The Developing Role of International Non-State Actors in the Market for Corporate Governance: The Case of the UN Principles of Responsible Investment (UN PRI)

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Abstract

Domestic markets for corporate governance have been influenced by a power struggle between nation-state regulatory agencies and NGOs which harness consumer market forces to gain rule-making authority. This influence is clearly visible in the rise of Non-State Market Driven (NSMD) environmental governance systems which aim to raise domestic and international standards of corporate environmental performance. As capital markets have grown to become a leading force of globalization NGOs are increasingly seeking to harness capital market forces in ways similar to the experiences of NSMD environmental governance systems. The leading such organization is the United Nations Principles of Responsible Investment (UN PRI). The UN PRI, as the flagship of emerging International Voluntary Non-State (IVNS) financial governance systems, presents a serious alternative to nation-state regulatory agencies as it attempts to harness the power institutional investor shareownership throughout the world. By means of a case study of the California Public Employees’ Retirement System’s (CalPERS) successful engaged shareownership practices we highlight the significant role institutional investors can play in the market for corporate governance. An additional case study of the 12 Canadian institutional investors which became signatories to the UN PRI allows us to highlight the motivational forces fuelling the growth of the UN PRI as an IVNS financial governance system. We demonstrate that, although IVNS financial governance systems are potentially a significant threat to nation-state rule-making authority in markets for corporate governance, the current structure and culture of the UN PRI undermines its own fledgling legitimacy and thereby its potential influence in the markets for corporate governance.
1. Introduction

Modern capitalism is based on a mutual relationship between corporations, which provide an efficient means of capital accumulation, and nation-states, which provide political and regulatory support (Shonfield 1965). As such, the evolving market for corporate governance is of significant concern to nations' political and economic landscapes. Yet the role of nation-states in the market for corporate governance is increasingly coming under review in light of the forces of globalization. At the heart of the matter is a power struggle between nation-state regulatory agencies and non-governmental organizations (NGO) which harness market forces to compete for rule-making authority (i.e. Doh and Guay 2006). These NGO efforts have been deployed primarily in the consumer markets since the early 1990s and are, however, now becoming increasingly noticeable in the global capital markets. Of greatest contention are the NGO efforts to influence the market for corporate governance to account for environmental and social considerations beyond what is enforced by nation-state regulators.

The rise of non-state market-driven (NSMD) environmental governance systems is often held as an example of the primacy of market forces in the market for corporate governance (Bernstein and Cashore 2007). NSMD environmental governance systems grew in prominence throughout the 1990s as state-level policy makers were confronted with increasing social pressure to address environmental protection while at the same time operating with reduced resources to effectively do so (Cashore and Vertinsky 2000). The privatization of environmental governance via the emergence of NSMD governance systems, such as the Forest Stewardship Council, emerged as a supposed compromise solution (Fletcher and Hansen 1999; Steelman and Rivera 2006). These systems aim to introduce environmental and social considerations into corporate decision-making on par with financial considerations in an attempt to force domestic and international standards upward (Meidinger 1997) and derive their rule-making authority not from nation-state sovereignty but from market forces (Cashore 2002; Cashore et al. 2004).

This appointed authority is based on the perception of legitimacy. Organization legitimacy has been defined as “a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs and definitions” (Suchman 1995, p.574). Suchman (1995) has elaborated organization legitimacy to include three categories: pragmatic, moral, and cognitive legitimacy; and Cashore (2002) has since developed these categories into an NSMD legitimacy framework (further elaborated in Bernstein and Cashore 2007). Pragmatic legitimacy is awarded by an external audience when the organization operates as expected in relation to its perceived objectives. Moral legitimacy is awarded based on moral and ethical values of the external audience; regardless of its pragmatic value, the organization must operate within the ‘socially constructed system of norms, values, beliefs and definitions’. Cognitive legitimacy is awarded when an organization and its operations have become central to the social norms and ‘to do otherwise is unthinkable’.

Such legitimacy, however, is dynamic. The majority of NSMD environmental governance systems in the United States were awarded legitimacy from external audiences based initially on moral considerations, however their lack of transparency and failure to attain environmental improvements (see Darnall and Sides 2008) have led to their lose of legitimacy based on pragmatic considerations. The market for environmental corporate governance is now influenced by a balanced relationship between nation-state regulatory agencies and a select group of NSMD environmental governance systems which have managed to retain their legitimacy.

These successful NSMD environmental governance systems operate by exerting pressure through consumer markets. Consumer market pressures, whether it be of environmental concerns or any other, have led some scholars to support the perspective that market
forces are the principle force influencing the market for corporate governance (i.e. Keck and Sikkink 1998; Bernstein and Cashore 2000; Ho 2002; Hardy et al. 2003; Kapstein 2006), and nation-states are becoming increasingly obsolete (i.e. O’Brien’s 1992 contention of ‘the end of geography’). Many scholars, on the other hand, continue to support the perspective that nation-states remain the principle influence as consumer market pressures cannot be exerted without an established domestic regulatory framework (i.e. Simmons 2001; Mattli 2001; Chey 2007).

