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Institutional Investors

– Ethical Criteria and Enforcement Practices

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Abstract

- Title:** Institutional Investors - Ethical Criteria and Enforcement Practices
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- Purpose:** The study aims to answer the following questions: Which are the ethical investment criteria of institutional investors and by what means do Institutional Investors enforce their ethical investment criteria? In order to answer the purpose the thesis aims to: To construct a theoretical framework which serves as a basis to identify and describes the ethical criteria and enforcement means of Institutional Investors. Empiric data will then be used to develop and refine the theoretical framework and to create an understanding of the ethical conduct of the Institutional Investors.
- Method:** A hypothetic-deductive approach was chosen to fulfil the purpose at hand. First existing theories were utilized to construct a preliminary theoretical framework. An explorative empirical study based on qualitative data (interviews with four institutions as well as secondary data gathering on 4 more) was then carried out to create an understanding of the different practices within the institutional investors and in order to refine the applicability of the theoretical frame of reference.
- Conclusions:** The institutions analysed can be categorized within two distinctive 'ethical' groups: the H/H (high level of ethical criteria as well as high level of enforcement) and the L/L (low level of ethical criteria and low level of enforcement) group. Within the H/H institutions have clear and well-defined criteria, often based on international guidelines and which are implemented through structured processes that ensure adequate acquisition and handling of intelligence. Within the L/L group institutions often have vague criteria which are implemented through simple and incomplete ethical governance structures.
- Key Words:** Institutional Investors, ethics, SRI, shareholder value, Corporate Governance, Agency Theory, Exit, Voice

Abstrakt

- Rubrik:** Institutional Investors - Ethical Criteria and Enforcement Practices
- Författare:** Carl Michael Nyberg
Karl Pettersson
- Handledare:** Professor Claes Svensson
- Syfte:** Undersökningen har som mål att besvara följande frågor: Vilka etiska investeringskriterier använder sig de institutionella investerare av och genom vilka medel tillämpar institutionella investerare sina etiska investeringskriterier? För att uppfölja syftet inriktar sig detta arbete på att konstruera en teoretisk referensram som kommer att vara grundläggande för att identifiera och beskriva de etiska kriterierna och tillämpningsprocesser som institutionella investerare har. För att utveckla och förfina den teoretiska referensramen kommer empirisk data att användas.
- Method:** Som metod valdes ett hypotetiskt-deduktivt tillvägagångsätt. Grundläggande teorier har använts för att skapa en preliminär teoretisk referensram. En explorativ empirisk studie baserad på kvalitativ data (intervjuer med fyra institutionella investerare samt sekundärdata av fyra till) utfördes för att få en förståelse av de olika metoder inom de institutionella investerare samt för att förfina applicerbarheten av den teoretiska referensramen.
- Slutsatser:** De undersökta institutionerna kan kategoriseras i två distinktiva "etiska" grupper: den grupp som kallas H/H (hög nivå av etiska kriterier samt en hög nivå av tillämpning) och den som kallas L/L (låg nivå av etiska kriterier och låg nivå av tillämpning). Inom H/H-gruppen har institutionerna klara riktlinjer som tillämpas genom strukturerade processer som tillgodoser adekvata urval och informationshantering. Inom L/L-gruppen har institutionerna ofta otydliga eller vaga kriterier som tillämpas genom enkla och okompleta etiska ägande strukturer.
- Nyckelord:** Institutional Investors, ethics, SRI, shareholder value, Corporate Governance, Agency Theory, Exit, Voice

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2 Introduction

2.1 Background to study

A noteworthy development in the finance sector during the last decades is the growth of Socially Responsible Investing (SRI). SRI can be defined as “[considering] the ethical, social and environmental performance of companies... as well as their financial performance.”¹ Thus, the criteria of an SRI investor are wider than of those that do not invest according to that perspective. The world-wide capital invested in funds with a SRI focus has grown considerably during the last ten years and currently exceeds \$2 trillion,² up from \$1 trillion³ in 1997. In France for example, the total SRI assets invested amounted to 4.4 billion Euros in 2003 as opposed to 2.5 billion Euros a year earlier.⁴ The Managing Director of the State Street Bank, the worlds largest financial assets custodian,⁵ recently claimed that the “world’s largest pools of capital are owned by investors who look favorably upon SRI. SRI has grown rapidly and will continue do so.”⁶ CalPers, the largest pension fund in the United States, has been at the forefront of SRI and more institutions are expected to follow their lead.⁷ CalPers announced its intention to take on a more active role as owner in March of 1996.⁸ In the Swedish setting, a movement towards more frequent institutional investor engagement in corporate policy issues has been observed, especially concerning stock option programs to top management teams.⁹

¹ Mallin (2001), p. 79

² www.socialinvest.org/areas/news/120403release.htm

³ Carroll & Buchholtz (2000), p. 55

⁴ Daniel Brooksbank (1/Apr/04), France sees SRI rise, www.ipe.com

⁵ www.bis.org/publ/bispap02h.pdf

⁶ Investment & Pensions Europe, www.IPE.com/article.asp?article=13449

⁷ Mallin (2001) article, p. 120

⁸ Mallin (2001) article, p. 120

⁹ T:son Söderström (2003), p. 135 f.

It should be noted early on that the term ‘Socially’, as well as ‘Social’, in this context is used quite widely and in addition to its common meaning it may also refer to environmental concerns and an ethical dimension. Thus, the concept of SRI has become synonymous to terms such as ‘Ethical Investing’ and ‘Natural Investing’. As a result of the many names and definitions of this phenomenon, a fundamental consensus of what it means in day-to-day operations is hard to find. A company labeling itself as a “socially responsible investor”, or an investor calling its funds “ethical” in its market communication can actually mean several different things.

A recent example of this quite confusing situation is the public debate between Folksam and Banco Fonder, where Folksam claimed that Banco Fonder misleads their clients by labeling themselves as ethical investors. Folksam's grounds for disputing this label was that Banco Fonder, despite having explicitly stated within its investment policy that weapon-related investments are unethical, held shares within both Ericsson and General Electric (GE). This, as argued by Folksam, was a dishonest practice as Ericsson Microwave Systems are one of Sweden's largest weapon-related products producers, and GE one of the world's largest weapons producers. Banco Fonder responded by noting that in both these cases, the percentage of total company turnover related to weapons is below 5%, being below the cut-off rate utilized by Banco Fonder, and that this rule of thumb was clearly communicated to their clients.¹⁰ The confusion is so widespread that not even the various actors on the market are able to agree on a definition.

Another development that has sprung forward in the finance sector concerns the institutional investors.¹¹ The role of the institutional investors has expanded in an exceptional manner during the past few decades, not only within Sweden but throughout the entire western world. European institutional investment now accounts for more than 336 billion Euros and is expanding steadily,¹² thus making the institutional investors a highly influential part of the

¹⁰ Hermele, Dagens Nyheter, 20040506, Ekonomi, p. 5

¹¹ An institutional Investor is a non-bank or organisation which has preferred treatment and lower commissions as a result of large trading and includes pension funds, mutual funds, investment banks as well as large insurance companies. see <http://beginnersinvest.about.com/library/glossary/bldef-institutionalinvestor.htm>

¹² Investment & Pensions Europe, www.IPE.com/article.asp?article=15542

international financial system. In comparison, the total market value of the companies in the A and O listings of the Stockholm's exchange amounts to 251 billion Euros.¹³ It has been argued that "The key role of institutional investors cannot be underestimated"¹⁴, and that "the growing influence of the institutional owner should be of utmost interest to academic researchers"¹⁵. When considering the difficulties of small, individual shareholders aiming to control a large corporation and the strong incentives for them to free-ride on the work of the majority owners, the institutional investors can be viewed as a perfect fit.¹⁶

The institutional investor community has been under fire lately with criticisms centering on their supposed lack of engagement in ownership issues. The traditional corporate governance strategy used by the institutional investors has been what is known as 'Exit' strategy - to sell the stock if they are not satisfied. This behavior was aptly named the "Wall Street Rule" by observers.¹⁷ However, a collective movement towards 'Voice' (i.e. taking an active role as an owner) has been identified.¹⁸ This may be traced back to pension fund holdings where the enormity limits the owner's ability to sell their stock without creating market disturbances. It could also be a result of the many criticisms directed towards the institutional investor community due their historically passive role.

