Regent's Working Papers in Business & Management 2013
Working Paper 1306: RWPBM1306

Investigation of institutional investors' responsible investment practices in UK

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Abstract: The focus of Corporate Governance is shifting from the role of directors to active ownership. Based on their fiduciary duty to other shareholders, it is believed that institutional investors have an important role to play in this regard. However, the Pension Funds and the Sovereign Wealth Organisations are not driven by the same set of objectives. In addition, Environmental Social and Governance (ESG) issues in investment decision-making are now becoming more important and they are capable of becoming the mainstream in the future. However, there are widespread variations in perception of fiduciary responsibilities, ESG issues appraisal, as well as the strategies adopted by institutional investors on shareholder engagement as responsible investors. Responsible Investment market is largely driven by institutional investors and they are expected to continue to lead the way. This research work investigates the role of the main asset owners and their advisors in responsible investment practices in the UK. It adopts a qualitative approach using semi-structured interviews, questionnaire and meetings observations. Gathered data is analysed using grounded theory and the findings highlight the perception of the various investor groups to corporate governance. The research work contributes to the body of knowledge by assessing the corporate governance perspectives of the various classes of institutional investors which may have practical implications for other countries.

This work was presented by the author, in his capacity as a PhD Student of King's College London, at the Henley Business School International Conference on Governance Accountability and Responsible Investment on 25-26 September 2013.

Keywords: Corporate Governance; Responsible Investment; Shareholder Activism; CSR.

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Contents:

Word count: 8,448.

List of acronyms, tables and figures

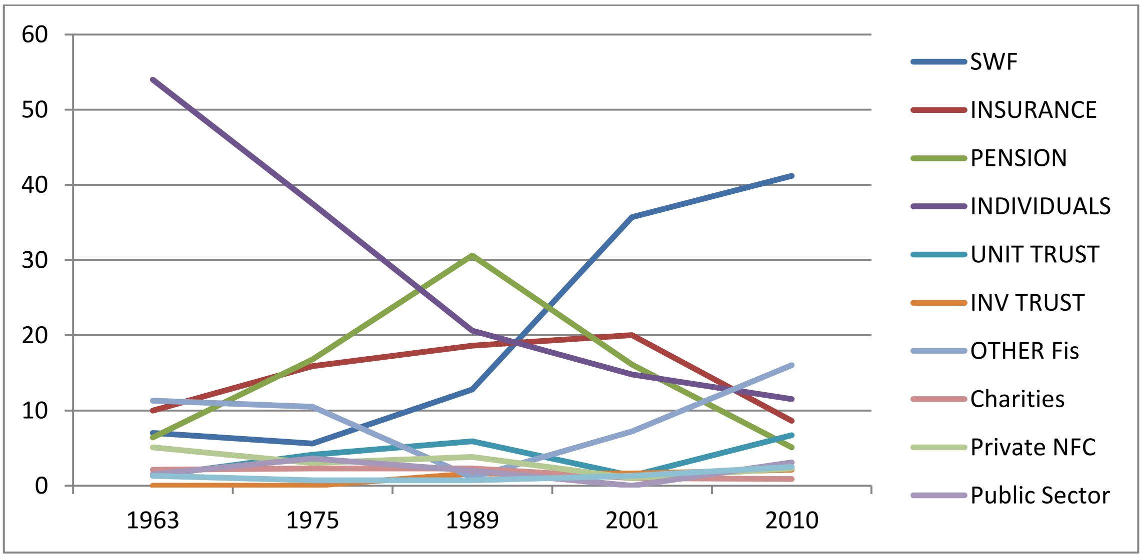
ABI	Association of British Insurers
AIC	Association of Investment Companies
AITC	Association of Investment Trust Companies
BVCA	British Private Equity & Venture Capital Association
CEO	Chief Executive Officer
CEPS	Centre for European Policy Studies
CFO	Chief Financial Officer
CSR	Corporate Social Responsibility
ESG	Environmental Social and Governance issues
FRC	The UK Financial Reporting Council
IMA	Investment Management Association
IMC	Investment Management Companies Code
ISC	Institutional Shareholders Committee
NAPF	National Association of Pension Funds
NED	Non-Executive Directors
OECD	Organisation for Economic Co-operation and Development
ONS	Office of National Statistics
RI	Responsible Investment
SWF	Sovereign Wealth Funds Organisation
UKSA	UK Shareholders Association
UNEP	The United Nations Environmental Programme
UNPRI	United Nations Principles for Responsible Investment

1. Introduction

The focus of Corporate Governance is shifting from the role of directors to active ownership. Based on their fiduciary duty to other shareholders, it is believed that institutional investors have an important role to play in this regard. Institutional investors, by virtue of their large voting shares are often expected to seize the opportunity to lend their voice on proper governance. However, they are not driven by the same objectives. In fact, bringing the foreign owners, pension funds and hedge funds together to agree on a governance issue is akin to *'herding the cats'*. In addition, ESG issues in investment decision-making are now becoming more important and they are capable of becoming the mainstream in the future. However, there are widespread variations in perception of fiduciary responsibilities, ESG issues appraisal, as well as the strategies adopted by institutional investors on shareholder engagement as responsible investors. Responsible Investment market is largely driven by institutional investors and they are expected to continue to lead the way (Solomon, 2009).

