



## Measuring the Impact of Engagement in Canada

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### **Abstract**

Institutional investors are becoming more concerned with the environmental, social and governance (ESG) standards of companies in which they invest. For these investors company-level ESG factors represent future risk when they hold their investments over a long period of time. Given the long-term nature of their portfolios, these investors engage with companies to raise these standards. This paper argues that corporate engagement has the potential to produce a positive change in company behaviour. It asks what leads to successful outcomes in engagement? We seek to quantify any observed positive change in corporate ESG standards that result from engagement. The paper extends the literature on stakeholder engagement. We use three case studies of engagements between institutional investors and companies in Canada over the past five years. We examine the outcomes of each engagement from the perspectives of the investor. We also consider the short term impacts and long term changes in corporate behaviour that resulted from engagement.

**Key Words:** corporate engagement, shareholder engagement, stakeholder theory, environmental, social and governance ESG standards.

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## **Introduction**

Large institutional investors in Canada are increasingly seeing the value in mobilizing shareholder rights to effect change in the environmental, social and governance (ESG) standards of companies in their investment portfolios. Engagement activities range from quiet conversations and private consultations, to minority shareholder resolutions and proxy voting battles. The effectiveness of engagement, both in terms of enhancing shareholder value and improving the ESG standards of companies, is often cited as a reason to maintain ownership of a company rather than divest when company ESG standards are below acceptable levels. However, given the often private nature of engagement and the reluctance of companies to admit that their reason for improvement is due to pressure from shareholder engagement, it is difficult to quantify the impact corporate engagement has on corporate ESG standards.

This paper argues that corporate engagement has the potential to produce a positive change in company behaviour. It asks what are the factors in engagement that lead to successful outcomes? The paper seeks to quantify any observed positive change in corporate ESG standards that result from engagement.

The paper extends the literature on stakeholder engagement. It examines three different types of engagements and sponsoring institutions. It details the impact of power, urgency, and legitimacy on stakeholder salience (Mitchell et al., 1997). It also builds on the sub-attributes of shareholder saliency demonstrated through a series of engagements (Gifford 2009).

The paper provides three case studies of engagements between institutional investors and companies in Canada over the past five years. It examines the outcomes of each engagement from the perspectives of the investor. It also considers the short term impacts and long term changes in corporate behaviour that resulted from engagement.

The paper is laid out in the following manner. In the next section we review the existing literature on this topic. The third section builds a theoretical framework in order to understand the salience of shareholders in their ESG engagement with companies. The fourth section of the paper introduces each of the three case studies and provides data on their engagements and their outcomes. The fifth section of the paper draws on public information and interviews with each of our three case studies to gain a deeper understanding of their engagement process. The sixth section looks at the implications of this research in terms of our theoretical understanding of corporate engagement. The paper wraps up with some concluding observations, the limitations of this current research and future research to be undertaken.

## **Understanding Corporate Engagement**

Responsible Investing (RI), once seen as antithetical to corporate profits, is facing a newly engaged global audience. Post-financial crisis, and with a growing awareness of sustainability issues, mainstream investors are beginning to lend a larger ear to the theme of Responsible Investing (UNPRI 2009, SIO 2008). They are increasing their initially tepid acknowledgement of the issues with a growing support seen in the increasing body of literature devoted to the subject (Hoepner et al, 2009). The old mindset of RI as divergent and to some extent adversarial to company and shareholder goals (Friedman, 1970) is eroding (Donaldson, 1990; Jones, 1995; Freeman, 1999). Responsible investing is being seen as a performance driver, not

as a performance laggard (Porter and Kramer, 2002; SAM 2010). It is seen as a means of driving shareholder profit through the risk management of environmental, social and governance (ESG) issues.

This fundamental change in mindset is being brought about by the reinforcement of the RI business case that seeks to develop and bind the notions of financial performance with environmental, social and governance indicators. The business case contends that it is not simply a matter of ethics but rather that financial gains, management of risk and corporate responsibility converge in the long run (Hill et al, 2006; Wood, 2009). The RI advantage is one of anticipating and mitigating long-term risks, through the implementation of ESG screens and indicators, not simply moral and ethical considerations (AMWG, 2008). However, there are still barriers to larger adoption of RI practices such as a lack of disseminated information linking RI factors to firm performance and a lack of financial incentives for investors.

While mounting attention to RI is new, the overall concept is not. Its not so humble roots were in the anti-apartheid movement and with religious groups who intervened with corporations on specific social and moral issues (Beabot & Schmiesing, 2003; Social Investment Forum 1995). Beginning in the early 1980's these social activist organizations were joined by two other forces, large individual shareholder activists, such as Robert Monks, and large institutional investors such as CalPERS (Hebb, 2008). These shareholder activists brought pressure to bear on companies concerning governance issues when their interests as shareholders were not aligned with company management (Gillan and Starks, 1998; Useem, 1996).

As corporate decision-making is delegated from shareholders to top managers, problems arise when the interests between managers and shareholders do not coincide. This happens when the basic opportunistic behavior of individuals means they would rather make choices that maximize their own benefit over that of others (Eisenhardt, 1989; Luft, 1997). Known as the Principal-Agent Problem, the question arises how to get managers to act as loyal agents for shareholders' interests rather than their own (Jensen and Meckling, 1976; Fama and Jensen, 1983; Schleifer and Vishny, 1997).

Whether or not management and shareholder views are likely to coincide are due to a variety of factors and prevailing conditions; personal preference, ethical beliefs, contracts, goals, organizational culture, and manager values (Diltz, 1995; Agle et al, 1999; Reinhardt et al, 2008; Howard-Grenville, 2006).