Drezner (2005) bridges the gap between market force/nation-state primacy by giving prominence to a select few nation-states, termed ‘the great powers’, in shaping the market for corporate governance followed by market forces for regulatory convergence across nation-states other than ‘the great powers’. ‘Great powers’ have been defined as those governments which parallel large internal markets. The U.S. and the E.U. have traditionally been considered the great powers, however Brazil, Russia, India and China may soon be joining the ranks (Wilson and Purushothaman 2003).

Consumer markets were at the leading edge of globalization and international integration in the 1970s and 1980s, however capital markets have since developed to become an equal, if not greater, force (Jordan and Majnoni 2002). During the latter portion of the twentieth century, a number of institutional investors, such as pension funds, banks, insurance companies, mutual funds and endowments, were receiving and investing ever increasing pools of capital. Of greatest concern for Anglo-American markets was the growth of pension funds which were the beneficiaries of mandated contributions (Clark 2000). As these funds grew in size, they eventually came to own entire cross-sections of national economies, thereby becoming universal owners (Hawley and Williams 2000). These funds mostly follow a modern portfolio theory of investment in which they design their investment portfolios based on considerations of expected risk and return of each equity in relation to its place within the portfolio (Markowitz 1952) and require significant quantities of information and financial intermediary services (Clark and Wójcik 2007).

As was the case of NGO influence in consumer markets, early-mover NGOs have seized on institutional investors’ needs for ever greater quantities of information to ensure that their interests are satisfied. Notably, the forces at play in NSMD environmental governance systems aiming to incorporate social and environmental metrics into corporate decision-making have resurfaced in capital markets to promote the incorporation of corporate environmental, social, and governance (ESG) metrics in investment decision-making. These forces have taken the form of international voluntary non-state (IVNS) financial governance systems which promote responsible investment and engaged shareownership (herein simply referred to as IVNS financial governance systems). Such organizations aim to harness the power of institutional investor shareownership in an attempt to influence corporate governance irrespective of nation-state jurisdictions. The United Nations Principles of Responsible Investment (UN PRI) has been the most successful such organization to date.

As capital markets have come to be another force of globalization alongside consumer markets, the power struggle between nation states and NGOs which harness market forces to promote their interests remains pertinent. La Porta, Lopez, Shleifer, and Vishny (1998) established a link between nation-state legal frameworks and corporate governance structures, and Stulz (2005) has determined that despite the advent of financial globalization since the 1950s, nation-states maintain a place of prominence in determining domestic corporate governance structures and cultures. Bruno and Claessens (2006) have suggested that nation-states are less important in the market for corporate governance across developed-nation jurisdictions, however they retain a position of prominence across lesser-developed-nation jurisdictions. Clark and Wójcik (2007) and Bauer, Braun, and Clark (2008) have demonstrated examples of convergence in the market for corporate governance across continental European jurisdictions fuelled by capital market pressures.

Although of potentially significant consequence for nation-state political economic landscapes, little research has yet discussed the role of IVNS financial governance systems
in the market for corporate governance. A temporary aggregation of international shareownership seeking the divestiture of apartheid-era South Africa had significant repercussions for that country’s political economic landscape (Sparkes 1995). In effect, IVNS financial governance systems are an attempt to aggregate these same market forces of concentrated shareownership for directed action on a permanent basis. Before a working relationship between such organizations and nation-state regulatory agencies can develop, the legitimacy of IVNS financial governance systems, as perceived by an external audience, must first be addressed in order to understand their potential rule-making authority.

In the case of IVNS financial governance systems, however, the external audience is quite complex. The majority of signatories to such financial governance systems are institutional investors and these investors are the agents of their numerous individual principals. The external audience is therefore composed of concerned individuals truly external to the IVNS financial governance system as well as concerned individuals who have a financial interest at play within the IVNS financial governance system by means of being the beneficiaries of signatory institutional investors. As such, the external audience determinants of IVNS financial governance system legitimacy are expected to be severely scrutinized. In this case, the value of perceived legitimacy cannot be overestimated.

In order to investigate the legitimacy of IVNS financial governance systems, and by extension their potential role in the market for corporate governance, we analyze the structure and culture of the UN PRI as the flagship of IVNS financial governance systems. We first provide an original case study of 15 years of successful engaged shareownership strategies employed by the California Public Employees’ Retirement System’s (CalPERS). Not only is CalPERS recognized as one of the most successfully engaged institutional investors in the world (Hebb 2006) it is also a signatory to the UN PRI and one of the largest U.S. institutional investors. This case study serves to demonstrate the significant potential impact of institutional investor shareownership within the market for corporate governance and highlights certain structural requirements for this force to be deployed successfully. Second, we provide an analysis of the motivational forces driving the 12 Canadian institutional investors which became signatories to the UN PRI to supposedly adopt responsible investment and engaged shareownership strategies. This analysis serves to demonstrate that although institutional investor shareownership can be a significant influence in the market for corporate governance, few such institutional investors are willing to exert their authority unless required to do so. Combined, these two analyses allow us to discuss the pragmatic, moral, and cognitive legitimacy of the UN PRI.

