

**Shareholders for Sustainability?
Assessing investor motivations to adopt the Principles for Responsible Investment**

by

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Author's Declaration

I hereby declare that I am the sole author of this thesis. This is a true copy of the thesis, including any required final revisions, as accepted by my examiners.

I understand that my thesis may be made electronically available to the public.

Abstract

The Principles for Responsible Investment (PRI) is a voluntary investor-led initiative, backed by the United Nations. Together, the six principles are meant to provide a ‘best practice’ code of conduct for institutional investors seeking to adopt responsible investment practices with a secondary goal of contributing to improved corporate performance on environmental, social and governance (ESG) issues. Launched in 2006, the PRI has grown to be the single largest global investor initiative with over 700 signatory financial institutions representing assets under management in excess of \$US20 trillion.

Contributing to the broader literature on plausible explanations for why firms participate in voluntary initiatives, the thesis is primarily concerned with the question of what has motivated institutional investors to create and publicly commit to the PRI. A review of the broader trends behind the growth of responsible investment and the emergence of the PRI indicates the dominant utilitarian, cost-benefit logic is not wholly persuasive in understanding investor motivations. The research findings indicate that decisions to integrate ESG issues and publicly commit to adopting the PRI should be primarily viewed as a response to formal pressures by external stakeholders and actors in an investor’s institutional environment. Regulatory and stakeholder influences in the form of NGO advocacy campaigns have established normative standards directed towards the conduct of investors. As public opinion has shifted to put greater emphasis on sustainable development, the image and reputation of a pension scheme in relation to these trends have come under increasing scrutiny such that being perceived as a ‘responsible’ investor – sometimes even in the absence of a direct market rationale – has become a central driver behind the growth of responsible investment. The decision to adopt the PRI and establish beyond-compliance commitments to integrate ESG issues into investment decision-making should principally be seen as embedded in broader reputational risk management strategies. These findings support complex market rationalism explanations for firm participation in voluntary initiatives which suggest that firms commit to such principles or codes of conduct as a means of assuring stakeholders that their concerns are being internalized into corporate practices.

A secondary focus of the thesis is to examine signatory implementation to-date, assessing the adequacy and effectiveness of the voluntary measure for the promotion of more socially-responsible and environmentally-sustainable investments. While substantial progress has been shown by a small group of PRI signatories, it remains unclear whether the PRI has generated significant improvement across the broader signatory base. The PRI suffers from several weaknesses commonly identified in the literature on voluntary initiatives. First, a lack of accountability measures limits incentives for investors to go beyond business-as-usual. Second, less stringent voluntary standards like the PRI are likely to suffer from adverse selection and free riding, therefore threatening the credibility of the initiative’s reputation over the longer-term. Ironically, weaknesses in the institutional design of the PRI may undermine the very reputational benefit sought after by signatories.

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Chapter 1 - Introduction

The relevance of financial institutions to sustainable development

Scholars and policy-makers are increasingly recognising that the financial services sector has a significant bearing on sustainable development. Importantly, this increased focus is not primarily because of the sector's own, direct environmental impact, but rather, due to the indirect effects of its loans to and investments that finance broader economic activity. Since the 1970s, companies have increasingly relied upon capital markets as sources for external financing, rather than internal funds generated from their operations. This has been referred to by some as the era of 'finance capitalism' (Clark and Hebb 2005) characterized by the massive growth of institutional investment, increased need for external financing sources and corporate managers' sensitivity to company stock prices. The growing influence of the financial sector also arises from the support it provides business through insurance and financial advisory services.

A broad literature has noted the problematic relationship between financial markets and sustainable development, focusing on the tendency of financial institutions to pursue short-term strategies that fail to account for – and perpetuate - negative externalities such as environmental damage and other market failures (Schmidheiny et al. 1996; Mayer 2002; Haigh and Hazelton 2004; UNEP FI AMWG 2007; Richardson 2007; Aspen Institute 2009). As a result of these issues, financial institutions are viewed as generally having little concern for long-term issues or the environmental impact of investments.

The short-termism argument rests on capital markets being too near-sighted in the way in which they evaluate company performance. As many sustainable development issues are inherently

long-term, short-termism results in the systematic erosion of incentives for company directors to initiate performance improvements which may not have immediate, discernable impacts (The Aspen Institute 2009). One identified cause of short-termism is the reality that investment managers are evaluated by their clients – for example, pension funds – based on short-term performance criteria (Haigh and Hazelton 2004). Fund managers with a primary focus on short-term trading gains have little reason to consider longer-term corporate performance or the production of negative externalities. Financial institutions are therefore less likely to exercise a positive role in promoting and improving corporate governance policies that result in more sustainable corporate behaviour over the longer-term. The problem has been acknowledged by the CEO of one of the U.K.’s largest institutional investors:

There appear to be resistors to responsible investing which relate to deeply rooted characteristics of the investment decision-making system, including the mandates that pension funds and their investment consultants set; the systems for measuring and rewarding performance (which focus on peer comparison and beating benchmarks rather than on fulfilling the long-term liabilities of pension funds); and the competencies of service providers (e.g. sell-side analysts). The effect of this resulting short-termism is that less attention is paid to responsible investment matters than is appropriate – these issues are too long term in nature to affect the day-to-day behaviour of fund managers (USS 2003).

As a result of the failure to internalize companies’ environmental and social costs on company balance sheets, capital markets do not incorporate these issues. This generates an environment where it would be irrational for investors to incorporate companies’ full social and environmental costs as they are not viewed as affecting profitability or earnings per share over the traditional investment time horizon. Furthermore, there is evidence that financial markets do not allocate capital efficiently and that unsustainable bubbles caused by speculation and

inattention to environmental or social issues result in broad inefficiencies and the misallocation of capital. Such capital flows may trigger undesirable social and environmental effects arising from specific company and project investment choices (Richardson 2005).

Until recently, discussions on the impact of finance on sustainable development have centered on the area of public development finance (Clapp and Dauvergne 2005). In particular, the roles of Official Development Assistance (ODA) and Foreign Direct Investment have been explored as tools for funding international sustainable development efforts. Additionally, the focus has tended towards the role of multilateral development bank (MDB) lending from the World Bank and its sister organisations. In addition to the conditions these organisations attach to project-based development loans, MDBs have attracted attention for their influence on the general economic policy of borrower countries through conditional structural adjustment and sector policy loans. Since the 1980s, international economic institutions have experienced increasing public pressure to reform their financial policies to address environmental and social risks. In contrast to private financial flows of capital, public development has attracted greater scrutiny given the higher profile of many projects including China's three gorges dam project (Hadfield-Hill 2007). This has resulted in some reforms at the operational level, including mandatory environmental assessments of some project financing proposals (IISD 2009).

While the reform of intergovernmental development finance is significant, alone, greening public development finance is not enough. The private capital markets must also be reformed to address issues such as climate change, as some have concluded private sector investors will be responsible for financing more than 85 percent of the global transition to a low carbon economy (Ceres 2010). Combined, private financial institutions hold greater capital resources and

influence over capital allocation than governments, and their hold over capital funds is increasing in the context of the globalisation of financial markets (Harmes 1998).

‘The building blocks of the world’s capital markets’

Of particular significance are public and private pension funds along with other institutional investors (mutual funds and insurance companies) that are central actors in private capital markets, accounting for up to 35 percent of total global investment (Watson Wyatt 2009). In many countries, institutional investors have become the predominant owners of equity capital in publicly listed companies and their influence and size worldwide is forecasted to continue growing, chiefly due to the privatisation and development of pension fund systems (Gillan and Starks 2003).

Institutional investors derive their power as central actors in capital markets from their ability to represent large numbers of beneficiaries combined with their day-to-day control of investment decision-making. The principal goal of institutional investors is to provide benefits for members and customers through prudent long-term investment returns. The object of their attention is the firm in which they invest, in order to generate and secure returns which enable the scheme to fulfill its obligations to legal beneficiaries.

Pension funds and other institutional investors aggregate shareholders’ interest within a broadly dispersed capitalist system, reversing a pattern of widely held ownership and declining shareholder power (Clark 2000; Hawley and Williams 2000; Monks 2001). For example, in the U.S., institutional investment has grown from 6.1 percent of aggregate ownership of equities in 1950 to approximately 66.3 percent in 2006. The Conference Board reports that total U.S. institutional investor assets have risen tenfold from \$US2.7 trillion in 1950 to \$US27.1 trillion in

2006. At the same time, institutional equity holdings have increased from 37.2 percent in 1980 (\$US571.6 billion) to 69 percent of the largest 100 U.S. corporations in 2006 (\$US12.9 trillion). In 2007, institutions owned 76.4 percent of the largest 1000 U.S. corporations, up from 61.4 percent in 2000 and 46.6 percent in 1987 (The Conference Board 2007).

Similar shifts in equity ownership have occurred in the United Kingdom (U.K.). The Myners Report notes that individual share ownership has declined from over 50 percent of the market in the early 1960s to approximately 15 percent in 1999. At the same time, institutional ownership has risen from 30 percent to over 50 percent (Myners 2001: 27). Concentrated ownership patterns are also increasingly visible in institutional investor holdings of foreign equities. In 2006, 78 percent of foreign equities were held by investors from nine countries (U.S., U.K., Germany, Luxembourg, Switzerland, Italy, the Netherlands, Japan and France) with U.S. and U.K. institutions alone accounting for 42 percent of the total (The Conference Board 2007).

In addition to their ability to re-aggregate ownership patterns and their growing assets, pension funds increase their leverage within the financial system through a newfound willingness for activism on corporate governance as a means of protecting and enhancing shareholder value both individually and in coalition with others (Hebb 2008). Institutional investors have influence through the shares they own in particular companies, which give them the opportunity to bring forth shareholder resolutions, and, when they own a large enough block of shares or act collectively, give them real voting power and management clout. Secondly, institutional investors have influence through the shares they do not own, but over which they exert influence by establishing standards or screens when considering future purchases, forcing companies that want their shares to be widely purchased to come into line with those standards (Haufler 2005).

With such large pools of capital under management and a necessity to diversify (Clark and Hebb 2005), institutional investors have come to be significant owners in that they own entire cross-sections of economies (Hawley and Williams 2000; 2005). As risk-averse value investors, institutional investors are required to hold securities in their portfolios for longer periods of time in order to realize gains in shareholder wealth (Clark and Hebb 2005). The long-term nature of these decisions requires investors have greater information about the underlying fundamentals of the firms in which they invest. The enormous size of pension fund capital pools furthermore deny them the ability to exit from firms in which they are invested in even in the face of dissatisfaction with firm performance (Clark and Hebb 2005).

In the past, the costs associated with corporate engagement, when measured against the possible gain in share value, meant that few individual investors were willing to take on company management. Because today's pension funds and institutional investors hold such large stakes in individual firms, they are able to either bear these costs alone or, more often, act in coalition with other investors (Amalric 2006). Pension funds have increasingly resorted to voice – rather than exit (divestment) - in order to influence investee firms and prevent or avoid value destruction and ensure the ability to meet long-term liabilities (Clark 2005:150). This has resulted in two important developments: corporate engagement has become a more potent force than in the past (O'Rourke 2003; Mayer 2002) and pension funds and other institutional investors have increasingly used their shareowner rights to exert control over firm-level decision-making via concerns with corporate governance issues (Clark 2004: 148).

On this latter point, commentators have emphasized the increasing - though fragmented – intersection of traditional corporate governance issues with broader stakeholder concerns, including environmental and social issues that have been historically viewed as 'non-financial'

or outside the investment analysis and decision-making process. Within institutional investment, these developments have been most closely associated with the emergence of ‘responsible investment.’

What is responsible investment?

‘Responsible Investment’ describes an investment process that incorporates an active consideration of environmental, social and corporate governance (ESG) factors within investment decision making and ownership practices (Mercer Investment Consulting 2009). Traditional ethical or Socially Responsible Investing (SRI) refers to an approach towards investment that seeks to achieve a balance between environmental or social and risk/return objectives. These two sets of objectives are seen, at least to some extent, as being in conflict, and SRI seeks to strike an acceptable compromise between them. (UNEP FI AMWG 2007). Responsible investment, on the other hand, is based on the belief that ESG factors can have a material impact on the operations of companies and on investment markets and that, therefore, analysis of these factors can enhance investment outcomes from a risk/return perspective. (See figure 1 below). SRI and responsible investment share some of the same techniques and often focus on the same issues. Also, the attention to ESG issues encouraged by responsible investment can often result in progress on social or environmental dimensions. Nevertheless, responsible and SRI are based on significantly different underlying philosophies. Further, the emphasis on the tools employed by each differs – whereas SRI tends to focus on screening and SRI-themed products, responsible investment will potentially use these options and pursue an ESG-integrated approach within mainstream investment strategies.

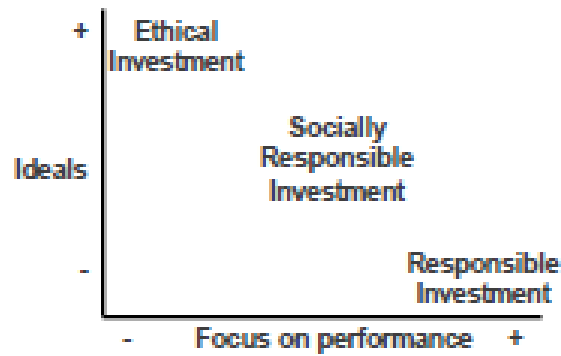


Figure 1 – Positioning RI alongside traditional SRI and ethical investment approaches

Another important distinction can be made regarding the primary actors and methods used in ethical or SRI investing and responsible investment. In the case of traditional ethical/SRI, church-based and ethical-branded mutual funds for individual ‘retail’ investors were the primary actors. However, in responsible investment, it is primarily institutional investors who are the main actors, citing arguments that environmental, social and corporate governance factors can be financially material and should therefore be embedded within the investment process to enhance long-term value creation. This has resulted in institutional investors expanding the boundaries of what is discussed with investee companies to include corporate ESG performance and increasingly utilizing active ownership tools, such as proxy voting, corporate dialogue and collaborative engagement with other investors under the pretext of protecting and enhancing shareholder value (O’Rourke 2003; Sparkes and Cowton 2004).

Environmental reforms targeting the financial sector

Given the potential of the financial services sector to act as a potentially powerful lever for the promotion of sustainable development, their reform to promote greater sensitivity to the environment may offer a way to reduce the incidence of unsustainable development. While

financiers have the means to influence these developments, there has been little policy intervention with only a few tentative environmental reforms targeting the financial sector at the state level. State regulations which focus on lender liability for environmental damage are present in only a few jurisdictions. Under the EU Directive on Environmental Liability (2004) and in the U.S. under the Comprehensive Environmental Response, Compensation and Liability Act, banks can be held directly responsible for environmental pollution of clients (Richardson 2007; Peeters 2003: 211). Economic incentives have also been established in the case of the Netherlands Green Investment Directive (1995) which provides tax concessions for environmentally-focused investment funds (Scholtens 2006).

As will be discussed in the fourth chapter, various states have also relied on informational policy instruments in the form of legislation requiring pension funds to disclose their policies on environmental, social and ethical considerations. Pension fund regulatory authorities in most OECD countries, however, have taken a relatively passive stance towards encouraging the consideration of ESG issues in investment decision-making. At present, where in existence, the approach taken by regulatory authorities relies largely on disclosure requirements that require pension funds to inform their clients of the extent to which ESG or ethical factors are incorporated into the fund's investment strategy.

In the absence of deeper regulatory intervention, reforms have tended to rely on financial institutions voluntarily committing to more environmentally-sustainable finance. While definitions of this phenomenon vary considerably, one general definition of voluntary environmental governance measures is that they are "commitments made in the absence of express legal requirements, commitments which prescribe norms to regulate behaviour in relation to their interaction with the environment" (Labatt and Maclaren 1998). Complementing

these initiatives is a growing literature on corporate citizenship and business ethics that challenge the dominant economic conception of companies and promotes “the business case” for CSR (Schmidheiny and Watts 2002). The voluntary approach, often described as corporate social responsibility (CSR) or business self-regulation is thriving in many countries and on a multitude of issue areas and industries (Utting and Clapp 2008).

The Principles for Responsible Investment

Categorized as a principles-based code of conduct, the Principles for Responsible Investment (PRI) represents the latest manifestation of a voluntary initiative focused on institutional investors. Launched in 2006, the PRI is an investor-led initiative, backed by the United Nations Environment Programme Finance Initiative and United Nations Global Compact that consists of a set of six voluntary and aspirational principles which institutional investors (asset owners such as pension funds and investment managers) are invited to publicly commit to.

1. We will incorporate environmental, social and corporate governance (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.

Discussed in the following chapter, the PRI emerged as an attempt to address a governance gap by providing institutional investors with a framework for incorporating environmental, social and governance issues into their investment decision-making and ownership practices.

Each of the Principles is accompanied by a list of possible actions (35 in total) meant to provide ‘best practice guidance’ in implementing each principle. As an example, possible actions for investors to be responsible investors via active ownership include ‘exercising voting rights or monitoring compliance with a voting policy (if outsourced); filing shareholder resolutions consistent with long-term ESG considerations; engaging with companies on ESG issues and participating in collaborative engagement initiatives.

Through institutional investor commitment to, and implementation of the Principles, the PRI sees several benefits:

While these Principles are designed to enhance the delivery of long-term returns to beneficiaries, their implementation will also focus greater attention on ESG issues throughout the investment and corporate sectors. New research and better metrics will be developed to support investors as they become increasingly active owners. Encouraged to adopt a more systematic approach to managing ESG issues, corporate management will take more interest in these extra-financial drivers of risk and reward, which will come to define corporate profitability in the medium and longer term. The PRI will also stimulate increased active ownership on ESG issues by investors. In this way, the Principles for Responsible Investment will contribute to improved corporate performance on environmental, social and governance issues (PRI 2007).

From a founding signatory base of 20 institutional investors at the launch of the PRI in 2006, as of March 2010, 714 financial institutions from 44 countries (consisting of public and private pension funds, mainstream investment managers and professional service providers) have

publicly committed to the PRI. In total, signatories to the PRI represent assets under management in excess of \$US 20 trillion (see figure 2).

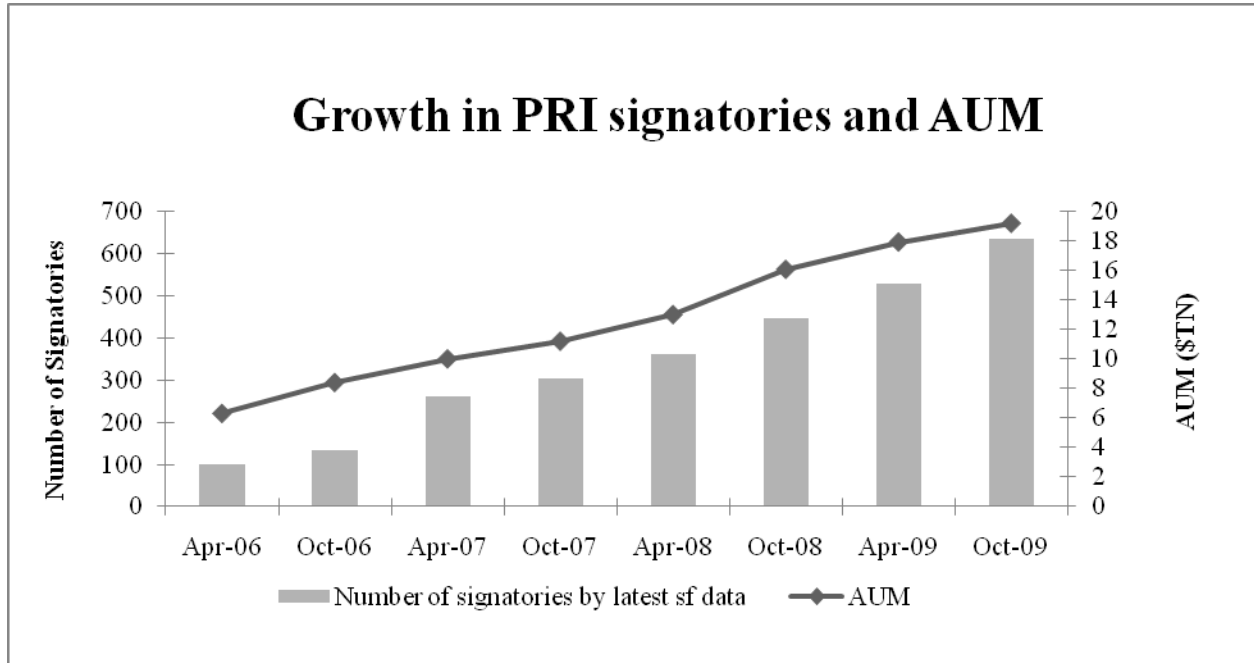


Figure 2 – Growth in PRI signatories and AUM since launch

While the dramatic growth of the PRI - has received ample coverage in the mainstream financial press, there is a notable gap within the academic literature with regards to analyzing the emergence of the PRI and investor motivations to adopt the principles. Furthermore, few studies have sought to measure the potential effectiveness of the voluntary initiative in inducing investors to actively consider environmental, social and governance issues in their investment decision-making.