Kay's (2012) report calls for a shift in the UK investment culture to address misaligned incentives and tackle short-termism is in agreement with Wong (2010) who observed that most asset owners evaluate the performance of their asset managers against a specified market index rather than on an absolute basis. Responsible investment practitioners like Soros (2008) and Gifford (2010), agree that the failure of the current financial model and the inadequacy of disclosure regulation and risk management tools to price risk are forcing stakeholders to ask questions about the systemic shocks posed by the failings to integrate ESG factors and sustainability into company valuations. A McKinsey survey (ASQ, 2009) before the financial crises indicated that demand for shareholder value created by ESG programmes will increase in the next 5 years.

Euler (2013) and Ghahramani (2013) have observed growing interest in the role of foreign owned institutional investors operating globally, especially on their capability to strengthen good corporate governance. In the UK, it has been noticed that personal ownership of shares has fallen to an all-time low, whilst foreign ownership of shares have grown to over 40% from less than 10% in 1963. Moreover, they are not under any obligation to comply with the requirements of the published Stewardship Code. Although Stiglitz, Bolton and Samana (2012) have argued that SWFs are capable of serving as a springboard for more sustainable economy, there have also been debates on their threats to the global economy as well as the fund recipient countries (Beck and Fidora, 2008).

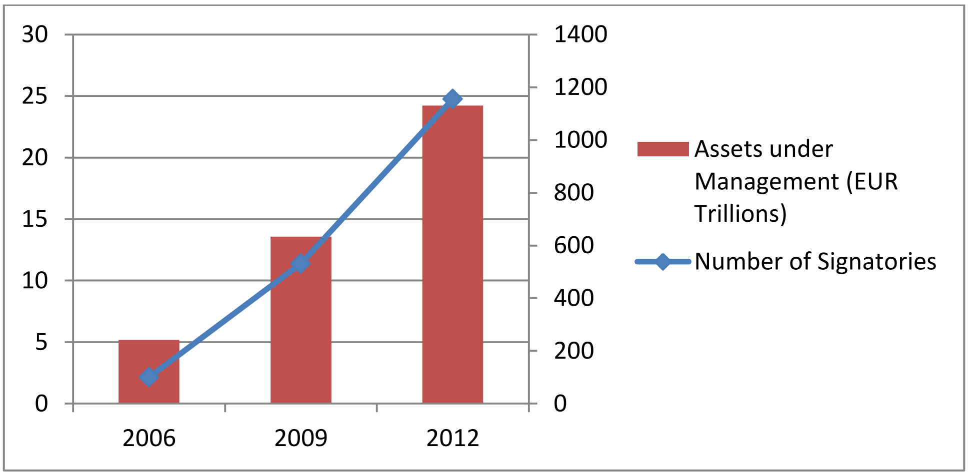


Percentage of total market value of UK quoted shares by sector of beneficial owner 1963-2010. Source ONS.

Figure 1: Trends in sectorial share ownership in UK

SWFs differs from other institutional investors due to the unique governance challenge that it poses. Since they are government owned, there is obvious closeness to politicians and the bureaucratic processes, and the discipline imposed by fiduciary duties on other funds are absent (Clark and Monk, 2011).

Many of the corporate governance studies on institutional investor governance in the UK (Lynn & Mulgrew, 2008; Sudarsanam et al, 2009; Mallin, 2010) have focused on pension funds to the detriment of the role of SWFs despite their growing size and political influence. In addition, the recent regulatory responses to improving stewardship failed to compel foreign investors to comply since the Codes operate on comply or explain basis. Gilson and Milhaupt (2008) have argued the need for the suspension of voting rights SWFs because their investment decisions carry underlying political motivations.



Notes: 1.The global Assets Under Management has grown from €5.18trillion in 2006 to €24.22trillion in 2012. Also the number of signatories has increased from 100 in 2006 to 1,155 in 2012. 2. As at August 2013, 31 Asset Owners, 102 Asset Managers, and 28 Professional Service Providers based in the UK have become signatories to the PRI Code. Source UNPRI

Figure 2: Commitment to the PRI Code

Recent survey by UNPRI (2013) found that there are still many barriers that limit the use of ESG research by portfolio managers, and that investors are still concerned about how to apply the information generated by specialist providers for decision-making purposes. Most importantly, fiduciary responsibility in the investment chain is yet to be fully codified in law, and this is currently the major impediment to ESG integration based on recent findings. KPMG EU survey on RI (2013) also identified a gap between ESG research produced and how they are being used, and that in the future, portfolio managers may be required to systematically integrate ESG research into investment decision. This research work is therefore concerned with the quality of engagement and RI strategies adopted by UK companies.

