

# Engagement practices in socially responsible investment: Competing paradigms of governance and the emergence of standards

## MBA Dissertation Summary

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Unlike conventional 'screened' ethical investment, **'engagement' SRI uses its ownership stakes to engage companies which under-perform in social, ethical and environmental (SEE) terms in dialogue and shareholder activism**, rather than excluding such companies from its investments. Such investors have effectively turned from 'exit' to 'voice' in their relationships with unsatisfactory companies.

Engagement SRI can be conceptualised within either a shareholder or a stakeholder paradigm of corporate governance. Within the conventional shareholder value paradigm, SRI is **a contribution to shareholder wealth maximisation** whilst in the stakeholder paradigm, SRI can be seen as **a means by which non-financial stakeholders' views and interests are communicated to - and potentially influence - management.**

Engagement fits a principal-agent context in either paradigm. Principal-agent problems typically involve asymmetric information and incomplete contracts in which gaps may be filled through the emergence of conventions or norms. SRI involves two sets of principal-agent relationships: between the investment manager and the corporate manager, and between the beneficiary (or ultimate owner) and the investment manager.

The latter is of particular interest. For an investment manager to sell her services as 'socially responsible', the client requires some assurance of this product feature. Conventional screened funds demonstrated their ethics through the objectively measurable construction of the portfolio. There is no simple means to demonstrate the social responsibility of engagement, and the companies involved are struggling to develop indicators of the effectiveness of engagement activities in changing the policies and practices of companies. **Although several leading UK and US SRI funds now apply engagement strategies, there are no agreed standards of engagement content, practice, reporting or governance against which their effectiveness and quality could be assessed.**

A review of relevant literature suggests that **engagement can be effective in changing company practice.** Collaboration, or scale, can help overcome free-rider problems and increase leverage and credibility. The key challenge for continued and demonstrable effectiveness is achieving the right combination of individualising and socialising measures, balancing the benefits of trust-based dialogue and with the transparency and accountability of shareholder activism. These conclusions are especially relevant for engagement on behalf of a wider stakeholder community.

A qualitative interview survey of twelve engagement managers, examining the governance, development and practice of engagement revealed that different practitioners have different understandings of engagement, which reflect the different paradigms of governance. **Practice suggests that norms are already emerging within and even between these paradigms.** Experience with engagement has led to some convergence of practice, which many funds are already trying to formalise. Networks and alliances are already sharing best practice in more frequent collaboration. But the two paradigms are reflected in philosophical differences between stakeholder and shareholder oriented funds.

The survey revealed established or emerging norms including:

- High discretion for engagement managers - with little influence by clients;
- Confidentiality at least while engagement is ongoing - this emphasises 'socialising accountability';
- A presumption in favour of collaboration - despite pressures on firms to differentiate;
- Treatment of shareholder resolutions as a last resort;
- Detailed reporting to clients, but not to other stakeholders;
- Voting with management except when management is given prior warning of intent to abstain or vote against; and
- Emphasis on face-to-face engagement

Participants in the industry appear to not recognise the potential competitive benefits of more formalised standards. This is partly explained by the likely costs of coordination - particularly given the two paradigms of engagement SRI. **There is a clear case for standards - probably in the form of best practice codes - to deliver marketing and assurance benefits.** This case encompasses both procedural standards - especially transparency - and content standards such as benchmarks for performance and common objectives. Such standards would differentially benefit a group of industry participants, and enhance the overall corporate governance system to help deliver the collective benefits of stakeholding.

**Through interaction between market players and governance institutions, norms and conventions are already emerging and there are incipient standard setting initiatives.** Several coordination norms in engagement practice appear to be emerging spontaneously through imitation and collaborative association. This is establishing a dominant architecture for effective engagement, within which there is competition between stakeholder- and shareholder-oriented models (see figure).

Figure: The paradigms contrasted

	Shareholder-led	Stakeholder-led
<b>Aim</b>	Financial performance improvement	Improvements in SEE practice
<b>Business case for SEE</b>	Central justification for SEE measures	Instrumental for SEE engagement
<b>Use of voice</b>	Because of indexing and scale issues	To represent stakeholders in dialogue
<b>Engagement targeting</b>	Company-oriented	Issue-oriented
<b>Collaborative partners</b>	Primarily other investors	Investors and stakeholder groups
<b>Standards for engagement</b>	Loose; open; process focused	Strict; 'proprietary' to a coalition; process and content
<b>Stakeholder relations</b>	'Management' - balance of power rests with company	'Accountability' - power balanced or rests with stakeholders
<b>Nature of trust</b>	Arises from calculative reasoning	Uncalculative, based in moral case

The case for formal standards is strongest within the stakeholder paradigm. **Emergent conventions are unlikely to reflect wider social interests without collective action by the stakeholder-oriented funds, and the process may even require Government action to seed the desired norms.** However,

if the stakeholder funds seek to set standards pre-emptively, strategic models and the conventions literature suggest they can succeed. Stakeholder oriented funds are beginning to collaborate amongst themselves to advocate and drive standards.

But they will not be unopposed. The philosophical conflict with shareholder-oriented funds is likely to generate a standards battle. **For the shareholder-based group SEE issues are an instrumental tool applied to increase returns to shareholders, whilst for the stakeholder based group, the business case for SEE is an instrumental tool to achieve desirable outcomes for wider society. The two paradigms imply different outcomes and thus different standards.**

There are multiple challenges for stakeholder oriented funds. In the UK, most such funds are part of larger conventional financial institutions, with an overall shareholder-orientation, rather than the stakeholder-orientation of their SRI funds - creating internal tensions. This exacerbates the challenge of accountability for the SRI funds themselves, which can only hope to obtain the marketing and leverage benefits of common standards if they provide strategic coherence between their practice and their accountability to their clients and stakeholders. Stakeholder oriented critiques of agency theory suggest that a delicate balance of trust and transparency is needed at this level too.

Despite accessing rich qualitative information, the conclusions of this paper are only tentative. Further research is needed to examine the effectiveness of activism and engagement in the context of system dynamics. Further work is also needed to examine which stakeholders SRI funds are responsive to, and how, and how those relationships change over time.

The tentative conclusions are:

- **The SRI industry reveals the emergence of a new 'investor-stakeholder' model of stakeholder governance distinct from the fiduciary and representative models.** In this model the SRI fund is both a coordinator and representative of diverse stakeholder interests.
- **Process and content standards for engagement would deliver positive network externalities.** Many of the lessons of strong network industries for standard setting are applicable in the weaker network setting of the SRI industry.
- **Emergent conventions in SRI are not necessarily optimal for society or even participants.** This justifies intervention in society's interests to replace dysfunctional conventions by seeding new ones, or applying reflexive law to establish standards.

To explore fully the challenges of agency theory and derive a comprehensive explanation of how the firm and its stakeholders relate to one another is beyond the scope of this paper. However I hope it offers some additional insight into the question of how private firms may best be governed in the interests of society and in particular, the role of standards in that process.

[ENDS]