Statement of the research question

To date, very few studies have examined the emergence and potential effectiveness of the PRI and its efforts within institutional investment to ‘mainstream’ and institutionalize the incorporation of ESG issues in investment decision-making and ownership practices. Scholars have tended to focus on the broad environmental implications of voluntary environmental programs within specific financial sectors including insurance (Paterson 2001) and project-finance in the case of the Equator Principles (Wright and Rwabizambuga 2006). Institutional investing has also been the focus of a number of studies (Harmes 1998; Hebb 2008; Kolk, Levy and Pinske 2008, Jagers and Stripple 2003) which address the potential influence of institutional investors on investee behaviour and the role of institutional investors in institutionalizing the norm of corporate disclosure of carbon emissions (Pattberg and Stripple 2007; Kolk 2008). Studies have also discussed the involvement of institutional investors in networks alongside NGOs which seek to leverage the collective power of investors to promote improved disclosure of corporate governance practices on the business risks and opportunities posed by climate change (O’Rourke 2004).

In light of the gap in the academic literature, the thesis will analyze the emergence and governance potential of the Principles for Responsible Investment. Two research questions guide this endeavour:

1. What has motivated institutional investors to create and publicly commit to the PRI - a voluntary code of conduct that addresses the environmental, social and governance aspects of their investments?

2. In assessing signatory implementation to-date, what observations and conclusions can be made about the adequacy of this voluntary measure for the promotion of more socially-responsible and environmentally-sustainable investments?

The dearth of literature regarding the growth of responsible investment among institutional investors is at least remarkable given the substantial growth of the PRI since its inception, having grown to be the largest voluntary initiative targeting financial institutions in terms of numbers of signatory financial institutions and assets under management represented. By analyzing investor motivations to adopt the PRI and publicly commit to integrating environmental, social and governance issues, this thesis seeks to contribute to the broader discussion of plausible explanations for why firms decide to adopt voluntary codes of conduct and how strategic motivations to participate influence the effectiveness of voluntary initiatives.

Methodology

The desired outcome of the research is the identification of the strategic motivations underpinning institutional investor decisions to publicly commit to the Principles for Responsible Investment. The research is exploratory and descriptive in nature given the gap in the literature on the growth of responsible investment practices among institutional investors in general, and the absence of scholarship to date on the Principles for Responsible Investment specifically. As a result of the nature of the research undertaken, a case study research method was adopted as a suitable approach (Yin 1984) for assessing the application of existing analytical frameworks to the case of the PRI. To assist in targeting and formulating the research questions, a literature review was conducted to establish what research has been previously conducted on the topic. As the topic has primarily been addressed in both business/management schools and the social

sciences (comparative political economy in particular), there was a need to synthesize the literatures with a focus on firm adoption of CSR commitments.

A detailed review of the literature on firm participation in voluntary initiatives identified both primary and secondary documents as significant data sources. Primary and secondary documents examined included published reports (in both hard copy and via internet) by internal and external stakeholders with a particular focus on industry association publications, marketing documentation and responsible investment reports from institutional investors. Industry surveys and perception audits related to responsible investment were also analysed.

While the above documentation provided for a rich understanding of responsible investment in general, limited data was available on the PRI specifically. The primary source of data for assessing the activities of PRI signatories was the PRI Reporting and Assessment survey. For the 2009 Reporting and Assessment survey, the data has been aggregated from 276 individual responses (124 Asset owners, 152 Investment managers) and made available by download from the PRI website.¹ The 2009 Reporting and Assessment survey is the third annual reporting process which communicates signatory performance against approximately 100 questions using predominantly qualitative indices. Interpretive and quantitative analysis of PRI signatory implementation was performed on publicly-available aggregate raw data available from the PRI website. As the data is produced in aggregate form, the nature of the data precluded more advanced quantitative techniques as discussed in Chapter 5.

Additional insight was gathered as a result of the researcher's unique experiences related to an internship/fellowship position at the PRI Secretariat in London, UK between July 2008 and

¹ Available at <http://www.unpri.org/reporting/result.php>

February 2010. These experiences included informal conversations with Secretariat staff and PRI signatories as well as attendance at several industry events and conferences.

Thesis overview

In responding to the above research questions, the thesis is structured as follows. Chapter 2 will provide an overview of voluntary initiatives and the financial sector before describing the formal processes leading to the emergence of the Principles for Responsible Investment initiative. Synthesizing the literature from both business schools and international relations on CSR and finance in particular, Chapter 3 will review a range of plausible explanations identified with regards to the various strategic motivations firms may have for participating in voluntary initiatives. In Chapter 4, the conceptual framework will then be applied to an empirical analysis of the factors driving the growth of responsible investment practices among institutional investors, responding to the primary research question of identifying the strategic motivations behind investors committing to the PRI and integrating environmental, social and governance issues. Chapter 5 will provide an analysis of implementation of the PRI among institutional investors drawing from the 2009 PRI Reporting and Assessment results, identifying how a variety of strategic motivations to adopt the PRI are illuminated in the varying degree of implementation and compliance demonstrated by signatories. In light of these findings, Chapter 6 will consider the effectiveness of the PRI to date with regards to governance potential and ability to challenge and reform investor practices.

Chapter 2 – Voluntary initiatives and the financial sector: the emergence of the PRI

As noted in the introductory chapter, attempts to reform the financial services sector vis-à-vis the incorporation of ESG issues into decision-making processes have tended towards a reliance on voluntary measures. The following chapter explores these developments in greater detail for the purpose of contextualizing the emergence of the Principles for Responsible Investment.

Several voluntary initiatives specifically targeting actors within the financial services sector have arisen although each differs in its design and function. For analytical purposes, these voluntary initiatives can be categorized² as: 1) principles and codes of conduct; 2) reporting and disclosure schemes; and 3) environmental management systems schemes, as described below.

Principles and codes of conduct

Commitments to codes of conduct or sets of principles are among the most widespread and widely adopted form of voluntary initiative (Greene 2002). Principles or codes of conduct may address a broad and general group of organisations, firms within a particular industry or geography, a supply chain or a more specific focus. Codes may originate from processes within individual firms or industry associations or may be multi-stakeholder, involving actors outside of industry including NGOs and governments.

The contents and aims of voluntary codes or principles can vary greatly. The exact content of the codes may be general, leaving much room for interpretation or prescriptive in the sense of

² See Auld, Bernstein and Cashore 2008 who identify seven categories of voluntary initiatives; other typologies include Clapp and Thistlewaite (forthcoming) who focus on the financial sector but include a fourth category of voluntary environmental markets in their broader discussions of voluntary climate change programs designed for the financial sector.

stimulating certain action or restrictive in discouraging or forbidding certain behaviour. We can also distinguish between those that are performance-based or process-oriented (Auld, Bernstein and Cashore 2008). Performance-based codes dictate substantive goals for the improvement of participant's environmental performance while process-oriented codes concern the procedures by which businesses manage their interaction with the environment, without setting specific targets for environmental performance. They may include, for example, expectations that participants publicly report on their environmental activities (Greene 2002).

Codes also differ in their regulatory function and policy scope. Some perform several regulatory functions such as rule making (target or standard setting), administration (reporting and monitoring) and enforcement (Auld, Bernstein and Cashore 2008). In terms of policy scope, some codes target specific environmental problems while others address the environment in the context of CSR or sustainability (Khanna and Brouhle 2008). Finally, codes differ with respect to their compliance mechanisms, a broad term referring to measures regarding implementation, monitoring, reporting, auditing, verification and enforceability (Prakash and Potoski 2006).

UNEP Statement by Financial Institutions on the Environment and Sustainable Development

Internationally, a catalyst for bringing environmental issues to the attention of global financial markets is the United Nations Environment Programme's (UNEP) Financial Institutions Initiative (UNEP FI). UNEP has been working closely with organisations in the financial services sector since the beginning of the 1990s at developing environmental management strategies specific to the industry. These developments occurred within a broader trend of UN agencies working in partnership with the financial (including commercial banks, investment banks, venture capitalists, asset managers and multilateral development banks and agencies) and

other commercial sectors during the run-up to and completion of the 1992 Conference on Environment and Development (Earth Summit). The partnership has evolved from an informal dialogue about the nexus between economic development, environmental protection and sustainable development. Underlying all of the Initiative's activities are the primary goals of promoting the integration of environmental considerations into all aspects of the financial sector's operations and services, and secondly, the goal of fostering private sector investment in environmentally-sound technologies and services.

Financial institutions are encouraged to participate by signing either the Banking or Insurance Statements and agreeing in principle to recommendations outlined in "Recommendations from the UNEP Finance Initiative Presented to the World Summit for Sustainable Development" (2002) UNEP FI Statements are aspirational, voluntary, non-binding declarations of intent with the clarification that becoming a signatory imposes no new legal liabilities upon the signatory. As well, signatories must pay an annual contribution fee and submit an environmental or corporate social responsibility report which details steps taken to advance commitments to the Statements. An additional aspect of the voluntary initiative is participation in several working groups on a range of themes including climate change and biodiversity. Such working groups emphasize providing a collaborative forum for financial institutions to discuss best practices and promote inter-firm learning. To date, 170 financial institutions from 44 countries have become signatories.

London Principles of Sustainable Finance

Launched at the 2002 World Summit on Sustainable Development (WSSD), the London Principles were promoted as an example of the Type II multiple stakeholder partnerships

involving both NGOs and business alongside public authorities. Eleven European companies and investment institutions have signed a set of seven principles intended to clarify how financial markets can encourage sustainable development. The London Principles, launched by the Corporation of London, commit signatories to provide greater access to financial products for the socially-excluded and to “use equity ownership to promote CSR.” The London Principles apply to all aspects of finance and not just value-based investments and banking niches. They are aspirational and seek to encourage continuous improvements in participant behaviour requiring signatories to report annually on their progress towards their implementation (Peeters 2003). Criticisms on the London Principles point to the fact that the seven principles are vague and that its efforts duplicate those of UNEP FI.

Equator Principles

The Equator Principles represent another example of a principle-setting exercise but one which focuses on the specific sector of project finance by providing an international voluntary code of environmental conduct for banks. Drafted in 2003 under the auspices of the World Bank’s International Finance Corporation, the Equator Principles provide a framework that commit signatory banks to develop individual policies, procedures and practices to ensure that projects are assessed and carried out according to specific social and environmental considerations (Wright and Rwabizambuga 2006). The Equator Principles are not a self-contained set of principles but incorporate other sets of standards, particularly the IFC’s Safeguard Policies which address environmental assessment, natural habitat, pest management, forestry, safety of dams, indigenous peoples, child labour and international waterways. Although the Principles are ‘adopted’ by interested banks, the bank’s borrowers, whether government or nongovernment, are

expected to adhere to them as long as the lender has put in place appropriate policies and procedures.

While some financial institutions outside of the project-financing sector have embraced the Equator Principles, and others have extended the Principles to their non-project finance activities, the Principles do not provide a general framework for promoting environmentally sound financing across the whole financial services sector. Rather, the Principles are structured around decision-making in project finance. They are not intended for, and cannot easily be adapted to, for example, equity investments made by pension funds and mutual funds.

Investor Network on Climate Risk Action Plan

The Investor Network on Climate Risk (INCR), launched in 2003, is a project of Ceres, a US-based NGO whose mission is ‘integrating sustainability into capital markets for the health of the planet and its people’ (Ceres 2007). Ceres aims to accomplish this by encouraging disclosure of information concerning aspects of a firm’s environmental performance and decision-making processes in a manner consistent and comparable in form to what is used by investors for analysis of corporate financial performance. While the core of Ceres work has focused on leveraging a network of investors and environmental NGOs to address the above issues, the Investor Network on Climate Risk Action Plan aims at influencing the behaviour of investors directly with regards to the issue of climate change.

As of 1 January 2010, investors with assets under management in excess of US\$9.8 trillion have committed to implementing the Climate Risk Action Plan which outlines nine action points investors can take to evaluate and reduce the impact of their investments on climate change. The nine points address matters relating to how investments are managed including methods of

measuring climate change risk in their portfolio, engagement with portfolio companies on disclosure and mitigation efforts related to climate change risks and opportunities, and the supporting of policy which aim to improve corporate disclosure on climate risks and opportunities.

Collevocchio Declaration

Civil society views on the role of financial institutions have also coalesced in the formation of the Collevocchio Declaration (2003). Endorsed by more than 100 NGOs worldwide, the declaration argues that the appropriate goal of financial institutions should be “the advancement of environmental protection and social justice rather than solely the maximization of economic growth and/or financial return” (Waygood 2006). The declaration calls on financial institutions to make six commitments including a commitment to fully integrating environmental, social and economic factors, a commitment to ‘do no harm’ and a commitment to actively supporting public policy which facilitates full-cost accounting among others.

Reporting and disclosure schemes

A second category of voluntary initiatives focus on the provision of information related to a firm’s behaviour. In the past decade, corporate environmental reporting obligations have been revamped in many jurisdictions to encompass the financial services sector. Underlying the emphasis on transparency rather than prescriptive requirements is the hypothesis that global firms will face greater scrutiny and pressure to change their behaviour. It is also argued that such approaches can lead to learning among stakeholders about corporate practices, facilitating greater interaction between firms and broader stakeholders and a more accurate understanding of firm behaviour (Kolk, Levy and Pinske 2008).

While the prevalence of information approaches at the state level has been well documented (Gupta 2008), it also exists internationally in a voluntary format through such efforts of the Global Reporting Initiative (GRI) (Levy, Brown and de Jong 2009). Established in 1997 by UNEP and Ceres, firms participating in the GRI voluntarily report the environmental and social impacts of their activities. The reporting rules are developed by stakeholder members of the GRI, with considerable discretion given to individual firms as they self-declare their level of adherence with the option of having this verified by a third-party. Since 2003, the GRI has developed a Financial Services Sector Supplement to encompass financiers (GRI 2009). The motivation for a financial services reporting framework within the GRI stems from recognition that the indirect environmental impacts associated with financial products and services are an area of interest to many stakeholders (GRI 2009). As financial institutions seek to manage these indirect impacts through the development of policies, systems and processes that help to enhance the quality of an institution's risk management and product offerings, the GRI's financial services performance indicators relate primarily to the systems used by financial institutions to incorporate environmental considerations into their business processes.

Environmental management systems

Environmental management systems (EMS) schemes establish standards about how firms are to manage internal approaches to environmental and social performance at the site level. They are intended to provide recognition for those firms who have established a program of environmental action designed to protect and to continuously improve their environmental performance (McKague and Cragg 2005). The most common requirements of an EMS are that an environmental policy be established within the organisation which is fully supported by senior management that outlines the policies of the company with regards to internal systems for the

management of a firm's environmental impact and performance and stresses a commitment to continuous improvement.

Of the two most prominent examples of EMS – Europe's Eco-Management and Audit Scheme (EMAS)(1995) and the International Organisation for Standardisation (ISO) 14001 (2004) – EMAS has provisions for the financial services sector which addresses investment banks, credit banks, insurance companies, pension funds, mutual funds and rating agencies (Richardson 2002). Consistent with other sector-based approaches in EMAS, the focus of financial service sector provisions are primarily on internal processes affecting site-level activities including the ecological footprint and energy efficiency of office buildings. Reference is also made that financial institutions reflect on systems to manage the indirect impacts of the activities (EMAS 2010).

EMS have been promoted for their ability to standardize firm practices across different sites and because they are viewed as promoting learning processes within the firm (Auld, Bernstein and Cashore 2008, 422). Internal auditing of systems is intended to lead to the identification of obsolete or inefficient practices that may produce dual benefits of improved efficiencies and environmental performance. In EMSs the focus is on systems rather than on behavioural on-the-ground requirements. Although firms are audited for adherence to their EMSs, schemes do not establish or require any particular substantive change in performance, only a commitment to continual improvement from the company's own specified targets.

Voluntary measures specific to institutional investors

The previous section has identified several voluntary initiatives which address the financial sector with regards to the consideration of the environment in their decision-making processes.

Reporting and disclosure schemes such as the GRI's Financial Services Sector Supplement or EMAS, however, only address the direct environmental impact of the sector and not its investment activities. One observation regarding the breadth of approaches and focus to date is that the principles and codes of conduct have tended towards focusing on specific sectors or issue areas. As the longest serving voluntary initiative addressing the financial sector, UNEP FI has primarily focused on banking and insurance-related issues. The London Principles are broader but centred on those financial institutions with a strong operational presence in the City. The Equator Principles are structured around decision-making in project finance. They are not intended for, and cannot easily be adapted to, for example, investments made by pension funds or mutual funds. Finally, the INCR Action Plan does focus on institutional investors and the area of climate change but focuses on institutional investors primarily as a means of leveraging their market authority to demand corporate disclosure on climate change risks and opportunities.

The emergence of the PRI

In mid-2004, a number of United Nations agencies and initiatives launched projects which would pave the way for the emergence of the PRI. It also marked the latest attempt by the United Nations to form a partnership with the private sector under the auspices of a UN-backed voluntary code of conduct related to responsible investment. The United Nations was influential in the process leading to the creation of the PRI as it was involved in the organisation and production of research supporting the intellectual foundations of the initiative. In particular, the experiences of UNEP FI and the UN Global Compact as well as UN-sponsored publications would serve as influential in the later development of the PRI, in terms of the institutional design of the initiative and its intellectual foundations.

Since 1990, UNEP FI, a global partnership formed between UNEP and the financial sector has focused on ‘understanding the impacts of environmental and social consideration on financial performance.’ Though the initiative has historically centred on engaging commercial banking operations and the insurance industry, a series of working groups recognized increasing demand from the fund management industry and sought to exploit the ‘synergies’ between the focus of UNEP on sustainability and institutional investor’s long-term outlook (UNEP FI 2003; 2005). Likewise, in 2003, the UN Global Compact, itself launched in 2000, initiated a dialogue with the finance sector on the importance of corporate performance against its 10 principles for investors within the ‘Who Cares Wins’ initiative. At this time, UN Secretary General Kofi Annan also indicated broader interest from the UN by convening the Institutional Investor Summit on Climate Risk alongside Ceres in December 2003 to discuss the financial implications of climate change.

Altogether these projects and initiatives produced a number of publications capturing the current research on the financial materiality of ESG issues to investors and identifying possible actions for institutional investors. The publications concluded that ESG issues can be material to investors, especially over the long-term and investors who do not take these issues into account may be putting the interests of their beneficiaries at risk and/or overlooking opportunities to generate a return (UNEP FI AMWG 2005; 2007). These publications also commented on the availability of corporate ESG performance data concluding that there was a need for better quality and more comparable information if investors are to assess the significance of these issues in their investments (UNEP FI AMWG 2007). Finally, while voluntary initiatives such as the GRI were seen as providing standardized reporting frameworks, the overall level of disclosure remained limited where provided and not focused on investor needs (PRI 2007).

The publications concluded that institutional investors, particularly when acting collectively, can have significant influence as asset owners and clients of companies, fund managers, consultants and brokers and can use this influence to encourage improvements in ESG performance by companies. On this note, the reports argued that existing frameworks for collaboration among institutional investors (including Ceres' INCR, the Carbon Disclosure Project (CDP) and regional networks such as the European Social Investment Forum (Eurosif)) were important in increasing the effectiveness of shareholder and policy-maker engagement, however, such platforms were generally found lacking or absent from most markets and on most issues (UNEP FI AMWG 2007). It was argued that such a framework and other efforts at capacity building were required in such a form that would allow the pooling of investor resources to reduce any free rider problems while providing guidance to investors on practical steps to integrating ESG issues into their investment decision-making processes. Both UNEP FI and UN Global Compact reports concluded that the integration of ESG issues was at very early stages but significant potential existed to leverage the existing experiences of both UN initiatives to form the basis of a global collaboration and capacity-building program around responsible investment.