The two fundamental mechanisms that a shareholder has to exercise are voice and exit. Voice has the potential to take many forms; private dialogue, public shaming, shareholder proposals and active monitoring. Exit on the other hand, has one simple option, divestiture (Hirschman 1970). While exit appears to be an alternative to voice, the threat of exit could be used as a form of voice (Palmiter, 2002). The threat of exit can further enable the effectiveness of behind the scenes negotiation. In theory divestment is seen as having a negative impact on firms as it can raise the cost of capital for the firm. In reality divestment does not often have an impact on the cost of capital but rather it is the threat to corporate reputation that companies fear. Consequently it is suggested that the threat of exit could possibly speak more authoritatively than conventional voice when used by smaller scale investors (Gallagher et al. 2009). Although

this is difficult to substantiate given the private nature of negotiations when the threat of exit may be used.

Full divestiture is still seen primarily as a means of ridding shareholders of poor performing stocks (Alexandrou and Sudarsanam, 2001). Some studies have noted incentives to divest might not be based solely on performance, but rather private and political views may force management strategies (Jensen and Murphy, 1990; Wright and Ferris, 1997).

Activist shareholders, those who choose to exercise voice in terms of influencing the direction of corporate strategy, use a variety of methods to signify their displeasure with corporate policies and governance issues (Hebb, 2008). While the positive effects of this type of lobbying by large institutional investors has been noted in some cases, known as the CalPERS effect (Anson et al, 2003; Barber, 2006; Smith 1996) and the Hermes effects (Becht et al 2006), there is still some contestation and contradiction in other studies over the positive effects of shareholder activism (Gillan and Starks, 2007; Karpoff, 2001; Romano, 2001).

The differing results of these studies are most likely a result of different metrics used and the single event or stochastic shock under investigation (Karpoff, 2001). Also, the studies which show a lacked correlation between shareholder engagement and financial benefits had access only to public information and due to the private nature of many negotiations it is unlikely that some of the activism was made public (Carleton, Nelson and Weisbach, 1998). In contrast Becht et al (2006), who found a very strong and positive relationship, had access to the material that reflected the behind the scenes negotiations and were able to factor this information into their analysis.

The active nature of voice centered shareholder engagement in terms of monitoring and dialogue with companies can make it prohibitively expensive in terms of potential returns (Bainbridge, 1995). As such it is beyond the means of most mainstream small scale investors who can rationalize leaving engagement to others rather than engaging themselves (O'Barr and Connely, 1992; Hendry, 2004). Generally only large institutional investors are able to absorb the hefty costs of continuous monitoring and overcome the free-rider problem of small investors receiving the same benefit without the associated costs (Coffee, 1991; Gantchev, 2009). However, the willingness of institutional investors to act in coalition and the increasing block ownership of funds are seen to be making it easier for smaller investors to pursue meaningful engagements over divestment (Hawley and Williams, 1997, 2000; Monks, 2000).

Recent studies of stakeholder theory reinforce the claim that shareholders play an increasingly important role in determining the corporate strategy (Wood & Jones 1995; Hillman and Keim 2001; Moneva et al, 2007). In the past, the importance of stakeholder claims was thought to rest solely on the shoulders of whether the particular claim or stakeholder was deemed to be legitimate or not (Clarkson, 1995). Now, stakeholder salience is understood to be the result of a variety of attributes; power, urgency and legitimacy (Mitchell et al, 1997).

### **Building a Theory of Corporate Engagement**

Shareholders have a particular problem when it comes to interacting with the firms in which they have an ownership stake. That is ensuring that the firms, or rather the decision making

managers, are pursuing and making decisions that are in the best interests of the shareholders, not simply representing their own opportunistic ends and needs. This is known as the Principal/Agent Problem and arises when there is a separation of ownership and control (Jensen and Meckling, 1976). The separation occurs when the principal, the shareholders, delegate their responsibilities of decision making to managers at the firm, the agent, who can consequently act in their own self interest and utility maximization which could undermine the interests of the shareholders (Berle and Means, 1932; Galbraith, 1976, 1976, Koford and Penno, 1992).

Principals delegate their decision making authority to agents because the agents who have a greater knowledge and awareness of day-to-day company operations, and hence will be in a superior position to facilitate and orchestrate profit maximizing decisions and choices, which coincides with the primary goal of shareholders (Friedman, 1970). This means that the actions taken by the agent have the potential to create a significant and hopefully beneficial impact not only for themselves but also for the principals. However, as noted above there are certain risks and conflicts of interest associated with this type of relationship which imbues the agent with decision making capabilities and powers of the principal, as both will try for rational utility maximization (Jensen & Meckling, 1976; Koford & Penno, 1992; Luft, 1997).

The point of contention manifests itself in two ways; moral hazard and adverse selection (Eisenhardt, 1989). Adverse selection addresses the possibility of agents misrepresenting their ability to perform their specific tasks and moral hazard refers to the danger of agents not maximizing their effort to act on the principals behalf. Both arise out of conditions of incomplete and asymmetrical information between the principal and agent. And both of these create residual costs (Eisenhardt, 1989). Therefore it is in the principals best interest to reduce the asymmetry of information, by determining what the agents are doing and mitigating behavior that is not in line with the interests of the principal (Shankman, 1999).

Monitoring is one of the control mechanisms that owners are able to exert on firms as a method of realigning their interests and values of the managers and ensuring that their values are being taken into consideration. However, monitoring is a costly exercise, and not something that can realistically be undertaken by a solitary investor because of the prohibitive costs and the propensity of the free rider problem, which undermines the incentives of any one firm to initiate a monitoring program on its own (Coffee, 1991; 1997).

The costly nature of monitoring, originally seen as a barrier to principals exerting a form of control, is slowly being alleviated through the increasing number of large scale shareholders and investors who work in coalitions. These groups are better able to manage and offset the costs of monitoring due to their large size and stake in the firm. This is seen as shifting of the power dynamic between owners and managers (Clark & Hebb, 2004, Hebb, 2008).