This research work therefore aims to investigate how selected institutional investors and their advisors adapt to changes in their engagement roles, and how they integrate ESG strategies into their investment decisions as the RI concept moves into the mainstream. This research work will adopt a qualitative approach using semi-structured interviews of experts in the field of Responsible Investment as well as investment management consultants. The three most important asset owners: Foreign owners, Hedge and Activist Funds, and Pension Funds have been selected for questionnaire survey. Also, UKSA analyst style meetings will be observed for evidence of strategies in collaborating with institutional investors. Gathered data will be analysed using grounded theory and the findings will highlight the perception of the various investor groups to corporate governance. The research work will contribute to the body of knowledge by assessing the corporate governance perspectives of the various classes of institutional investors which may have practical implications for other countries.

2. High profile cases in responsible investment

Empirical evidence emanating from the analysis of recent UK shareholder activism indicates that institutional investors are pivotal to the success of any key action in engagement and ESG issues. Collaboration amongst them can work effectively but unfortunately many of them do not have the same objectives. Also, many of them are paying 'lip service' to environmental and social issues because they consider them immaterial in value creation. The only shareholder proposal on environmental issue in BP which was well publicised failed due to the inability of the sponsors to convince major institutional investors to support the vote. Some important cases in shareholder activism are discussed below.

2.1 Imposing ESG and CSR policies on an investee company

2.1.1 British Petroleum

13½% of shareholders in BP Amoco voted 'YES' for the agenda on 'strategic positioning over climate change' on April 13, 2000. The agenda requests BP to stop the development of the Northslope field in Alaska, and redistribute the investment to the BP Solarex division. The proposal was sponsored by the PIRC and supported by other environmental activists like Greenpeace, US Public Interest Research group, Trillium Asset Management Company, and the SRI rating agency, Innovest. Prior to the Annual Meeting, a campaign website www.sanebp .com containing the proposal as well as background information about the company was created.

Although the proposal failed in 2000, another proposal was launched in 2001 asking BP to 'outline how it plans to move away from fossil fuels to renewable energy'. The 2001 resolution was supported by more than one hundred and thirty shareholders holding over eleven million equity shares but BP ruled out the resolution on a legal technicality.

In 2002, WWF spearheaded the campaign, and also paid for adverts in the Washington Post and Financial times to sensitise the shareholders before the Annual Meeting. The WWF resolution required BP to disclose how it plans to mitigate the environmental risks and its impact on shareholder value. The result of the 2002 campaign showed 11% voting 'YES' plus additional 9% abstentions which was seen by environmental campaigners as a big success.
In recent times, shareholder activism against BP has been concerned with the issue of executive pay. In 2012, the ABI issued an "amber top" alert to its fellow institutional investors, to take a look at the issues surrounding bonuses exceeding £100,000 awarded to two EDs in charge of finance and downstream – Byron Grote and Iain Conn. These payments were seen as unethical because they were proposed on the heels of the environmentally damaging oil spills in the Gulf of Mexico.

2.1.2 Lonmin Group

Lonmin is a company listed as a Responsible Investment on both the FTSE4Good and the JSE SRI indices. On 16th August 2012, the tragic event at Lonmin group's Marikana platinum mine threw into stark relief, the simmering safety and employee relations problems at the FTSE-250 listed firm. The company rose to international attention after the Marikana miners' strike in which 36 employees were killed and 78 wounded by the Police in South Africa. It is claimed that some investors were aware of the labour risks at Lonmin long before the disaster happened but they failed to do anything about it because the issues were not considered material enough to affect shareholder value. For example, the ESG analysis carried out by an ethical fund manager, Alquity Investment Management in 2010 had flagged up poor labour relations in the company.

If the main investors needed convincing of the potential materiality of ESG issues, the Marikana disaster should have convinced them. Nearly 19% was wiped off Lonmin's market capitalisation in the days following the disaster, and by end-2012 the stock had fallen by more than 60%. In November 2012, the company posted a loss before tax of $698m for the 2011/2012 financial year, a massive reversal from the $293m profits declared in 2010/2011, forcing the company to consider a rights issue to raise $817m in order to recapitalise. The consolidated result of the new Glencore Xstrata as at May 2013 indicated that $7.7 billion had been written off its mining assets. This led to increased pressures for the removal of the Lonmin CEO Ian Farmer who was seen as the chief culprit in destroying shareholder value.

With benefit of hindsight, Xstrata, a FTSE-100 company, and the largest shareholder in the Lonmin group with 25% equity stake should have been proactive in adopting engagement approach with Lonmin by influencing positive corporate behaviour on the volatile labour relations issues via one-on-one meetings or by collective engagement with other investors.

2.2 Limiting directors pay and firing under-performing directors

Most of the recent high profile confrontation between executive boards and institutional shareholders in 2012 and 2013 hovered around the issue of executive pay. The public fury at executive pay encouraged by the statistics in the newspapers which indicates that despite the economic downturn, average executive pay rises by 12% p.a., and that the total remuneration of a FTSE boss is £4.8 million which is 200 times the typical £24,000 average private sector wage.