We find that the UN PRI, as an IVNS financial governance system, currently lacks sufficient prescriptive structure to successfully harness and direct the forces of institutional investor shareownership. Furthermore, its fledgling legitimacy is at risk of being eroded by its own organizational structure and culture. If the UN PRI fails to properly adapt, it is not likely to remain a significant influence in the market for corporate governance. These findings are important for nation-state regulatory agencies and for current and future IVNS financial governance system administrators.

2. UN Principles of Responsible Investment

The UN PRI is an investor initiative in partnership with the United Nations Environment Program-Finance Initiative and the United Nations Global Compact. The UN PRI is a set of six voluntary and aspirational principles with the objective of integrating environmental, social, and governance (ESG) concerns into mainstream investment decision-making. Developed in 2005, the UN PRI has grown to be the leading international responsible investment framework whose signatories manage over $15 trillion USD. Signatories are encouraged to internalize the spirit of the six principles which in short entails the
incorporation of ESG metrics in their investment decision-making as well as encouraging other investors and corporate managements to also incorporate ESG metrics into their respective decision-making processes.

To date, the greatest success of the UN PRI is, arguably, its contribution to the legitimacy of the use of ESG metrics in mainstream investment decision-making. The use of certain ESG metrics in traditional SRI investment initiatives throughout the twentieth century attributed a moral legitimacy to the movement (i.e. Sparkes 1995). As a few universal owners began (successfully) relying on certain ESG metrics in their investment decision-making, such as the California Public Employees’ Retirement System’s (CalPERS) reliance on corporate governance metrics, a degree of pragmatic legitimacy was attributed to this behaviour. The pragmatic legitimacy was further supported by studies which documented a positive correlation between corporate financial performance and ESG metrics (Orlitzky et al. 2003; Derwall et al. 2005). Ultimately, however, it was the UN PRI which assembled an international array of institutional investors and supporting financial intermediaries which fully provided pragmatic legitimacy to the incorporation of ESG metrics in investment decision-making and has since offered such strategies a degree of cognitive legitimacy.

With legitimacy in hand, signatories are encouraged to make recourse to their shareowner rights and become engaged with corporate managements; however the principles are not prescriptive in structuring engagement initiatives and both private and public initiatives are encouraged. The UN PRI has expanded its organizational framework to include a ‘reporting and assessment tool’ as well as an ‘engagement clearinghouse’. The reporting and assessment tool is an annual survey signatories are invited to complete which ultimately highlights their performance in implementing the six principles. This survey is simply a guide for each signatory as the UN PRI has no sanctions for weak implementation. The engagement clearinghouse is a members’ forum in which signatories can outline their corporate engagement initiatives in an effort to seek support and refine their strategies.

Participation in either of these two areas is voluntary and all information involved remains strictly confidential. As such, an external audience cannot determine the degree of success of the UN PRI as an organization or the degree of success of individual institutional investor corporate engagement initiatives. This lack of transparency may be an obstacle to an external audience which is attempting to determine the legitimacy of the UN PRI. By means of an original case study of CalPERS’ publicly disclosed institutional investor corporate engagement initiatives we will demonstrate how transparency is in fact required for success in influencing the market for corporate governance.

3. The CalPERS Case

CalPERS is a defined benefit pension fund which was established in 1931 and, as of January 31st, 2007, controlled $232.5 billion USD with $93.8 billion USD in domestic equities with 26.8 percent of this being actively managed (CalPERS 2007). In 1984, CalPERS initiated a corporate governance reform program and has evolved into one of the leading engaged institutional investors in the world (Hebb 2006).

In 1992, CalPERS formalized the structure and content of its engagement program. The engagement program is conducted annually and involves a quantitative screen of approximately 1,200 corporations held within the domestic equity index. The screen is based 40 percent on stock performance, 30 percent on capital efficiency, and 30 percent on corporate governance. The list of underperforming corporations is narrowed via a qualitative assessment in order to identify the 25 most egregious corporations. These corporations are privately engaged and corporations which respond meaningfully are placed on a private Monitoring List. Corporations which do not respond meaningfully are placed on a public Focus List. The annual Focus Lists usually contain 5-10 corporations.
CalPERS persists with its corporate governance engagement program with the understanding that corporate governance is positively correlated with good corporate financial performance (i.e. Gompers et al. 2003; Bebchuk et al. 2004; Cremers and Nair 2005; Brown and Caylor 2006). Over the years, the program has become increasingly focused on improving the transparency of corporate decision-making (Hebb 2006).

The CalPERS engagement program is well studied. Nesbitt (1994), Wahal (1996), English, Smythe and McNeil (2004), Anson, White, and Ho (2003; 2004), Nelson (2006), and Junkin (2006) have all determined that the engagement program is correlated with improved corporate financial performances. Del Guercio and Hawkins (1999) associate the engagement program with positive proxy proposal outcomes. Furthermore, Hebb and Wójcik (2005) have associated CalPERS’ investment strategies with the convergence of emerging market countries’ regulatory frameworks to higher global standards.