2.2 Problem formulation

The institutional investor community has seen their share in the stock exchange increase steadily during the last decades. Furthermore, these have been criticized for holding passive ownership policies. In response, they are currently moving towards a more active ownership role, and given the growth of SRI it can be expected that SRI may be a part of their active ownership strategies. Under SRI, corporations are evaluated based not only on their economic

¹³ www.stockholmsborsen.se/exchange/index.asp?lank=17&lang=swe

¹⁴ Mallin (2001), p. 63

¹⁵ Sherman et al. (1998), p. 166

¹⁶ T:son Söderström (2003), p. 134

¹⁷ Sherman et al (1998), p. 167

¹⁸ Sherman et al (1998), p. 167

and legal performance but also on their Corporate Social Responsibility (CSR)¹⁹. However, the market thus far has failed to establish a single definition of what ethical or socially responsible conduct actually means, and what criteria that should be applied to the evaluation of SRI-related conduct in corporations. International guidelines have been established by major organizations to try to tackle this problem. Investment consultants have also sprung up to help institutions implement their ethical investment criteria. Yet little research has focused on the actual criteria and implementation practices which the institutional investors have assumed with regards to ethics. An increase in active ownership would imply a change in the use of governance tools with a greater focus on more direct and political ‘means’ of ownership influence.

It is increasingly important for corporations to understand the ethical requirements laid upon them by their shareholders and the society at large so as to better align their business principles to these requirements. If not corporations can find themselves in situations where their ethical policies are unsynchronized and out of balance with that what is required by their owners. This could entail severe consequences for the executive management team or the stock value of the corporation.

Equally, the incorporation of ethical practices within institutional investment will post severe challenges and changes to these as investment criteria and processes are affected. Traditional processes which focused on estimating the present value of future cash-flows are not sufficient in ethical investments where the scope is wider and thus new criteria and processes are necessary for a correct selection of investments. What these criteria actually consist of is an interesting field of study as the matter of ethics is often vague and open to personal interpretation. The new investment criteria entail new governance structures where traditional engagement based on financial objectives are expanded to include ethical engagement. Thus, the ethical conduct of the Institutional Investors is a highly interesting area as this could affect corporations and institutions alike profoundly.

¹⁹ CSR expands corporate goals to not only incorporate responsibilities to shareholders but also ethical and philanthropic responsibilities towards groups which have an interest in the organisation. See Carroll & Buchholtz (2000), p. 33

The ethical conduct of an investor has thus two dimensions: The investor's integration of ethical criteria in their overall investment process and their level of enforcement of those criteria. The level of enforcement can further be divided into two areas: Selection & Evaluation and Implementation. The thesis thus aims to answer the following questions:

- Which are the ethical investment criteria of institutional investors?
- By what means do Institutional Investors enforce their ethical investment criteria?

2.3 Aim

The aim is to construct a theoretical framework which serves as a basis to identify and describes the ethical criteria and enforcement means of Institutional Investors.

Empiric data will then be used to develop and refine the theoretical framework and to create an understanding of the ethical conduct of the Institutional Investors.

2.4 Delimitations

Our study will focus on Institutional Investors that are based on the Swedish market. Preliminary research indicated that little research had been conducted on this market concerning ethical institutional criteria and practices. The authors thus found it highly interesting to shed some academic light into this yet uncharted geographical area. Furthermore, an expansion into neighboring economies would have broadened the scope of the analysis significantly and would have made conducting an in-depth and thorough examination almost impossible.²⁰ Thus the institutions included in the study conduct the majority of their business, in terms of sales, in Sweden. The thesis will focus on the SRI-related ownership policies of institutional investors; what they consist of and how they are enforced. We will not analyze the extent to which corporations adhere to their socially responsible policies as this is beyond the scope of this study.

²⁰ According to Halvorsen a too broad formulation of the problem is a common mistake authors make within the planning phase. Halvorsen (1992), p.22

Furthermore, the thesis will not take a normative standpoint regarding ethical issues. This means that it will not deem the ethical guidelines or conduct of the examined investors as “right” or “wrong”.

2.5 Target Audience

The target audience of this thesis is primarily the students and faculty of the School of Economics and Management at the University of Lund. Other parties that should find it interesting are the institutional investor community, as it sheds light on their practices within the growing field of socially responsible investment and in addition the business community at large, as it concerns the behavior and expectations of their owners. Moreover, with business ethics and ethical investment being a popular topic in the contemporary debate in society, the authors have a hope that the thesis can reach outside the world of academia.

2.6 Disposition

The first chapter consists of a presentation of the subject of study, its aim as well as background information and problem description.

The second chapter presents the methods utilized in the study as well as the method-related choices made by the authors.

The third chapter is a presentation of the constructed theoretical frame of reference of the study, which is referred to as the governance cycle. It contains relevant theories regarding the governance cycle, such as the agency theory, Hirschman’s theory on Exit, Voice and Loyalty and perspectives on ownership. It also distinguishes the differences in approaches to the governance cycle between the more traditional shareholder value approach and the SRI view, as well as presents a debate between the standpoints with the aim to clarify and provide a deeper understanding to the reader. This debate is deepened in appendix A, for the benefit of the inquisitive reader. Also featured in the chapter are theories on CSR (Corporate Social Responsibility) and Stakeholder balance, which can be seen as the management foundation upon which SRI is built.

Chapter four presents the dominating international guidelines for the criteria of ethical conduct in order to provide the reader with the background knowledge as well as a foundation for a comparison of the criteria of the institutional investors. It also offers the reader information regarding the ethical consultants, GES and Core Ratings, whose services are used by the analyzed institutions.

The fifth chapter presents the empiric material that has been collected in the study, while simultaneously conducting the analysis. The analysis utilizes the theoretic framework that was constructed in chapter three.

The sixth chapter presents the results of the study and discusses their relation to the theoretical framework.

3 Method

A method is a tool; a way of solving problems and reaching new knowledge; everything that contributes to these objectives is a method.²¹ Studies of society present the researcher with a complex and multifaceted reality. There is not one method which is able to capture the richness of reality, which is why a profound understanding of the characteristics of the different methods is important. When selecting a method, the aim of the study should be taken into account.²²

In any academic study or essay, authors make certain choices, consciously or not, regarding the theories applied and their perspective on the problem at hand. The purpose of this chapter is to explain and clarify the choices in methods that have been made during the course of this thesis, as the authors believe that this is necessary for the reader's process of properly understanding and interpreting its results.