Despite much opposition by shareholders to executive pay reports of FTSE-100 companies in 2012, only two executive pay reports were defeated. Since the non-binding advisory vote on executive pay was introduced under section 439 of the Companies Act 2006, only 18 remuneration reports had received a protest vote greater than 50%. Many shareholders are now advocating that the 'say on pay' should carry a binding vote.

The issue of executive remuneration reporting has made a case for proactive reporting to gain the support of the stakeholders in line with the arguments of Tilling (2004), who has argued for "extended legitimacy". This should go beyond the remuneration report by integrating ESG criteria. At Lonmin group in 2011/2012, ESG criteria such as safety, loss of production and rising costs due to labour strike were applied by the remuneration committee which scored the board 46.3%. Consequently, performance bonuses were not paid because minimum targets were not achieved.

3. Responsible investment

3.1 Introduction to ESG Issues

ESG factors are public interest issues that relates to the welfare of the society, environment and human beings. These issues are region, context and industry specific, and this is why it is important for each investor should adopt its own criteria for identifying the ESG factors that are most relevant in their context. In other words, it is impossible to have universal applicability for these sustainability issues. Taking ESG issues into consideration by investors is supported by the public sector argument that the private sector has societal responsibilities for sustainability. However, the private sector often responds with the classical argument that the business of business is business (Cherneva, 2012).

Environmental (E)	**Social (S)**	**Governance (G)**
Emissions	Bribery & Corruption	Accounting quality
Energy efficiency	HIV/AIDS	Audit quality
Environmental management	Labour relations	Board skills
Environmental policies	Product safety	Board structure
Genetic engineering	Respect for human rights	Independent directors
Hazardous and solid waste	Stakeholder relations	Independent leadership
Pollution	Treatment of customers	Remuneration
Toxic chemicals	Working conditions	Separation of chair & CEO
Water	Workplace health & safety	Shareholder rights

Source UNPRI.

Table 1: Typical ESG issues

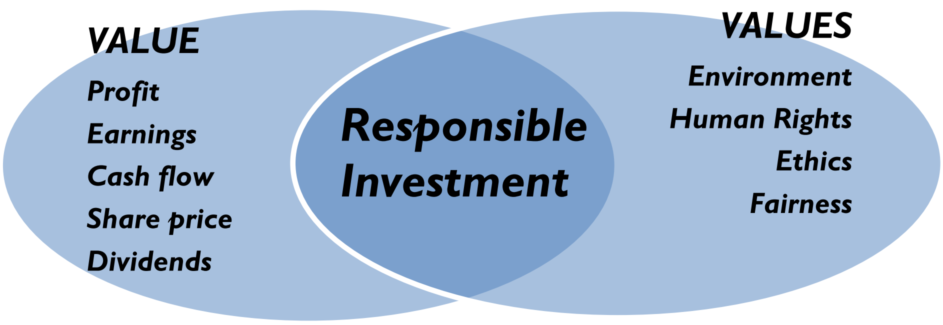
The general public would prefer that all sustainability issues are factored in by the private businesses. However, due to profitability constraints, private businesses are not ready to make any sustainability sacrifices beyond the legal requirements. The pertinent questions then are: (1) What the common area of interest for public interest and private capital as per ESG issues? (2) What are the profit motives, in other words, business case that would motivate the private capital providers to act on this area of common interest? The ESG issues are context and industry specific, and therefore cannot be generalised unlike the financial values. Existing literature (Gompers et al, 2003; Orlitzky et al, 2003; Donald and Taylor, 2008) empirically reveal that the integration of ESG factors can lead to superior performance in the long run. However, the opinion of many fund managers and analysts is that this is difficult to demonstrate because most ESG issues are either long-term or intangible, and are therefore excluded in market valuation models.

Some neo-classical schools of thought have however argued that social responsibilities other than profit maximisation can be confusing, fund managers may consider ESG issues in derogation of profit objectives, and that ESG appraisal is incompatible with quarterly appraisal due to its long-term nature.

3.2 The Concept of Responsible Investment

Responsible investment can be seen generally as the consideration of financial criteria and ESG issues when taking investment decisions. In other words, the strategy is to generate financial and sustainable values. Responsible investment can be seen from at least three different paradigms: as a product, a process or a practice. As a product, RIs are held not only for the favourable financial yield that they promise, but also because of ethical and ESG reasons.

Over the years, the various stakeholders have promoted variants of responsible investing, and this is reflected in its evolution and the many names by which it is known. For example, religious organisation: ethical investing, human rights community: socially responsible investing, and those in favour of governance: ESG investing. Irrespective of the vocabulary used, the main objective is to discourage short termism and encourage long-term focus on rewards measurement and valuation (Louché & Lydenberg, 2011).



Source UNPRI.
Figure 3: Focus of Responsible Investment

The metrics for measuring business success differs from how the society appraises business effectiveness. It is believed that the long term interests of the business unit are to create and maximise economic value while the society views the business through the ethical environmental and human rights paradigms.