But how do firms give priority to the rising number of stakeholder claims? How do they choose who to listen to? Not all stakeholders are treated equally. Some appear to have stronger voices than others (Henriques and Sadorsky, 1999). Mitchell et al (1997) suggests there are three key attributes that affect stakeholder salience; power, urgency and legitimacy. There must be an accounting for all three, as stakeholder influence will be positively related to the

cumulative attribute factors. Gifford (2009) builds on the descriptive framework established by Mitchell and further subdivides the categories into sub-attributes and maps them onto stakeholder engagement practices. He also found that these attributes are most salient when the managers hold values that accommodate the stakeholders concerns.

Gifford suggests “that within the engagement practitioner community, there is a strong preference for legitimacy based engagement in the first instance, with an appropriate degree of intensity, and power being applied only after legitimacy-based options have been exhausted.” This would suggest a temporal element with factors drawn upon in a sequential pattern rather than all at once during shareholder engagement of ESG factors (Gifford, 2009).

Stakeholder theory while still predominantly concerned with the corporate point of view towards business practices (Frooman, 1999) is slowly beginning to take into consideration external factors when dealing with stakeholder relationships (Harrison and Freeman, 1999). Phillips et al. (2003) suggest that stakeholder theory must “... incorporate a respect for both the power of managerial action and the constraints and catalysts stakeholders create for managers” if it is to address the nature of stakeholder importance in changing and improving on company strategy. Reconciling the different avenues of stakeholder research; normative, descriptive and instrumental is difficult, because the different streams function more as alternative approaches to stakeholder theory rather than as complements (Donaldson and Preston, 1995). This represents a serious obstacle in the development of stakeholder theory and will likely keep a unified theory at bay until it is reconciled (Agle et al, 2007).

While addressing the issues of integrated stakeholder theory is important, this article seeks to further develop and build upon normative and descriptive areas of stakeholder theory. It examines which factors contribute to shareholder salience in improving environmental, social and governance standards of investee companies.

## **Methodology**

In exploring the Canadian experience with shareholder engagement and its impact on corporations, the paper uses Grounded Theory to develop a framework inductively from the data collected in our case studies (Glaser and Strauss, 1967). Eisenhardt (1989) argues that “multiple cases are powerful means to create theory because they permit replication and extension among individual cases”. By replication we are not referring to enhancing chances of statistically significant results by increasing sample size, but rather the possibility of collecting more available observations and design variables to enhance depth of our comparisons (Yin, 2009). Our research does not focus on specific variables, recognizing that each case as a whole is a set of complex interactions between variables and it is these interactions within the case as a unit that are important rather than the variables themselves (Eisenhardt, 1989). We develop three case studies; two focusing on institutional investors and one on an investment organization. The three cases are selected based on their size (large institutional investors/advisors), reputation for engagement (leaders in Canada), and representation of different types of investment institutions (pension fund, mutual fund and investment advisor).

Each case focuses on a specific area of engagement, representing either an environmental,

social and governance issue. Data are collected through semi-structure interviews and document review.

The interviews are designed to uncover the impact of engagement from the perspective of the investor. One interview is conducted in person, while the other two interviews are conducted by telephone. Interview questions are constructed to reflect why the organization chooses to engage, how the organization conducts its engagements and the impact of the engagements on the firms. The interaction between these variables contributes to developing a framework of the engagement experience in Canada and its impacts.

In addition to the interviews, some quantitative data are collected through review of public documents. This data includes voting outcomes on shareholder proposals, forms of engagement, focus areas of engagement, changes in corporation's ESG policies and a time dimension. These data complement the interviews, allowing us to quantify observed positive changes in corporate ESG standards and measure them against what we find in interviews related to the reduction of risk or impact on financial returns in aggregate.

Our analysis relies on a comparative case study approach of Grounded Theory (see Post and Andrews, 1982). This allows us to compare cases that are similar with respect to several variables but with different outcomes (impact) and cases with similar outcomes but many variable differences to examine which conditions they have in common, allowing us to uncover some possible causes in both scenarios (Yin, 2009). It is our intention to piece together the individual patterns to draw a more complete theoretical picture of the engagement process. (Eisenhardt, 1989).

### **Three Case Studies of Canadian Corporate Engagement**

In this section, we present data on engagement to gain a deeper understanding of the engagement practices of each of our three case studies, CPPIB, SHARE and NorthwestEthical Investments. Each of the three case studies is separate and distinct. Each has different organizational structures, policy frameworks and mandates. As a result each case study's engagement practices should be viewed as a discreet set of practices. This section of the paper is drawn from publically available information.

The Canada Pension Plan Investment Board (CPPIB), which was incorporated in 1997 as a federal Crown corporation, is a professional investment management organization responsible for investing the \$123.9 billion assets of the Canadian Pension Plan (March, 2010). CPPIB is a large asset owner and undertakes direct and collaborative engagements in the companies in which it invests, as well as industry dialogue, and proxy voting. CPPIB currently focuses its engagement on three areas: climate change, extractive industries (oil and gas and mining) and executive compensation. We examine CPPIB's Climate Change engagement, an area the investor believes to have the potential of significantly impacting long-term shareholder value. CPPIB focuses in particular on the energy and utilities sectors, as the increasing regulations on GHG emissions will likely lead to higher costs for firms. The investor's overall objectives with respect to this focus area are to enhance disclosure and corporate reporting on strategies to manage climate change risks and to improve research and analysis on the impact of increased

regulation of GHG emissions on long-term shareholder value (CPPIB Report on Responsible Investing, 2009).

The Shareholder Association for Research and Education (SHARE) was established in 2000 as a social enterprise with a mandate to coordinate and implement responsible investment practices (SHARE, 2010). It provides services mostly to smaller funds, such as Meritas Mutual Funds, which has combined assets under management (with Qtrade Fund Management) of \$350 million (\$4 billion under administration). We focus on SHARE's Say on Pay campaign, which promotes the establishment of an advisory vote on executive compensation. The Say on Pay campaign began with the banking sector in Canada and grew to include the energy and oil and gas sectors, among others.