Based on these conclusions, in mid-2004, UNEP FI and UNGC committed to the creation of a UN-backed global initiative to promote responsible investment. These efforts were supported by a number of large public institutional investors including CalPERS, ABP, Canada Pension Plan, Fonds de reserve pour les retraites (France), the New York City Employees Retirement System and the Norwegian Government Pension Fund. Additionally, corporate pension schemes with strong union influences (BT Pension Scheme) and schemes representing university professors and healthcare employees (Universities Superannuation Scheme and PGGM (Netherlands) were supportive of the endeavour. The UN, it was announced, would partner with institutional

investors to work towards providing a common framework from which investors could develop their own policies and approaches to addressing ESG issues while at the same time providing a forum of exchange that would allow investors to work together on ESG issues, pool resources and share the costs of activities related to research and shareholder engagement (PRI 2007). As well, it was expressed that such a network/framework would internationalize the debate on RI by bringing developed, emerging and frontier market investors together to discuss these issues (PRI 2007).

The formal creation of the PRI, involving the drafting of the Principles and the initiative's governance were undertaken over a one year period from early 2005. An advisory group consisting of leading thinkers and proponents of responsible investment (many of whom were active in the space through participation in issues-based initiatives such as INCR and regional social investment forums (Eurosif, UKSIF, SIF (US), ASRIA)) were active in developing the PRI. It was determined that the initiative should be led by asset owners – primarily pension funds – given their position at the top of the investment chain. It was also a concern of the advisory group that if fund managers or service providers drove the process the initiative might focus on a commercial product or service-orientation rather than addressing systemic market failures. It was argued that such a focus would likely hinder efforts at engendering industry-wide reform (PRI 2007).

Over nine days of in-person meetings, two groups were established to draft the text of the Principles. A 20 person investor group of mainly pension fund CIOs, CEOs and trustees were granted ultimate veto over the included text, and a 70 person group consisting of specialist and mainstream fund managers, NGOs active in the SRI space, academics, consultants and UN representatives. The stated goal of the drafting process was to develop a set of voluntary

principles which reflected best practice among leading institutional investors, which, if implemented broadly, would “contribute to improved financial returns and improved corporate performance on environmental, social and governance issues.” (PRI 2007)

In the drafting process, the larger group of stakeholders first met to establish key points thought to be core to a set of principles for responsible investment. The group recommended that the Principles should commit investors to: the integration of ESG issues in investment analysis (which became Principle 1); active ownership - exercising ownership rights by voting shares and through shareholder engagement (Principle 2); transparency of investor and investee ESG performance (Principles 6 and 3); and, the need for institutional investors to send signals throughout the investment chain that ESG issues need to be incorporated (Principle 4).

A number of additional points were discussed and recommended but ultimately rejected by the investor group. These included: measures against short-termism for institutional investors – which was touched on in Principle 4 but rejected as a principle on its own; assessment of the impact of the integration of ESG issues on investment performance, corporate behaviour, the environment and society – only its impact on investment performance was touched on in Principle 6; incorporation of international norms such as the UN GC, ILO core conventions, Universal Declaration of Human Rights – ultimately rejected except in so far as Principle 3 seeks disclosure from companies on performance against such; and, a commitment to responsiveness to beneficiary needs and preferences – ultimately rejected on grounds that calculating needs and preferences from such large and often disparate groups was not feasible.

Many of the large pension funds and mainstream fund managers argued that the Principles would only be adopted by institutional investors if set firmly within the scope of fiduciary duty. It was

therefore argued that it was necessary that the Principles remain narrowly focused on the financial risk/return objectives of the fund. Agreement was reached, however, that within the paradigm of ‘exclusive (financial) interests of beneficiaries’ there was significant scope to integrate ESG issues into investment and active ownership processes. In qualifying the rationale for the integration of ESG issues by institutional investors, it was adopted that “ESG issues are potentially material to corporate performance and are not currently adequately incorporated into mainstream investments and ownership processes... doing so, should enhance risk-adjusted returns and deliver improved ‘ESG outcomes’ over the long term” (PRI 2007).

Within these points, the investor group developed the key philosophies that would underpin the initiative. Investor commitment to the Principles would be framed in terms of fulfilling the primary responsibilities of the fund. Hence the text in the preamble notes that the Principles are to be applied in ways that are consistent with the investor’s fiduciary duties. It was agreed that the Principles should be aspirational rather than prescriptive and contain practical suggestions for implementation. Finally, the founding signatories in the investor group concluded that the Principles would represent a voluntary industry code of conduct but contain a commitment to reporting and implementation of the Principles should have a positive impact on investment performance and improved corporate environmental, social and governance performance.

Implementing the PRI

There are three main categories of signatory in the PRI: asset owners, investment managers and professional service partners. In signing, institutions are asked to provide a letter from the CEO or equivalent which includes a statement confirming the organisation’s approval of the Principles and a commitment to take part in the annual Reporting and Assessment process. Investors must

commit to implementing the Principles across the entire organisation as opposed to specific SRI funds or ESG practices. The objective is that the Principles be integrated across the investment functions of the entire organisation rather than being applicable within specific asset classes or product lines.

The Principles are designed to be ‘voluntary and aspirational’ in that signing “represents a commitment to work towards implementation.” (PRI 2007) The one mandatory requirement of being a signatory is that asset owner and investment manager signatories must complete the Reporting and Assessment survey annually. There are no compulsory fees associated with becoming a signatory to the PRI, however, a voluntary fee of US\$10,000 is requested to assist the work of the Secretariat to support signatories and promote adoption of the Principles.

Like the UN Global Compact and UNEP FI Statement for Financial Institutions, the PRI is explicit in stating that there are no legal or regulatory sanctions associated with the Principles. In terms of penalties for non-compliance, the Principles state that there “may be reputational risks associated with signing up and then failing to take any action at all, but the commitments are, for most signatories, a work in progress and a direction to head in rather than a prescriptive checklist with which to comply.” The constitution of the PRI has provisions for the removal of signatories if they do not participate in the annual Reporting and Assessment process for two years consecutively, or if the signatory “fails over successive years to progress towards the commitments outlined in the Principles.” The PRI are governed by a board which consists of elected asset owner signatories and two UN-partner representatives from UNEP FI and UN Global Compact.

The main accountability mechanism for the PRI is the annual Reporting & Assessment process. New signatories are given an initial one year grace period, after which they are required to self-report their progress against approximately 100 indicators. Professional service providers are not required to complete the survey. The Reporting and Assessment process is meant to provide a broad range of benefits to stakeholders, including: a learning tool for signatories; an opportunity for the Secretariat to identify areas where further resources and guidance are needed; an off-the-shelf reporting framework for investors to disclose their progress and benchmark themselves against peers and finally, a credibility measure to maintain the PRI brand (PRI 2007).

There is no formal independent auditing of signatory responses, however, the Secretariat performs hour-long verification phone calls with a portion of signatories each year focused on signatory responses to a group of (scored) questions. The purpose of these calls is to consider the validity of signatory self-assessments and any assumptions made. While the Reporting and Assessment survey has been referenced as a measure to ensure integrity of the PRI, the emphasis to date has been less on the accountability aspect of the survey. The PRI's soft-touch approach to monitoring and assuring (verifying) the performance of signatories has been – it is argued – to encourage the perception of a low barrier of entry and an emphasis on signatories going through a 'learning-by-doing' process (PRI 2008). While the Reporting and Assessment survey is referenced as a disclosure framework, signatories are not required to disclose or make their survey results publicly available, nor does the PRI state they must disclose activities to clients, beneficiaries or customers.

Having established the context in which the PRI were created and elaborated upon what it demands of institutional investors, the aim of the thesis is to speculate on what has motivated investors to publicly commit to the principles en masse by exploring reasons why institutional

investors participate in the voluntary measure. The secondary focus is to examine the extent to which the PRI itself is conducive to promoting sustainability development by assessing signatory implementation to-date and analysing the institutional design of the initiative in light of the broader literature on the effectiveness of voluntary environmental governance measures. The following section reviews the literature on why private actors participate in voluntary environmental or CSR measures and what incentives financial institutions have for publicly committing to principles related to 'responsible' investor conduct.

Chapter 3 – Why do firms participate in voluntary initiatives?

This chapter outlines a conceptual framework for understanding why firms participate in voluntary initiatives that establish a firm's commitments and responsibilities in relation to environmental and social concerns above what is legally required of them. A review of the literature identifies three waves of explanations for explaining firm participation in voluntary initiatives. The first and most prevalent explanation is commonly associated with the 'business case for CSR' and has emerged primarily from the business school literature. This literature portrays participation in voluntary initiatives as primarily a strategic and functional response to pressures from internal and external stakeholders driven by a utilitarian, cost-benefit logic in firm-level decision-making. A second wave of explanations has emerged from the comparative political economy literature focusing on how national legal, social and political institutions shape the economy and firm decision-making. The institutional perspective suggests a firm's decision to participate may be influenced by what is perceived as legitimate and acceptable by actors in the company's relevant institutional environments, regardless of direct economic calculations.

Finally, a more recent wave of explanations within the concept of complex market rationalism (Vogel 2008) suggest a more nuanced understanding due to the evolving and complex interactions between factors identified in the business school and international relations literature. This literature emphasizes how utilitarian/functionalist logic may be influenced by evolving norms in a firm's institutional environment. The second half of the chapter reviews empirical research on voluntary initiatives in a variety of industries and sectors including project finance, forestry services and the chemical industry. These studies suggest participation can be grounded in a variety of strategic motivations that often do not fit neatly into either business

school or institutional theories, supporting complex market rationalism understandings of firm decision-making.

Three waves of explanations

Utilitarian, cost-benefit logic

The prominent explanation for the growth of CSR and firm participation in voluntary measures related to environmental or social responsibilities is that an explicit market rationale exists which motivates a decision to participate. The broader emergence of CSR in its present form is said to be closely linked with the rapid pace of economic globalisation and resulting ‘governance gap.’ As argued by Ruggie (1998; 2003) and Strange (1998), the decline of the post-war system of ‘embedded liberalism’ ushered in a new age characterized by the dramatic increase in the transnationalization of companies, foreign direct investments, global commodity chains and short-term capital flows. The diminished ability of governments to control and regulate companies that ensued, in particular as regards TNCs, led to greater insecurity and increased social costs, culminating in strong public protests against globalization in the mid to late 1990s. Of particular importance was the nature of these protests as they were aimed not primarily at governments but at business. Anti-globalization pressures and resulting demands for more socially and environmentally responsible globalization posed a new set of challenges to business, specifically for those with truly global operations. Participation in voluntary initiatives is portrayed as a strategic and functional response to pressures from internal and external stakeholders. Whereas in the past it sufficed for companies to follow national rules and regulation, the resulting governance gap forces them to go beyond legal requirements to be perceived as responsible and legitimate actors. Thus, for commercial reasons, corporations need

to establish a new form of legitimacy and a social license to operate (Sklair 2001) in which adoption of voluntary codes of conduct have become integral tools. The 'business case for CSR' emerges from the positive and negative incentives associated with stakeholder pressures (Haigh and Jones 2006; Gjolberg 2009).

The fundamental logic underlying this view is that a firm's decision to participate in voluntary initiatives and adopt CSR-related commitments emerges as a functional response to anti-globalization and anti-corporate sentiments. Consequently, at the core of this hypothesis is corporate enlightened self-interest. Business CSR literature abounds with examples of 'the business case for CSR': improved risk management, reputational and brand image, access to niche markets, cost savings and improved access to capital, improved employee relations, etc. (SustainAbility and UNEP 2001; Zadek 2001; Vogel 2005). These explanations stress the strategic and economic benefits of adopting CSR practices and participating in voluntary, beyond-compliance measures. Acting more 'responsibly' by taking into account the concerns of sustainability and the firms' wider stakeholders, therefore addressing the long-term financial interests of business is a dominant theme in much popular and business writings on CSR (Vogel 2005). Such explanations suggest CSR and beyond-compliance corporate environmental practices makes 'good business sense,' (Schmidheiny 1992; Schmidheiny et al. 2002; Mazurkiewicz 2005) suggesting participation in a voluntary initiative can encourage internal processes of learning and adaptation while providing a means for firms and stakeholders to discuss issues and collaborate in resolving them. Moreover, it is suggested that collective sharing of experience can improve on best practices, allowing firms to acquire innovative pollution prevention technologies while fostering competition (Ruggie 2002). In this way, functional and utilitarian understandings suggest participation in voluntary initiatives can be more cost efficient

based on the idea that they permit firms to respond in their own manner, as each firm has different costs and capabilities for adoption, rather than in a way prescribed by command and control regulation.

Institutional theory

A second explanation and more normatively-driven logic for companies to engage in voluntary CSR initiatives are argued for in the comparative political economy literature. Institutional theory focuses on how national legal, social and political institutions have shaped and continue to shape the economy and in turn, corporate strategy. A number of studies adopting firm-centred approaches have argued that the institutional structure of a particular political-economic system provides firms with a specific set of comparative institutional advantages for specific types of activities. Importantly, despite the forces of globalization, this suggests the nation state still provides a crucial context for the development of corporate strategies. On the basis of comparative institutional advantages, these studies suggest differences in political-economic institutions will be reflected in differences in participation rates in CSR-type voluntary initiatives. The main mechanism proposed by several studies is that stronger institutions for the social embedding of the economy will result in higher participation rates and stronger CSR performance. Specifically, studies have focused on the corporatist arrangements and the general role of culture, norms and values and the question of political culture as impacting firm participation (Rivera 2004).

One institution identified in the literature as relevant to firm participation is the presence of corporatist arrangements. Most important in this regard are the function of labour unions who can have an important advocacy role in promoting higher labour standards as well as other social

issues (Campbell 2007). Studies have indicated that strong traditions for cooperation between the social partners provide a platform that teaches, and to some extent also forces, business to pay due regard to broader societal concerns and to balance profit maximization against the interests of stakeholders. As a result of the generally closer involvement of business and labour as well as NGOs in policy-making in corporatist countries, it is proposed that business is held more accountable to the public. This can be expected to impose a longer-term perspective on business strategies related to society and the environment. Thus, strong corporatist traditions are expected to lead to a stronger embedding of companies, and consequently to stronger participation by firms in CSR in areas covered by corporatist relations.

The more general question of political culture has been an integral part of the study of political economy and culture, norms and values are shown to be indispensable to the functioning of political-economic institutions. In studies of CSR practices and performance across a large number of countries, Rivera (2004) and Gjølborg (2009) concluded that a strong political culture, in terms of traditions for public participation, is a driver for improved CSR-performance in companies and have proposed that strong welfare state policies create direct and indirect forces that encourage companies to adhere to higher standards. Specifically, resourceful external stakeholders such as outspoken NGOs and a critical free press were shown to influence consumer awareness and public debate, providing companies with stronger incentives for engaging in voluntary environmental measures.

To conclude, explanations found in comparative political economy literature emphasize the importance of public policies and political-economic institutions as pivotal normative expressions of national expectations of the role of business in society (Utting 2005; Rivera 2002; Vogel 2008; Gunningham, Thornton and Kagan 2003; Aguilera, Rupp and Williams., 2007). In

an institutional perspective, a firm's willingness to participate and its CSR efforts may be influenced by what is perceived as legitimate and acceptable by actors in the company's relevant institutional environments, regardless of direct economic calculations (Gjolberg 2009). Compared with the mainly utilitarian cost-benefit logic of the previous hypothesis, the institutionalist perspective opens for a more normatively-driven logic for companies participating in voluntary initiatives related to CSR. Thus, this perspective assumes that a strong social embeddedness renders firms normatively inclined towards increased CSR efforts and in turn, greater participation in voluntary initiatives.

Complex market rationalism

The most recent wave represents a sort of hybrid to the preceding explanations, suggesting the need to merge certain aspects of the functionalist/utilitarian and more normative, institutional arguments. Vogel (2008) argues for a more nuanced understanding of firm participation in voluntary initiatives, citing the complex interaction between strategic and functional responses and normative pressures. Along these themes, Vogel argues that the complex environment in which firms operate is constantly evolving – the result of historical macro-trends. As opposed to operating in a pure market environment, one explanation holds that business operates in an environment shared with other private actors including civil society, customers, shareholders and stakeholders. In this space, each actor brings with them particular role conceptions and normative standards directed towards the conduct of business operations (Vogel 2006). The argument is not that economic rationality is replaced by an intrinsic normative orientation. Rather, the concept of market rationality is changing its meaning under the conditions of a normatively-enriched environment. Complex market rationalism emphasizes the changing nature or costs and benefits which must be accounted for by business, differentiating between three

aspects that increasingly factor in business calculation of costs and benefits. This includes: the risks associated with stringent and costly public regulation; the risks associated with civil society action and consumer boycotts; and, the opportunities associated with making profits or producing goods for ecologically/socially-aware consumers. All of these considerations, Vogel argues, may cause individual firms or industries to create and/or comply with voluntary initiatives that demand beyond-compliance behaviour (Vogel 2008). Thus, the overlap between functional/strategic motivations and regulatory and/or stakeholder influence is considerable.

Complex market rationalism explanations suggest that a firm's decision to commit to a voluntary initiative should principally be seen as a response to internal and external pressures shaped by normative standards imposed by external institutions. In essence, there is a complex interaction between CSR, globalisation and domestic political-economic institutions. While there are purely functional reasons for firms to participate in voluntary initiatives (i.e. cost savings, reputation, differentiation), normative pressures from internal and external stakeholders can provide motivation for firms to establish commitments meant to provide or enhance their legitimacy and social license to operate, seeking to be perceived as responsible and legitimate actors. As Wright and Rwabizambuga (2006) conclude in their analysis of the Equator Principles (project finance), decisions to adopt voluntary measures that establish commitments and responsibilities related to 'responsible' conduct can be principally seen as embedded in the broader risk management strategies of the firm. As the following section notes, detailed research on a variety of specific CSR voluntary initiatives reveals the difficulty in disaggregating functional/utilitarian and normative/institutional explanations. Rather, supporting Vogel (2008), empirical research indicates such a decision can be grounded in a variety of strategic motivations that are commonly

linked in complex ways to both functional, cost-benefit explanations and more normatively-driven logic.

Strategic motivations identified in empirical research

Reputation and brand benefits

The strategic motivation commonly identified in the literature on voluntary initiative is that firms adopt beyond-compliance measures as a means of protecting or enhancing their reputation by assuring stakeholders that it operates responsibly. Studies have indicated that adopting and committing to a voluntary code of conduct or other voluntary initiatives has become an important feature of a firm's public relations and communications strategy in managing relationships with the firm's primary stakeholders (Gibson 1999; Prakash and Potoski 2006; Wright and Rwabizambuga 2006; Auld, Bernstein and Cashore 2008).

Recent empirical work suggests that companies' environmental practices, including their decision to participate in voluntary programs particularly in high-impact sectors such as mining, are shaped by a perceived license to operate comprised of social, regulatory and economic pressures (Howard-Greenvillet, Nash and Coglianese 2006). Firms are motivated by the reputational benefits provided by participation in a voluntary initiative, viewing the adoption of a voluntary code of conduct as related to their perceived need to protect their social license to operate by maintaining the trust of primary stakeholders, avoiding the attention of environmental groups and preserving the company's reputation as an environmentally-responsible entity (Gunningham, Thornton and Kagan 2003). While reputational and brand benefits may be sought via the adoption of voluntary initiatives primarily as a means of responding to direct pressures, Rivera's analysis of Sustainable Tourism voluntary schemes also indicate that the decision may

be influenced by what is perceived as legitimate and acceptable by actors in the company's relevant institutional environments, regardless of direct economic calculations (Rivera 2004).

Participation in a voluntary initiative is therefore meant to serve as a signal to stakeholders of the firm's association with corporate practices recognized as 'best practice' or 'responsible' within the industry (see Cashore and Vertinsky 2000 on sustainable forestry management). Association with a voluntary initiative can therefore enable firms to manage the increasing demands and the complexities of its operating environment and enhance its relationship with a variety of stakeholders by communicating its commitment and reporting on its activities.