3.3 Key characteristics of Responsible Investment

Louché & Lydenberg identified three features of responsible investment

Long-term perspective: The traditional economic valuation model consider streams of future cashflow over the cost of investment without giving consideration to ESG issues, which are also seen as societal values the absence of which the investment itself would be deem unsustainable in the long run. It is argued that the business survival in the long-term is only possible when the global consumption levels are sustainable (WWF, 2012).

Stakeholder perspective: Long-term perspective also involves meeting the needs of the stakeholders which is in tandem with the European and Japanese model of corporate governance. According to Post et al (2002) one important principle that differentiates responsible investment from the mainstream is that it would guarantee long-term return on a range of *"values"* to all stakeholders and not just maximising shareholder financial *"value"*.

Societal engagement: It is argued that the current model of market pricing is inefficient as it failed to consider sustainability. It is based on the assumption that material and financial inputs are unlimited. It is therefore important to include intangible values which are considered important in the proper functioning of the society.

4. UK history of responsible investment

Responsible investment is a concept that had evolved over the years, from the early 18th century when Christian preachers advised against certain investment, till today when the RI idea tends to be moving into the mainstream. The following stages have been identified: the foundation, development, transition, expansion and mainstream. There are various motivations for engaging in responsible investment, and they range from the need to avoid profiteering from immoral behaviour in the 18th century, to environmental social and political reasons in the modern era.

4.1 Preliminary stage (Up to the 1970s)

This stage was typified by protests and Christian preaching. For example there was a religious movement that set out to boycott the sale of shares in Dutch East India Company in 1602 until the company eliminate violence from its business operations[3].The earliest responsible investment activists were Christian organisations who were campaigning against investment in unethical organisations or what they termed 'sin stocks'. In the UK, the earliest adopter of the responsible investment tenets was John Wesley, the co-founder of the Methodist Church. He consistently preached against unethical business like tanning, gambling, tobacco, liquor, and chemical production that damages the health of workers and damages the environment. In the mid-18th century, a conservative Christian denomination known as "The Quakers" or Religious Society of Friends barred its members from slave trade transactions. There were no records of any practical steps taken by the religious organisation in the UK to set up an ethically focused fund during this period. Having hitherto taken stock market as another form of gambling, the Methodist Church in USA started its investment arm, applying positive and negative screening of stocks. 'The Quakers' also followed suit with avoidance of 'sin stocks'. However, it was in 1928 that Philip L. Caret established the first mutual fund based on ethical values, known as the Fidelity Mutual Trust. It is the third oldest mutual fund established in the USA.

4.2 Forming and Development Stage (1970s – 2000)

The period starting from the 1960s up to 1990 marked the period of pronounced activism by RI advocates on a large scale, as well as the growth of ethical investment funds. For example in 1977, 'End Loans to South Africa' a UK-based organisation introduced at Midland Bank plc., a dissenting shareholder resolution forcing the company to act responsibly on the issue of Apartheid in South Africa. In 1979, Sir Charles Williams Jacob, who is known as the father of UK ethical investment - after three separate rejections by the department of trade between 1973 and 1979 - succeeded in setting up 'Stewardship Fund' (also known as "The Friends Provident Stewardship Unit Trust") that is focused on ethical investment. The success of the 'Stewardship Fund', despite the initial reluctance of the department of trade because of the initial doubts on the level of demand for ethical funds, actually helped the development of the sector, and there are over 80 such funds in the UK. The effect of this success was replicated in Europe as a number of such investment companies, such as the *Triodos Bank* in Netherlands were established during this period.

The period of the 1990s witnessed the evolution of a new form of responsible investing with focus on the impact of environmentally sustainable development on business. This was largely encouraged by the Brundtland Report (WCED, 1987) which emphasised the concept of sustainability, and the Kyoto protocol (UNFCCC, 1997) on climate change. In 1989, as a result of the oil spill in Alaska, the CERES 10-point code principles on corporate environmental conduct was produced and later endorsed by over 50 companies. 'Green funds' that focus on environmentally friendly investments started to emerge. For ethical investors, this was a period of transition from negative screening/avoidance of certain investments, to positive screening offering sustainable and environmental investments. In 1990, the Domini 400 stock index for social and environmental excellence was launched, and this is the first RI index ever maintained (Cheng, 2007).

Interest in responsible investment in the year 2000 and beyond can be attributed to the direct intervention by the UK government through the UK Pension Disclosure Act mandating all private sector pension funds to include voting right as well as environmental and social issues in their investment criteria. The year 2000 is therefore seen by many as a turning point in the practice of responsible investment in the UK. This law has helped in raising the profile of ESG considerations in the UK investment community. It is widely believed that this law is capable of moving ESG issues to the mainstream of investment decision making due to the large capital being mobilised via pension funds (Boatright, 2010:408). Many European countries have adopted similar disclosure regulation in addition to the EU Accounts Modernisation Directive. The GRI reporting framework (2002) for sustainability reporting on people, planet and profit, arising from the failure of current governance structures to respond to changes in the global economy, also expanded the focus on responsible investment.