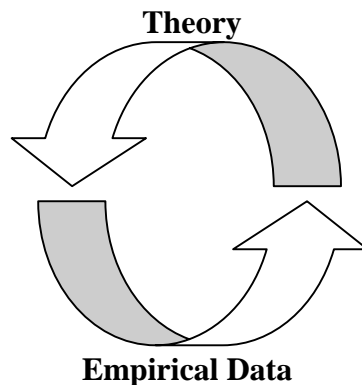
This thesis takes the form of a combined literature, theoretic and empiric study, where the literature study is undertaken in order to generate a profound knowledge base of the problem at hand and from that foundation construct a theoretical framework of the ethical conduct of an investor. The said framework will be utilized in the analysis of the collected empiric material, and will contribute to a deepened understanding and possibly also to the generation of new knowledge. The empiric study also provides the opportunity for testing and developing the theoretical framework.

²¹ Holme & Solvang (1997), p. 13

²² Holme & Solvang (1997), p. 76

3.1 Dominant methodic approach

As no specific theory, which encompasses all aspects of the research study, was found²³, a theoretical frame of reference was constructed prior to gathering and analysing the data. Due to this an inductive²⁴ or deductive²⁵ approach was not applicable. Instead, the hypothetic-deductive approach was chosen as the most suitable as it allowed the authors “to test the sustainability of theories through hypothetical experimentation.”²⁶ Conclusions based on theories are sought when analysing empiric data. The hypothetic-deductive approach aims at simplifying the complexities of reality in order to generate hypothetical assumptions. The boundaries between the theoretical and empirical domains are within this approach rather ambiguous as there is a constant shift between these.²⁷



The hypothetic-deductive approach was thus in line with the two-fold aim of combining the construction of a theoretical framework with an empirical collection of data. The study first used existing theories to construct a preliminary theoretical framework. An explorative empirical study was then carried out to create an understanding of the different practices

²³ Various academic literature as well as a thorough article search, including an ELIN database search and screening of every issue of the journal of “Corporate Governance: An International Review” for the past 5 years, was conducted with unsatisfactory results.

²⁴ An inductive approach attempts to explore certain patterns and phenomena and thereby create a theory in a previously un-chartered research area through analyzing the entirety of the aspects. Holme & Solvang (1997), p. 51

²⁵ Within deductive analysis, quantitative research is preferred, whereas the inductive approach favours a qualitative exploration. Halvorsen, K (1992), p. 78

²⁶ Halvorsen (1992), p. 79

²⁷ <http://www.fpf.sdu.dk/download/presentation/28>

within the institutional investors in order to refine the applicability of the theoretical frame of reference.

3.1.1 Perspective

Prior studies and literature which have been written concerning the field have usually taken a normative approach.²⁸ In these cases, the author(s) have had a distinct opinion on the merits of SRI, which often has influenced their work. In this thesis, the authors have therefore chosen to analyse the problem from a neutral point of view as they believe that such a perspective can increase the objectivity of the study as well as lead to a better understanding of the matter at hand.²⁹ The aim is to study the situation within the institutional investor community through selecting specific institutions with diverse ethical criteria and enforcement practices. The authors seek to find variations within the criteria and enforcement practices of the institutional investors through analysing the various individual actions.³⁰

3.2 Method Selection

The various methods that are available to a researcher can be divided into quantitative and qualitative methods, respectively. Both of these alternatives have their strengths and weaknesses, and the choice of method should be made with the problem formulation of the essay in mind.³¹ Quantitative studies are often conducted based on hypotheses that are tested by statistical methods. As there are relatively few encompassing theories for the study at hand, a theoretical framework had to be created out of the existing academic literature and empirical analysis. Quantitative methods thus were not feasible as the variables to be statistically tested were not known. Furthermore, quantitative methods are formalized, structured and more controlled by the research team.³² Quantitative measures were thus deemed inferior given the specific problem at hand.

²⁸ For example, Boatright (2000), Carroll & Buchholtz (2000) and Vinten (2001) all have a pro-SRI approach while Sternberg (1994, 1998) and Friedman (1962) have a negative view on the merits of SRI.

²⁹ Lundahl & Skärvad, (1999), p.71

³⁰ Halvorsen (1992), p. 38

³¹ Holme & Solvang (1997), p. 14

³² Holme & Solvang (1997), p. 14

The aim of the study is to shed new light into the field of institutional investor ethical criteria, evaluation and implementation practices. Thus qualitative methods have been considered appropriate by the authors as it enables researchers to focus on generating an understanding of the subject at hand. The use of qualitative methods implies a low level of formalization where the central issue is to collect information that will deepen the understanding of the complex problem and describe the totality of the context where it takes place. By analyzing a few institutional investors qualitative studies enabled a greater insight into the relevant variables at hand.³³

3.3 Theory

This thesis has a two-fold aim, and one part of it is to construct a theoretical framework of the ethical conduct of an investor. With that in mind, it is clear that the role played by existing theory in the thesis is an important one. Various academic literatures were collected from the field of corporate governance and ethical investment as well as prior studies on its effects on the market. In the process of conducting the research for relevant theories, several sources were utilized, such as the ELIN article database, the LIBRIS literature search and internet search engines as well as recommendations from our tutor Claes Svensson. This wide approach to the collection of theory ensures that as little as possible of relevant theories were left out.

The theories utilized in the thesis also serve as a foundation for the construction of the theoretical framework, and also help in the interpretation of the collected empiric material. In addition, they provide both the authors and the readers a broad knowledge base in the area of study. It has been argued that a theoretical frame of reference or a model is a compromise between what is 'true' and what is manageable.³⁴ Thus a balance has to be found between the dual purpose of being easy to use and of representing reality properly. When constructing a

³³ Holme & Solvang (1997), p. 14

³⁴ Holme & Solvang (1997), p. 60

theoretic frame of reference, it is of importance to review it critically. Holme and Solvang³⁵ suggest that a theory or a theory construct should be evaluated after the following criteria:

- Are the most important factor represented? Does it explain the phenomenon?
- Are the concepts unambiguous, fruitful and clear?
- Does it lead on to proper conclusions?
- The relation empirical data – theory: Is there a connection?

In the creation theoretical frame of reference it was important for the authors to conduct a broad search for theories. This was done in order to be able to cover relevant factors and provide a wide basis from which the institutional investors could be analyzed. Completeness was sought as the variations within the investment process were to be analyzed. It was thus important to include the various stages of this process within the theoretical frame of reference: investment criteria, selection and evaluation of investments and the implementation of criteria. In order to explain investment criteria, the authors sought relevant theories within ownership perspectives such as the ‘shareholder value perspective’ and the ‘socially responsible investment approach’. The selection and evaluation process of institutional investors could be explained by the agency theory. For the implementation process relevant theories were found within Hirschman’s ‘exit & voice’ framework.

In the theory search and selection process, the authors were guided by certain principles. These principles were based on the assumption that an academic work that seeks to construct a theoretical frame of reference is only as good as its ‘source-theories’ and thus the authors sought academic excellence in the theory selection process. As a result, preferred treatment was given to academic studies and literature as opposed to consultant reports and ‘popular science’-literature. Moreover, acclaimed academic classics, such as Friedman and Hirschman, were preferred over more recent colleagues as to avoid the influence of management fads in the theory section. This was however difficult in regard to theories on SRI and CSR, as these are comparatively recent fields of research.

³⁵ Holme & Solvang (1997), p. 62

3.4 Collection of Data

During the data collection process, a combination of primary and secondary sources was consulted.