Drawing on the economic theory of club goods, Prakash and Potoski (2006) argue voluntary programs are like clubs in that they offer their membership non-rival, excludable benefits such as a positive image, goodwill, legitimacy and reputation for environmental stewardship. Their research on the ISO 14000 EMS suggests firms are motivated to adopt codes to reap branding benefits such as shared reputation and goodwill that emanate from their association with the voluntary club's brand. Because outside stakeholders (consumers, regulators, investors and suppliers) are unable to monitor a firm's environmental programs and verify a firm's claims, adoption of a voluntary code of conduct can solve information asymmetries between firms and their stakeholders, helping them build the firm's reputation, which in turn shapes their relations and interactions with stakeholders (Prakash and Potoski 2006: 777).

Participation as a means of differentiation or emulation

Firms may also be motivated to participate by viewing the code of conduct as a cost-effective strategy for the firm to attain higher reputational status and differentiate themselves from competitors. A strategic desire to differentiate a firm's practice and reputation from those of

competing firms is particularly strong for those perceived negatively by stakeholders in the case of ISO 14000 (Prakash and Potoski 2006). Studies on the chemical industry have found industry-wide initiatives emerging where companies hold collective reputations, whereby a bad image of the industry impacts all companies, regardless of a firm's individual performance (Prakash 2000; Auld, Bernstein and Cashore 2008).

Firms that have already implemented internal policies or practices may view adopting a code as a means to seek recognition thereby reinforcing their reputations. Others, who have not implemented internal policies and practices, may adopt a code of conduct as part of a broader reorientation of corporate strategy towards sustainability, often driven by competitive pressures in their industry (Wright and Rwabizambuga 2006). Firms may adopt strategies through a modelling process based on competitors that are perceived to be successful. Firms may then participate, seeking to emulate the behaviour of others as a means of appearing legitimate or where management is uncertain about the sources of competitive advantage, as illustrated in the growth of 'sustainable tourism' voluntary standards (Rivera 2004).

Related to these strategic motivations, studies on alternative markets and sustainable product certification schemes highlight the material and normative aspects of corporate strategy (see Giovannucci and Ponte 2005 on sustainability initiatives in the coffee industry). A market rationale is apparent in that voluntary participation is viewed as a means of creating an alternative market for a differentiated product or service. At the same time, however, corporate strategy is shaped by a normative logic as firm participation consists of active engagement in establishing the norm that such an alternative market for 'green' products exists.

Preventative action towards more intrusive state regulation

The ability of the government to influence firms' behaviour has been found to be significant, even when regulations have not been enacted and no specific penalties are imposed (Cashore and Vertinsky 2000). Institutional theory emphasizes the role of legal institutions in shaping corporate strategy. Threats of new environmental regulations or explicit government support of beyond-compliance environmental practices are known to be significant incentives for firms to participate in voluntary environmental initiatives (Rivera 2004). These government pressures have a higher impact on firms that face greater monitoring because they are more likely to be affected by government decisions. Firms facing higher government oversight also tend to have more information about regulatory and enforcement trends.

In some cases business self-regulation and the adoption of voluntary codes of conduct may represent a political strategy for avoiding additional or more intrusive regulation. Several studies have found the adoption of codes to serve as a form of preventative action by firms. For example, Responsible Care, the chemical industry's code of conduct was adopted by several national chemical associations in part to forestall national laws establishing more stringent plant safety standards following the chemical plant explosion at Bhopal, India in 1984 (King and Lenox 2000). Studies examining the International Chamber of Commerce's Business Charter for Sustainable Development have argued its initiation by global firms was at least in part driven by fears that the 1992 Rio Earth Summit would lead to an expansion of international environmental regulation. Likewise, in an analysis of ISO 14000 standards, Clapp finds industry support and adoption to represent a strategy to pre-empt, or at least soften, present and future state-determined environmental regulations (Clapp 1998: 295). Firms may therefore seek to engage proactively with the corporate responsibility agenda and activists in an effort to deflect or dilute

certain pressures while seeking to influence the evolution of future regulation and standards (Utting 2002, Fuchs 2005).

As a related issue, studies have also shown firms adopt and comply with codes of conduct as a means of demonstrating and providing evidence of due diligence (OECD 2001; Lenox and Nash 2003). Where regulatory measures may have not clarified the nature of due diligence obligations for an industry or in an evolving issue-area, adoption of a widely-adopted and recognized code of conduct may be viewed strategically as a means of demonstrating the exercise of due diligence.

Firm-specific motivations

Finally, several studies have also identified firm-specific motivations for adopting a code of conduct which are outside of social pressures emanating from external stakeholders or the firm's institutional environment. Studies found that the formal education and environmental expertise of senior management and the CEO in particular also correlates with firm participation and early adoption of climate change strategies in the oil and gas sector. These findings are reinforced by additional research which suggests managerial attitudes and values and the presence of proactive individuals influences firm responses (Hoffman 2001).

Summary

The above framework offers a number of plausible explanations for the emergence and adoption of voluntary initiatives. The review has identified well-established theories from the business school and political economy literature, focusing on factors that are alleged to be highly relevant to corporate strategy. While the utilitarian 'business case for CSR' explanation remain the dominant mode of thinking on this issue, importantly, empirical research suggests the need for a more nuanced understanding of firm motivations as developed in the concept of complex market

rationalism (Vogel 2008). To respond to the primary research question of what has motivated institutional investors to adopt responsible investment practices and commit to the PRI, the following chapter will test the explanatory power of the identified theories, applying them to a detailed analysis of responsible investment among institutional investors. A key assumption is that as the first global voluntary ‘responsible investing’ initiative, the decision to participate in the Principles for Responsible Investment is directly linked to the broader motivational forces behind the growth of responsible investment practices among institutional investors. The following chapter will therefore explore the broad trends behind the growth of responsible investment before the PRI is analysed in detail in chapter five.

Chapter 4 – The growth of responsible investment among institutional investors

The ‘materiality of ESG issues

The factors behind the emergence of ESG integration and responsible investing are most commonly argued by the institutional investors themselves to be the result of a growing awareness of the impact of ESG factors on the financial performance of companies (UNEP FI AMWG 2007; BSR 2009). These publicly cited reasons tend to reinforce the dominance of the business school explanation. The ‘materiality of ESG issues’ rests on the market rationale that a business case exists for sustainability and suggests that the consideration and integration of ESG issues in investment decision-making results in the improved analysis and risk/return characteristics of investments. The increased awareness of the ‘materiality’ of ESG issues is driven by a growing body of academic and industry research that has bolstered the investment case for considering ESG issues, and has shown that contrary to modern portfolio theory, underperformance is not linked to responsible investment strategies.

Conventional financial theory has generally been dismissive of the inclusion of ‘non-financial’ ESG issues in investment strategies. The assumption is that the introduction of non-financial factors into investment decision-making, through the use of negative screens excluding sectors such as oil and gas or weapons manufacturers, will harm diversification and thereby incur penalties in terms of risk and return (UNEP FI 2005). However, empirical research has been influential to the growth of the business-case justification for the inclusion of environmental, social and governance issues in investment decision-making and adoption of responsible investment practices. A growing body of research has challenged these beliefs, indicating that corporate environmental performance can be material to financial performance. Moreover,

studies have shown that the adoption of responsible investment practices may have the ability to increase portfolio risk-adjusted rates of returns. This represents a pronounced shift from historical perceptions of the value of integrating environmental and social issues into valuations as being negligible or even negative. Although there is still significant scepticism about the positive impact of ESG integration on financial performance in mainstream finance, the increase both in volume and sophistication of studies demonstrating outperformance has served to legitimize the discourse surrounding responsible investment and the active integration of corporate ESG performance data.

Operating in a world of constant calculation of risk and return, the long-term, temporal nature of decisions made by institutional investors requires greater information about the underlying fundamentals of the firms in which they invest. Climate change, for example, can pose significant (and varying) physical, regulatory, litigation and competitive risks for individual firms and entire sectors with the potential of seriously impacting the financial performance of a company over time. Adjustments in average temperatures and the frequency and magnitude of extreme weather events has the potential to cause property damage, pollution-related liabilities, business and supply-chain interruptions and loss of utility services – physical impacts to businesses that pose significant financial risks. In addition to physical risks, determining the competitive risks a firm faces is an important consideration in calculating the financial value of a firm. A company's climate risk preparedness in relation to its competitors is a key factor in determining its ability to compete over a longer time horizon. Companies that have become laggards in adapting to consumer and regulatory demands are likely to require costly retrofits and are likely to therefore become less competitive in relation to their industry peers.

Additionally, increased stakeholder pressures – most notably from civil society organisations – have impacted or have the ability to impact corporate financial performance and hence, the investor’s calculation of risk and return. Pressures from civil society organisations have changed the liability landscape for companies and contributed to the transformation of business risks considered by the firm in their strategic calculations. Activists have changed what risk means in the modern era through their ability to impose direct costs on companies by undermining reputations, bringing lawsuits and limiting sales and investment in companies that violate norms (Ruggie and Kell 1999). Many global firms tend to be particularly sensitive to reputational risks with the growing importance of intangible goods such as branding and goodwill. To the degree that activists, media and other institutions are able to successfully link the activities of a company or its investor with negative outcomes such as environmental degradation or corruption, then that actor is more likely to consider changing its behaviour (Sustainability and UNEP 2001). To illustrate, share prices measure expectations of future returns based on all available information. Attacks on brand image and reputation bring new information to capital markets that may dampen these future expectations. As a result, there is increasing concern among investors of the threats of systemic attacks on brand image and corporate reputation because such attacks can have a direct impact on portfolio-wide risk calculations and long-term returns through adverse current and future stock price changes.

The potential regulatory risk a company faces is also critical for investors seeking a complete understanding of a company’s net present and future value. In the case of climate change, active strategies by NGOs have pressured international, national, state and local governments to regulate companies with greenhouse gas emissions from operations or products to reduce those emissions and to purchase and trade carbon credits. Understanding how individual companies

and sectors are incorporating current and potential regulatory risk into capital investment decisions and strategic planning are important in the valuation of a firm.

Finally, stakeholder pressures have also introduced liability risks. According to a report by SustainAbility, legal risks have increased due to a “well funded litigation industry, highly motivated legal activists; expanding boundaries of liability in both legal and accounting terms and a decline in societal trust in business (SustainAbility 2004). As an example, in 2006, the Attorney General of California filed a nuisance suit against six automakers arguing the car manufacturers should be held responsible for damages caused by the emissions produced by their products, as well as for the costs of monitoring and combating climate change in the state (Kiernan 2009). Should courts hold the companies liable in such cases, the potential liability is immense. Moreover, the costs of litigation and reputation effects incurred by companies involved could be damaging in their own right to the value of the firm’s common shares. By turning CSR into a feature of risk management, stakeholder pressures have altered the competitive landscape for companies. Responsible investment, considered to constitute the integration of ESG issues into investment decision-making is therefore framed as a key component of strategic planning, enabling investors to identify and mitigate risks and identify opportunities in the investment process to better deliver long-term value.

In general, studies show that investments selected on the basis of identifiable ESG factors – such as eco-efficiency, employee engagement and corporate governance – do tend to outperform, serving to legitimize the business case for responsible investment (See Bauer et al 2006; Edmans 2007; Association of British Insurers 2008). The evidence in terms of fund performance is less clear cut. A 2007 review of the academic literature analysing the performance of funds adopting SRI screening suggests that out of eleven studies, three identified positive results, two were

negative and six were generally neutral (UNEP FI AMWG 2007). A 2008 paper surveyed sixteen studies between 1992 and 2007 and concluded that two showed a positive relationship, one identified a negative relationship, with the remainder concluding that SRI funds did not exhibit any significant difference in performance from other funds (Kiernan 2009). Finally, a 2009 report by Mercer Investment Consulting surveyed sixteen studies which apply traditional finance theory to ESG factors, spanning a variety of research methods, regional samples and investment approaches (such as screening, integration and shareholder engagement). This report found that the majority of the studies (ten) showed a positive relationship between ESG factors and companies' financial performance; four studies indicated a neutral relationship and two which showed a neutral to negative relationship (Mercer 2009).

There are also a number of qualitative rationales cited to explain the value of ESG integration. Many investors describe strong ESG performance as a proxy for strong and effective management (BSR 2009; Goldman Sachs 2007). Identification and oversight of ESG issues facing the firm in its operations is argued to be an indicator of a management team that has a high awareness of the company's external operating environment partnered with a keen ability to identify emerging issues, risks and opportunities to the firm (Hudson 2006). Similarly, positive ESG performance is considered by some to serve as an indicator for a company's ability to manage risk and adapt in the face of new challenges in their business models. In line with this, portfolio managers are increasingly considering ESG performance as a part of understanding business context.

Investors also state that strong ESG performance is indicative of a company's ability to take a long-term and strategic approach to growth. Companies focused on short-term returns and immediate payouts are less likely to invest in ESG issues as well as in other intangible initiatives

that create long-term value. However, companies that can anticipate changes in the marketplace driven by ESG issues are increasingly perceived as being poised to turn challenges into opportunities. Consequently, although questions about direct correlations between the integration of ESG issues, corporate performance and financial returns persist, many investors are recognizing the value of ESG integration in other ways. Lengthening the investment horizons are argued to enhance long-term value while active ownership is seen as protecting and strengthening investments. To that end, investors are increasingly accepting and understanding that responsible investment and ESG factors can play a role in supporting strong fiduciary responsibility (BSR 2009; PRI 2007).

Publicly stated reasons and motivations listed by institutional investors would therefore seem to support functionalist cost-benefit assumptions that institutional investors adopt ‘responsible’ investment practices in light of growing empirical research that demonstrates the materiality of ESG issues. Institutional investors have marketed responsible investment as an aspect of their direct risk management strategies, identifying that corporate environmental performance can impact financial performance thereby improving the risk/return profile of their investments.

Evolving views on RI and the fiduciary responsibilities of pension trustees

Outside of the growth in empirical research that indicates ESG issues can be material to corporate financial performance, a second broad trend influencing institutional investor practices regards the interpretation of fiduciary duty vis-à-vis the inclusion of ESG issues in investment decision-making. Historically, the uptake of responsible investment and integration of ESG issues by pension funds and other institutional investors remained low due to a tendency to interpret fiduciary duty as requiring short-term financial performance while obstructing the

consideration of any stakeholder interests outside the financial interests of beneficiaries (UNEP FI 2005). A barrier for the active consideration of corporate ESG performance has therefore been the interpretation of the law that fiduciary duty equates to profit maximisation. This has produced an environment where pension funds are likely to be apprehensive about creating an investment strategy premised on long-term investment which comprises a wider stakeholder group out of concern that it may be interpreted by courts as violating fiduciary duty (UNEP FI 2005). Importantly, however, the question of whether it is permissible to consider ESG issues has been challenged by legal opinions in the last decade, shifting the debate towards whether it is a requirement to consider ESG issues. Institutional investors have subsequently faced growing political and regulatory pressure to clarify the extent to which they integrate corporate ESG performance into their investment decision-making (BSR 2009).

In OECD countries, most legislation establishes a fiduciary relationship between investors and the manager of the investor's funds. Fiduciary duties apply to trustees directly and to fund managers and investment consultants indirectly and act as the 'key source of limits on the discretion of investment decision-makers in common law jurisdictions (UNEP FI 2005: 8) Broadly, fiduciary duties are duties imposed upon a person who exercises some discretionary power in the interests of another person in circumstances that give rise to a relationship of trust and confidence (UNEP FI 2005: 8) Thus, while an investor fund's considerations of ESG issues may take a broader conception of the fiduciary's interest, most legislation restricts the responsibility to maximizing the investment's expected risk-adjusted returns. This interpretation of fiduciary duty is particularly strong in the case of pension funds and their core duties of loyalty and prudence.

In Anglo-American trust law, fiduciary duty structures the way pension fund trustees manage fund assets for beneficiaries. It has two core components: the duty of loyalty and the duty of prudence. The duty of loyalty requires pension fund trustees to act in the sole interests, or in some circumstances, the best interests, of beneficiaries when carrying out their investment strategy. While beneficiary interests must remain paramount, legal provisions do not explicitly prevent investment strategies from creating positive outcomes for non-beneficiaries. The duty of prudence requires pension fund trustees to act with prudence, or skill, care and diligence, in managing funds for beneficiaries. In the U.S., the duty of prudence is contained in the modern prudent investor rule, which requires trustees to “manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust.” (Richardson 2007) In the U.K., trustees must “exercise such care and skill as is reasonable in the circumstances.”

Significantly, the prevailing view of fiduciary duty presenting a barrier to the inclusion of ESG factors in investment strategy has been criticised by several recent legal opinions. In a 2005 report by Freshfields, Bruckhaus, Deringer, the global law firm was asked to determine whether the integration of ESG issues ‘into investment policy (including asset allocation, portfolio construction and stock-picking or bond picking) is voluntarily permitted, legally required or hampered by law and regulation; primarily as regards to public and private pension funds.’ (UNEP FI 2005, 8) The report explored a mix of common and civil law jurisdictions: Australia, Canada, France, Germany, Italy, Japan, Spain, the U.K. and the US. In summarizing the study and their conclusion, Freshfields argued that “conventional investment analysis focuses on value, in the sense of financial performance...the links between ESG factors and financial performance are increasingly being recognised. On that basis, integrating ESG considerations into an

investment analysis is clearly permissible and is arguably required in all jurisdictions.” (UNEP FI 2005: 12)

In forming their opinion, Freshfields argued that the links between ESG factors and financial performance were increasingly recognized in the sense that integrating ESG considerations can contribute to improved risk/return and financial performance. Importantly, consideration of ESG issues was firmly rooted in process considerations. Freshfields argued that ‘Trustees must consider these factors ‘because there is a body of credible evidence demonstrating [they] often have a role to play in the proper analysis of investment value.’(UNEP FI 2005: 9) That said, Freshfields concluded that this did not alter the trustees’ discretion in assigning a weight to these factors. In fact, fiduciaries remain free to decide that, for instance, they will have no material effect on the investment’s performance. But, Freshfields argues, they must assess them and that assessment must take place within the disciplined investment process expected of fiduciaries.

In addition, integrating ESG factors to include beneficiaries’ views and to decide between investments of the same value are also accepted. The report argued that while it is difficult to find consensus as to the interests of beneficiaries, it is accepted that the average beneficiary would agree not to invest in investments that are linked to breaches of human rights, labour conditions, corruption or environmental degradation. Freshfields also cited that ‘a majority of the jurisdictions have legislated (or are expected to do so shortly) to require investment decision-makers, particularly in the pensions context, to disclose the extent to which they take ESG considerations into account.’ (UNEP FI 2005: 11) Related to this final point, the following section explores regulatory influences on investor behavior relating to the integration of ESG issues.

Government monitoring of institutional investor behavior via disclosure-based regulation

Since 2000, various governments (as detailed below) have relied on informational policy instruments in the form of legislation requiring pension funds to disclose their policies on environmental, social and ethical considerations. Pension fund regulatory authorities in most OECD countries have taken a relatively passive stance towards encouraging the consideration of ESG issues in investment decision-making. At present, where in existence, the approach taken by regulatory authorities relies largely on disclosure requirements which require pension funds to inform their clients of the extent to which such ESG or ethical factors are incorporated into the fund's investment strategy. While regulatory developments have not mandated the adoption of responsible investment practices, increasingly such actions have created space for institutional investors to take these approaches, removing some of the barriers in certain jurisdictions and imposing more stringent requirements in other regions.

The first jurisdiction to establish such requirements was the U.K. in 2000 when the U.K. Pension Act was amended to require trustees of occupational pension plans to disclose their policy on SRI as part of their Statement of Investment Principles. In doing so, trustees are required to declare 'the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realization of investments' and 'the policy (if any) directing the exercise of the rights (including voting rights) attached to investments.' As well, U.K. courts have concluded that the concept of beneficiaries 'best interest' under a pension trust may extend beyond their financial interests to include their views on moral and social matters.

In Australia, the Financial Services Reform Act (2000) which requires that all products with an investment component – including superannuation funds and mutual funds – include disclosure

of the extent to which labour standards or environmental, social or ethical considerations are taken into account in the selection, retention and realization of the investment.