With these developments, ethical or responsible investment principles began to find acceptance amongst mainstream investment practitioners, and therefore, responsible investments are now being viewed as a commercially viable business (Déjean et al, 2004). The FTSE4Good index was set up in July 2001 to measure the performance of companies that meet universally recognised standards, and also encourage investment in such companies. Analysis of performance indicates that the FTSE4Good has consistently outperformed the FTSE-100 index since the first-half of 2003. By 2005, the UNPRI was set up by international group of institutional investors to promote adoption and the implementation of six principles promoting environmental, social and governance issues in investment practice. As at August 2013, 31 UK asset owners, 102 asset managers and 28 professional service providers are now signatories to the PRI scheme.

4.3 Mainstreaming (the future)

It is expected that as ESG integration into the investment decision-making process continues to gain ground, a time come when it comes the standard criteria globally. This is further strengthened by the In October 2011, The European Commission formally invited all asset managers and asset owners domiciled within the EU area to sign up to the PRI code [11].

However there will be need for the ESG criteria to become standardised using transparent and robust models. Institutional investors will be expected to take a lead in this area. It is believed that if asset managers fully accept ESG as part of the universal investment criteria, then the portfolio managers will have no option but to integrate ESG into their decisions too.

4.4 Strategic approaches to Responsible Investment

Investors have adopted several forms of RI strategies using ESG information in a variety of ways. Seven RI non-mutually exclusive strategies have been identified, and the aim of adopting each strategy include discouraging unethical behaviour, encouraging positive lines of businesses for corporations, developing stronger stakeholder relations, avoiding underperforming stocks, and encouraging positive corporate behaviour.

Avoidance: The strategy here is to exclude certain identified investment from the basket of investment holdings based on company type (e.g. tobacco or gambling) because of perceived societal harm, or country (e.g. Syria) due to dictatorship. The objective is to discourage profiting from unethical behaviour.

Inclusion: The strategy here is to identify and then invest in businesses that will benefit the society. The objective is to encourage businesses in positive lines of businesses.
Best-in-class: also known as relative selection strategy, which involves cherry picking or preferentially investing in outperforming stock or avoiding non-performing stocks based on selected ESG criteria

Engagement: The strategy here is active and long-term ownership through engagement with investee companies and voting on ESG matters. The objective is to encourage a positive corporate behaviour and enhanced disclosure in corporate reporting.

Integration: The strategy here involves inclusion of ESG risks and rewards criteria that would likely impact on the company's financial performance into the traditional investment decision-making model. Although the concept is simple, there are differences in methods applied by various asset managers. Proponents of this strategy have argued that ESG integration is a big step towards mainstreaming. Critics however argue that it is a diluted approach, and investors are not sure how far they should go in order to become a 'responsible investor'.

Impact investment: This is an emerging strategy that involves investing in a company with the aim of generating social and environmental impact together with financial return.

Research carried out by Dimson et al (2012) on the effect of rigorous engagement on ESG issues in US companies between 2000-2009 revealed a positive impact averaging premium of 4.4% in annual returns.

4.5 Fiduciary duty of integrating ESG into institutional investment

Fiduciary duty, also known as the duty of loyalty, is the responsibility to act prudently and also in accordance with the purpose for which the powers were granted. e.g. the duty of directors to act in the financial interest of the shareholders, or the duty of the trustees to act in the financial interest of the trust beneficiaries. They are duties of professional skills and care that are expected to build trust and confidence.

The term 'fiduciary duty' is a product of case law, and it represents a major limiting factor on the decision preference of institutional investors in the UK. The leading cases on fiduciary responsibility in the UK are *Cowan V Scargill (1985)* and *Harries V The Church Commissioners for England (1992)*. The Goode Report on pension law review (1993) recommended that having a policy on ethical investment by a trustee is in agreement with fiduciary duties, and this is now part of the section 36 of the Pension Act 1995. However, the fiduciary positions of a fund that are not structured as trusts e.g. asset managers and insurance companies are yet to be clarified by law. This issue came up again in the Kay report (2012) which identified prevalent concern about who was subject to fiduciary duties in the context of investment.

Wong (2010) noticed a misguided interpretation of the fiduciary duty across the investment chain as the emphasis is on meeting the economic interest of clients and the ultimate beneficiaries. Long-term non-financial interests are rarely considered. He proposed the shortening of the ownership chain and lengthening of the ownership period.

Although the issue of fiduciary responsibilities of institutional investors are yet to be codified in law, it is clear that body language of the government and all the regulatory bodies support the recognition of ESG in the investment decision making progress. For instance, The London Principles which is a joint voluntary initiative between the UK government and the London Corporation for promoting sustainable development requires that the cost of environmental and social risks be reflected in the pricing of financial and insurance products. Also, the ABI disclosure guidelines on RI, the combined code on Corporate Governance, ISC Code for Institutional Shareholders and Agents, and the Stewardship Code all encourage the integration of ESG (UNEPFI, 2005).