3.4.1 Primary data

Primary data was collected in the form of interviews with a number of players within the institutional investor community. Personal interviews were chosen given the sensitivity of the current problem area. Interviews allow the interviewee to gain a deeper understanding of the problem at hand. Personal interviews provided the authors with the means of “questioning” answers and thereby developing a clearer understanding of the situation. In comparison, a study based on statistical questionnaires would not have allowed the freedom to challenge any statements made or elaborate on issues and aspects which might arise. Furthermore, the form of semi-structured interviews has been selected as this enables the authors to gain an insight into the fields which the interviewee deemed important, while also ensuring that certain areas considered of central relevance by the authors were always included. A ‘funnel technique’ was employed, where one first try to gain a general idea of the situation and then proceeds to specific target areas of special importance.³⁶ Due to time and place constraints, the interviews were conducted by telephone. They were recorded to minimize the risk of mistakes and misunderstandings in the process of analysis.

Moreover, an interview with the locally leading consultant within the SRI area provided information concerning the extent of the applicability of the conclusions drawn from the empirical study. This interview was carried out through telephone, and was recorded in order to minimize the risk of mistakes and misunderstandings in the process of analysis. The conclusions from the empirical study will be confronted with the information from this interview in the final chapter.

³⁶ Patel & Davidson (1994), p. 66

3.4.1.1 Respondent selection

The authors found large discrepancies upon closer investigation within institutional investor community concerning their ethical criteria as well as enforcement tools. It was thus important to select a diverse range of respondents based on these differences in order to develop an understanding of the variations and different approaches within the industry and thus be able to develop the applicability of the theoretical frame of reference. The respondent selection process began with the construction of fact sheets on eight different institutional investors in Sweden. These included Folksam, Robur, The Third AP-fund (AP3), AMF Pension, Alecta, Banco Fonder, SEB Fonder and KPA. Information regarding the institution as a whole, investment and corporate governance policies as well as ethical criteria and implementation practices were gathered and summarized. This information was obtained from the websites of the institutions as well as general web searches. Of those eight, four institutions were selected for interviews based on their diversity within their investment policies. Selection of respondents based on similarities would have skewed the empirical foundation and not provided the diversity which was sought. The authors acknowledge that such a method could lead to selection error³⁷ however as the purpose of the study is not to draw a statistically reliable conclusion on the practices of the industry, but rather to develop a theoretical understanding of the situation, the risk of selection error is limited. Interviews were conducted with the following four institutional investors:

- AMF Pension
- AP3
- Robur
- Folksam

It has been argued that the institutional investor community is a heterogenic one: that “institutional investors have heterogeneous objectives that result in different behaviors”³⁸. The institutional investor’s community consists of mutual funds, insurance companies, public and

³⁷ Selection error: The measured respondents are not in proportion to the population as a whole. This is especially the case when one has a smaller number of respondents. Eriksson & Wiedersheim-Paul (1999), p.161

³⁸ Sherman et al (1998), p. 167

private pension funds, endowment funds and banks.³⁹ Through analyzing a diverse group of institutional investors such as pension funds, insurance companies and mutual funds, the authors aimed to generate an overall understanding of the practices within the industry. Due to time constraints the authors have not included the remaining institutional categories. There is a risk that the remaining institutional sectors have ethical criteria as well as enforcement means which differ substantially from the ones analyzed. The authors deem such “elimination error”⁴⁰ as well as frame error⁴¹ to be small as institutions with distinct and diverse investment criteria were sought to provide an insight into the field and furthermore no identical ethical investment and governance practices were identified within the various sectors.

Individuals (see bibliography for personal details) from each organisation with a deep insight into the examined problems were interviewed. Each participant was selected through contact with the respective institutional investor, where the area of interest and purpose of the thesis was presented and the most appropriate individual was named by the company. It could be argued that since the interviews were conducted with individuals that hold different positions in the internal organizations, the answers could be difficult to compare due to the different perspectives of the individual respondents. There is also the risk of the company, by their selection of respondent, affecting the information given in the interview. However, the authors see no better way of handling the respondent selection process. In addition, the authors were aware of this possible problem during the process of analyzing the interviews.

3.4.2 Secondary data

Secondary data has been collected from various journals as well as newspapers and internet resources to provide an understanding of the current market situation and developments. In addition, research was undertaken on the various international standards in the area of business ethics.

³⁹ Sherman et al (1998), p. 167

⁴⁰ Elimination error: When respondents which differ substantially from the norm are eliminated in the selection process elimination error can result as such variables are ignored. Eriksson & Wiedersheim-Paul (1999), p.161

⁴¹ Frame error: When groups of respondents are missing or wrong groups are measured there can be a risk for missed respective irrelevant data collection. Eriksson & Wiedersheim-Paul (1999), p.161

The most common internet sources that were used are ipe.com (a pan-European website specialized in pensions and investment), ges-invest.com (the leading SRI consultant in the Nordic market) and the respective website of the respondents in the interviews (see bibliography for details). As for journals and newspapers, the most commonly employed sources were ‘Corporate Governance: An International Review’ and ‘Business Ethics: a European Review’. These journals were selected due to the explicitly international perspective. Journals such as ‘The Journal of Business Ethics’ and ‘The Journal of Financial Economics’ have predominantly an American perspective and is thus influenced by the Anglo-Saxon system which differs significantly from the Swedish market.⁴² Thus, by employing journals with an international perspective the risk for adopting a less applicable American perspective⁴³ is minimized. This is not to say that the American perspective is uninteresting; however in the context of the thesis it is less relevant.

3.5 Analysis

The analysis is the combination of the collected theories and the empirical foundation. In the process of analysis, the constructed theoretical framework was confronted with the information from the interviews. The analysis was conducted on a company-by-company basis, which provides a holistic perspective on the conduct of each institutional investor making it easier for the reader. Later on, in the conclusion chapter, the companies are compared and contrasted with respect to each stage of their SRI-processes.

3.6 Validity and Reliability

“In order to provide a high validity, both the reliability and the definitive validity have to be high.”⁴⁴ This shows that an empirical analysis does not only have to ask relevant questions given the problem at hand; the empirical data gathered has to fulfill certain minimal

⁴² See De Geer et al. (2003)

⁴³ The American system has often been referred to as a “shareholder oriented model”, as opposed to the rather stakeholder systems of Germany and Japan and Sweden, see De Geer et al (2003), p. 188

⁴⁴ Halvorsen (1992), p. 43

requirements of reliability. In the following two sub-chapters the authors will elaborate on the concepts of validity and reliability as well as present these theories in reference to this study.

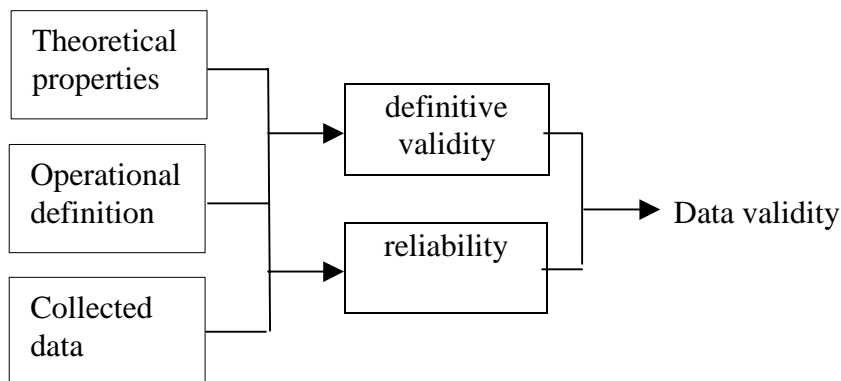


Figure 1 The Input-Output Model⁴⁵

3.6.1 Validity

When conducting research, an important question is if the material collected is valid, i.e. if the applied “measurement instrument” really does measure what is relevant.⁴⁶ Validity concerns the relationship between the theoretical reference of the underlying problem and the operationalisation of the variables to be analyzed in the process of collecting data.⁴⁷ In this study, the operationalisation process was carried out after an extensive period of research. As a result, each of the questions in the interview structure was related to an underlying theory and the constructed theoretical framework to ensure that the operationalisation would be proper. This approach ensures a high validity.