Indeed, like the U.K. and Australia, many other states have put similar rules in place with regards to occupational pension funds: Sweden, France and Germany in 2001; Norway, Belgium and Italy in 2005; Austria in 2005; and Spain (pending). Additional pending regulation is under discussion at the EU level where the European Directive on Institutions of Occupational Retirement Provision Committee on Economic and Monetary Affairs has proposed the inclusion of ‘full disclosure of a funds’ ethical and socially responsible investment principles in its statement of investment principles.’

In Canada, only Manitoba specifically permits consideration of ‘non-financial’ criteria permitted that trustees and administrators still satisfy the requisite standard of care. Subsequently, a 2007 NRTEE report on capital markets called for disclosure rules for pension plans in Canada similar to those in the U.K. and the 2008 Arthurs Commission in Ontario has made similar recommendations. In October 2009, a private member’s motion was introduced in the House of Commons calling on public and private pension plans to disclose how they track and manage ESG-related risks.

A more proactive and prescriptive form of legislation has been applied to public pension funds in many OECD countries, and especially to the national pension reserve funds that have been established in recent years to help finance public pension systems. In several jurisdictions, legislation is more explicit in requiring the consideration of ESG or ‘social responsibility’ issues and risks in investment strategies, though the degree of detail required in disclosure varies.

In New Zealand, for example, legislation states that public pension funds are to ‘avoid prejudice to New Zealand’s reputation as a responsible member of the world community’ and to disclose its policy regarding investments. In Canada, legislation has gone further where federal legislation establishing the CPPIB calls on its board members to address social and environmental risks in its investment strategy. Likewise, provincial legislation establishing OMERS and OTPPB require consideration of social responsibility issues. French legislation governing the state Fond de Reserve pour les Retraites (FRR) goes further than Canadian legislation in that it requires FRR to include in its investment policy how it accounts for social, environmental and ethical issues.

The most progressive legislation is found in legislation governing Norwegian and Swedish public pension funds. Norway’s 2004 ethical guidelines require negative screening of companies producing certain categories of weapons, exclusion of companies responsible for human rights violations, gross corruption and environmental degradation and a corporate governance policy which targets long-term financial returns, mainly formed on the basis of UN Global Compact and OECD Guidelines for Multinational Enterprises. In the Swedish Public Pension Funds Act of 2000, national pension funds must describe how environmental and ethical considerations are considered in investment activities and the impact of such considerations on fund management decisions. According to the law, funds may not own shares in companies that violate the funds’ policies on the environment and ethics. The finance department has the responsibility of controlling whether funds are applying the laws. Since 2002, Sweden’s AP funds ‘must take environmental and ethical considerations into account without relinquishing the overall goal of a high return on capital.’

Interestingly, the US presents a counter case to developments surrounding disclosure of ESG consideration by pension plans throughout OECD countries. A US Department of Labor’s

Pension Welfare & Benefit Administration advisory opinion from May 1998 has remained a major barrier. The opinion has been broadly interpreted as concluding pension fund trustees or managers may be in breach of their fiduciary responsibility if they engage in SRI which demonstrably results in lower returns than alternatives. Thus, US pension funds have been wary of negative screening based on SRI-type themes or ESG factors.

Upon reflection of these various state-induced regulations, it can be argued that mandatory standards for institutional investors and other financiers are rare and tend towards a reliance on informational policy instruments. Bolder proposals such as a proposed amendment to Britain's Financial Services and Market Act (2000) to include sustainable development as one of the principal considerations of the regulator's mandate have been rejected to date. Regarding the regulation of pension funds, disclosure has been the focus particularly in those markets where investors are free to choose among pension funds (in most personal or retail-based private pension systems, including the mandatory defined contribution systems in OECD countries). In these cases, the pension fund is often viewed as a simple intermediary and disclosure is viewed attractively in that it allows beneficiaries and potential members to consider how ESG factors may affect the future evolution of their investment portfolio.

While regulation that mandates disclosure has been applauded by some, others have raised issues and cited shortcomings in the ability of the regulation to challenge conventional investment practice. First, disclosure regulations have not provided a standard definition and classification of SRI or ESG integration. None have required or declared a separation of ethical considerations from ESG risks which is problematic given empirical research which indicates differing financial performance. Second, all disclosure-based regulations have left a high degree of discretion on the

type and content of disclosures made by institutional investors and regulators have remained silent on how pension funds should integrate ESG criteria into their investments.

Referring to the literature on firm participation in voluntary initiatives, several studies have found threats of new regulation or explicit government support of beyond-compliance environmental practices to be significant incentives for participation (Rivera 2004). Reflecting on regulatory trends in several OECD countries, institutional investors are increasingly subject to disclosure-based regulations that require investors clarify the extent to which ESG issues are integrated into their decision-making processes. Furthermore, uncertainty relating to the fiduciary responsibilities of institutional investors has created pressures for trustees to demonstrate and provide evidence of due diligence although the legal interpretations have not clarified the nature of the fiduciary obligation.

While not mandating the inclusion of corporate environmental performance, legislation has raised the profile of responsible investment practices, requiring institutional investors to disclose whether they consider ESG issues. Such developments suggest firms may be motivated to adopt responsible investment practices and participate in the Principles for Responsible Investment as a strategy for avoiding additional or more intrusive regulation in the future. As a means of taking preventative action, institutional investors may seek to engage proactively, interpreting disclosure-based regulations as part of broader regulatory trends concerning their behaviour as investors. Investor involvement in the creation of the PRI and subsequent widespread participation may be understood as an effort to deflect or dilute certain regulatory pressures. As an example, the CEO of Robeco, a Dutch asset manager and signatory to the PRI addressed an industry event calling on the asset management industry “to take the lead in ESG and show how we can set an example instead of waiting for government to impose rules on us.” (Responsible

Investor 2009) On this point, several institutional investor associations have also publicly noted the importance of proactively considering ESG issues and adopting the PRI as a means of mitigating the risk of regulatory intervention and influencing the evolution of future regulations and standards (Mercer Investment Consulting 2009; Eurosif 2009; Allianz Global Investors 2010).

Stakeholder pressures from non-governmental organisations (NGOs)

The rise of responsible investment among institutional investors cannot be isolated from the increased presence and activity of non-governmental organisations (NGOs) who have put increased pressure on institutional investors to align their interests with broader societal goals. NGOs have opportunities to influence corporate conduct via direct, indirect, and interactive influences on the investment community. Tactically, civil society organizations have deployed two often complementary techniques in an advocacy role: first, pressuring investors to invest capital in one company or sector rather than another; and, second, using the rights and influence associated with share ownership to voice concerns directly with company directors and senior management (activists often file shareholder resolutions related to social or environmental issues at corporate annual meetings, or use other measures including the media to try and shape corporate actions).

While the majority of early interventions were antagonistic, focusing on disrupting AGMs, the tactics of NGOs have steadily become much more sophisticated. Recent years have seen NGOs employ a range of approaches, including the production of investment analysis in support of their campaign issues (Waygood 2006); direct attempts to move capital into certain investment projects and out of others (Ougaard 2002); ongoing programs of communication with investors

in relation to specific issues of CSR; and, in some cases, formal programs of collaboration between investors and NGOs. More strategically, some NGOs have also engaged in public policy advocacy on the rules that govern the capital market, focusing primarily on issues of short-termism and market failure. In sum, the overall influence of NGOs as major actors in promoting responsible investment is growing with attendant consequences for the corporate strategies of institutional investors (Guay, Doh, Sinclair 2004; Sparkes and Cowton 2004; Waygood 2006).

Why are non-governmental organizations (NGOs) targeting capital markets and how this has influenced institutional investor behaviour (i.e. how this has created pressure and influenced risk management strategies of institutional investors to consider ESG issues)? As the following analysis indicates, investors are increasingly working with, and/or being influenced by, civil society organizations such as non-governmental advocacy, activist and consumer groups. The primary goals of these actors are, ostensibly, quite different than the financial motivations of investors. Increasingly, however, they view institutional investors as a strategic means to leverage the private sector and influence corporations via shareholder activism.

For an expanding body of institutions representing civil society – notably environmental, development, and human rights organizations – capital markets are seen not just as an instrumental mechanism for changing corporate practices, but also as a target for systemic change because their current structure undermines long-term sustainable development goals. In some cases, these campaigners have influenced the target company's cost of capital, tarnished its reputation and mobilized significant shareholder votes against management. In a few extreme cases, campaigners have also motivated company brokers to reject clients and stock markets in order to bar listings.

Waygood (2006) documents 30 NGOs in the U.K. alone that have used the capital market as a part of their company campaigning. Examples of such campaigning include Greenpeace, Amnesty International and World Wide Fund for Nature campaigning Shell to publish a corporate responsibility report to shareholders as a result of the execution of Ken Saro-Wiwa, who had been campaigning against the devastation of the Niger Delta by Shell and others; Surfers against Sewage questioning the board at South West Water's AGM about its policy in relation to marine dumping of sewage; Christian Aid targeting British Petroleum (BP) and other institutional investors in PetroChina, due to the latter's involvement in Sudan where an oil-funded civil war was under way; and the Campaign against the Arms Trade 'naming and shaming' pension funds with holdings in defence companies.

The rapid growth in capital market campaigning has created new risks for companies and their primary investors, institutional investors, and has not gone unnoticed. The Financial Times listed 'growing pressures from international NGOs, armed with unprecedented resources, credibility, access to company data and global communications capabilities' (Kiernan 2005) as one of the five socio-economic mega-trends affecting the security and earning power of long-term retirement savings.

Zadek (1998) argues that one emerging role of civil society is to regulate corporate behaviour, deeming such activity 'civil regulation' – with the capital markets being just one arena within which this takes place. More broadly, the literature on the active engagement of civil society in market governance identifies three main contributions that NGOs can make.

First, NGO campaigns can be an effective method of achieving welfare-enhancing social and/or environmental goals. Davis et al. (2006) argue that NGOs have a specific role in creating a more

sustainable economy. In a civil society, they argue, “parallel institutions of a civil economy can be understood as engaged shareowners, independent monitors, credible standards and civil-society organisations participating in the marketplace.” Davis et al. (2006) and others argue that civil society organisations are an important and legitimate lever to ensure that financial institutions advocate socially responsible management to the companies in which they invest.

An additional reading of the role of civil society is that by enhancing information flows regarding corporate performance on social, ethical and environmental issues that may be material to share price, NGOs can improve investment analysis. One practical reason why NGOs may be a useful source of relevant investment information is that they tend to spend time analysing and lobbying for changes to public policy. Consequently, NGOs may be a useful indicator of future public policy that could be material to company evaluation. Where NGO capital market intervention contributes to enhanced investment analysis, that intervention is legitimate because it helps to improve investment decisions and market efficiency (Zadek 1998; Waygood 2006).

Finally, while NGO capital market intervention may serve to improve investment analysis, there are circumstances in which it has been detrimental to a company’s share price. Although campaigns may represent a short-term financial burden for a company, this alone is not a sufficient reason to render the activity illegitimate. This is because companies benefit from the existence of the capital market, and the existence of any market depends, in part, upon society’s trust in order to maintain its own legitimacy. As Korten (1995) argues, an economic system can remain viable only so long as society has mechanisms to counter the abuses of either state or market power. Increased scrutiny by civil society has therefore been argued to serve an important function in enhancing market trust, contributing to the long-term viability of capital markets.

Historically, NGOs have relied on purchasing shares of corporations, engaging in shareholder activism using proxies and other strategies to pressure individual companies to change corporate behaviour. An example of this strategy are the tactics used by Friends of the Earth (FOE) with Exxon-Mobil in the early 1990s when FOE staff and supporters attended the annual Exxon shareholders meeting following the Exxon Valdez oil spill in 1989. At the meeting, FOE raised questions of the Chairman and Board of Directors on the failure of Exxon to exercise precaution in the transport of crude oil. At the 1990 Exxon shareholder meeting, FOE arranged for the filing of four shareholder resolutions to pressure Exxon to adopt better safety procedures and environmental practices. In total, the NGO was able to obtain proxies for over 400,000 shares from its membership and supporter base. FOE also worked in an unsuccessful effort to have former Senator Gaylord Nelson, founder of Earth Day placed on Exxon's Board. While in these cases, the positions of FOE were unsuccessful in changing the outcome of Exxon's policies, FOE's tactics did persuade other NGOs and shareholders to support their position, bringing unwelcomed public attention to Exxon's corporate practices.

NGOs have also sought influence by working directly with traditional SRI funds, serving as advisors and experts on ethical and social responsibility screens used to determine the composition of such funds. In this capacity, NGOs have engaged by providing advice, consultation and input for SRI funds and in some cases, including the Sierra Club, have sponsored funds, often focusing on a particular subset of SRI practices.

More recent developments, however, suggest a shift in the strategies of NGOs. NGOs are increasingly using their status to urge institutional shareholders such as large public employee pension and retirement funds to pressure change in corporate governance and conduct. In this way, NGO advocacy efforts have increasingly focused on scrutinizing the practices of

institutional investors, pressing these investors to engage in more socially responsible investing. NGO direct and interactive influences include ad-hoc campaigns which rely on ‘naming and shaming’ of pension funds with holdings in target companies. Direct lobbying and media campaigns have also focused on influencing pension scheme beneficiaries (most notably trade unions and professional bodies).

The most significant recent development in NGO campaigning is, however, the emergence of formal partnerships with institutional investors. This represents a notable shift in tone from adversary to partner as partnerships seek-out common interests. NGOs have increasingly altered the tone of their campaigns to one which is firmly couched in the materiality discourse, arguing that a concern for environmental and social performance is a requirement of institutional investor’s long-term fiduciary responsibilities and that considering ESG issues results in enhanced investment analysis and proactive measures to address long-term systemic market failures. Symptomatic of the change in strategy, was a 2002 report by Ceres (preceding the launch of the Investor Network on Climate Risk) that concluded that U.S. company directors and institutional investors face a growing financial and legal risk that global climate change will adversely affect the value of the assets for which they have fiduciary responsibility. While climate change is an extraordinarily complex issue, this report’s message to U.S. corporate directors and institutional investors is straightforward: failure to assess the risks of climate change for one’s company or investment portfolio would not only be imprudent, it could represent a significant breach of fiduciary responsibility and carry potentially serious legal liabilities (Ceres 2002).

Examples of formal partnerships between NGOs and institutional investors include the aforementioned INCR (launched by Ceres) and the Carbon Disclosure Project that focus on

climate change-related risks and company disclosure. More targeted partnerships include WWF and Insight Investment working together to benchmark the U.K. house-building sector's performance on sustainable homes; Flora and Fauna International working with Aviva Investors, F&C, Insight Investment, Pax World and other institutional investors on the Natural Value Initiative, which seeks to benchmark the food production, processing and distribution sectors' performance on biodiversity issues; Co-operative Insurance Society (CIS) working with Forum for the Future to identify the financial benefits of sustainable investment in their 'Sustainable Pays' report; and Transparency International working with F&C on bribery and corruption issues. When done successfully, the NGO receives the influence, corporate access, authority, resources and financial support of the investor. In turn, the institutional investor receives improved access to policy expertise, research resources and better-on-the-ground corporate performance information.

Stakeholder pressures from beneficiaries

Related to stakeholder pressures from NGOs, beneficiary pressures have evolved to focus on 'CSR' issues so that institutional investors are increasingly cognizant of their own social license to operate and brand/reputation. Institutional investors and pension funds, in particular, operate simultaneously on the capital market, the acquisition market and the labour market. They also operate on what has been referred to as the "market of social acceptance." (Weber 2008) This is the market on which schemes receive their social mandate through the trade in reputation and 'license to operate' defined as the perceived legitimacy of the scheme in offering services in general, and to their participants in particular. Ultimately, the legitimacy of a pension fund lies in its ability to serve the interests of the beneficiaries. Maintaining a 'social license to operate' has become an important element in the daily management of many companies – in particular the

mining and extractives industries – who are concerned with anticipating the needs of customers, workers and local communities.

While pension funds do not have to respond to all of society's demands, they appear to be sensitive to broader trends and norms that define socially responsible standards of behaviour. Of particular importance has been the broader trend of increased pressure for greater accountability - of corporations and its primary beneficiaries, its investors - for the environmental and social impacts of its operations not just from stakeholders but also scheme beneficiaries. By implication, just as the boundaries of what constitutes responsible corporate conduct have been challenged by the corporate social responsibility movement, institutional investors - given their dominant role in financial markets and role in representing beneficiaries - are also tuned into these normative conditions in their institutional environments and debates as to what is considered legitimate and appropriate conduct.

National opinion data in the U.K. suggests that 75 percent of the public prefer their pension fund to consider environmental, ethical, social and governance performance in a way which does not put any risk on the investment performance (USS 2003). As public opinion has shifted to put greater emphasis on sustainable development, the image and reputation of a pension scheme in relation to these trends have come under increasing pressure such that being perceived as a 'responsible' investor has become a central driver behind the growth of responsible investment among pension funds and other institutional investors. While these motivational drivers appear to be increasingly common across institutional investors and pension schemes as a whole, they manifest themselves in different ways. Indeed, it is important to distinguish between the pressures public and private institutional investors face.

Public institutional investors are governed by a board of trustees and receive their investment capital by means of primarily mandatory contributions. While governance channels exist in cases where beneficiaries of the scheme are dissatisfied with the performance of the board, beneficiaries cannot – in general – withdraw their investment capital. Therefore, inherent to their organisational structure, public institutional investors are concerned not with competitive pressures but rather driven by a need for social legitimacy and being seen to reflect the interests and beliefs of its beneficiaries.

Private institutional investors, rather, are represented by management and actively compete to attract investment capital. Beneficiaries of private institutional investors are free to remove and relocate their investment capital though sometimes facing minimal penalties for doing so. Private institutional investors do not benefit from mandated contributions and must therefore attract and retain investment capital. As such, these funds are primarily motivated by competitive concerns. In addition to the financial performance of the fund, private institutional investors will seek to differentiate themselves from their competitors. As customer preferences change, these private funds will seek to adapt their strategies to keep pace or may even pursue strategies in attempt to influence customer interests or reap first-mover advantages.

The centrality of reputational risks and influence of broader societal norms to understanding the emergence of responsible investment is confirmed in several industry surveys. The predominant response is that the most important consideration for schemes in involving environmental and social factors in the investment process is the connection with corporate governance policies and the belief that attention for responsible investment enhances a scheme's 'reputation.' (Dutch Association of Industry-wide Pension Funds 2008) Surveys of the U.K., France, the Netherlands, Germany, Switzerland and Italian markets have indicated more than 70 percent of respondents

consider public opinion to be the most important factor driving responsible investment (Allianz Global Investors 2010). The results of these surveys show the perception that image/reputation as a ‘responsible asset owner’ is the number one driver. Political and beneficiary pressures are also listed as important factors, again linked to the reputation of the asset owner (Eurosif 2009).

Remarkably, the group of pension funds responding to these surveys citing the importance of responsible investment as improving risk/return profiles is relatively small. Only one-fifth of pension funds in a Dutch national survey, for example, referenced financial considerations for shaping their opinions on the value of responsible investment. Against the background of common arguments for the consideration of ESG issues as a means of improving risk/return as a component of fiduciary responsibility, this finding is at least remarkable. Rather, these results suggest the adoption of responsible investment strategies are influenced by a response to direct stakeholder pressures (and the perceived threat to the reputation of the investor) as well by what is perceived to be legitimate and acceptably by actors in the investor’s relevant institutional environments.

What is driving the growth of Responsible Investment among institutional investors?

Referring back to the primary research question of what has motivated institutional investors to adopt responsible investment practices and publicly commit to the PRI, at first glance, a review of motivations publicly cited by institutional investors appears to fit neatly with the business school functionalist explanation. These explanations suggest firms adopt beyond-compliance measures and responsible investment practices due to the strategic and economic benefits of integrating ESG issues into their corporate practices. In the case of responsible investment, institutional investors have primarily marketed the ‘business case’ for integrating ESG issues

into investment decisions, referring to the materiality of corporate ESG issues on financial performance. Although doing so is said to provide tangential benefits for society, the primary impetus for investor adoption of responsible investment practices is cited as a component of their direct risk management strategies in seeking to improve the risk/return characteristics of investments. However, purely financial cost/benefit explanations based on the belief of improved investment returns are less persuasive in light of further analysis of the broader influences driving the growth of responsible investment among institutional investors. Findings suggest investor behaviour is shaped by responses to formal pressures from other organisations and by conformity to normative standards established by actors in their institutional environments. Regulatory and stakeholder pressures in particular shape investor perceptions of what constitutes legitimate or ‘responsible’ behaviour vis-à-vis their interactions with the environment.

