public policy debate, we are an advocate for transparent data on sustainability.

Such transparency enables the investment community to integrate the risks and opportunities arising from the transition to a sustainable economy into their investment strategies and into their stewardship and engagement activities.

To achieve this there is a need to improve understanding along the investment chain so that issuers understand investors’ needs and investors get access to the information they need. The role of data, disclosure, benchmarks and taxonomies is critical to enable these changes.

Policy makers need to help support a drive for consistency and minimum standards, although at the same time they must not be too prescriptive where market innovation is taking place, and they must also strike the right balance in the reporting burdens they place on the market.

Given the role of the LSEG and its group companies, including FTSE Russell, in working closely with issuers, investors and policymakers, we have a clear role to play in helping drive this transition, to the ultimate benefit of the societies we operate in.
At the December 2017 FTSE Russell ESG Advisory Committee meeting, the committee members considered recent trends in ESG Ratings by industry and by country, as well as the ESG Ratings thresholds for companies’ inclusion in and deletion from the FTSE4Good Index Series.

The committee members noted a continuing improvement and an upward trend in ESG Ratings for companies assessed worldwide, from an average 2.18 to 2.52 over a three year period; an increase of 7.4% per annum.

Despite this improving global picture, ESG performance remains uneven by country. Companies in the European developed markets of the Netherlands, Norway and Finland demonstrate the highest average ESG Ratings, while South Africa leads the way amongst emerging markets when it comes to ESG performance.
Recognizing these trends and in an attempt to catalyze the further improvement of global ESG standards, the ESG Advisory Committee at its December 2017 meeting, discussed and supported a proposal to increase the ESG Ratings thresholds for the FTSE4Good Index Series. As an initial target, the committee members supported a course of action to:

- raise the inclusion threshold for developed markets incrementally over time, with a long-term goal to reach 3.5 by 2021, and to raise the deletion threshold to 3.0; and
- raise the inclusion threshold for emerging markets incrementally over time, with a long-term goal to reach 3.0 by 2021, and to raise the deletion threshold to 2.5.
Role of benchmarks

Stewardship in asset management implies the management of funds to fiduciary standards and usually consists of regular direct engagement between investors and investee companies.

Stewardship is often regarded as most effective when conducted by investors whose portfolios exhibit a high active share. In other words, normally where the investor has a small number of high-conviction holdings, enabling a deeper understanding and dialogue with investee businesses.

But does this mean that benchmarks and indexes have no role to play in influencing the market? In fact benchmarks and indexes, once regarded purely as mirrors of the market, are now increasingly influencing both investor and issuer behavior.

Corporate issuers usually wish to be included in high-profile indexes to gain access to the large pools of capital represented by index-tracking funds and other funds benchmarked to those indexes.

It follows that index rules on topics such as free float requirements or voting rights can have a direct influence on corporate decisions. Further, the environmental, social and governance (ESG) standards that are increasingly being built into index designs can have a similar effect on corporate practice, particularly if the ESG indexes are high profile, or have significant assets associated with them.

It’s important to recognize that the type of interaction an index provider has with issuers is very different to the interaction of a fund manager with his or her portfolio companies. But while the index firm’s practices can never replace engagement by investors, who are the ultimate owners of businesses, they can still be a powerful mechanism to help raise corporate standards.

In this manner the “engagement” effect of high-profile ESG indexes is highly complementary to the more nuanced and focused engagement conducted directly by investors.

FTSE Russell as an enabler of this type of collaborative engagement can help drive the adoption of standards of good practice, as well as helping investors achieve the step change required for the transition to a more sustainable economy.

“In fact benchmarks and indexes, once regarded purely as mirrors of the market, are now increasingly influencing both investor and issuer behavior.”

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4 Active Share and the Three Pillars of Active Management: Skill, Conviction and Opportunity, Martijn Cremers, Financial Analysts Journal, 2017
5 The Kay Review of UK Equity Markets and Long-Term Decision-Making, published in 2012, states that “Good practice in asset management involves substantial ‘active share’, since indexation to a benchmark is a commodity that can be purchased extremely cheaply. Good practice in asset management therefore leads naturally to stewardship activity.”
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Neville White
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About FTSE Russell

FTSE Russell is a leading global index provider creating and managing a wide range of indexes, data and analytic solutions to meet client needs across asset classes, style and strategies. Covering 98% of the investable market, FTSE Russell indexes offer a true picture of global markets, combined with the specialist knowledge gained from developing local benchmarks around the world.

FTSE Russell index expertise and products are used extensively by institutional and retail investors globally. For over 30 years, leading asset owners, asset managers, ETF providers and investment banks have chosen FTSE Russell indexes to benchmark their investment performance and create investment funds, ETFs, structured products and index-based derivatives. FTSE Russell indexes also provide clients with tools for asset allocation, investment strategy analysis and risk management.

A core set of universal principles guides FTSE Russell index design and management: a transparent rules-based methodology is informed by independent committees of leading market participants. FTSE Russell is focused on index innovation and customer partnership applying the highest industry standards and embracing the IOSCO Principles. FTSE Russell is wholly owned by London Stock Exchange Group.

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