Ethical Funds, a Canadian mutual fund company which has been active in socially responsible investing since the 1980's, established its Shareholder Action Program in 2000. In 2007, Ethical Funds partnered with Northwest Funds, creating Northwest & Ethical Investments L.P. (NEI). NorthwestEthical has close to \$4 billion in assets under management (March, 2010). We focus on NorthwestEthical Funds' engagement with Barrick Gold. Areas of engagement with this company have included human rights, environmental justice, biodiversity, climate change, HIV/AIDS. Community Engagement has been a focus of its engagement with Barrick over recent years. In 2006 Ethical Funds submitted a resolution asking Barrick to develop and disclose its Community Engagement and Sustainable Development Guidelines. Unsatisfied with its progress on this issue, the investor filed a second shareholder resolution in 2009 on this issue, which received 17% support.

### ***Breadth and Depth***

We note that independent of their asset size, all respondents target their engagements in an effort to balance their depth and breadth of investments. We also observe that all cover a range of environmental, social and governance (ESG) issues in their focused engagements.

SHARE engages across all three areas. See Figure 1 for a quarterly report of SHARE's 2009 engagements under each ESG category. We see a significant increase in environmental engagements in quarter 3, which is due to SHARE's involvement in the Carbon Disclosure Project's letter campaign (46 letters). Overall, there is some variance between the number of issues addressed under each category.

In 2009 Ethical Funds placed most emphasis on environmental and social issues (38 and 31 engagements respectively) and less on governance (3 engagements). However, from 2006 to 2008 Ethical engaged more heavily on governance issues, writing to all companies on the Toronto Stock Exchange (TSX) Composite Index asking them to link executive and director performance evaluations and compensation plans to the achievement of long term environmental, social, and governance (ESG) objectives, and to disclose this to investors.

In aggregate over 2009, Ethical Funds reported on 72 focus engagements and SHARE reported on 65 (plus 46 letters to companies on CDP). These figures do not reflect number of companies engaged however, because in some cases investors will engage with the same company on several issues. Figure 2 shows the number of focus issues, representing breadth of

engagements that each investor/agent covered in 2009. Ethical covered 7 overall themes and 26 different specific issues, and SHARE addressed 17 issues.

CPPIB in its annual Report on Responsible Investing highlights its impact across each of the three focus areas; climate change, extractive industries, and executive compensation. Many of CPPIB's engagements are undertaken in collaboration with other concerned investors. The report indicates areas where there have been improvements in corporate standards and disclosure. It also details CPPIB's engagement in other areas beyond the three listed above including a collaborative engagement on the Global Compact and issues concerning Burma.

From the information available in public reports we are also able to observe the breadth and depth of the specific engagement cases we focus on in the interviews. SHARE's Say on Pay engagement started with the *big five* banks in Canada and has now reached a total of 21 corporations. NorthwestEthical has engaged on 7 issues with Barrick Gold beginning in 2005. CPPIB's focused Climate Change engagement involves both direct engagement with companies and collaboration through the Carbon Disclosure Project. The Climate Change engagement began in 2006. Ethical's engagement with Barrick Gold originated in 2002-2003 demonstrating the level of commitment involved in each of these focus engagements.

### ***Methods of engagement***

Although at this time we do not have specific data on the number of letters, phone calls and meetings for all three cases, this corporate dialogue can be inferred from the residual of the total number of engagements and in some cases shareholder proposals filed for each investor. SHARE and NorthwestEthical both file proposals as part of their engagement program. In 2009, SHARE filed a total of 23 proposals, which made up 36%, (22% when 46 CDP letters are included) of its total engagement activities. NorthwestEthical filed 11 proposals in 2009, constituting 15% of its total engagement activities in 2009. On average, NorthwestEthical filed 12 proposals over the past five years and SHARE filed an average of 24.5 over the past two years. In contrast, CPPIB has not filed shareholder proposals. However "where appropriate CPPIB will work with other investors to help draft shareholder proposals (CPPIB Policy on Responsible Investing, 2009)."

In 2009, NorthwestEthical filed the majority (eight) of its proposals on issues regarding human rights/ indigenous rights and three related to disclosure on environmental performance. In contrast, SHARE's 2009 proposals are concentrated on governance rather than social and environmental issues, with a total of 21 proposals filed on executive compensation, 1 on a social issue and 1 on CDP disclosure. We find similar results in 2008.

With regard to the method used for each case's specific engagements, Say on Pay began with letters and then escalated to filing proposals. NorthwestEthical took a similar escalating approach to its engagement with Barrick Gold, beginning with dialogue in 2002-2003 on a number of issues and has filed two shareholder proposals since this time against the company.

CPPIB uses a number of approaches for engagement including direct engagement, collaborative engagement, industry dialogue and proxy voting. On issues of climate change CPPIB both engages directly with companies and collaborates with the Carbon Disclosure Project (CDP). In

2009 the CDP sent out 3700 questionnaires including 200 in Canada on climate change. Following a request by CPPIB in 2008, the Canadian Institute of Chartered Accountants published guidelines for the inclusion of climate change-related disclosure in the Management's Discussion & Analysis (MD&A) section of companies' annual reports. Additionally, CPPIB actively seeks and encourages third party research that incorporates long-term, material ESG factors.

One common trend we observe between all three cases is the use of collaboration in their focused engagements. For example CPPIB as mentioned above collaborates with the CDP on its Climate Change engagement. SHARE collaborates with the Canadian Coalition for Good Governance (CCGG) and NorthwestEthical collaborates through the UNPRI on its indigenous people and extractive industry engagements.