Although not mandating the inclusion of ESG issues into investment decision-making by institutional investors, disclosure-based legislation suggests firms may be motivated to adopt responsible investment practices as a strategy for avoiding additional or more intrusive regulation in the future. By engaging proactively, investors participating in the PRI can be understood as an effort on the part of some to mitigate the risk of future regulatory intervention or as a strategy of influencing the evolution of future legal norms.

In addition to regulatory influence, stakeholder pressures have resulted in increased scrutiny of the environmental impact and social responsibility of institutional investor behaviour. A review of efforts by NGOs and the increase in capital market campaigning indicates that reputational risks have been central – yet not sufficiently recognized – to understanding the adoption of responsible investment strategies and public commitments to the PRI. Broadly, reputational risks in relation to the consideration of ESG issues by institutional investors are a function of

stakeholder pressures on institutional investors to adopt an investment approach that is more aligned with broader societal interests. Increasingly, institutional investors are subject to pressures from external stakeholders (namely NGOs but also beneficiaries) as well as broader norms of what constitutes legitimate and socially acceptable behaviour. Not only do institutional investors appear concerned about ESG issues in terms of the potential financial or reputational risks to companies held within their portfolio, but the preceding analysis would suggest it represents a response to pressures vis-à-vis the reputation of the investor.

First, pressures from NGOs on issues broadly captured under the heading of ‘CSR’ have been extended to financial institutions via direct advocacy campaigns. While pressure historically focused more on banks and project finance in particular, given their growing size and influence, institutional investors have increasingly come under scrutiny in terms of the indirect environmental and social impacts of their investments. A significant development has been the emergence of several multi-stakeholder initiatives and formal partnerships which seek out ‘synergies’ between civil society organisation agendas and institutional investors. These partnerships range from ad-hoc arrangements for the purposes of information sharing and the production of research reports and benchmarking studies to more enduring initiatives such as the Carbon Disclosure Project and Ceres’ INCR that seek to leverage institutional investor shareholder power for improved corporate disclosure and performance. NGO tactics have included ‘naming and shaming’ of pension funds that have significant holdings in targeted companies and media campaigns. While the impacts of individual campaigns vary, a common theme advocated has been that investors failing to account for issues such as climate change is not only imprudent and potentially misaligned with their beneficiary’s interests, but could

represent a significant breach of fiduciary responsibility, carrying potentially serious legal liabilities.

Second, and interrelated to the above trend, from an institutionalist perspective norms have evolved regarding what is perceived as legitimate and acceptable in an investor's institutional environment. Social expectations have evolved to focus on CSR issues alongside the traditional function of financial performance, presenting a reputational risk to the institutional investor. Of particular note has been the increase in references made by investors to protecting their own brand and maintaining their 'social license to operate.' As noted by the CEO of one institutional investor (and signatory to the PRI), "failure to integrate ESG will cost [your] license to operate in the next ten years." (Robeco 2009) This phenomenon is made apparent in several industry surveys that indicate increasing recognition of needing to be perceived as a 'responsible' asset owner or investment manager. Remarkably, the group of pension funds and investment managers responding to these surveys citing the importance of responsible investment as driven by the purely financial logic of the business case explanation is relatively small. Instead, the most important consideration for schemes in involving social and environmental factors in the investment process is the connection with internal corporate governance policies and the belief that attention for responsible investment enhances a scheme's reputation and aids in securing a firm's social license to operate.

While the forces influencing public and private institutional investors' license to operate differ to some degree, both have increasingly sought to manage potential reputational risks which may affect their competitiveness and perceived reputation. This suggests that, rather than being motivated solely by a market rationale, institutional investors may adopt responsible investment practices for primarily reputation and brand benefits as well as motivations to take preventative

action in response to emerging regulation on disclosure and evolving views of fiduciary responsibilities in relation to the incorporation of ESG issues into investment decision-making and ownership practices. These findings suggest institutional investors are influenced by pressures exerted by external stakeholders and are sensitive to external norms and values in their institutional environments that provide a sense of social legitimacy and positive reputation.

Summary

In considering the political and regulatory influences and the role of stakeholders and social factors in the growth of responsible investment, it is apparent that in operating in a complex and evolving environment, institutional investors are subject to external pressures and norms that challenge their cost/benefit calculations. Changing regulatory pressures and stakeholder expectations have increasingly induced institutional investors to consider environmental, social and governance issues. As apparent in the growth of investors committing to the PRI, these pressures have induced firms to publicly declare their commitments to integrate stakeholder concerns into their corporate practices. In this way, the PRI voluntary code of conduct primarily functions as a tool for maintaining or enhancing corporate reputation in an institutional environment where it is threatened. Adopting the PRI and thereby signalling an intention to conform to responsible investment 'best practices,' primarily reflects a strategic desire among institutional investors to maintain or acquire a positive reputation within their institutional environment.

The pre-dominant assumption of much of the empirical work on firm participation in voluntary initiatives has been that the decision and selection of corporate environmental practices is the result of a purely functional, market rationale. The business school explanation emphasizes

financial costs and benefits and the strategic and economic benefits (the business case) of corporate responsibility (Rivera 2004). A review of the factors behind the growth of responsible investment, however, indicates that this explanation is not wholly persuasive in understanding why institutional investors have adopted responsible investment practices. Rather, the research indicates that institutional investor decision-making regarding the integration of ESG issues and adoption of responsible investment practices are shaped by both responses to formal pressures by external stakeholders (state regulation and NGO campaigning activity) as well as broader social norms shaped by actors in the investor's institutional environments (articulated in the perceived beneficiary and societal expectations). Principally, regulatory and stakeholder influences have established normative standards directed towards the conduct of investors. These findings support complex market rationalism explanations that suggest firm participation should principally be seen as a response to pressures and demands from external stakeholders to conform to changing expectations of what is considered legitimate, appropriate or 'responsible' investor behaviour (Vogel 2008). As such, the decision to adopt the PRI and establish commitments to adopting investment decision-making processes and ownership practices deemed 'responsible' may be seen as embedded in broader reputational risk management strategies, grounded in a variety of strategic motivations to assure stakeholders that their concerns are being internalized into corporate practices. The next chapter will focus on the activities of PRI signatories to assess the extent to which these general findings related to responsible investment are valid in the case of the PRI.

Chapter 5 – Analyzing PRI signatory implementation

The preceding analysis indicates that the decision to adopt commitments regarding ‘responsible’ investment behaviour can largely be seen as embedded in broader reputational risk management strategies of the institutional investor. Concerning the growth of responsible investment and public commitment by institutional investors to PRI, research findings indicate that a variety of strategic motivations stemming from both direct and non-direct economic calculations have been influential in this development.

The growth of empirical research indicating the ‘materiality’ of ESG issues has strengthened the ‘business case’ for integrating ESG issues into investment decision-making processes. This suggests that the adoption of responsible investment practices and adoption of the PRI may be part of a firm’s direct risk management strategy, integrated into the firm’s core practices and directly motivated by corporate profitability.

The analysis here, however, indicates that strategic motivations flow from formal pressures from other organisations and by a desire to conform to normative standards established by actors in the firm’s institutional environment. In many jurisdictions, disclosure-based regulations have required pension funds to clarify the extent to which ESG issues are integrated. Adoption of the PRI may also be perceived as a form of preventative action, motivated to proactively respond to current or future regulatory trends.

Finally, the role of stakeholder pressures – most notably from NGOs and beneficiaries - have resulted in increased scrutiny of institutional investor behaviour resulting in greater concern on the part of investors for reputational risks. This suggests the PRI is adopted to protect a firm’s

reputation by assuring stakeholders that it operates responsibly. By publicly committing to the PRI, investors can signal commitment to concerns raised by different stakeholders seeking to increase its credibility and respond to changing public expectations of what constitutes legitimate or ‘responsible’ investor conduct. As well, in some cases, firms who have already adopted responsible investment practices may seek to reinforce their reputations or differentiate themselves from competitors by committing to the PRI.

Having established the general motivations for investor adoption of responsible investment practices, this chapter analyses publicly available data on PRI signatory implementation specifically. Assessing the aggregate responses of PRI signatories to the Reporting and Assessment survey enables a deeper understanding of the distributional characteristics of institutional investors that have publicly committed to integrating ESG issues into their investment decision-making process. Specifically, the extent to which institutional investors have internalized their commitments to the PRI code of conduct may point to differences in the institutional contexts within which a strategic decision takes place.

A lack of progress in areas considered core to integrating ESG issues into investment decision-making may indicate signatories are more interested in the benefits of affiliation with the positive brand reputation of the PRI and its UN affiliation than a meaningful commitment to radically alter behaviour that economic rationality explanations would suggest. Signatory results in the Reporting and Assessment process may be more of a reflection of the extent to which commitment to the PRI is used by institutional investors in corporate communications for reputation management, rather than strategically motivated by the business case and integrated into direct risk management practices.

PRI Reporting and Assessment survey data

All signatories who have been involved in the PRI for more than one year are required to complete the reporting and assessment exercise whereas more recent signatories are invited to do so voluntarily. Although completion of the exercise is, for some, a requirement, signatories are not required to disclose the outcome of their reports. The following qualitative and interpretative analysis has been organized along the core implementation areas of the PRI, employing publicly-available aggregate data from the 2009 PRI Report on Progress. For the 2009 Reporting and Assessment survey data analysed in this chapter, the data has been aggregated from 276 individual responses (124 Asset owners, 152 Investment managers) and made available by download from the PRI website.³ The 2009 Reporting and Assessment survey is the third annual reporting process which communicates signatory performance against approximately 100 questions.

Although individual PRI signatories receive a report benchmarking their progress relative to their peer group, this data is not publicly available. Signatories self-report in relation to predominantly qualitative indices (e.g. large extent, medium extent, etc.) suggesting the reliability and validity of the results may be weakened by the possibility of broad (mis)interpretation. As an internal control, the PRI Secretariat seeks to verify a proportion of the responses via phone interviews with signatories.⁴ During verification calls, the PRI Secretariat confirms any assumptions made by the signatory in their self-reporting. Although there a (potentially) significant methodological problems stemming from the self-reporting and qualitative nature of the survey, it remains the

³ Available at <http://www.unpri.org/reporting/result.php>

⁴ The PRI Secretariat reports having made verification calls with 100 PRI signatories in 2009.

only publicly available data set for interpreting the activities of signatories regarding their commitments to the PRI.

Governance, Policy and Strategy

In terms of governance measures adopted by PRI signatories, the vast majority of responding signatories report having a policy which explicitly addresses either responsible investment or ESG issues (87 percent of asset owners versus 84 percent of investment managers)(Q5⁵). As well, approximately 86 percent of signatories (90 percent of asset owners and 84 percent of investment managers) have taken steps ‘to at least some extent’ in translating the policy into a plan of action as reflected in business planning, strategic planning or similar internal management processes (Q10)(Figure 3).

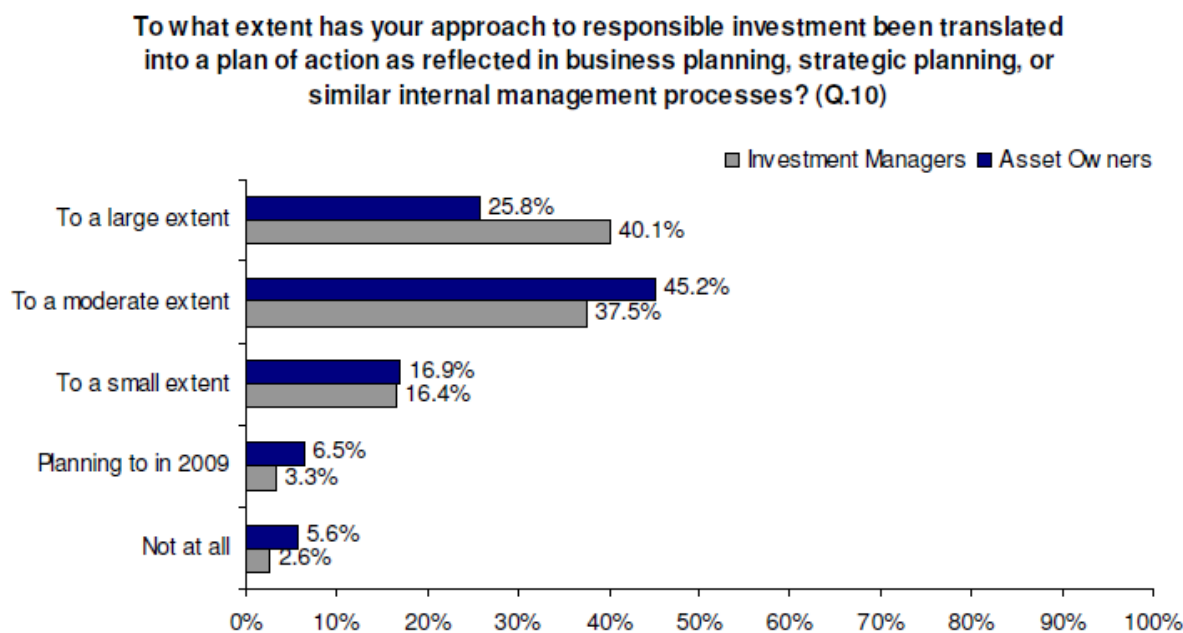


Figure 3 – Translating responsible investment into action

⁵ This refers to the question numbering as it appears in the 2009 Reporting and Assessment Survey. The full survey is available at: http://www.unpri.org/files/20100218_Offline%20Survey.pdf

When considering those that have done so ‘to a large extent’ however, the figure drops to only 25.8 percent of asset owners and 40.1 percent of investment managers suggesting the broader majority are only in the initial stages of doing so. Governance structure is also an interesting feature to look at, the asset owners were much more likely (2/3 of respondents) to have board responsibility for responsible investment whereas 1/3 of investment managers have board of directors involved in the oversight of responsible investment activities (Q11).

Integration of ESG issues by PRI signatories

PRI signatories are most likely to have a policy that makes specific reference to the incorporation of ESG issues into investment analysis and decision-making processes (Q6). Across asset classes, signatories report the highest degree of integration in listed equities with 89 percent and 94 percent of investment managers reporting they integrate RI/ESG issues in developed markets and 79 percent/84 percent for emerging markets (Q23). Signatories also report a high degree of integration in infrastructure assets (76 percent of asset owners and 62 percent of investment managers) where more established methodologies often draw from project finance standards relating to ESG. Notably, signatories report less progress in the area of fixed income assets where a higher degree of integration is reported for corporate issuers (59 percent of asset owners and 62 percent of investment managers) versus non-corporate issuers including sovereign debt. While signatories indicate the greatest progress towards integrating ESG issues in the area of listed equities, on the whole, signatories report integrating ESG issues across approximately 55 percent of their asset allocation (including listed equities, fixed income, private equity, listed and non-listed real estate or property and infrastructure).

Also apparent from the 2009 Reporting and Assessment report is that although signatories to the PRI have grown significantly, within the context of capital market integration, total assets subject to integration by PRI signatories are still relatively small versus total market capitalisations (figure 4).

Asset Class	Assets subject to integration via PRI signatories (US\$ in trillions)	Total market size (US\$ in trillions)	Share of total market subject to integration by PRI signatories (%)
Listed equities, developed markets	1.29	27.2	5
Listed equities, emerging markets	0.17	5.4	3
Fixed income, excl corporate	0.67	22.9 ^(a)	3
Fixed income, corporate	0.77	6.2 ^(b)	12
Listed real estate	0.06	0.4	15
Unlisted real estate	0.19	10.0 ^(c)	2
Private equity	0.12	2.5 ^(d)	5
Hedge funds	0.06	1.5 ^(e)	4
Infrastructure	0.04	18.9 ^(f)	<1

(a) Sovereign plus quasi-sovereign

(b) Corporate plus high yield but excluding asset-backed

(c) Real estate currently owned by professional investors for an investment purpose. Inclusion of assets that are currently owner-occupied but which may in time become institutionally-owned raises the total to US\$16 trillion. Figures are as at December 2006.

(d) Overall assets under management by private equity firms including an estimated US\$1 trillion in funds raised but not yet deployed.

(e) A similar figure (\$1.4 trillion) was provided by Bank of New York Mellon Casey Quirk

(f) Estimated total stock of infrastructure assets, including assets in public ownership.

Sources

Listed equities, developed and emerging markets: World Federation of Exchanges

Fixed income: Bank of America Merrill Lynch Bond Index Almanac

Listed real estate: FTSE EPRA/NAIRET Global Real Estate Index

Unlisted real estate, private equity and infrastructure: RREEF

Hedge funds: Deutsche Bank 2009 Alternative Investment Survey

Figure 4 – ESG integration by PRI signatories relative to total market size

Shareholder engagement on ESG disclosure and collaborative engagement

Critical to the development of responsible investment strategies are signatory/investee company relations that generate supply and demand pressures for disclosure of ESG information. In terms of what investors are asking companies from an ESG reporting and disclosure perspective, the Reporting and Assessment process asks whether signatories are requesting disclosures be made in their financial reports, have a stand-alone CSR report, or use the GRI reporting framework or Carbon Disclosure Project (Q62). Twenty-three percent of asset owners report having ‘asked investee companies to produce standardized reporting on their RI/ESG issue policies, practices

or performance’ to a large extent whereas 26 percent have not done so at all. Nine percent of asset owners ‘have provided feedback to investee companies on their reporting on RI/ESG issues’ to a large extent whereas 35 percent have not done so at all. The distribution of responses indicates investors are not demanding the disclosure of ESG issues by investee companies in any one common form. This result suggests investors are more interested in accessing this information in whatever form possible, but also that mixed signals are coming from investors in their relationships with investee companies.

Although signatory engagement policies that direct engagements most commonly include expectations of companies with regards to corporate governance issues (49.2 percent of asset owners and 36.2 percent of investment managers), a slightly smaller proportion of signatories also include expectations with regards to environmental issues (44.4 percent of asset owners and 33.6 percent of investment managers (Q56).

On questions surrounding investor policies and practices towards collaborative engagements, 30 percent of asset owner signatories joined a collaborative engagement organized via the PRI Engagement Clearinghouse, an online portal for signatories. Additionally, the majority of signatories report participating in collaborative industry initiatives, with the most prominent initiative being the Carbon Disclosure Project, followed by the Institutional Investors Group on Climate Change (IIGCC) with a smaller proportion (approximately 23.8 percent) participating in the Ceres-led Investor Network on Climate Risk (INCR) (Q80).

Internalizing responsible investment strategies

Analyzing responses to Principle 4 (‘We will promote acceptance and implementation of the Principles within the investment industry’) is interesting as the questions analyze how signatories

are integrating responsible investment and requirements to consider ESG issues in their contractual relationships and incentive structures (Q67). A key issue discussed in the drafting of the Principles was that by being asset-owner driven, the PRI is meant to harness the power of asset owners in the investment supply chain. For those pension funds or investment advisors who use sub-advisors (external managers), approximately 30 percent of asset owners report including RI/ESG elements in contractual relations some of the time, whereas 37.5 percent of asset owners and 49.1 percent investment managers report no efforts taken in this regard.

Looking at Principle 2 regarding engagement, asset owners are more likely to outsource their engagement activities either to their investment managers or to a third-party engagement overlay provider. This is an interesting response when considering which parties are actually involved in engaging with companies on environmental, social and governance issues as asset owners are less-likely to do it themselves. To the extent signatories are assessing the ESG engagement activities of their external investment managers, 12.3 percent of asset owners report doing so to a large extent and 40.4 percent to a moderate extent while 12.3 percent report taking no such action at all (Q54). Similar distributions are found with regards to the number of signatories considering the capabilities of external investment managers to engage with companies on ESG issues when searching for, selecting and retaining investment managers. 29.3 percent of asset owners reporting doing so for all of their external managers, while 24.1 percent reporting do so for less than half of their managers and 34.4 percent do not currently address these issues (Q55).

Finally, apart from inclusion in contractual relationships, signatories also report on the extent to which they have internalized their responsible investment policies and practices in incentive structures for both internally and externally-managed investments. 73.3 percent of asset owners and 56.5 percent of investment managers report not including RI/ESG elements in incentive

structures for internally managed funds (Q67) (Figure 5). This figure grows to 87.7 percent of asset owners and 77.2 percent of investment managers when asked whether RI/ESG elements are included in externally-managed incentive structures (Q67) (Figure 6).