3.6.2 Reliability

Reliability concerns that the measurement instrument and gauges the consistency and stability of results, i.e. the same results would be found provided the study was carried out again.⁴⁸ It is a concept that is more important when conducting quantitative research, than when

⁴⁵ Halvorsen (1992), p. 43

⁴⁶ Halvorsen (1992), p. 41

⁴⁷ Holme & Solvang (1997), p. 167

⁴⁸ Halvorsen (1992), p. 42

conducting qualitative ditto. When using qualitative methods, such as personal interviews, the reliability is less important as a number of factors will affect the answers.⁴⁹ In order to increase the reliability of the study, the interviews were structured in a semi-standardized manner to ensure that certain central areas were always covered. Moreover, the approach was used since it provided a basis for comparison however still enabled the authors to gain a deeper understanding of the problem through asking complementary questions. Furthermore, ethical consultants to the institutional investors were contacted and asked specific questions to test the reliability of the data collected.

3.7 Source criticism

3.7.1 Primary Data:

According to Eriksson & Wiedersheim-Paul researchers need to evaluate their sources out of three critical aspects:⁵⁰

Tendency criticism: The area of SRI and CSR is a sensitive subject; a corporation in contemporary society finds itself under a lot of pressure from various groups to adhere to these principles. As a consequence of this, the risk of biased answers from the respondents is considerable. However, the authors have taken several measures to limit the risk of bias. The choice of a semi-unstructured interview as primary method might be the most prominent as this allows for “counter questions”. Moreover, collecting data from not only the institutional investors but also ethical consultants will limit the risk of influence from biased answers.

Dependency criticism: However, the consultants are dependent on the institutional investors and there exists a risk for skewed answers. To limit this risk, the questions to the ethical consultants did not focus on specific institutional investors but rather on the industry as a whole. Finally, since the authors acknowledge this risk early on in the study, their awareness of this problem throughout the process will be greater. However, a certain risk that a

⁴⁹ Holme & Solvang (1997), p. 94 f.

⁵⁰ Eriksson & Wiedersheim-Paul (1999), p.161

respondent gives untruthful information, or chooses not to present some aspects in their answers cannot be fully eliminated.

Contemporary criticism: In addition, there is also the ever-present risk of the respondents misunderstanding the questions asked, but since these are carried out over telephone both parties have the option of clarifying what they mean. Furthermore the use of a recording device reduced any risk of adverse time effects.

Moreover, when conducting interviews there is a risk for an interviewer-effect, i.e. that the interviewer influences the interviewee during the interview and thus affect the information collected. Through the semi-standard interview approach that was utilized, the interviewee was able to control much of the interview thereby limiting the interviewer effect.

3.7.2 Theory and secondary data:

Concerning the literature study, the material consists primarily of academic literature and publications by respected organizations. The authors have not had the possibility to verify the information presented therein, but still consider the material used as trustworthy as it is based on acclaimed sources.

3.8 Neutrality and personal background

As conclusions can be used for political or ideological purposes, be presented in a fashion which benefits a certain actor or be shifted to suit the requirements, objectivity is of central importance⁵¹ and the authors have gone to great lengths to minimize subjectivity in order to present the findings in as true and accurate a manner as possible. In addition to this the authors asked external individuals (GES Invest) involved within the field to verify as well as criticize findings for greater objectivity and to maximize the inter-subjectivity⁵² of the

⁵¹ Lundahl & Skärvad, (1999), p. 78

⁵² Inter-subjectivity of a conclusion is the point whereby any analyst with equal background and method choice would attain the same result. The conclusion is thus unbiased and objective. See footnote 48.

conclusions.⁵³ The authors have furthermore tried to indicate whenever subjective judgments and conclusions have been drawn or presented.

According to Myrdal, in order to achieve objectivity in social empirical analysis it is essential to present the author's values and political standpoint and make clear how these may have influenced the conclusions. Yet according to Lundahl & Skärvad, in doing so one could end up presenting a shallow and opportunistic account of one's principles.⁵⁴ As the area of business ethics and social responsibility is quite sensitive, the authors have chosen to state their personal views on the matter as clearly as possible: Both of the authors believe that the business community should take on a level of social responsibility that is higher than that required by the law. However, the authors also acknowledge that this is not an area that is black or white in its nature: when dealing with ethics there are no easy and clear-cut answers. Since the authors take a relativist rather than a radical position in this matter, it could be argued that the risk of personal influence on the results, and thus poor objectivity, is rather low. However, this risk still exists and is recognized by the authors, who have consciously re-evaluated their work to try to minimize the influence of their personal opinions in the study.

Regarding personal experience, the authors have a working background within both corporate and personal banking as well as fund management and institutional consulting. Within academia, the authors have a diverse background within the fields of business administration such as marketing and finance. In addition, the authors have both undertaken the Strategic Management program at the School of Economics and Management at the University of Lund. The authors believe that their diverse personal backgrounds as well as academic experience provide a solid foundation for a thorough and objective examination of the matter at hand.

⁵³ Lundahl & Skärvad, (1999), p. 79

⁵⁴ Lundahl & Skärvad, (1999), p. 77

4 Theory

4.1 Introduction

The following chapter contains relevant theories regarding the problem at hand, such as the agency theory, Hirschman's theory on Exit, Voice and Loyalty and ownership perspectives. It also distinguishes the differences in approaches to investment between the more traditional shareholder value approach and the SRI view, as well as presents a debate between the standpoints with the aim to clarify and provide a deeper understanding to the reader. Also featured are theories on CSR (Corporate Social Responsibility) and Stakeholder Balance, which can be seen as the management foundation upon which SRI is built.

Building on the foundations of these theories a theoretical frame of reference, the Governance Cycle, is constructed. The contribution of each theory to the Governance Cycle is explicitly presented throughout the chapter.

4.2 Ownership Perspective

When management is detached from ownership, and especially when ownership is diffused, it is possible for managers to run a corporation to serve their own ends. Therefore, mechanisms are needed for ensuring that corporate assets and agents are devoted to achieving the corporate purpose as established by the owners of stock. This is the foundation of corporate governance, which is thus related to the agency theory (see section 4.6).

Corporate Governance can be defined as “the system by which companies are directed and controlled”⁵⁵. The key concept in corporate governance is accountability. This implies that individuals and institutions are responsible for what they do: they (i.e. Managers) must account to others (i.e. Owners) for their conduct and for their use of resources.⁵⁶

There are two ways of looking at the concept of corporate governance. One view has its roots in the classic economic theory and claims that properly understood, corporate governance refers simply to ways of ensuring that a corporation's agents, actions and assets pursue the definitive corporate ends (i.e. profit) set up by the corporation's shareholders.⁵⁷ This view is known as the *shareholder value perspective*. From this view follows that financial criteria, and those criteria only, should be relevant in the investment process.