### ***Divestment***

In 2005 Ethical Funds divested from 5 of 45 companies it engaged and in 2006 it divested from 3 companies after attempts of engagement were not successful. Since 2006 however, Ethical Funds has not divested from any companies with which it engages. We find no evidence of any of SHARE's engagements resulting in divestment and nor has there been any divestment at CPPIB as they believe that engagement is more effective than divestment in improving company standards.

### ***Proxy Voting***

All three organizations see Proxy Voting as part of their Responsible Investing mandate and see proxy voting as a valuable asset. SHARE divides its services to clients between engagement and proxy voting. CPPIB and NorthwestEthical include it in their engagement activities.

As noted in CPPIB's Report on Responsible Investing, during the 2009 proxy season, CPPIB voted at 3,070 meetings on 17,937 agenda items. CPPIB voted against management 15% of the time. CPPIB reviewed on a case by case basis all of the shareholder proposals and voted on 763 shareholder proposals, comprising 4.3% of all resolutions they voted on. "A number of shareholder proposals were withdrawn by their proponents following successful engagement, resulting in companies agreeing to take action in response to the proposals (CPPIB Report on Responsible Investing, 2009). CPPIB supported several shareholder proposals requesting improved disclosure of governance, social and climate change related risks. Examples include disclosure on environmental and social risk (voted for 18/26 proposals) and majority vote for election of directors (voted for 27/28 proposals).

Ethical Funds voted proxies at 634 company meetings in 2009 and opposed management's recommendations to shareholders 46% of the time. Main areas of contention included director independence, options, compensation, auditor independence, and shareholder resolutions. Ethical Funds supported resolutions filed by shareholders 84% of the time. Although SHARE cannot vote proxies, it provides a comprehensive proxy-voting service to help institutional investors exercise their voting rights. "SHARE assesses environmental, social and governance factors to help investors exercise voting rights in a way that builds long-term shareholder value (SHARE, 2010)."

## ***Impacts of engagement***

### *Shareholder Proposals*

Compared to the results of corporate dialogue, outcomes of shareholder proposals prove to be much easier to quantify. Of the eleven proposals filed by Ethical Funds in 2009, we observe four positive results, where three were adopted after a vote and one withdrawn before making it on the ballot. Ethical characterizes the outcome of two of its proposals as neutral. These two proposals resulted in votes that did not pass but did gain significant leverage or were withdrawn. We observe negative results from the other five proposals, where the support was poor or the vote was not placed on the proxy circular.

Of the 23 proposals filed by SHARE in 2009, we observe that ten have been adopted or withdrawn before a vote. The other thirteen proposals have not yet been voted on or the results are not available publicly. For all proposals filed by SHARE 2008 and 2009 where results are available, all have been adopted, withdrawn, or raised significant support and were adopted in the following year.

### *General impacts*

We also look at results of all methods engagements in aggregate to capture the impacts of dialogue on corporations' behaviour. In the case of Ethical Funds, the investor has experienced more positive results overtime, with positive results in 39.5% of its total engagements in 2006 to 45.7% in 2009. For SHARE it is more difficult to capture the general trends in engagement in terms of percentage since SHARE presents its data quarterly and engagements stretch across several quarters. But overall it is possible to observe an aggregate of 69 positive trends compared to 34 negative trends over 2008 and 2009. CPPIB's annual Report on Responsible Investing highlights a number of areas where their engagement has been successful.

We now turn to considering the particular outcomes of the three focus engagements. For CPPIB, "Several Canadian companies we engaged improved the quality of their reporting on climate change and sustainability issues, including providing more detail. Ninety-nine Canadian companies provided a response to the CDP information request in 2009" (CPPIB, 2009).

For SHARE, of the 'Say on Pay' shareholder proposals that went to a ballot in 2009, the average shareholder support was 53%, (4 votes) which is 12% more votes than received the previous year at Canada's banks. These majority votes have resulted in Say on Pay policies now in place at Canada's major banks. In 2010 SHARE submitted 12 more proposals on Say on Pay and already three companies have engaged in discussions with SHARE in an effort to have the proposals withdrawn.

Ethical Funds has engaged with Barrick Gold since 2002-2003 through dialogue and submitted two shareholder proposals over this time. Areas where engagement appears to have an impact include Barrick's establishment of a human rights policy, joining the UN Global Compact on corporate responsibility and providing antiretroviral drugs to employees and their families in Africa. However Barrick has not been responsive to Ethical's request that the company conduct a human rights impact assessment of a project in the Western Shoshone community in Nevada. Ethical Funds filed a shareholder proposal in 2009 in an effort to get the company to improve its human rights and environmental performance. The proposal received 17% support.

### **Corporate Engagement: Canadian experience**

Semi-structured interviews were conducted over the winter of 2010 with representatives of engagement teams at CPPIB, SHARE and NorthwestEthical Funds. The interviews are designed to identify each organization's definition and approach to engagement, success indicators and impacts. Interview questions are broadly organized into three categories, yet the variables within these categories are intricately linked. The first set of questions explore why investors use engagement, territory that has been extensively covered in responsible investing literature (Hebb 2008). The second set addresses the methods of engagement used by these organizations. An understanding of the rationale and methodology of engagement for each case provides a basis for exploring the impacts of engagement, which is our third category of interview questions. These three sets of questions will build on the data we provided in the previous section to deepen our account of the engagement experience and impacts in Canada.

### ***Why Engage?***

Interviews begin by asking participants what shareholder engagement means to their organization and how they define the concept. The most apparent theme that emerges in this section of the interviews is that all respondents view engagement as a large part of their responsibility as long-term investors. One respondent describes themselves as “active owners that engage to enhance long-term financial performance” (CPPIB). Another comments that “using the rights associated with share ownership, investors can influence companies to improve their management of environmental, social and governance (ESG) risks and opportunities, helping to build accountability and long-term shareholder value” (SHARE). For our third respondent, “engagement is a very crucial part of what we do as investors. We take ownership very seriously” (NorthwestEthical).