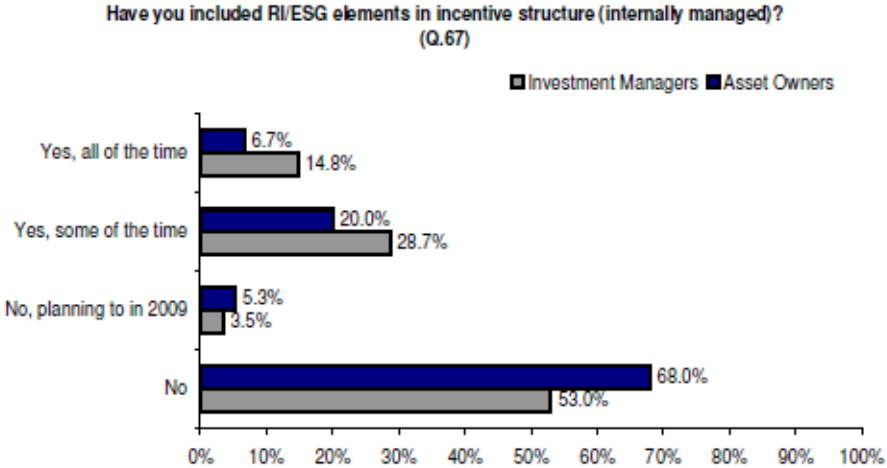


Figure 5 – Inclusion of RI/ESG elements in internally-managed incentive structures

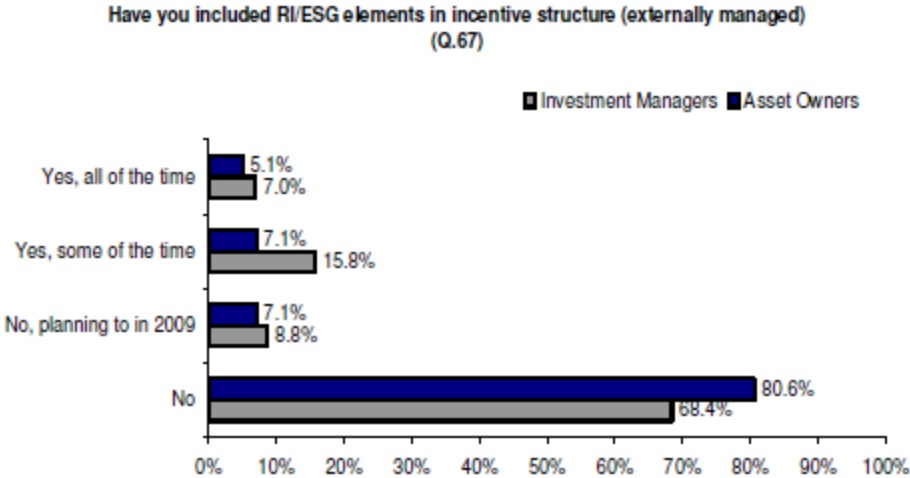


Figure 6 – Inclusion of RI/ESG elements in externally-managed incentive structures

In committing to the PRI, asset owners are meant to include RI/ESG issues in their contractual agreements and incentive structures thus providing market pressure or a commercial component

to get investors to adopt responsible investment practices. Results suggest, however, this has yet to materialize in a significant manner across the signatory base.

Investor reporting on responsible investment activities

With regards to investor reporting on responsible investment practices, Principle 6 assessment results indicate that 20 percent are publicly disclosing their Reporting and Assessment results. While the absolute numbers of signatories publicly disclosing has increased over time, in relative terms this proportion has declined. Perhaps most interesting, however, is the data concerning the use of RI performance metrics and what steps signatories have taken to measure the impact of responsible investment activities on their financial performance. Only 13 percent of asset owners have sought to determine what impact their RI/ESG issue related approach has had on the performance of their portfolio (Q91) to a large extent, whereas 38 percent have not done so at all. Furthermore, only 5 percent have sought (36 percent have not) to determine what impacts their RI/ESG issue related efforts, requests, and guidance have had on the consideration of RI/ESG issues by their external investment managers (Q92).

Leaders and Laggards amongst PRI signatory base

A clear trend in PRI implementation is visible within the Reporting and Assessment results. The PRI has been successful at attracting numerous asset owners to become signatories, yet not all signatories interpret their commitment and act on the principles in the same manner. It would appear that a significant minority of asset owners have fully internalized responsible investment strategies and rendered the strategies actionable (or taken steps towards such). The remaining majority of signatories have as of yet, not demonstrated progress to suggest they are acting on their commitments in a meaningful manner. This finding indicates differing levels of firm

adoption suggesting that institutional investors do not necessarily experience or perceive pressures from external institutions and stakeholders in the same manner.

Furthermore, Reporting and Assessment survey results suggest a link between disclosure-based regulation and PRI adoption. A review of signatories finds that of the 44 countries represented by PRI signatories, nearly 67 percent of signatories are based in one of thirteen countries with current or expected regulations requiring disclosure of whether a fund has a policy which references responsible investment or ESG issues. These observations suggest that a large majority of PRI signatories are headquartered in countries with disclosure-based regulation. It suggests that the higher rate of adoption among these investors versus other regions illustrates how codes of conduct primarily function as tools for maintaining or enhancing corporate reputation in institutional environments where it is highlighted and/or threatened. Where these pressures are weaker or non-existent, the strategic motivations for adopting the PRI are reduced.

The PRI has strongest market penetration in countries where disclosure-based regulation has raised the profile of responsible investment, however, this has not necessarily equated to better performance in the PRI Reporting and Assessment survey. For example, while U.K. signatories recorded higher scores than their peers from other regions, Australian scores for each Principle were lower (on-average) than any other developed country suggesting despite regulation, a significant proportion of signatories had not yet developed their implementation to the level observed on average amongst other regions.

Leaders

A review of Report and Assessment results suggests that a minority of signatories have taken action to internalize their commitment to the PRI, having reported a high degree of

implementation of responsible investment-related practices. This suggests that this minority appear to be motivated to join the PRI and publicly commit to adopting responsible investment practices as a function of their direct risk management strategies, demonstrating real progress via the Report and Assessment survey that suggests responsible investment is viewed as strategic components in ensuring long-term value creation and assuring stakeholders. Although difficult to confirm due to the limitations of the data set, some research has also shown that early adopters of new voluntary codes of conduct are typically those firms that already have the most advanced policies and procedures. Though speculative, this may indicate that the proactive institutional investors seek to reinforce their reputations through participation in the PRI.

In addition to reputational benefits derived from affiliation with the UN-backed initiative, these funds are also motivated to adopt the PRI and participate in its networking activities as an opportunity to refine their investment strategies in a collaborative manner thereby reducing agency costs. The PRI, for these signatories, provides a framework for benchmarking assistance towards achieving their corporate strategy. While it is unclear to what extent other motivations influence their decision-making due to the aggregate nature of the data set, it appears that these investors have internalized the basic tenets of responsible investment - that ESG issues can be material and that consideration of these issues is consistent with their fiduciary responsibilities to beneficiaries. Their decision to publicly commit to the PRI and subsequently make the commitment actionable would suggest their motivation is more closely tied to direct economic calculations rather than solely a communications or public relations strategy.

Laggards

For the broader majority of signatory responses, institutional investors have indicated a willingness to commit to the Principles but have not shown sufficient progress to suggest motivation is a function of their direct risk management strategies. These ‘underperforming’ signatories appear to interpret initial commitment as a primary means of assuring stakeholders that it operates responsibly and do not appear to interpret pressures as significant enough so as to warrant more meaningful action.

Of this group of signatories, many indicate first steps taken towards implementing the principles, including the establishment of policies referencing responsible investment and ESG issues. As far as additional measures, however, results suggest these signatories have made fewer efforts to develop a strategy or plan of action for implementation. Most significantly, a broad majority of signatories have taken no steps towards including RI/ESG elements in contractual relationships or incentive structures and have demonstrated no action towards understanding the link between their responsible investment practices and the financial performance of their portfolios. Commitment therefore seems to be first and foremost about being perceived as a responsible asset owner or investment manager rather than fully internalizing responsible investment practices. This majority, then, appears to derive benefit from signing the PRI primarily in terms of brand/reputational benefits in essence free-riding off the efforts of the minority of signatories. This broader majority benefits from the PRI in terms of access to competitive information regarding responsible investment strategies of other signatories and a degree of social legitimacy provided by the UN-affiliated voluntary initiative.

Just as investors have shown increasing concern about the reputational risks their investee companies face, the social license to operate has become an important element in the risk management practices of institutional investors. Pension funds and other institutional investors

appear to be sensitive to the broader trends and norms that define standards of behaviour. For the majority of signatories demonstrating little progress, attention to responsible investment and a commitment to the PRI appears to be firmly rooted in risk management strategies meant to preserve or enhance a scheme's reputation. Most public institutional investors, being motivated by a search for social legitimacy, will incrementally adopt new strategies and change their behaviour to the point at which they attain sufficient legitimacy. Likewise, private institutional investors are motivated by these same pressures in addition to competitive concerns and a search for distinguishing characteristics to differentiate themselves. The PRI, with its connection to the UN, provides legitimacy while imposing relatively low costs to adopters. It would appear that many institutional investors have concluded that professing their commitment to responsible investment by committing to the PRI makes business sense. Unlike those who have demonstrated taking action to internalize their responsible investment strategy, business sense for this broader majority has primarily centred on reputational risk management.

Summary

The data on signatory implementation from the 2009 Reporting and Assessment survey suggest a large majority of PRI signatories have not taken steps to integrate ESG issues/implement PRI principles/commitments in several key areas. Although a large majority of investors have developed policies and high-level strategy for incorporating ESG issues into investment decision-making processes, very few have taken more extensive measures to operationalise their commitment in contractual obligations and incentive schemes. This suggests that a large portion of PRI signatories do not currently view responsible investment as a component of core business practices. The seemingly cursory attention paid by this large group 'laggards' supports the findings of Chapter 4 that participating in the PRI is primarily a means of addressing stakeholder

concerns rather than direct risk management practices. However, Reporting and Assessment results suggest we cannot fully generalize across all PRI signatories as there appear to be a small minority that report significant progress and efforts made to internalize their commitments related to the PRI in their internal processes.

Chapter 6 – The effectiveness of the Principles for Responsible Investment

While the preceding chapters have focused on the strategic motivations of institutional investors to publicly commit to implementing the PRI principles and responsible investment practices, this chapter will reflect on whether the PRI, as a voluntary initiative, is likely to be effective at challenging investor behaviour and mainstreaming responsible investment. Although more speculative in nature given the short history of the initiative, the chapter draws on the broader literature on voluntary initiatives in general, focusing on the institutional design features that determine and impact its effectiveness. The following section provides a brief overview of common weaknesses of principles or codes-based voluntary initiatives before assessing the effectiveness of the PRI in greater detail.

Identified strengths and weaknesses of voluntary initiatives

Voluntary, self-regulation is said to provide greater flexibility with regards to adapting to new circumstances and their voluntary nature is said to provide greater potential in bringing more sceptical firms into the process of committing to certain standards. Due to the non-binding nature of these codes, the barriers for accession to the code may be lower for individual firms. Once a firm has become party to a code, proponents argue that there is potential for changes to corporate behaviour as a result of processes of social learning (Ruggie 2002). By providing a forum for the sharing and exchange of knowledge and ‘best practices,’ it is argued that voluntary initiatives can result in these practices becoming commonly accepted norms for a broader range of firms. Additionally, by committing to a voluntary code of conduct, firms subject themselves to peer pressure and greater scrutiny by stakeholders. Such external processes are argued to provide a

measure of accountability, such that codes may take on an important role in either supplementing or preceding public regulation (Haufler 2001).

Critics of principle-based codes of conduct, however, identify several common weaknesses that can severely limit the effectiveness of voluntary measures. More sustained critiques have gone so far as to label voluntary initiatives as ‘greenwashing’ exercises, of a mainly symbolic character that are otherwise of little significance in improving the environmental and social performance of firms (Greer and Bruno 1997). Together, the weaknesses identified in several studies have important implications for the legitimacy and accountability of voluntary initiatives (Backstrand 2005).

Insufficient implementation measures and a lack of specific guidance on how individual commitments will be put into practice has shown to be a general weakness of voluntary measures across several industries and issue areas (Bondy, Matten and Moon 2004). Vague wording and a lack of guidance may provide for a broad range of interpretations, lessening the impact of efforts to standardize behaviour. Related to this, Clapp and Thistlewaite (forthcoming) argue a common feature of voluntary initiatives, and the GRI specifically, is the prioritisation of cost-saving measures over longer-term measures that address structural factors or indirect benefits. Finally, by focusing on process-related outcomes or the standardization of policies and procedures, critics argue that many voluntary initiatives do very little to target actual environmental performance (Backstrand 2005). Lacking performance-based benchmarks or thresholds as a component of participation, many voluntary measures permit firms to join without having shown any real effort beyond committing to continual improvement and refinement of processes and management systems. A concern for procedural aspects also complicates the task of assessing the performance of a voluntary initiative where no concrete environmental targets are provided.

The most common critique levelled against voluntary initiatives, however, are deficiencies in transparency, monitoring and enforcement mechanisms that provide for weak accountability of participating institutions (Utting 2002; Clapp 2005). Importantly – given the relationship to the PRI and similar approach to enforcement and accountability mechanisms - these critiques have been levelled against the UN Global Compact. Drawing from the literature, a voluntary initiative is more likely to be effective when its design includes an auditing, disclosure and sanctioning component aimed at enforcing compliance with the standard (Prakash and Potoski 2006). When all are present, a voluntary initiative is more likely to curb shirking because together they provide a monitoring mechanism; provisions for increased transparency that can mitigate information asymmetries between participants and stakeholders; and, thirdly, create a mechanism for the sanctioning of non-compliant firms. Auld, Bernstein and Cashore (2008) found that when specific environmental standards, third-party oversight and sanctioning are absent, firm support does not tend to equate with on-the-ground changes in practices. Additionally, Prakash and Potoski's research (2006) suggests that policymakers and stakeholders should be sceptical of voluntary programs without any monitoring and enforcement rules as it can be expected that such programs will exhibit high levels of shirking and therefore be expected to generate very small positive externalities.

Given the issues raised in a number of studies, previous methods of evaluating governance quality have been based largely upon input/output legitimacy (see Backstrand 2005). Input legitimacy refers to the participatory quality of the decision-making process and issues of transparency, representativeness and accountability. Output legitimacy relates to the problem-solving capacities of the voluntary initiative and whether the mode of governance is effective. Importantly, although the two are interrelated, high output legitimacy in terms of effective

collective problem solving can compensate for low input legitimacy. Alternatively, a lack of output legitimacy often suggests the need for greater input legitimacy in terms of transparency and accountability processes.

Institutional design and the effectiveness of the PRI

The PRI has been very successful to-date in attracting institutional investors and fund managers to commit to implementing the principles in that in its current design, firms incur relatively low costs of adoption. Additionally, Reporting and Assessment results indicate the PRI Engagement Clearinghouse has been effective in generating greater support for signatory-led shareholder engagements. As an example, a PRI collaborative engagement pressuring companies to join the UN Global Compact resulted in approximately one hundred new firm commitments to the code of conduct. Additionally, a related engagement resulted in approximately 1/3 of non-responsive signatories fulfilling their reporting requirements in the Global Compact (PRI Report on Progress 2009). Relatively vague and aspirational language, however, which forms the basis of the PRI voluntary set of principles produce what Prakash and Potoski (2006) term a 'lenient standard.' Investors are able to adopt the principles, signalling to stakeholders their commitment to responsible investment while incurring low costs of adoption given the lacking performance standards and non-prescriptive 'possible actions' that allow signatories to selectively implement responsible investment practices. Signatories are able to benefit from affiliation with the initiative's positive brand reputation and legitimacy provided by UN affiliation with no real requirements to alter their behaviour. From the perspective of attracting participants, this characteristic has been fundamental to the widespread adoption of the PRI. Importantly, however, this trait may prevent the PRI from providing clear guidance to institutional investors and limit the ability of the PRI to act as a meaningful governance mechanism to significantly

improve investor practices regarding the integration of corporate environmental and social performance into investment decision-making.

The PRI appears, however, to have replicated in many ways existing regulation and its associated shortcomings. A noted shortcoming of disclosure-based state regulation is the lack of a clear and common definition of what constitutes ‘responsible’ investing or ESG integration. Indeed, it is rare that the term responsible investment be explicitly defined by those who have built product and service offerings around the concept in the financial services industry (Sethi 2005). While an objective of the PRI was to provide a global standard based on best practices from which responsible investment could be mainstreamed, the PRI has, to-date, not explicitly defined responsible investment, instead opting for the current framework which provides process-oriented principles with no prescriptive or performance-based thresholds. The PRI, however, has been successful in legitimizing the term ESG and distinguishing its brand of responsible investment from the terms SRI or ethical investment which imply a subordination of financial returns in favour of ethical or broader stakeholder considerations. With such a large number of signatories, including some of the world’s largest pension funds and mainstream investment managers, the term ESG and concept of responsible investment has gained increasing cognitive legitimacy in mainstream finance (Hudson 2006). The term ‘ESG’ has been promoted – though vaguely defined – as an investment strategy which is directly related to long-term financial value. As written in the Principles themselves, the focus is on institutional investors behaving as more active owners through engagement rather than divestment and considering ESG issues - where ‘material’- in the investment decision-making process. Again, a shortcoming of this approach is that what constitutes both active ownership and ESG integration has not been explicitly defined and remains open to significant interpretation by signatories.

When compared to disclosure regulations in various jurisdictions, the PRI has, for the most part, replicated the shortcomings of these measures by not, as of yet, seeking to provide a standard definition and classification of responsible investment and ESG integration. Furthermore the Principles do not require particular behaviour from signatories or prescribe how pension funds and other institutional investors are to integrate environmental or social issues into their investments. Although the 35 ‘possible actions’ related to the six principles provide some guidance, the PRI Secretariat has emphasized that these actions are not necessarily required for all signatories. This has left signatories with a high degree of discretion in defining their investment approach as consistent with the PRI.

A second noted shortcoming of disclosure-based state regulation is its failure to demand that investors report on which ethical or ESG criteria they include in their responsible investment policies and how these issues may be expected to affect the financial performance of the fund. Again, the PRI is limited in this regard, asking only for disclosure as to whether the investor has a policy or set of policies that make specific reference to responsible investment and if so, whether it covers environmental, social or governance issues. The PRI does not ask signatories to commit to reporting which ESG issues are included or what the methodology behind integration is. Among the list of conceivable actions for Principle 1 which addresses integration, there are no stated expectations that investors actually incorporate environmental or social factors into their ultimate portfolio construction (Richardson 2009).

With regards to measuring the impact of the voluntary initiative and effectiveness of the PRI in radically challenging and reorienting investment practices, it is uncertain whether the PRI represents a viable governance mechanism to promote the institutionalisation of responsible investment. As the initiative was launched in 2006, it is unclear that the PRI has delivered any

measurable improvement in the mainstreaming of institutional investor activism on ESG issues beyond what would have occurred as a result of existing disclosure-based state regulations. This uncertainty is a direct result of weak accountability mechanisms which raise significant concerns regarding the extent to which the majority of signatories are implementing their commitments.

Enforcement and accountability mechanisms

As mentioned above, apart from considering the stringency of voluntary standards in determining their likely effectiveness, a key insight of the literature on the effectiveness of voluntary initiatives is that their efficacy can be undermined by free rider problems (Gibson 1999). In turn, the effectiveness of the PRI, which represents an attempt at industry self-regulation, is also contingent upon the nature of the monitoring and compliance mechanisms brought to bear on non-compliant firms.