The other view takes a wider account of the concept of corporate governance. Here, corporate governance can be understood as: “...a set of relationships between a company's board, its shareholders and other stakeholders. It also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance, are determined.”⁵⁸ This view is known as the *Socially Responsible Investment (SRI) perspective*. This perspective implies that not only financial criteria, but also ethical, social and environmental ones should be applied in the investment process.

4.3 The Shareholder Value Perspective

Shareholders have historically been the most influential stakeholder group as their position has been secured by legislation. Proponents of this theory claim that shareholders are the only ones which are to be regarded as these are the recipients of the residual profit. Shareholders will therefore ensure that companies act in the most effective way possible which in turn would benefit the remaining society.

⁵⁵ Mallin (2001), article p. 118

⁵⁶ Sternberg (1998), p. 30

⁵⁷ Sternberg (1998), p. 18

⁵⁸ Mallin (2001), p. 4

The shareholder value perspective is often referred to as the 'classical economic view'. With its origin in the industrial revolution it is still a widely shared notion of the economy. McKie states that business is indispensably separate from other activities and thus serves other goals than that of social organizations. Corporations should therefore primarily be engaged in economic activities and should be assessed purely according to their "economic efficiency and growth in production of goods and services."⁵⁹ Business organizations have a primary objective of maximizing profits through sustaining efficiency and exploiting opportunities. Social goals therefore cannot be addressed by business.

Friedman, a key proponent of the shareholder value perspective states that "few trends could so thoroughly undermine the very foundations of our free society as the acceptance by corporate officials of a social responsibility other than making as much money for their stockholders as possible."⁶⁰ Friedman goes on to say that "in [a free] economy, there is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition, without deception or fraud."⁶¹ In other words the shareholder value perspective believes that the social responsibility of business is to maximize long term shareholder value. Businesses which pursue other goals directly oppose or defy shareholders requirements and thus are in violation of the 'social responsibility' of the organization. The SRI perspective is in their view a direct violation of the 'business ethics'.⁶² The use of resources for moral purposes is considered a socialistic act, and referred to as an unjust or 'unauthorized' taxation.

Sternberg, another proponent of the shareholder perspective, views social engagement as theft. "Business managers who eschew maximizing long-term owner value, and direct their firms to any other goal, are as much prostitutes as artists or sportsmen who sell out for financial gain. In each case, the activity is perverted, and the 'right, true end' is neglected in

⁵⁹ Boatright (2000) p. 342

⁶⁰ Friedman (1962), p.133

⁶¹ Friedman (1962), p.133

⁶² Elaine Sternberg used the term 'ethics' of business to describe the adherence to the rules of the game. See Sternberg (1994), p. 16

favor of some other extraneous objective.”⁶³ The shareholder theorists believe that it is the responsibility of the rest of the society to establish a legal structure in order for individuals to be “led by an invisible hand to promote an end which was no part of his intention [...] By pursuing his own interest, he frequently promotes that of the society more effectively than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good”.⁶⁴

‘Business ethics’, in Sternberg's view, are thus not discretionary responsibilities as proposed by the SRI perspective⁶⁵ but rather the basic values which enable the trading of goods and services to take place. These include trust, respect, honesty and fairness and are contained within what she refers to as ‘ordinary decency’ (treating equals equally) as well as ‘distributive justice’ (fair distribution of benefits).⁶⁶ Adherence to these unwritten rules will lead to profitable business conduct as stakeholders will engage in business with the organization and the organization can focus on their destined task instead of engaging in ‘self-preserving activities’ as a result of unfair play. Sternberg claims that business cannot ignore their stakeholders as this could lead to a loss in business. Moral considerations have to be made in order to ensure that customers are content with products and services.

In summary, the classical shareholder value perspective thus view business as an “economic activity in which economic resources are marshaled for the purpose of making a profit.”⁶⁷ It views all corporate entities as market variables: Customers purchase goods and services which are in essence regulated by the open market. Equally the firm can ‘acquire’ employees as well as select the best supplier from the open market. This ‘Smithian’ view of the corporation is referred to as the Input-Output Model:

⁶³ Sternberg (1994), p. 42

⁶⁴ Friedman (1962, p.133

⁶⁵ Archie B. Carroll viewed social responsibility to be built around four different layers where legal and economic responsibilities are the foundation upon which discretionary responsibilities, responsibilities which serve a greater social good, are placed. See Carroll & Buchholtz (2000), p. 33

⁶⁶ Sternberg (1994), p. 84

⁶⁷ Boatright (2000), p.357

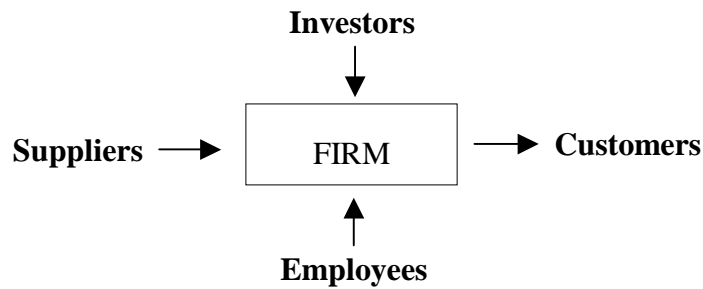


Figure 2 The Input-Output Model⁶⁸

4.4 Socially Responsible Investment

The Socially Responsible Investment (SRI) concept emerged in US in the 1980's. It can be defined as “[SRI] considers the ethical, social and environmental performance of companies...as well as their financial performance.”⁶⁹ It can be seen as “an implementation of what stakeholder theory might prescribe, of theory put to practice”⁷⁰ in an investment context. The total worldwide SRI portfolio exceeded \$1 trillion in 1997,⁷¹ and more than \$2 trillion in 2003.⁷² From a demand perspective, the remarkable growth of SRI has its origins in four separate trends.

The first of these are the changing values, which according to several trend researchers can be identified in some parts of contemporary society. This trend focuses on what is called post-material values, which has led to an increasing interest in the SRI concept. The individuals who connect to this trend tend to be well educated and comparatively well-off in life. The second trend has its roots in ecological imperatives; as the acceptance of the environmental deterioration of the planet is becoming more and more accepted by its inhabitants. The more people that take action guided by this line of thinking the more influential the SRI concepts will become. Yet another trend that has fuelled the growth of SRI has been the rise of

⁶⁸ Boatright (2000), p.357

⁶⁹ Mallin (2001), p. 79

⁷⁰ Sparkes (2001), p. 204

⁷¹ Brill et al (1999), p. 38

⁷² www.socialinvest.org/areas/news/120403release.htm

investment, where the number of people owning and depending on stock has increased heavily during the last 20 years. From being a concern of the wealthy, the stock market is now relevant to all. For the first time in the history of the world, we have a mass culture of investing. As the investment cake is growing, SRI is bound to garner its share of the growth. Finally, there is the rise of the corporations. As a result of an enormous shift in power during the last decades, it has been argued that “Corporations are the real governance system of this country [USA], and in fact the world.”⁷³ The rise of the giant multinational through mergers and acquisitions has created a class of corporations increasingly detached from their former local communities and thus their responsibilities towards it. Not unexpectedly, this has resulted in a response from the communities. As a part of this movement, many people have discovered that they, through their investment choices, can influence the corporations and as a result, SRI has grown more and more important.⁷⁴

The growth of SRI may also be explained from a supply perspective, which explains why a certain investor chooses to incorporate SRI in their investment process. The explanation stems from increased client demand, where the increased demand can be seen as the result of the four trends presented above, working separately or in combination. Moreover, there is the reason of corporate citizenship, a view which is based on the belief that a corporation has a responsibility above those prescribed in the law. This view is strongly contested by those that adhere to the shareholder value perspective. Finally, there are the potential economic benefits; in this view, companies that have a high ethical performance will have a higher long-term return.⁷⁵ However, the various studies which have examined this point have not been able to provide conclusive and reliable answers.