All three engagers see engagement as broader than simply dialogue with companies in their portfolio. Rather it represents all positive forms of interaction between the shareholder and the company including, dialogue, reports, direct and collaborative engagement, input to regulators, developing codes of conduct, and proxy voting. In the case of SHARE and NorthwestEthical Funds it also includes submitting shareholder resolutions.

There is also a consensus between investors we interviewed that the definition of engagement extends beyond interactions with companies in their portfolios, to include industry associations, regulators and other stakeholders in the process. Only one respondent framed its definition of engagement by comparing it with alternative forms of socially responsible investing, claiming “[engagement] is preferential to screening stocks”.

Respondents were then asked to identify the process of selecting firms with which they engage. All investors we interviewed have developed focus areas for their engagement. However, we identified some divergence between each cases' process of selecting focus areas. One investor “engages in a portfolio review to establish its focus areas. ESG issues are prioritized using a risk based approach, including relative risk and size of holding” (CPPIB). Although concern for risk is incorporated into the other two respondent's selection process, they both use a range of factors, including Canadian values, investors' interest and expert opinion, to identify corporations and focus areas for engagement. Both respondents acknowledged their limited

resources and suggested that concern for the likelihood of success plays a role in terms of selecting their engagements.

“Some issues are harder to engage on than others. Corporate governance is the easiest because there are mechanisms and support to make this work.” (NorthwestEthical Funds). The respondent suggests issues that are more difficult to engage on such as human rights, are often intangible particularly if there is an absence of credible third parties to promote the cause or the issue is not reflected in legislation. An example of such an issue is ‘free, prior and informed consent’ that impacts communities serving as host to large scale developments around the world (NorthwestEthical Funds).

Engagement can be a costly and resource intensive activity, which raises the question of how it aligns with an investor's fiduciary duties. Two respondents stated that they conduct cost-benefit analysis to determine whether or not to engage with a company. The third respondent suggested that “it is less about costs and more about efficient use of resources and focusing our efforts.” (NorthwestEthical Funds). Though engaging with companies internationally was raised as a cost constraint (NorthwestEthical Funds). Two respondents agree that often “it is too costly *not* to engage in many cases” and our third respondent suggests that “compared to what portfolio managers get paid, shareholder engagement is a bargain” (NorthwestEthical Funds).

When asked to consider whether other investors may abstain from engagement to reap the benefits from others undertaking engagement, one interviewee comments that their organization “works with investors who do not raise the free-rider problem as an issue because for them, improving the environmental, social and governance profiles of the companies in which they invest is an endeavour to which they have strongly committed themselves” (SHARE). All respondents referred to collaborative efforts as a strategy to reduce the costs of engagement. One respondent stressed the importance of collaborative efforts such as the UNPRI which has “tilted the tables in our favour” (NorthwestEthical Funds).

### ***How to engage?***

We then ask our respondents to describe how they engage with firms in their focus areas. This is inherently dependent on their rationale for engagement and will contribute to understanding the impacts of engagement. All respondents indicated that they use a variety of engagement methods and that “the method of engagement we use, depends on the issue” (CPPIB). However, there is some divergence in the method that is used most frequently by each organization and how these methods are applied.

In thinking about the methods of engagement they use, we asked our respondents to describe their engagement approach in terms of the three pillars of stakeholder theory; legitimacy, urgency and power. All respondents identify legitimacy as the most important aspect of their engagement. Legitimacy is not only defined by size of the investor, but also by the approach that is taken in the engagement. All respondents agree that power is a last resort and not something that is commonly used. “We are not often a large investor; we don't often fall in the top ten to twenty investors... corporations are not responding to us because we have power” (NorthwestEthical Funds).

CPPIB's "engagement involves dialogue with senior executives and board members of companies in which we invest as well as with regulators, industry associations and other stakeholders. Engagement can be direct or collaborative with other investors in order to combine resources and expertise (CPPIB, 2009)." CPPIB first conducts extensive research on the engagement before the company is even approached. CPPIB uses a four step approach in its engagements. First it analyzes the ESG risks of companies in its public equity portfolio using internal and third party research. Then it identifies the engagement focus areas considering materiality, time horizon, resource implications and likelihood of success. It determines the optimum method of engagement: direct, collaborative, proxy voting and/or input to regulators. The fourth step is to develop a list of companies for direct engagement and set specific engagement objectives. (CPPIB) With its commitment to disclose its responsible investing activities CPPIB publishes an annual report of its responsible investing activities and achievements.

NorthwestEthical Funds also uses in-person meetings with the progress of these meetings reported in their public documents. Ethical Funds uses minority shareholder resolutions if they do not see significant progress through dialogue. They begin their dialogues with comprehensive research on both the company and the case. Although they lack the size of CPPIB, they gain legitimacy with companies through their engagement approach "We do not treat annual meetings as theatre, we don't embarrass executives through press releases, we do not use the media to make our case. We are solutions oriented (NorthwestEthical Funds)." This speaks to both the use of legitimacy and the use of urgency of the issues in increasing saliency on engagement with companies. However the fact that they are willing to put forward minority shareholder resolutions does increase the power of this small fund.

Consistent with our findings for the other two respondents, SHARE also uses letters and in-person meetings frequently in its corporate dialogue. Also like the other two engagers, solid arguments backed by in depth research provide the organization with the urgency and legitimacy required to gain saliency with the companies with which it engages. For this respondent, "persistence is a key to successful engagement" (SHARE). Like NorthwestEthical Funds, SHARE is also willing to use minority shareholder resolutions when dialogue falters. For them engagement is issues driven "If we can't make headway on the issue and generate support broadly we generally don't pursue it through the proposal mechanism" (SHARE).