3.1 Case Study Methodology: This case study has proceeded by aggregating information from the archived CalPERS Focus Lists which have been checked for completeness against the originally published Focus Lists in the Wall Street Journal (WSJ archives accessed via the LexisNexis Global Business and News Service). Additional information has been collected from Fidelity Investments, the LexisNexis Directory of Corporate Affiliations, and the US Corporate Directory. Two portfolios of corporations have been assembled to allow for controlled quantitative analysis. The Focus portfolio consists of corporations which have been included in a CalPERS Focus List at some point from 1992-2006. The Focus portfolio has a median market capitalization of $5.32 billion USD and a standard deviation of $42.35 billion USD. Each corporation present in the Focus portfolio was matched with an industry-peer corporation in the Control portfolio. The industry class distribution displayed within the Focus portfolio was reflected in the Control portfolio in order to account for industry-specific variations in corporate governance issues. The Control portfolio consists of publicly traded corporations which have never been identified by a CalPERS Focus List. These corporations were randomly selected from the LexisNexis Directory of Corporate Affiliations and the US Corporate Directory. The Control portfolio has a median market capitalization of $1.31 billion USD and a standard deviation of $122.82 billion USD.

From 1992 to 2006, the Focus Lists were publicly released in the Wall Street Journal between the months of February and May. A media analysis was conducted for each Focus and Control portfolio corporation. The analysis proceeded by retrieving Wall Street Journal articles centered on the Focus portfolio corporation 12 months prior to the release of the respective Focus List and 12 months following the release of the respective Focus List. The same was undertaken for each corresponding Control portfolio corporation.

3.2 Case Study Results: CalPERS has initiated approximately 375 private corporate engagement campaigns from 1992 to 2006. Of these, 294 (78.40%) engaged corporations responded to CalPERS’ initiatives in a sufficiently meaningful manner so as to maintain their private engagement status. Eighty-one (21.60%) of the engaged corporations did not respond to CalPERS’ initial private overtures in a sufficiently meaningful manner thereby leading CalPERS to launch public engagement campaigns. Subsequent to the 81 public engagement campaigns, 49 (60.49%) of the engaged corporations remain as publicly traded entities; 29 (35.80%) have been removed from public trading, with 28 (34.57%) having been the target of an acquisition strategy and one (1.23%) having failed due to bankruptcy; information was not available for three (3.7%) corporations (reported as of July 2007). The proportion of publicly engaged corporations which are removed from trading following the release of the respective Focus Lists is statistically significant (t-paired=5.851, df=18, p<0.000).

Focus portfolio corporations received significantly more media coverage in the Wall Street Journal compared to their respective Control portfolio corporations (t-paired=10.765, df=23, p<0.000). Over the corresponding 24 month periods surrounding the release of each Focus List corporations included in the Focus portfolio were reported in a monthly average of 1.77 articles (std. dev.=0.37) and corporations in the Control portfolio were reported in
a monthly average of 0.81 articles (std. dev.=0.16). This finding is perhaps explained by analyses of the role of the media in institutional investor behaviour (i.e. Falkenstein 1996; Clark et al. 2004). Furthermore, there was a clear spike in media coverage of Focus portfolio corporations surrounding the release of the Focus Lists (Fig. 1). This increase in media coverage is significant when compared with prior average monthly coverage of the same corporations (t=3.342, df=3, p<0.04).

[Insert Figure 1 approximately here]

3.3 Case Study Discussion: The information used by CalPERS throughout the engagement program is all publicly available yet there appears to be increased interest in it once CalPERS presents it in a structured manner, as demonstrated by the significant increase in media coverage surrounding the release of the Focus Lists. Although the information is all publicly available, the magnitude of the distribution of the information relating to each corporation’s governance structure and culture may be prohibitive to smaller scale money managers. CalPERS employs a full-time department to manage its corporate governance engagement program. Such high agency costs may preclude smaller-scale money managers from accurately aggregating and synthesizing the information. Due to its large size and market presence, CalPERS gains a ‘monopolistic’ access to information; however instead of privately profiting from this information, CalPERS releases it to the public markets in a structured presentation which is easily assimilated. The Focus Lists may be a way in which CalPERS contributes to the development of efficient markets, as institutional investor ownership has been positively correlated with equity price efficiency (Bartov et al. 2000; Collins et al. 2003; Chen 2007).

The CalPERS Focus Lists connect both internal and external corporate governance mechanisms as they inform other market actors that the identified corporations are potentially undervalued due to poor governance. Equity prices have been positively linked to strong external corporate governance (Gompers et al. 2003; Bebchuk et al. 2004) as well as to strong internal corporate governance (Cremers and Nair 2005; Brown and Caylor 2006). Internal mechanisms ensure the proper governance of the corporations and thus prevent it from being undervalued. External mechanisms ensure that the corporation is exposed to the market for corporate control. The external mechanisms operate as a safeguard in case internal mechanisms were to fail; failure of internal corporate governance mechanisms renders the corporation attractive to hostile takeover bids and external mechanisms ensure that the corporation is not buffered from such risks, thereby aligning management and investor interest.