4.4.1 Corporate Social Responsibility

Corporate Social Responsibility (CSR) follows from a decision by management to “expand traditional governance arrangements to include accountability to the full range of stakeholders.”⁷⁶ Thus, it is the management correspondence of SRI. The central line of

⁷³ Brill et al (1999), p. 46

⁷⁴ Brill et al (1999), p. 43 ff.

⁷⁵ Mallin (2001), p. 80

⁷⁶ <http://www.conferenceboard.ca/GCSR/>

thought in the concept of CSR is that the corporations “have not one but many different kinds of responsibility”⁷⁷

On a general level, corporate social responsibility (CSR) can be defined as “seriously considering the impact of the company's actions on society”⁷⁸ This is quite an imprecise definition, but the varying characteristics of corporations make it difficult to reach a suitable consensus that is more precise. There is however a consensus that the totality of CSR includes four aspects:⁷⁹

- Economic responsibilities: A corporation should produce and sell goods and services that society want at fair prices that represent their fair value and an adequate profit.
- Legal Responsibilities: Society has laid down the fundamental rules – the legal system – under which business operate. It is the responsibility of the business community to comply with these rules.
- Ethical responsibilities: These are “additional behaviors and activities that are not necessarily codified into law but nevertheless are expected of business by society’s members.”⁸⁰ Ethical responsibilities are generally poorly defined and under continuous public scrutiny and debate, making them a difficult area for business to adhere to.
- Philanthropic responsibilities: This aspect differs as it is based upon voluntary or discretionary actions yet corporations adhere to these in order to “meet society’s expectations”.⁸¹ This category is often referred to as corporate citizenship.

⁷⁷ Boatright (2000), p.340

⁷⁸ Carroll & Buchholtz (2000), p. 31

⁷⁹ Carroll & Buchholtz (2000), p. 33

⁸⁰ Boatright (2000), p. 340

⁸¹ Boatright (2000), p.340

In brief CSR is thus a “voluntary assumption of responsibilities that go beyond the purely economic and legal responsibilities of business firms.”⁸² Corporations adhering to this will therefore work to achieve a satisfactory level of return yet refrain from certain profit earning activities to fulfill and follow non-economic goals and standards. The corporation thus does not act on a purely financial and legal basis but rather on a broader social level which is “congruent with the prevailing social norms, values, and expectations of performance”⁸³.

Both CSR and SRI have their roots in the stakeholder theory. A stakeholder may be defined as “any individual or group on which the activities of the company have an impact”⁸⁴. The stakeholders are thus a wider group than the shareholders, however the shareholders are part of the stakeholders and are also generally the most influential of them (depending on tradition, culture and legal aspects).⁸⁵ However, if an entity, be it a physical or virtual, is directly or indirectly affected by a company’s actions it is a stakeholder and thus has a right to be considered in the corporate strategies.⁸⁶ Stakeholders therefore include customers, suppliers, partners, employees as well as credit institutions and shareholders. Such stakeholders are directly related to the corporation. Indirect stakeholders include local as well as national governmental bodies and environmental groups.

4.4.2 Strategies for SRI

SRI can be either active or passive: active means that the investor, through the corporate governance system, takes an active role in the company while passive refers to various methods of choosing which corporations to invest in and which to avoid.⁸⁷ The strategic alternatives to an investor, given an SRI context, are a choice between, or a combination of, engagement and evaluation.⁸⁸ The strategic SRI alternatives can be divided into the following categories.⁸⁹

⁸² Boatright (2000), p.340

⁸³ Boatright (2000), p.340

⁸⁴ Mallin (2001), p. 43

⁸⁵ Mallin (2001), p. 14

⁸⁶ Vinten (2001), p. 37

⁸⁷ Brill et al (1999), p. 38

⁸⁸ Brill et al (1999), p.71 f.

- *Engagement*: As a holder of stock, identify where in the corporation that ethical, social and environmental improvements can be made, and encourage the company to make those improvements. This is the only strategy that is based upon direct participation, and thus is considered as the most influential one.
- *Preference*: Work out a set of guidelines that sum up your view on investment, evaluate, and then invest in the companies that are the closest. The preference option can also be carried out by creating a weighted portfolio based on these parameters. This approach combines financial and ethical decision-making.
- *Screening*: Limit investments to a list of companies screened and evaluated for their behavior. The screening process can be done either positively (i.e. Find companies with good behavior) or negatively (i.e. Sort out those companies with poor ethical performance).

Engagement is the only active ownership alternative. An active owner has several alternatives to make their voice heard.⁹⁰

- *Dialogue*: This is what in corporate governance discourse is called the voice option. There are several methods for an investor to use the dialogue option, such as one to one meetings and correspondence by mail.
- *Shareholder resolutions*: This is making official suggestions to the annual meeting for voting, and can be an alternative when the dialogue between an investor and a corporation is unfruitful.
- *Divestment*: When all else fails, the investor has a last resort of selling his stocks, and informing the company of this. Although this may not lead to any changes in corporate policy, if it is done in large enough numbers it might draw attention to the problem.

⁸⁹ Mallin (2001), p. 81

⁹⁰ Brill et al (1999), p. 141 ff.

Concerning the screening and preference strategies, the main question is what can be seen as constituting pro-ethical/social/environmental performance in the evaluation process. This is a controversial issue, and has its roots in the always debatable question of what is ethical? As an example in the U.S., abortion and birth control is one of the top five screens in terms of money.⁹¹

4.5 The Shareholder Value versus SRI debate⁹²

During recent years the debate between the shareholder perspective and SRI has increased dramatically as society is growing increasingly aware of ethical, social and environmental problems and issues. In order to provide a clearer perspective and illustrate some of these arguments within the almost politicized dispute, the academic debate between the two frontiers is presented below. The authors have tried to illustrate these opinions in an unbiased form as it is not their intention to promote either the one or the other but rather to provide an overview of the disagreement.

4.5.1 Shareholder value arguments against the SRI perspective

The main argument against the SRI approach, as well as against CSR and the stakeholder balance view, stems from classical economic theory. This view holds that the corporations as a whole serve only one purpose and has only one responsibility: to provide the holders of stock with profit, naturally while obeying the law.⁹³ Social issues are not the concern of the corporation, and should be left to the free market system. If the free market cannot solve the problem, then it is up to government to do that through legislation. Related arguments suggest that corporations and their managers are not equipped to serve social problems, and engaging in CSR would put the business community out of its depth. Another objection to the concept

⁹¹ Brill et al (1999), p. 94

⁹² For the inquisitive reader, a thorough presentation of the debate is presented in Appendix A.