5. Relevant institutional investors

5.1 Pension Funds

Private pension funds in the UK represent a substantial part of the financial markets and they are seen as an essential contributor to savings and economic growth. They are valued at approximately two-thirds of the GDP in 2012[13]. In order to spread risks, their investments are diversified and spread on to many channels including listed equities.

Unlike hedge funds that are on pressure to earn huge fees, or private equity that wants to take the investee company off the public listing, or SWFs that may harbour underlying political interests, pension funds are relatively free from conflict of interest. These are some of the reasons why Coffee (1991) argued that pension funds are relatively superior to other institutional investors, and are therefore in the best position to enforce good corporate governance through active ownership due to their freedom from conflict of interest and long-term investment horizon. This is in agreement with the conclusions of Karpoff (2001) that a positive correlation exists between shareholder activism and good corporate governance. However, empirical evidence from the works of Del Guercio and Hawkins (1999); English et al (2004) suggests that there is limited evidence to support this theory. Result of a recent survey by NAPF (2010) concluded that majority of UK pension funds are active investors as over 90% of the UK pension funds delegate engagement work to investment manager or other consultants. Unfortunately, pension funds ownership of UK quoted shares have fallen from its peak of over 30% in 1989 to less than 10% in 2010. In the recent 'shareholder spring' in the UK, pension funds were active and in most cases, recommended that shareholders vote against executive pay reports.

5.2 Private Equity and Hedge Funds

Offensive shareholder activism sponsored mainly by hedge funds and private equity firms sponsoring private buyouts of public companies became prominent in the UK after 1990 (Chefins, 2008). Hedge Funds are privately organised investments administered by professional managers with performance-based reward, and this investments are not available to the general public (Brav et al., 2008). The pay reward structure encourages risk taking and therefore induces value-creating activism. Hedge fund managers make their money in two ways: by charging average annual fee of 2% on the value of assets being managed and 20% return as performance fees (Clifford, 2008). Until November 2010 when the EU parliament approved a directive that subjects them to regulation, hedge funds were operating outside of the FSA regulations. Due to the lack of regulation hitherto, hedge funds were able to take big risks by taking a leveraged position in their target companies. In addition, they are not compelled to diversify their investment portfolio.

Clifford (2008) argued that hedge funds are formidable threats to their target companies due to their offensive activism style. Unlike most other institutional investors adopting defensive activism, they can threaten to buyout their target company and this would force the directors to reach a compromise with them. Their objective of hedge fund activists is to arbitrage in the market where there are inefficiencies in order to maximise returns. For example buying an underperforming company and selling for a profit thereafter.

The main motivation therefore, for a hedge funds activist is the promised rewards. A hedge fund manager will engage in activism if the benefit accruing from the intervention exceeds the cost. Brav et al., (2008) found that hedge fund activism "generates large positive abnormal returns for both shareholders in the target companies and those in the activist hedge funds". Although the objective is to maximise wealth, the professed motives include capital structure, business strategy, sale of target-company, and few governance issues. Hedge funds concentrate on maximising short term returns. There is scarcity of literature presently on how hedge funds incorporate ESG issues into its investment process.

However, ESG issues awareness is increasing amongst private equity managers. For instance in February 2009, the 'Guideline for Responsible Investment' was issued by the Private Equity Council in the US, and this had been replicated in the UK by the BVCA.

5.3 Sovereign Wealth Funds

SWFs are government owned funds that are invested globally in equity etc. They are a by-product of government budget surpluses that have accumulated due to favourable macroeconomic indicators. They are now attracting attention from corporate governance scholars due to their rapid pace of asset accumulation, the relative size of funds and the underlying political interests that they represent. The Santiago Principles was developed and adopted by 26 signatories who are members of the International Working Group on SWFs to standardise governance based on a body of voluntary code. The implementation of the code had been left to the individual funds, and there has been uneven commitment to the implementation based on the Santiago Compliance Index. Halvorssen (2010) and Reiche (2010) however view the Norwegian Fund's ethical investing as a model for other SWFs.

Gilson & Milhaupt (2008) have argued that SWF are new vehicles for promoting state capitalism to the detriment of free market principles, and they should therefore be subjected to restrictive regulatory policies above other institutional investors because they represent political interests that are capable of damaging business. This view is supported by the view that they are responsible for blurring the lines between international economics and geopolitics. On the other hand, Avendaño and Santiso(2009) argue that SWFs should be held to the same governance standards as other institutional investors. Truman (2010) also rejected the arguments that they pose threats to international economic competitiveness by proposing stronger accountability and transparency that neutralises any political motivations.

There is an increasing influence of SWFs on global economy considering the size of the funds. Their close proximity to political actors is critical and needs to be addresses if they are to achieve their aim as catalyst for a more sustainable economy. Bernstein et al (2009) argued that SWFs are particularly in a position of strength because they have high tolerance for risks, and that they exhibit the tendencies to engage in countercyclical investment behaviour. SWFs are therefore trapped between financial and political imperatives.