The greatest concern in the market for corporate control is the availability of reliable information (Manne 1965). The market for corporate control rests on the presence of information asymmetries. Managers and corporate raiders specializing in targeted industries will be informed as to whether underperformance is due to poor management or an unfavourable environment. Most shareowners as well as raiders specializing in other industry sectors may not necessarily be privy to such knowledge (Scharfstein 1988). The CalPERS engagement program effectively rectifies such asymmetries by informing all market participants that the underperformance of the identified corporations is due to poor governance and not solely due to an unfavourable environment. At this point the identified corporations become targets within the market for corporate control by raiders hoping to profit from the supposed unrealized potential value. Furthermore, shareowners are made aware of the potential for greater value and will either support the CalPERS engagement campaigns or will support takeover bids in an attempt to unlock the value.

Mergers and acquisitions generate shareowner value, with target corporations experiencing a 16 percent abnormal positive return in the three day event window and a 24 percent abnormal positive return in a 142 day event window following a takeover bid (Andrade et
Focus List corporations experience a one percent increase in share value upon the public release of CalPERS’ engagement intentions (Wahal 1996) and a 12 percent abnormal positive return in the three months following the release of the Focus Lists (CalPERS 2006). Such an abnormal return can, arguably, be subdivided into three primary causes: (1) a proportion may be due to investor confidence in the CalPERS engagement process which will lead to corporate governance reform and thus improved future financial performance; (2) a proportion may be due to investors expecting to profit from near-future mergers and acquisitions; (3) a proportion may be due to other market actors buying a foothold in the target corporations prior to making a hostile takeover bid (Bebchuk and Hart 2001 have demonstrated that a combination of a proxy fight with a takeover bid is the most efficient approach to acquisitions).

Recall that, from 1992 to 2006, approximately 375 corporations have been engaged by CalPERS and 78.4% of these have responded to CalPERS’ grievances privately thereby avoiding being placed on a public Focus List. These particular corporations recognized the validity of CalPERS’ claims and/or the potential consequences of a public engagement campaign and were therefore willing to negotiate a private compromise. The true threat inherent in CalPERS’ corporate engagement program is not the risk of divestiture but more so the risk of an informed market for corporate control. Universal investors cannot effectively threaten corporate managers with a risk of divestiture as the reduced ability of universal investors to divest themselves of dissatisfactory corporations is what leads them to use voice in the first place. From this perspective, the risk of aggregated, synthesized, and analyzed information previously not fully assimilated by public markets being ‘leaked’ represents a sufficient threat to drive corporate management to action. In the case of CalPERS’ engagement program the threat of public disclosure is not empty as a significant proportion of the Focus portfolio corporations in this study (34.57%) have been acquired following the release of the respective Focus Lists.

Presumably, the continually enforced corporate governance engagement program produces some indirect benefits in that other corporations may ensure they maintain suitable corporate governance structures and cultures in an attempt to prevent themselves from ever even being considered as a potential target by the CalPERS program. Such ripple effects should be considered as an integral component of any responsible investment program. Although the CalPERS corporate governance engagement program relies on both private and public engagement initiatives, it is the presence of the public engagement initiatives, in existence and in threat, which secure the program’s success.

3.4 Case Study Conclusions: CalPERS’ successful engagement initiatives are allied with an active market for corporate control, which is activated by the public disclosure of engagement information. As the majority of institutional investors own less than five percent of any one corporation’s equity they are unlikely to affect corporate reforms when operating independent of other market actors. The lessons from this case study are not limited to institutional investors operating in parallel with active markets for corporate control, but apply to all institutional investors across all markets: successful corporate engagement initiatives are dependent on the activation of other market actors and all such actors are activated by the public disclosure of information. The concentrated shareownershi of institutional investors has the potential to be a strong capital market force in the market for corporate governance; however this force requires structured deployment, which includes public disclosure, in order to be successful.

4. Motivational Forces

Drawing from work by Aguilera, Williams, Conley, and Rupp (2006) and Bansal and Roth (2000), institutional investor corporate engagement, and how corporate management responds to such engagement, can be understood to be driven by the motivational forces
of legitimacy, competitive, and ethical concerns. Ryan and Schneider (2002) have further identified the financial, social, and legal antecedents which influence institutional investor activism. This section will bring these three streams of research together to describe the motivational forces involved in the process and outcomes of institutional investor corporate engagement initiatives with respect to a variety of classes of institutional investors. This description will produce a generalized motivational matrix which will be employed to identify the primary motivational forces at play in determining why 12 Canadian institutional investors decided to become signatories to the UN PRI.

4.1 Motivations: Institutional investors can be categorized as being either private or public. Public institutional investors are managed by a board of trustees and receive their investment capital by means of mandated and/or voluntary contributions. The beneficiaries of public institutional investors, when dissatisfied with the board of trustees can become engaged by means of certain governance channels however usually cannot relocate any investment capital to another institutional investor. Private institutional investors, on the other hand, are represented by management teams which actively compete for investment capital. The beneficiaries of private institutional investors are free to remove and relocate their investment capital as they see fit. The performance of public institutional investors is nominally measured against a legislated rate of return whereas the performance of private institutional investors is measured against peer-group performance.