A major problem that voluntary initiatives face is that firms can commit to a voluntary code of conduct but fail to comply with – or show progress towards – its requirements. An indication of the problems the PRI faces in this regard are apparent in the experiences of one signatory, the United Nations Joint Staff Pension Fund (UNJSPF). A founding signatory to the PRI, with approximately US\$28 billion in assets under management, UNJSPF currently allocates no capital to investment products termed ‘responsible’ or ‘sustainable.’ (Kiernan 2009) In the two years following signing and committing to the principles, the pension fund had not established a policy or set of policies that made specific reference to responsible investment or how specific environmental, social and governance issues were to be integrated into investment decision-making and ownership practices (Principle 1). Nearly three years after signing, the fund finally began the process of establishing a policy on responsible investment and defining an

implementation strategy. Only in January 2010 was it reported that the UNJSPF was requesting a budget to hire a consultant to help implement a responsible investment program (after funding for a dedicated internal investment officer for responsible investment was rejected by the UN general assembly) (Responsible Investor 2010). A lingering problem, therefore, is that institutional investors like UNJSPF can become a signatory to the ‘aspirational’ principles without first demonstrating that they meet specific performance thresholds or progress benchmarks in subsequent years. The UNJSPF experience is a compelling example which illustrates the gap between rhetoric (becoming a signatory and publicly committing) and reality in ensuring that those who make a commitment are actually taking actions towards translating them into changes in investment practices. While a high-profile example given the UN-linkages, it is unlikely that this experience is unique to UNJSPF and it is reasonable to conclude based on Reporting and Assessment results that many other signatories have similar experiences.

One outcome of the most recent (2009) PRI Reporting and Assessment process was the delisting of five signatories who failed to respond to the survey on their implementation of the Principles. Although the five signatories delisted are unlikely to make headlines given their small size, several critics who in the past had raised concerns with the PRI, noted it as a significant step forward in demonstrating that there are consequences to treating the PRI as nothing but a brand enhancer (Financial Times 2009). However, it is important to consider that those who were delisted for not having completed the survey cited that the survey was too time-consuming, finding it difficult to allocate the necessary resources to complete it (ibid.) This raises a concern regarding whether the Reporting and Assessment process is biased towards larger institutional investors given the internal resources required to complete the survey. For smaller foundations

and endowments with very small staff numbers, the completion of the survey may be too cumbersome, even though they may be proactively working to implement the principles.

The Reporting and Assessment survey has been referenced as a measure to ensure the legitimacy and integrity of the PRI. However, the emphasis to-date has been to limit the burden and demands of the reporting process for signatories, to the detriment of it serving as an effective accountability mechanism. As a result, signatories self-report and are not required to publicly disclose their results. The soft-approach of the initiative to reporting and monitoring has been – it is argued by the PRI Secretariat – to encourage the perception of a low barrier of entry with an emphasis on encouraging processes of collaboration and ‘best practice learning.’ This has resulted in a voluntary initiative with weak enforcement mechanisms and no provisions for third-party auditing of signatory claims. For the PRI and other self-reporting initiatives that rely on the threat of reputational risk due to non-compliance, a lack of transparency prevents oversight by external parties from occurring and provides no enforcement mechanism or incentive for investors to take proactive measures.

While the constitution forming the PRI has in place a provision for the removal of signatories if the signatory ‘fails over successive years to progress towards the commitments outlined in the Principles,’ as yet, this has not been tested and there remains no transparent rules on how such a progress threshold may be determined or monitored. A key philosophy of the initiative is that more significant pressures to adopt and conform to the set of principles will be driven by market forces and the reputational risks of non-compliance (PRI 2007). As indicated in the previous chapter, being asset-owner driven, the PRI is meant to harness the power of pension funds and other institutional investors in the investment supply-chain, pressuring their fund managers and service providers to adopt consistent practices. However, PRI Reporting and Assessment results

indicate the majority of signatories are not including such requirements in their contractual relationships with third-parties or in incentive structures for internally and externally managed investments (PRI 2009). Another report has indicated that signatories pay little attention to the results of the survey or inquire as to efforts made by their service providers (Ethical Investor 2009).

The full impact of the market forces that the PRI is intended to harness have therefore been blunted by inaction and weak demand signals from asset owners. With regards to reputational risks signatories may face who are not complying, weak monitoring and a lack of transparency severely curtails the likelihood that signatories will face any reputational risks. As disclosure is not mandatory, the Reporting and Assessment process does not provide either clients and beneficiaries or external stakeholders with an opportunity to assess the actions taken by signatories. Because the PRI is designed to be voluntary and aspirational, it is limited in the tools it can resort to in challenging signatories to improve in these areas.

As indicated in the preceding section, weak input legitimacy in the PRI institutional design raises significant concerns regarding the likely effectiveness or output legitimacy of the initiative. The extent to which the PRI leads to the desired outcome of increased investor activism regarding ESG issues is still difficult to assess. Historical data on signatory implementation over time is still unavailable given the short history of the PRI. However, this research has identified a number of potential weaknesses with regards to procedural elements including a lack of transparency and accountability that suggest adverse selection and free riding are strong possibilities in the absence of more substantive enforcement mechanisms. This suggests the need for increased scepticism regarding short-term claims of the effectiveness of the PRI initiative and the long-term viability of the voluntary and aspirational design.

Recent developments that suggest a possible ‘ratcheting up’ of PRI standards

In a 2005 study, Utting points to the development of reforms that suggest an example of “ratcheting-up” of standards and a slight hardening of the soft volunteerism that characterized the early experiences of CSR, which centred on corporate self-regulation (Utting 2005). In light of these wider developments, it is important to consider the likelihood of the PRI reforming its current weak compliance procedures as the initiative evolves. Several recent developments suggest a gradual scaling-up of the PRI is more likely in the near term.

The PRI Secretariat announced in July 2009 that it will consult with signatories on a mandatory transparency framework to become part of the Reporting and Assessment process. In announcing this decision, the PRI Executive Director stated that “signatories should be sufficiently transparent to ensure their clients, customers, members and other stakeholders have a clear sense of their responsible investment processes, activities and capabilities.” (Financial Times 2009) Such a move suggests recognition on the part of those governing the PRI that the initiative has very rapidly become a successful brand image and that as discussed above, current measures may be unsuitable to protect the integrity and legitimacy of the initiative going forward. Although it is unclear what is precisely motivating this decision to move towards greater transparency, several factors may be influential.

A possible explanation is that this move could be a response to external stakeholder pressures – most notably from NGOs - for improved transparency of signatory results. Yet, to-date, there is limited evidence of a concerted effort by NGOs or other stakeholders to push for such action. One example surrounds Crédit Agricole, France’s largest bank and its advertising campaign identifying it as ‘the Green Bank.’ (Crédit Agricole 2010) Friends of the Earth called the

marketing push “the worse example of greenwash it had ever seen.” In response, FOE publicized a dossier on the bank’s activities in the fossil-fuel and defence industries and submitted it to the advertising standards board. Similarly, reports by BankTrack have argued that climate change and other environmental issues have influenced banks’ investment decisions only marginally, finding that banks with green reputations including Crédit Agricole, Standard Chartered of the U.K. and HSBC consistently finance environmentally destructive projects (BankTrack 2010). In response, to FOE, Crédit Agricole said the advertising campaign was “not simply an environmental notion” but was meant to highlight a broader change in the bank’s approach to business, focusing on more responsible and ethical practices, pointing out that it was a signatory the UN Principles for Responsible Investment and member of SRI index, FTSE4Good. This example illustrates how financial institutions and PRI signatories do face some scrutiny when advertising their green credentials. Still, there are limited cases both of NGOs scrutinizing the PRI as an initiative and more concerted campaigning from NGOs as in the case of BankTrack and the Equator Principles, or Corpwatch and the UN Global Compact.

Another possible explanation is that the PRI Secretariat and its governing board are responding to internal stakeholder pressures from signatories and the mainstream financial press. Several publicised comments from signatories would suggest dissatisfaction with the current lack of transparency regarding implementation by other signatories. In the 2008 Report on Progress, the PRI Secretariat recognized that some signatories have expressed a concern that other reporting signatories were over-estimating their degree of implementation and execution (PRI 2008). An article by the Financial Times in July 2009, titled “UN Principles need sharper teeth” also concluded that under the current design, the initiative did not provide adequate transparency from which investor behaviour could be scrutinized. Such deficiencies, it was argued, meant

some signatories lay themselves open to the charges of ‘greenwashing’ – the act of misleading consumers and stakeholders regarding the environmental practices of a company or the environmental benefits of a product or service. The CEO of VicSuper, a founding signatory, echoed these criticisms stated that “[he was] excited that a lot of funds have signed up to the UNPRI, but [he] think[s] the level of integration of these issues is probably pretty superficial.” (Ethical Investor 2009) These comments were confirmed in an independent study of Australian PRI signatories by Mercer Investment Consulting which concluded that currently only about one in ten Australian equity managers achieved an ESG rating of a “good standard,” while 56 percent were ranked as “less than adequate.” (Mercer 2009) In their report, Mercer assessed the investment managers’ ability to integrate ESG factors into the investment process based on the competences and skills of team members, their access to and use of appropriate data for evaluation of ESG risks and opportunities, and the extent to which these metrics are embedded into the generation of the performance over and above a benchmark index.

Such comments suggest increasing scrutiny of the currently weak monitoring and enforcement mechanisms from signatories themselves. The Chair of the PRI, Donald MacDonald reported in an interview that responding to suggestions by a small number of signatories, the PRI was exploring the possibility of allowing signatories on a voluntary basis – whether asset owners or investment managers – to seek third-party verification of their assessment results (EvoTV 2009). Those suggesting such measures are likely those who are genuinely motivated to implement the Principles and who view signatory status in the PRI as a means of differentiating themselves from their competition. From a reputational point of view, firms that are genuinely trying to integrate ESG issues into the fund management process may see it in their interest to submit themselves to a more detailed and rigorous process. Similarly, pension funds – whether public or

private – may be motivated to be more transparent and publicize third-party audited results as a means of increasing confidence in their process and fund offerings.

Conclusion

A review of the current institutional design of the PRI and its monitoring and enforcement mechanisms highlights significant gaps in accountability and legitimacy. This puts a significant damper on the likely effectiveness of the Principles serving to challenge investor behaviour. In sum, these problems add up to a lack of incentive for firms to go much beyond “business as usual” as signatory institutions are able to benefit from affiliation with the PRI brand and a UN connection, while facing very little pressure to demonstrate implementation and progress.

The consequences of this are twofold and interrelated. First, limited transparency and no real requirements that investors demonstrate they meet performance thresholds may risk legitimizing merely a slight variant of the status quo. This would blunt the potential impact of the PRI in serving as a vehicle to improve corporate performance on ESG issues and better aligning investment activities with the broader interests of society. Second, as Prakash and Potoski’s (2006) findings indicate, the reputational benefit derived by participants in a voluntary initiative is linked – over the long-term – to the perceived effectiveness of the initiative. In short, the design of the initiative is the primary driver of branding benefits. As the literature notes, less stringent voluntary standards are likely to threaten the credibility of the initiative’s brand over the longer-term. A voluntary initiative with a reputation for shirking as well as ineffective policing and sanctioning mechanisms is likely to suffer from problems of adverse selection and free riding. Therefore, in the future, the PRI could provide limited reputational benefits to participating institutions if a majority of signatories are shown to be making little effort at

integrating the principles into their core activities. In turn, this may deter proactive signatories - or potential signatories and those primarily motivated by the reputational benefits - from continuing to participate, seeking to distance themselves from an initiative viewed as non-credible or illegitimate. Such developments would further reinforce the concerns that the PRI's institutional design is ineffective in leading to substantive change in investor behaviour.

Chapter 7 - Conclusion

A dominant assumption of recent empirical work on firm participation in voluntary initiatives has been that the decision and selection of corporate environmental practices is the result of utilitarian cost-benefit logic emphasizing a market rationale (the business case) of CSR and participation in voluntary initiatives. Contrary to this literature, however, the findings of this research indicate that cost-benefit explanations are not wholly persuasive in understanding why institutional investors have adopted responsible investment practices and decided to participate and publicly commit to the PRI.

As argued in this thesis, institutional investor decisions to integrate ESG issues and adopt responsible investment practices are significantly influenced by formal pressures by external institutions. Principally, stakeholder and regulatory influences have established normative standards directed towards the conduct of investors. Public opinion has evolved – the result of NGO capital market campaigning and advocacy efforts - to put greater emphasis on sustainable development. In turn, the image and reputation of a pension scheme in relation to these trends have come under increasing pressure such that being perceived as a ‘responsible’ investor has become a central strategic motivation of institutional investors. The centrality of reputational risks to understanding the emergence of responsible investment is confirmed in several industry surveys. The predominant response is that the most important consideration for schemes in involving environmental and social factors in the investment process is the connection with corporate governance policies and the belief that attention for responsible investment enhances a scheme’s reputation.

Although not mandating the inclusion of ESG issues in investment decision-making by institutional investors, disclosure-based legislation has raised the profile of institutional investor behaviour. Surveys of institutional investors suggest firms are motivated to adopt responsible investment and participate in the PRI as form of preventative action, seeking to avoid additional or more intrusive regulation in the future by engaging proactively in an effort to influence the evolution of regulatory trends.

Significantly, these findings support complex market rationalism explanations that suggest firm participation should principally be seen as a response to pressures and demands from external stakeholders to conform to changing expectations of what is considered legitimate, appropriate or 'responsible' investor behaviour. As such, the decision to adopt the PRI and establish commitments to adopting investment decision-making processes and ownership practices deemed 'responsible' should principally be seen as embedded in broader reputational risk management strategies, grounded in a variety of strategic motivations to assure stakeholders that their concerns are being internalized into corporate practices. These findings also support the conclusions of Wright and Rwabizambuga (2006) in their analysis of project finance banks' participation in the Equator Principles.

Interestingly, the number of financial institutions adopting the PRI increased during the global financial crisis (2008-2009) reinforcing the view that investors perceive the PRI as an attractive source of legitimacy and branding benefits. In response to public outrage over failures in corporate governance and accountability, financial institutions have sought to assure immediate beneficiaries as broader stakeholders that they have adequate risk management practices in place. With its association with the UN and industry 'best practice,' the PRI serves as a sort of signpost for good governance while presenting low adoption costs to the investor.

The discussion of results and the conclusions from this study need to be considered in the context of several important limitations. As the research is exploratory and descriptive in nature, the focus is general in nature, seeking to identify the broad motivations underpinning the growth of responsible investment among institutional investors and the decision to publicly commit to the PRI. Related studies on firm participation in voluntary initiatives indicate that a firm's overall reputation reflects its ability to respond to the demand of multiple stakeholders with different normative perspectives, interests and objectives (Wright and Rwambizambuga 2006). As such, the institutional environment of a particular firm varies, suggesting that external institutional pressures from stakeholders or regulators can vary in the extent to which they challenge a firm's overall reputational status. These variations in institutional environments produce different strategic incentives for firms to adopt voluntary codes of conduct. For example, studies have indicated that a firm closely monitored by an NGO may face greater reputational risks than firms facing less scrutiny. Future research must therefore adopt a firm-centred approach as well as addressing how regional patterns in adoption rates reflect variations in the institutional environment of institutional investors. In particular, what differences may explain a similar firm, operating in a similar environment as a PRI signatory, opting to not become signatory to the principles? The research undertaken for this thesis has indicated that participation in the PRI largely depends on the reputational benefits flowing from such actions. If more detailed data on the PRI signatory base was made available, future research could analyze how the perceived level of threat to corporate reputation is shaped by the institutional environment of the financial institution. Future research may also identify why firms who have otherwise already adopted beyond-compliance measures choose not to participate in voluntary initiatives. Such empirical work may hold important insights for regulators and stakeholders seeking more effective

strategies for leveraging the power of institutional investors in promoting improved corporate environmental practices.

The secondary research question has explored the adequacy of the PRI to serve as an effective governance mechanism to institutionalise responsible investment practices. Although the results are more speculative in nature, these findings indicate that while some progress has been shown, it remains unclear as to whether the PRI has generated significant improvement in the majority of signatories related to the integration of ESG issues into decision-making. In particular, it is difficult to assess whether the PRI has delivered any measurable improvement in investor activism on ESG issues beyond what would have occurred anyways or as a result of the existing patchwork of disclosure-based state regulations which exist in numerous OECD countries. Rather, the PRI appears in many ways to mirror existing disclosure regulation, in many ways accommodating rather than radically challenging the status quo via prescriptive or substantive performance requirements. Vague language which forms the basis of the voluntary and aspirational code of conduct and a lack of enforcement mechanisms prevents the PRI from serving as a meaningful mechanism to significantly improve investor practices concerning the integration of corporate environmental performance in investment decision-making.

A reliance on voluntary and aspirational principles with no real requirements that investors demonstrate they meet performance thresholds may risk, over the longer-term, legitimizing merely a slight variant of the status quo, blunting the full intended impact of responsible investment and the promotion of improved corporate performance on ESG issues. As argued, this has two consequences. First, a lack of accountability measures limits the likely effectiveness of the PRI in realising its stated goal of better aligning investment activities with the broader interests of society. Second, as the literature notes, less stringent voluntary standards are likely to

threaten the credibility of the initiative's reputation over the longer-term. A voluntary initiative with a reputation for shirking as well as ineffective policing and sanctioning mechanisms is likely to suffer from problems of adverse selection and free riding. Significantly, a failure to reform the institutional design may result in the initiative providing limited reputational benefits to participating institutions over the longer-term.

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Appendix

Full text of The Principles for Responsible Investment

The Principles for Responsible Investment

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 corporate 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.

Possible actions:

- Address ESG issues in investment policy statements
- Support development of ESG-related tools, metrics, and analyses
- Assess the capabilities of internal investment managers to incorporate ESG issues
- Assess the capabilities of external investment managers to incorporate ESG issues
- Ask investment service providers (such as financial analysts, consultants, brokers, research firms, or rating companies) to integrate ESG factors into evolving research and analysis
- Encourage academic and other research on this theme
- Advocate ESG training for investment professionals

2 We will be active owners and incorporate ESG issues into our ownership policies and practices.

Possible actions:

- Develop and disclose an active ownership policy consistent with the Principles
- Exercise voting rights or monitor compliance with voting policy (if outsourced)
- Develop an engagement capability (either directly or through outsourcing)
- Participate in the development of policy, regulation, and standard setting (such as promoting and protecting shareholder rights)
- File shareholder resolutions consistent with long-term ESG considerations
- Engage with companies on ESG issues
- Participate in collaborative engagement initiatives
- Ask investment managers to undertake and report on ESG-related engagement

3 We will seek appropriate disclosure on ESG issues by the entities in which we invest.

Possible actions:

- Ask for standardised reporting on ESG issues (using tools such as the Global Reporting Initiative)
- Ask for ESG issues to be integrated within annual financial reports
- Ask for information from companies regarding adoption of/adherence to relevant norms, standards, codes of conduct or international initiatives (such as the UN Global Compact)
- Support shareholder initiatives and resolutions promoting ESG disclosure

4 We will promote acceptance and implementation of the Principles within the investment industry.

Possible actions:

Include Principles-related requirements in requests for proposals (RFPs)
Align investment mandates, monitoring procedures, performance indicators and incentive structures accordingly (for example, ensure investment management processes reflect long-term time horizons when appropriate)
Communicate ESG expectations to investment service providers
Revisit relationships with service providers that fail to meet ESG expectations
Support the development of tools for benchmarking ESG integration
Support regulatory or policy developments that enable implementation of the Principles

5 We will work together to enhance our effectiveness in implementing the Principles.

Possible actions:

Support/participate in networks and information platforms to share tools, pool resources, and make use of investor reporting as a source of learning
Collectively address relevant emerging issues
Develop or support appropriate collaborative initiatives

6 We will each report on our activities and progress towards implementing the Principles.

Possible actions:

Disclose how ESG issues are integrated within investment practices
Disclose active ownership activities (voting, engagement, and/or policy dialogue)
Disclose what is required from service providers in relation to the Principles
Communicate with beneficiaries about ESG issues and the Principles
Report on progress and/or achievements relating to the Principles using a 'Comply or Explain'* approach
Seek to determine the impact of the Principles
Make use of reporting to raise awareness among a broader group of stakeholders

*The Comply or Explain approach requires signatories to report on how they implement the Principles, or provide an explanation where they do not comply with them.

The Principles for Responsible Investment were developed by an international group of institutional investors reflecting the increasing relevance of environmental, social and corporate governance issues to investment practices. The process was convened by the United Nations Secretary-General.

In signing the Principles, we as investors publicly commit to adopt and implement them, where consistent with our fiduciary responsibilities. We also commit to evaluate the effectiveness and improve the content of the Principles over time. We believe this will improve our ability to meet commitments to beneficiaries as well as better align our investment activities with the broader interests of society.

We encourage other investors to adopt the Principles.