

# **Research & Engagement Brief**

Third Quarter 2013

The Intergovernmental Panel on Climate Change (IPCC), the world's leading scientific authority on climate change, recently released its Fifth Assessment Report (AR5) that focuses on the physical science behind the earth's warming (AR4 was published in 2007). There is virtually no ambiguity in the report's conclusions: warming is described as "unequivocal," observed changes as "unprecedented," and human influence as "extremely likely" to be the main cause.

#### **CLIMATE CHANGE AND THE ENVIRONMENT**

Research and engagement activities to encourage companies and policy-makers to mitigate and adapt to climate change is Walden's highest ESG priority. In recent weeks we have reached out to 32 companies across an array of industries with three primary requests: to set greenhouse gas reduction goals for company operations that enable society to stay within its carbon budget as assessed by IPCC (50% reduction of  $CO_2$  globally by 2050 to avoid the worst impacts of climate change), to disclose goals and progress regarding mitigation and adaptation, and to ensure that public policy advocacy is in alignment with company goals. Among energy companies we emphasize the latter request given their disproportionate influence on public policy and our strong belief that a carbon pricing mechanism (e.g. a tax or cap and trade system) is essential for meaningful progress. Conversations have already begun with more than half of the companies, and we are pleased that one firm has committed to review its policy based on the new IPCC assessment.

Several other Walden initiatives are making good progress. McCormick published its first sustainability report after having received significant input from Walden and Calvert Investments. It included goals for reductions in water and electricity use, greenhouse gas emissions, and container packaging weight. Encouraged by Walden and Loring Wolcott & Coolidge, Microsoft amended its Oversight and Transparency of Trade Association Contributions policy and committed to an annual review of trade association memberships. Despite its membership in the Communication and Technology Task Force of ALEC (American Legislative Exchange Council), an organization working to thwart state renewable energy initiatives, Microsoft stated publicly that "ALEC is not speaking for us on renewable energy policy." Moreover, Microsoft will lobby for renewable energy in U.S. states where it has operations. United Natural Foods delivered on its commitment to conduct and report on a water risk assessment in its Albert's Organics division. Management reported that water analysis tools could help the company evaluate existing and prospective supplier relationships.

As a member of Ceres' Investor Network on Climate Risk (INCR), Walden joined numerous investors who are asking more than 50 of

the world's major fossil fuel and electric power companies to assess their exposure to carbon asset risk—risk related to achieving climate polices consistent with IPCC targets as well as those associated with the physical impacts of climate change. Also with INCR, Walden signed a letter to President Obama supporting the Environmental Protection Agency's (EPA) proposed carbon pollution standards for new power plants and encouraged strong guidelines for existing sources as well. Fossil fuel-fired electric power plants are the single largest source of CO<sub>2</sub> in the U.S., representing approximately one-third of all greenhouse gas emissions.

#### **BOARD DIVERSITY AND THE WORKPLACE**

Engagement with the few portfolio companies that do not have women on their boards of directors is another priority. We seek: adoption of corporate governance policies and nominating charters that include gender and race explicitly as among the factors considered in director selection; a public commitment to a diverse candidate pool; and a description of implementation plans (e.g. mandates to director search firms or recruitment from less traditional venues such as government or academia). We are pleased to report that two companies where Walden has raised concerns for more than one year, NetApp and ResMed, have recently added women directors. Additionally, a constructive conversation with City National has assured us that the company is taking significant steps to identify women candidates. Finally, a new conversation on board diversity is underway at Polypore International.

Walden's longstanding efforts continue to encourage publicly accessible nondiscrimination policies inclusive of sexual orientation and gender identity. Recently, **Liquidity Services** and **St. Jude Medical** committed to post their inclusive policies on their websites.

In September, a controversial component of the Dodd-Frank financial reforms overcame fierce opposition from the U.S. Chamber of Commerce and others when the U.S. Securities and Exchange Commission released proposed rules mandating disclosure of CEO pay relative to median employees. Such disclosure helps investors better evaluate compensation as well as the corporate role in growing income inequality—an injustice to workers that also is harmful to economic growth and business prosperity.

### PRIVACY

With public concern about privacy on the rise, we are pleased to report that Walden joined the Global Network Initiative, a multistakeholder organization of technology companies, civil society organizations, academics, and investors working to protect freedom of expression and privacy of information in communications technologies.