Inherent to their organizational structure, public institutional investors are not concerned with competitive motivations and are motivated primarily by a need for social legitimacy. It is possible that certain public fund trustees may be motivated by ethical concerns however it would be difficult to act on such motivations if a majority of the fund trustees and a majority of the beneficiaries were not motivated by similar concerns. This is particularly the case if acting on the ethical concerns would sacrifice potential investment returns. Private institutional investors are primarily motivated by competitive concerns as they attempt to attract and retain investment capital, however a smaller sample of private funds may be motivated by ethical concerns. Such private funds typically attract like-minded investors and are willing to potentially, but not necessarily, sacrifice investment returns in order to ensure that their morals and ethics are reflected in their investment decisions.

Institutional investors will adopt responsible investment and engaged shareownership strategies to a degree sufficient to fulfill the motivational force inherent to their organization. Although scholars and practitioners may draft an idealized assemblage of responsible investment and engaged shareownership strategies it is unlikely that institutional investors would internalize this ideal and render it operational. Most public institutional investors, motivated by a search for social legitimacy, will incrementally adopt responsible investment and engaged shareownership strategies to the point at which they attain sufficient legitimacy. As the discourse of responsible investment and engaged shareownership strategies is immature, such social legitimacy is perhaps attainable by simply forming a research group to investigate the possibility of creating such investment strategies. As the discourse matures, and assuming that it remains of concern to the external audience, these institutional investors will be forced, at risk of losing their social legitimacy, to further develop their responsible investment and engaged shareownership strategies.

Similar forces are at play in private institutional investors who will shape their responsible investment and engaged shareownership strategies to attract a particular customer segment. As customer interests change these private funds will seek to adapt their strategies to keep pace; reflexively, they may also adopt certain strategies in an attempt to influence customer interests. Private institutional investors which adopt engaged shareownership strategies can be further sub-categorized as being specialist funds, mainstream funds, and strict SRI funds.
Specialist funds invest in a limited number of corporations and retain some form of industry sector-specific knowledge comparable, or superior, to that of corporate managements; these investors become engaged in an attempt to get their portfolio corporations to out-perform their peers. Mainstream funds invest in a wider array of corporations and adopt varying degrees of responsible investment and engaged shareownership strategies in an attempt to attract an increasing number of customers. These funds typically do not resort to any negative screens and range from funds with no concern for responsible investment and engaged shareownership strategies to funds with fully-internalized responsible investment and engaged shareownership strategies. Strict SRI funds do employ negative screens in their investment decision-making and are willing to sacrifice potential returns in order to ensure their ethical and moral beliefs are reflected in their portfolios. Although some strict SRI funds may engage corporate management such occurrences should be rare as dissatisfactory corporate behaviour will prevent investment during the initial negative screening process or lead to immediate divestiture if the corporation is already in the fund portfolio.

Engaged corporations, on the other hand, are also driven by the same three motivational forces when deciding to act on issues raised during an institutional investor engagement initiative. Corporations seeking social legitimacy will adopt certain reforms if doing so prevents the erosion of their social license to operate. In this case, the engagement initiative will be more likely to be successful if it can contribute to the increasing social pressure surrounding the particular concern. Corporations may also adopt reforms if doing so will lead to a competitive advantage. In this case the engagement initiative must contain some form of specialized knowledge and is not likely to be undertaken by large public institutional investors which do not usually retain such specialized knowledge (Gilson and Kraakman 1991).

Corporations may also adopt certain reforms if the reforms are in-line with managements’ ethical and moral values. In this case, engaged corporations must adhere to a culture which allows for the inclusion of ethical concerns in their operations and the engaged issues must address a broad ethical base in order to be internalized by all corporate officers and directors.

4.2 Canadian UN PRI Signatories: These motivational forces are displayed by the 12 Canadian UN PRI signatories. The 12 Canadian signatories make for an efficient analytical sample as they have all become signatories to the same principles of responsible investment and all operate within the same national political economic landscape yet have all implemented the promoted responsible investment strategies to varying degrees. These 12 institutional investors can be sub-categorized as: four public pension funds, two private pension funds, one private specialist fund, four private mainstream funds, and one private strict SRI fund. The information concerning these institutional investors has been collected from readily available information made available from their own published materials (online and in print). Although additional information is available from filings with provincial securities commissions this information was not openly considered as it is not likely to be readily understood nor assimilated by stakeholders operating outside of the professional financial domains and therefore not likely to contribute to the external audiences’ considerations of legitimacy. The sole unifying variable across all 12 institutional investors is that they all clearly publicize the fact that they have become signatories to the UN PRI.

Of the four public pension funds, two mention having a responsible investment policy however neither is explicit in how this policy is rendered operational. These same two funds also make their proxy voting records readily available. None of the four funds disclose any of their corporate engagement initiatives and only one fund has filed at least one shareholder proposal from 2000 to 2008. Of the two private pension funds, one fund discloses a responsible investment policy and as well as its proxy voting records, however neither discloses any information concerning corporate engagement initiatives nor has either filed a shareholder proposal from 2000 to 2008. Of the four private mainstream
funds, two funds have made responsible investment and engaged shareownership strategies an integral component of their business structure and both clearly disclose their responsible investment policies, their proxy voting records, and their corporate engagement initiatives, and both have regularly filed shareholder proposals from 2000 to 2008. The remaining two private mainstream funds have never filed a shareholder proposal from 2000 to 2008 nor do they disclose any corporate engagement initiatives; one fund clearly discloses its proxy voting records but not its responsible investment policy, whereas the reverse holds true for the other fund. The single private specialist fund does not disclose a responsible investment policy, its proxy voting record, or its corporate engagement initiatives. This fund has never filed a shareholder proposal from 2000 to 2008. The single private strict SRI fund discloses its responsible investment policy and has been a regular filer of shareholder proposals from 2000 to 2008, however it does not make its proxy voting records readily available nor does it disclose any corporate engagement initiatives.