Respondents were also encouraged to discuss their experiences with negative approaches to engagement, including divestment and reputational damage. These investors try to avoid the use of negative media campaigns and cited that reputational damage is not in the best interest of investors or the company.

### ***Impact of Engagement***

All respondents agree that measuring success is a difficult task, particularly on an annual basis, as in many cases it may take a few years before seeing any change in a firm's behaviour. Additionally there is difficulty when there is a disconnect between a corporations' policy and performance. A third problem identified by a respondent is determining whether a change in behaviour was a direct result of their own engagement actions, because "corporations are loath to admit that our engagement had an impact on them" (Ethical Funds).

CPPIB uses three indicators to measure success: more disclosure, financial performance, and lower risk. A second respondent's definition of success requires a "concrete balance of depth of dialogue with the companies and the breadth of the engagers willing to address the issue" (SHARE). For this respondent, success is about "attention to an issue where there was no attention before and bringing about change where issuer willingness and/or shareholder consensus is found" (SHARE). Our third respondent measures its success by setting objectives for engagement and tracking against these benchmarks. The results of their engagement measured against key progress indicators are reported annually.

In addition to commenting on more general trends, we prompt our respondents to provide their perspective on the impact of their specific engagements (Climate Change Say on Pay, and Barrick) and the response they have received from corporations. There was some variance in the degree of positive response to engagement that each of the three cases experienced. One investor reported an overall positive response in its focused engagements. "Several Canadian companies we engaged improved the quality of their reporting on climate change and sustainability issues, including providing more detail about how their strategies are being implemented and about performance on climate change and sustainability-related goals (CPPIB, 2009 pp.6)".

Our other two cases both reported experience with some negative responses, claiming that response from the firm depends on the issue, and also on whether the firm has previous experience with the engagement process. In the case of the latter, a positive response was more likely when the firm was familiar with the engager, finds one respondent. The Say on Pay campaign received a very strong positive response. "The response to our letter was quite good, although it took the banks some time to get into the issue substantively" (SHARE). Our third respondent reported a mix of positive and negative responses from its engagement with Barrick.

In general we find through our interviews that urgency and legitimacy are more critical to successful stakeholder salience and engagement than the attribute of power. In the next section of the paper we will discuss the implications of our findings.

### **Testing the Saliency of Shareholder Engagement**

Concern for companies' environmental, social and governance (ESG) standards are becoming increasingly acknowledged by today's investors. In the past financial data was deemed the primary source of information required to judge the suitability of investment. But a deeper understanding of the impact that ESG performance has on risk over time is making Responsible Investing a mainstream activity for investors. With company ESG data now available through such dominant information providers as Bloomberg, Thompson Reuters, and MSCI, investors are able to monitor these standards at the company level with greater efficiency.

The mantra of today's investors is one of active ownership. Increasingly these investors directly engage companies in their investment portfolio in an effort to raise their ESG standards. The three cases under investigation all use corporate engagement as their preferred method of Responsible Investing and active ownership. They see positive corporate engagement as a

more effective method of influencing and raising corporate environmental, social and governance standards than using negative screens or divestment. Increasingly divestment is not being used as a tool to influence positive corporate change, as it is a blunt instrument and doesn't deliver an effective message to company management. The largest of our cases (CPPIB) focuses on engagement rather than on divestment in its climate change engagements. NorthwestEthical has not used it in the past few years, and SHARE is a service provider on engagement rather than an asset owner in its own right.

The question we ask in this paper is whether such engagement does indeed have a measurable impact on companies' ESG standards. If so, to what can we attribute the saliency of these particular stakeholders? It has been suggested that power, legitimacy, and urgency are the key attributes of stakeholder saliency (Mitchell et al, 1999; Gifford, 2009). Our three cases confirm this central thesis.

We suggest that shareholders are stakeholders of today's corporations. Granted they are a unique class of stakeholder given their legal status as owners of public companies. As a result of their status, the claim of shareholders (also known as principals) on the firm is seen as legitimate with their rights enshrined in law (Jensen et al, 1976; Shliefer et al, 1996). While this is also true of other company stakeholders whose claims are legitimized through legal contracts (employees and suppliers), legitimacy is not so clearly recognized for external agents that represent communities of interest such as customers, NGOs and activists. These external stakeholders must work harder to establish legitimacy in their claims than shareholders.

In contrast, shareholders are encouraged to act as corporate monitors, applying a level of oversight to their actions and decision-making. Though it is fair to say that to date shareholder rights have been restricted to a narrow band of influence. Establishing ESG corporate practices are usually seen as the domain of managers. Such practices are often deemed 'ordinary business' and therefore not subject to shareholder intervention. As a result company managers are often unwilling to acquiesce their day-to-day management authority on these issues to shareholders. They resist external interference in setting corporate standards.

Our findings suggest that the power of the shareholder appears to be the least important of the three attributes that contribute to shareholder saliency. Comparing the results of our three cases we find similar impacts on corporations whether the shareholder is large (as in the case of CPPIB) mid-sized (NorthwestEthical) or small (SHARE). Though it should be noted that the two smaller engagers (by asset size) do put forward minority shareholder resolutions if they are unable to achieve satisfactory results with dialogue and therefore bolster their power in their relationship with the firm. In contrast the largest engager, representing the largest fund in Canada (CPPIB), has not used the threat of public shareholder resolutions to achieve its desired results.

In most cases power strategies of divestment and use of media for negative campaigns have not been used. In fact it was suggested that such campaigns are far less successful in achieving meaningful change with companies as they result in entrenched positions and have a negative impact on the reputation of the engager. Only in case of the two smaller engagers was the sub-attribute of shareholder rights used to enhance the power of the engagement. Still, it appears

that legitimacy and urgency in corporate engagement are of greater significance in achieving actual change within companies than power.