Though SWFs are not subject to fiduciary duty in a formal legal sense, the international community informally holds them accountable as fiduciary investors (Clark & Monk, 2010). Clark & Knight (2011) acknowledge the function of some SWFs to provide intergenerational equity and give consideration to longer-term investment horizon that requires the inclusion of non-financial factors like climate change into investment decision-making.

Most existing studies focus on traditional fiduciary investors. Therefore there are few studies on governance frameworks for responsible investments. A degree of ambiguity in governance framework is permissible due to the political objectives of the country sponsoring the funds. This can be done by bringing more flexibility. It is thought that heavy political coloration will affect the weight that the SWFs attach to certain ESG issues since they cannot be divorced from their political context. Some may therefore be included or excluded from the investment process. For fiduciary investors, the exclusion may be deemed necessary, as trustee performance is conditioned by a legal obligation to their beneficiaries and current legal interpretation of fiduciary duty is based on conventional investment practice (Woods, 2011).

Furtherance to evidence from existing literature (Gompers et al, 2003; Orlitzky et al, 2003; Donald and Taylor, 2008) that reveals that integrating ESG factors lead to superior performance in the long run, Hawley & William (2007) concluded that large sovereign funds adopting effective RI strategy can generate material value because it is the success of the economy (dependent on ESG factors) rather than individual corporations that is of consequence to these universal owners.

It is believed that RI can serve to reconcile financial and political imperatives of SWFs if it is supported by governance framework that is transparent and encourages accountability.

5.4 Professional Service Firms

Investment management consultants have a crucial role to play in the investment chain. In the last decade, the UK market has witnessed the rise of professional advisers offering governance services. They advise asset owners on various issues including fiduciary duties, voting alert and voting on proposals, proxy advisory, engagement style, solicitation services and even advise ESG issues e.g. The PIRC and the LAPFF played an important recent role in issuing voting alert prior to companies' AGMs; 28 such professional service providers have registered with the UNPRI as at August 2013.

6. Research background and literature gap

In recent times, the UK has witnessed a rise in institutional investors' activism due to recent developments such as the calls for active ownership as a result of the recent financial crises resulting from short-termism, publication of the stewardship code by the FRC (2010), governments' demand for responsible ownership where investors take up the moral and fiduciary duty of overseeing the proper functioning of the corporate governance system. This is a new trend of corporate governance driven by shareholders as opposed to corporate governance codes that were developed in the 1990s which focused more on directors' independence and auditors. Many of the early works on corporate ownership and control (Jensen & Meckling, 1976; Shleifer & Vishny, 1997) have implicitly assumed that the main driving force is the need to maximise shareholders' wealth. However evidence from recent studies (Karpoff, 1996 and Romano, 2001) on the growth of shareholder activism in the US indicates that there are no relationships between shareholder activism and company performance. This research work will investigate the role of the various categories of institutional investors to shareholder activism as there is scarcity of materials on this area at the moment.

6.1 Contribution to body of knowledge

Due to the growing need to direct the global economy towards a sustainable path, the UNPRI requires that asset owners should integrate ESG into their legal contracts with the investment managers. There is presently scarcity of literature on how institutional investors can integrate ESG issues into the investment process. It is believed that integrating ESG issues into the investment process will help in building a sustainable and responsible capital market which is seen as a prerequisite to achieving a green and sustainable economy. The Freshfields report (UNEPFI, 2005) commissioned by UNEPFI, which is the most effective report that promotes the integration of ESG issues argued that *"integrating ESG considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguably required in all jurisdictions."*

The KPMG report on European Responsible Investing Fund Survey (2013) stated that for ESG to move into mainstream, ESG considerations will have to be fully integrated into the investment decision-making process in a consistent manner by applying models that that are transparent to the investors, and that institutional investors are expected to lead the way in this area. The NAPF report on engagement with companies (2013) concluded that there is a gap between the ESG research produced and how they are used today, and that portfolio managers should, in future, systematically integrate ESG research into investment decisions. Though the field of corporate governance is wide, little attention has been paid to role of institutional investors especially in this age of "pension fund capitalism" where they wield substantial powers economic and financial powers (Clark & Hebb, 2004). Most of the existing research works in these areas have been focused on the role of pension funds to the exclusion of SWFs and their investment advisers.

6.2 Research Aims

The aim of this research work is to apply the UK as a case study in investigating the roles of the various institutional investors and their professional advisers in the institutionalisation of the shareholder activism culture as well as their contributions towards moving responsible investment into the mainstream of investment decision-making. As the UK is seen as a net exporter of corporate governance (Black and Coffee 1994), it is believed that the recommendations arising from the theories developed from the research findings in the UK will impact positively on code developments and law enactments in other jurisdictions. This would also enrich the body of knowledge in the area of corporate governance and responsible investment.

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