When the opportunity to disclose responsible investment policies, proxy voting records, and corporate engagement initiatives, as well as the opportunity to file shareholder proposals are all considered to be equal responsible investment strategies presented to the Canadian UN PRI signatories, the public institutional investors as a group capitalize on 31.25% of these opportunities whereas the private institutional investors as a group capitalize on 43.75% of these opportunities. Interestingly, mutual funds operating in Canada are required by National Instrument 81-106 to retroactively report their annual proxy voting records to their respective provincial securities commissions yet it appears that only 50% of the observed private funds choose to also make these records readily available to non-professional stakeholders throughout their own promotional material.

As discussed above and highlighted by observations of the 12 Canadian UN PRI signatories, it appears that public institutional investors claiming to adopt responsible investment and engaged shareownership strategies are primarily motivated by a search for social legitimacy whereas most private institutional investors are primarily motivated by a search for competitive advantage. The institutional investors seeking a competitive advantage appear to be more likely to adopt, implement, and disclose a full spectrum of responsible investment and engaged shareownership strategies when compared to institutional investors seeking social legitimacy. It is important to note that although the UN PRI promotes particular responsible investment and engaged shareownership strategies, the average signatory is far from implementing all such strategies.

5. Implications for the UN PRI

The UN PRI remains in the early stages of development, only being formed in 2005. From the above discussion, the following points highlight certain aspects of the current structure of the UN PRI as a representative of the growing body of IVNS financial governance systems:

1. A significant portion of all equities held by institutional investors are held by public institutional investors which are, according to financial, social, and legal antecedents, most predisposed to become active shareowners (Ryan and Schneider 2002).

2. Large public institutional investors are universal owners in that they own cross-sections of entire economies and their returns are thereby based on the interactions of all corporations operating within the economy (Hawley and Williams 2005). As such, universal owners are unlikely to retain any industry sector-specific knowledge comparable to that of industry sector-respective corporate managements and are primarily concerned with reducing long-term risk and corporate underperform-
mance in relation to economy-wide benchmarks. This is opposite the case of private specialized institutional investors which are more concerned with ensuring that the corporations they are invested in out-perform economy-wide and peer benchmarks.

3. As demonstrated by the CalPERS case study, public disclosure is an integral component of any successful institutional investor corporate engagement campaign initiated by a public institutional investor.

4. In theory and in practice public institutional investors adopt responsible investment and engaged shareownership discourses in an attempt to bolster social legitimacy whereas private institutional investors do so in an attempt to bolster their competitive legitimacy.

5. As the responsible investment and engaged shareownership discourse is immature, public institutional investors appear to be able to gain social legitimacy by claiming to participate in such a discourse without offering any form of meaningful transparency or commitment, as demonstrated by the analysis of the 12 Canadian UN PRI signatories.

Herein lays the principal weakness of the current UN PRI structure. The UN PRI is expected to harness the forces of institutional investor shareownership in order to influence the market for corporate governance. For large-scale success the UN PRI must recruit public institutional investors. In order to significantly influence the market for corporate governance such investors must in turn make recourse to public disclosure during their corporate engagement initiatives. For their part, public institutional investors join the UN PRI primarily out of concern for their social legitimacy and are thereby likely to implement the principles only to an extent sufficient to gain their much desired social legitimacy. Without strict guidelines, a clearly delineated structure of accountability, and enforced transparency the UN PRI as currently structured is at significant risk of being used by public institutional investors as a cloak of legitimacy without leading to any significant influence in the market for corporate governance.

The UN PRI is at risk of becoming the victim of its own success. Institutional investors are only capable of gaining additional legitimacy by joining the UN PRI because the UN PRI has managed to legitimize the use of ESG metrics in investment decision-making. Having accomplished this task, however, the UN PRI must adapt or risk undermining its own legitimacy. Following Suchman’s (1995) theory of organization legitimacy, the continuously developing UN PRI must strive for pragmatic, moral, and/or cognitive legitimacy, and ultimately a combination of all three. Cognitive legitimacy is the last form of legitimacy to be granted to an organization and as responsible investment and engaged shareownership strategies are relatively young, achieving cognitive legitimacy will be of little concern in the near- to medium-term. Pragmatic and ethical legitimacy, on the other hand, are critically important at this time.