While shareholders have legitimacy with the firms they hold in their portfolio, it could be argued that when it comes to raising ESG standards, legal status is a necessary but not sufficient condition. Our case study suggests that for shareholder influence on corporate ESG standards other sub-attributes of legitimacy and urgency are required. Here we draw on the work of Gifford (2009) [See Appendix for a detailed description of the sub-attributes of shareholder saliency.] All three cases undertake extensive research on the issues. They use research to establish a strong case for the environmental, social or governance issue on which they engage. CPPIB first conducts extensive research on the engagement before the company is even approached. This would suggest that while their size and role in the Canadian economy gives them a significant amount of power, they prefer to engage the company through both the urgency of the issue and the legitimacy of their claim.

Strategies to develop legitimacy on issues include white papers, reports, roundtables, and presentations to company managers on the issue. They look for allies, work in coalitions, and point to legislative and regulatory agendas as part of their engagement with the company. All three cases highlight the critical importance of having a solid case to put before management, establishing a reputation, adding value in the discussion, and coming with solution oriented approaches. All three credit their success to their ability to engage management in a positive and constructive manner.

Legitimacy is further enhanced through attributes of knowledge, reputation, and individual values. The status of the engager is also important. Development of the business case for the issue under engagement (as detailed above) was also seen as critical to success in the engagement, as was presenting the societal case and the legal and regulatory framework. All three cases indicated that without building a substantive case on which to engage they doubted that they would have been successful.

Urgency is generated in the engagements but is not the essential driver. All three cases benchmark their engagement outcomes. Several engagements took place over a number of years with successful conclusions. None of the three cases under investigation pointed to the attribute of urgency as a driver of successful engagements nor was the lack of urgency discussed as the cause of unsuccessful engagements. In most cases the ability to bring forward a strong business case to back the ESG concern, combined with a reputation for positive, solution oriented outcomes was given as the key driver in successful engagements.

As suggested by Gifford (2009) each case stressed that the moderating influence of individual values of company management played a role in ensuring successful results from their engagement. In many cases engagers sought out company managers with shared values and a deep understanding of the issue under discussion.

## **Conclusion**

These three case studies examine shareholder engagement and its ability to raise the environmental, social and governance standards of firms. We suggest that such engagement is

able to raise corporate ESG standards. Our three case studies back this claim. Given that shareholders are able to exert influence on company managers, we ask what attributes contribute to the salience of these particular stakeholders? Here we build on the stakeholder typology developed by Mitchell et al. (1997) and further refined Gifford (2009). We find that of the three attributes deemed critically important to stakeholder saliency: power, legitimacy and urgency, that legitimacy is the most critical attribute in shareholders' ability to influence managers to raise corporate ESG standards.

We further find that the sub-attributes of legitimacy detailed by Gifford (2009): credibility of individuals, status and reputation of engaging institution, strong business case, strong societal case, and policy and regulatory environment are critical to successful engagements. While some might assume that the legal status as shareholders would be enough to make these particular stakeholders salient, our case studies indicate that building on this legitimacy through exercising the sub-attributes is critical to successful engagement as measured by meaningful company change.

Currently our research looks at the impact of shareholder engagement from the perspective of the investor. We measure success in engagements using the metrics of the investors rather than from the perspective of the firm. This is a limitation of the research to date. We are unable to focus on impacts of engagement on particular firms using share prices and risk reduction indicators, as this requires significant time to establish a relationship with the firm. In addition, we do not attempt to build an econometric model for measuring the impacts of shareholder engagement. Although the share price, risk and changes in ESG policies of the firm are quantifiable, the independent side of the equation, such as the private conversations between managers and investors and trust building efforts, are complex and would be difficult to assign numerical values to these variables.

Future research will build on our current findings. We will provide a deeper analysis of the underlying externality and its broader social costs that each engagement represents. We will investigate the perspective of corporate managers on the engagement and its impacts. To do this we will interview company managers to capture their understanding of the engagement process and its outcomes in terms of ESG standards at the company level. We will look for their indicators of shareholder saliency and compare these to the investors' perspective detailed in this paper.

Additionally we will attempt to quantify the changes that occurred in these companies as a result of engagement. What change in policies and practices resulted from the shareholder engagement? How were these implemented? What were the outcomes of these changes? How are they measured? Finally we will look to third party ESG rating agencies to see if the improved ESG standard at the company is captured in this data. We will also examine the financial impacts for the firm and investors of the ESG change.

Shareholder engagement is most often cited by institutional investors as their preferred method of implementing Responsible Investing policies (PRI, 2009). To date engagement impacts lack detailed academic research to back the claim of their effectiveness. Through this research we hope to address this gap.



## Appendix

### Attributes of Shareholder Saliency on ESG Corporate Engagement (Gifford 2009)

#### Power-oriented

- **Use of shareholder rights:** shareholder resolutions, votes against management, director elections
- **Use of economic power:** divestment (or investment)
- **Use of the media and/or public statements/peer pressure;** public shareholder campaigns; threats to reputation

#### Legitimacy-oriented

- **Credibility of the individuals:** seniority, experience and expertise; ability to develop trust and collegiality
- **Status of the engaging organization:** degree to which shareholder is perceived to be 'mainstream'; perceived alignment of interests between the shareholder and the company; organizational alignment and consistent messaging
- **Strength of the business case:** validity of the argument; evidence; extent of new information provided to the company; maturity of the issue
- **Strength of the societal case:** social and cultural context; existence of legitimising standards, norms and principles
- **Political/policy context:** supportive political environment; regulatory momentum

#### Urgency-oriented

- **Time-sensitivity:** deadlines, benchmarks
- **Intensity of private engagement activities:** assertiveness and persistence

#### Moderating influences

- **Relative economic and governance power:** size of the stake, investor and firm
- **Coalition building:** leveraging other investors, NGOs and policy makers
- **Values of managers:** degree of alignment with investor request

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