## J.P. MORGAN: TOO BIG TO HOLD?

Here's an obvious question for Walden: How can an investment manager who integrates environmental, social, and governance (ESG) factors in investment decision-making hold J.P. Morgan (JPM) stock? The extent of troubling revelations surrounding the firm's basic business ethics and risk control practices is astonishing. In the last quarter alone, JPM has committed to pay \$410 million in fines and settlements for manipulation of energy markets in California and the Midwest; \$389 million in fines and refunds to regulators for wrongful debt collection practices; and most recently, \$920 million to multiple regulators in the U.S. and abroad for the "London Whale" trading fiasco that tallied over \$6 billion in losses for the bank. The latter came with a first-of-its-kind admission of wrongdoing.

There is more to come. The Securities and Exchange Commission is investigating bribery charges (via the Foreign Corrupt Practices Act) associated with J.P. Morgan's hiring of children of influential government officials in China. It is one of many banks charged with manipulation of the London Interbank Offered Rate (LIBOR). But most consequential, by far, is ongoing negotiations with the Justice Department to settle charges of fraudulent mortgage-backed securities and bad residential mortgages, which is expected to have a price-tag in excess of \$10 billion.

Investing in J.P. Morgan raises difficult and complex questions. Is the crux of the issue that JPM is just too big to manage? Quite possibly. Do we think that JPM is inherently different from other major financial institutions? Probably not so much. *The Wall Street Journal* Money Beat reported that since January 2010 JPM settlements total over \$5 billion compared to \$45.9 billion for Bank of America. No one doubts, however, that after being lauded in the midst of the 2008 financial market meltdown, JPM is the current bull's eye target of regulators. Such scrutiny should compel better behavior.

Setting aside several relatively positive environmental and social aspects of J.P. Morgan's overall ESG profile to focus on core business ethics and risk control concerns, Walden's decision process has emphasized two primary considerations: the sufficiency of JPM's response and the effectiveness of investor engagement to encourage better corporate governance.

Judging the adequacy of J.P. Morgan's response will require the passage of time, but Walden is encouraged in both its substance and scope. Highlights include:

- Enhanced board oversight by strengthening the role of the newly titled lead independent director and replacing two board members with new directors that have risk management expertise;
- Creation of a firm-wide Oversight & Control Group, separately staffed, with strong senior manager accountability structures centrally and in each business line;
- 4,000 new employees since 2012 dedicated to control initiatives (Risk, Compliance, Legal, Finance, Technology, Oversight & Control and Audit), and \$1 billion in spending on controls in 2013;
- 750,000 hours of Regulatory and Control-related training across the franchise along with a 27% increase in Regulatory and Control technology investment since 2011;
- Simplifying and refocusing business priorities; and
- Working closely with regulators.

Since the 2008 financial crisis, Walden has voted proxies, engaged in dialogue and filed shareholder resolutions addressing key areas of concern at J.P. Morgan—the lack of an independent board chair (Jamie Dimon serves as both CEO and Chair), the need for better alignment of performance and executive compensation, and loan modification and mortgage servicing progress to stem foreclosures. There remains ample room for improvement, but positive momentum exists on all fronts. As described, JPM has taken steps to strengthen board oversight; risk control performance is a component of executive compensation (though still exorbitant, too discretionary, and insufficiently transparent); and substantial progress is being made on mortgage servicing, the area in which Walden has been most focused. According to Walden's expert consultant, CANICCOR, who helps guide our shareholder engagement on mortgage servicing, "the quality of [JPM's] servicing increased greatly, resulting in the lowest volume of untimely responses of these major servicers to complaints of 0.2% during 2012. This CFPB [Consumer Financial Protection Board] untimely response rate then dropped to 0.0% in 2013."

For now, Walden continues to hold J.P. Morgan stock in many client portfolios. We anticipate lively discussions internally as we continue to monitor the bank's performance and encourage progress.

The information contained herein has been prepared from sources and data we believe to be reliable, but we make no guarantee as to its adequacy, accuracy, timeliness, or completeness. We cannot and do not guarantee the suitability or profitability of any particular investment. No information herein is intended as an offer or solicitation of an offer to sell or buy, or as a sponsorship of any company, security, or fund. Neither Walden nor any of its contributors makes any representations about the suitability of the information contained herein. Opinions expressed herein are subject to change without notice.