The UN PRI will be unlikely to maintain pragmatic legitimacy under its current structure. Having legitimized the use of ESG metrics in investment decision-making, the UN PRI is now expected to influence the markets for corporate governance throughout the world by encouraging its signatories to implement the espoused responsible investment and engaged shareownership strategies. As demonstrated, however, the signatories are not required to fully implement the strategies in order to attain the legitimacy they seek from the UN PRI. Without structured institutional investor engagement guidelines which enforce public disclosure, the UN PRI will be unable to successfully harness the power of concentrated institutional investor shareownership. Pragmatic legitimacy is awarded by the external audience when an organization achieves its expected objectives, and the UN PRI appears to currently be unlikely to do so.
The UN PRI is unlikely to retain its moral legitimacy due simply to its lack of transparency. An organization can attain moral legitimacy when it is perceived, from an external audience’s perspective, to have internalized the ideals of the larger audience’s norms, values, and beliefs. Hebb (2006) has demonstrated how public institutional investors are becoming increasingly concerned with issues of corporate transparency. The UN PRI moral legitimacy may be questioned when an increasing number of its signatories demand increased transparency from corporate managements yet ensure that their own actions and those of their UN PRI colleagues remain obscure.

This analysis need not be read as the death knell for the UN PRI. The UN PRI has certain benefits by its position of being the leading IVNS financial governance system. First, the UN PRI has the option of flexibility in its design as the external audience has not yet been conditioned to a particular structure by previous IVNS financial governance systems. Although this does mean that the UN PRI cannot draw on previous peer experiences, the UN PRI should not hesitate to make recourse to the lessons from related NSMD environmental governance systems. Second, having been the organization to legitimize the incorporation of ESG metrics in mainstream investment decision-making, the UN PRI is in a position to actively influence the external audience’s perception of appropriate responsible investment and engaged shareowner strategies. This allows for a more gradual learning curve. Yet this also carries with it the greatest risk of all: the legitimacy of ESG metrics in mainstream markets remains linked to the legitimacy of the UN PRI— a failure by the UN PRI to retain its legitimacy could have significant negative impacts on the emerging ESG metrics industry.

6. Conclusion

IVNS financial governance systems, and the UN PRI in particular, have the potential to be significant actors in the market for corporate governance. These organizations attempt to harness and direct the market forces inherent in institutional investor shareownership. By way of a CalPERS case study, we have demonstrated that institutional investors, if they so desire, can have a significant influence in the market for corporate governance. A market organization which successfully aggregates numerous institutional investors for directed action could, understandably, rival nation-states for rule-making authority in domestic markets for corporate governance. This would be a momentous development in the forces of globalization: IVNS financial governance systems are not beholden to any particular nation-state and have the potential to promote a truly global code of practice accountable only to its own signatories.

The CalPERS case study highlights not only the importance of institutional investor shareownership as a force in the market for corporate governance but also the delicateness of such a force. The successful deployment of this force requires a significant degree of structured management and relies on inter-connections with other market forces. In short, concentrated shareownership in itself is not a market force; it only becomes a market force when purposefully deployed as such. This deployment requires much planning and commitment and, as the case study of the 12 Canadian UN PRI signatories highlighted, most institutional investors are not sufficiently motivated to do so.

The case study of the 12 Canadian UN PRI signatories also documented how public institutional investors adopt responsible investment and engaged shareownership strategies sufficient to garner social legitimacy, and private institutional investors do so to garner competitive legitimacy. As the responsible investment and engaged shareownership discourse is relatively young, it appears that most institutional investors can gain their desired degree of legitimacy by making a commitment to such strategies without necessarily implementing them. To date, this commitment has taken the form of becoming a signatory to the UN PRI.
The UN PRI, as an autonomous organization, must itself be concerned with questions of legitimacy if it desires to become a serious market-based rule-making authority. It has successfully aggregated hundreds of institutional investors and financial intermediaries and is now expected to deploy these harnessed market forces throughout global and domestic capital markets. The UN PRI’s weak degree of transparency, indefinite accountability, and non-existent implementation enforcement capabilities will render such successful deployment nearly impossible. Although the UN PRI’s flexible structure and culture may have been instrumental in attracting signatories, this same flexibility threatens to undermine the organization’s fledgling legitimacy.

The importance of legitimacy cannot be overestimated, as the development of NSMD environmental governance systems in international consumer markets over the last two decades has demonstrated. Initially, thousands of voluntary environmental programs arose to capitalize on consumer market forces in an attempt to secure rule-making authority, yet over the years, these organizations failed to meet their objectives and thus lost their legitimacy and have since become irrelevant. A select few programs, such as the Forest Stewardship Council and other such NSMD environmental governance systems, have managed to develop and maintain their legitimacy as perceived by external audiences and have grown into significant market-based rule-making authorities. The market for environmental corporate governance is now influenced by a balanced relationship between NSMD governance systems and nation-state regulatory agencies.

This same process has been initiated in the global capital markets. The UN PRI may be the first IVNS financial governance system to promote responsible investment and engaged shareownership strategies, but it is unlikely to be the last. Ultimately, domestic markets for corporate governance will be influenced by a balanced relationship between IVNS financial governance systems and nation-state regulatory agencies. The form and function of this balanced relationship will depend on which IVNS financial governance systems are successful in developing and maintaining their legitimacy as perceived by external audiences. Developing and maintaining such legitimacy is not necessarily a straightforward procedure, however the process has now begun and the markets for corporate governance can be expected to be influenced accordingly.
References