⁹³ The renowned economist Milton Friedman stated four decades ago that “few trends could so thoroughly undermine the very foundations of our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for their stakeholders as possible. This is a fundamentally subversive doctrine.” See Friedman (1962), p. 133

of CSR is that the corporations are already so powerful, so to leave the social field in their hands would be foolish.⁹⁴

Moreover, it has been argued from the classical economic side that SRI and stakeholder theory are fundamentally wrong and is not leading to better corporate performance. This view of stakeholder theory implies that it is incompatible with the basic corporate objective and also undermines both the concepts of private property and accountability, respectively. It interferes with private property as it takes away the right of the owners of a corporation to do with it what they please while it is incompatible with the concept of accountability as it argues that the manager of a corporation is, in extreme cases, responsible to all stakeholders. This is practically unworkable as one who is accountable to everyone is accountable to no one. In this aspect, the stakeholder theory and thus SRI destroys conventional corporate governance which is based on the accountability of the managers and directors of a corporation to its owners.⁹⁵

4.5.2 SRI arguments

According to proponents of the SRI perspective there are two main reasons for a corporation to embrace the social responsibility (SR) concept: for the purpose of competition and the theory of the social contract. The advocates of the former reason argue that being better at SR than one's competitors is becoming more and more advantageous, in terms of improving the "bottom line".⁹⁶ This school of thought claims that SR is to be seen as a method to improve the financial performance of the corporation. Moreover, it is put forward that the reason that companies take SR to heart is most often a crisis or extreme public pressure, or both.⁹⁷ Thus, SR is not something that commonly emanates from inside the boardroom of a multinational. In this view, the three key benefits of SR are brand value and reputation, improvements in human capital and revenue generation. In summary, the 'bottom line'-approach sees the time,

⁹⁴ Carroll & Buchholtz (2000), p. 39 f.

⁹⁵ Sternberg (1998), p. 93

⁹⁶ Halliday et al (2002), p. 105

⁹⁷ Halliday et al (2002), p. 109

energy and funding that a company puts into SR as an investment that is supposed to pay off financially.⁹⁸

The social contract theory takes another approach to the concept of SR. According to this line of reasoning, an organization is accountable to all its stakeholders because organizations use society's resources and enjoy special privileges from society at large.⁹⁹ Thus, a corporation should embrace the SR concept in exchange for the fact that society provides it with resources. The social contract between the business community and society can be understood through the following two aspects:

- Laws and Regulations: Established by society as a framework within which the business community must operate.
- Shared understandings: Each group's expectation of the other, with concern to role, responsibilities and ethics.

The first aspect – laws and regulations – spell out the formal rules of the game and are by definition clear and easily understandable. The shared understandings, conversely, are known to create more room for mishaps and confusion as this is the tacit part of the contract. They refer the normative perspective – what ‘ought’ to be done by each part.¹⁰⁰

Hill and Jones believe that the argument the stakeholder theory destroys conventional corporate governance due to denial of accountability is fundamentally flawed as the foundation upon which corporate governance is built, i.e. the principal-agent relationship, is in effect “a subset of the general stakeholder-agent relationship”¹⁰¹. Furthermore, proponents of the theory claim that the view that the basic concepts of private property will be undermined by including stakeholders is fundamentally flawed as including the entire spectrum does not necessarily lead to a win-lose situation as proclaimed by Sternberg.¹⁰²

⁹⁸ Halliday et al (2002), p. 112 f.

⁹⁹ Sternberg (1998), p. 103

¹⁰⁰ Carroll & Buchholtz (2000), p. 18

¹⁰¹ Vinten (2001), p. 41

¹⁰² Vinten (2001), p. 42

4.5.3 Overview

Depending on what view of ownership that is preferred by an investor the investment criteria will differ as is visualized by the diagram below:

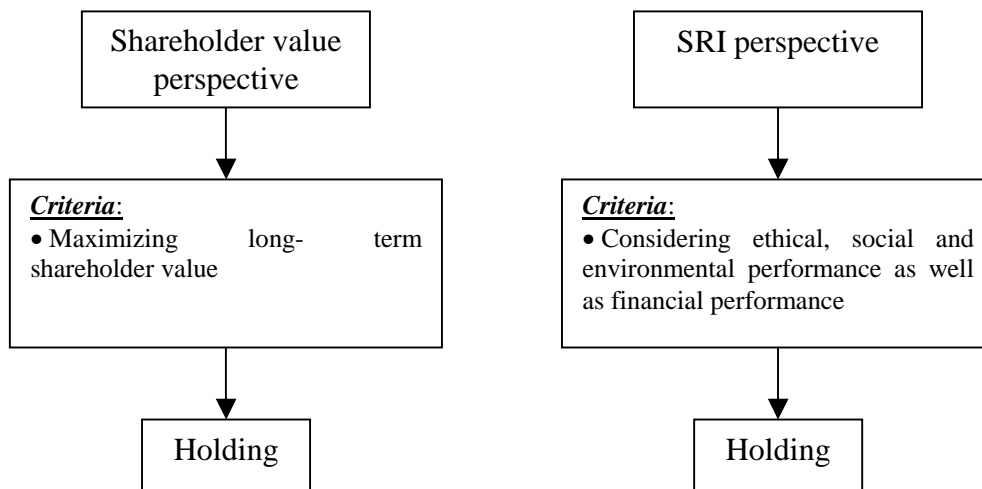


Figure 3 Investment Perspectives

4.6 The Agency theory

The Agency Theory refers to a relationship in which one party (i.e. the principal) delegates work and responsibility to another party (i.e. the agent).¹⁰³ This relationship could be said to be the raison d'être for the field of corporate governance. In the corporate governance context there is a separation of ownership and control where the investor acts as the principal and the board of directors and management as the agent. For a holder of stock, this means that the management of his property is transferred and that he loses the opportunity to continually follow the operations and take part in the management. This pacification of ownership creates a space for action for the board and management of the company which is to be used in its best interests. Herein lays the conflict: neither the board nor management is guaranteed to have a direct financial interest in the decisions they make while those who do have relinquished the right to intervene.¹⁰⁴

¹⁰³ Mallin (2001), p. 10

¹⁰⁴ Bergström & Samuelsson (2001), p. 79

4.6.1 The principal/agent-relationship

A distinctive characteristic of a principal/agent relationship in a corporate setting is that the parties at the start of the relationship as well as during the length of it have different information about the operation. The agent will, during the course of the relationship receive information and develop knowledge through his involvement in the operations and the principal has no way of doing this. The problematic aspect is whether the agent chooses to use this advantage to serve himself or the company. This asymmetry of information can be broken down into two areas: adverse selection and moral hazard.¹⁰⁵

4.6.2 Adverse Selection

Adverse selection concerns the type of information-related problems that exist between the principal and the agent before an agreement has been reached. In a corporate governance context this implies that an investor that seeks to invest in a certain company has significantly less information about the future risks and opportunities than the current holders of stock and the management of the company. This in turn affects the selection of investments. When one party has more information regarding a certain problem than another this situation can arise. The party with more information is then induced to lie to gain an economic profit.¹⁰⁶ A way for the investor to minimize this problem is through due diligence, however this process is dependent on correct and adequate information from the company of interest.¹⁰⁷ A further measure in order to minimise asymmetric information is through consulting external “expert” information.¹⁰⁸

4.6.3 Moral hazard

This aspect of the problem of asymmetric information focuses on the principal/agent relation after a deal has been agreed, since the problem then changes characteristics. The main issue from this moment and onwards concerns whether the agent will make the decisions that are

¹⁰⁵ Bergström & Samuelsson (2001), p. 22 f.

¹⁰⁶ Schotter, (2001), p. 615

¹⁰⁷ Bergström & Samuelsson (2001), p. 23 f.

¹⁰⁸ Schotter, (2001), p. 615

the most appropriate from that principal's perspective and not take advantage of the fact that decision-making has been delegated to him. A related problem is the difficulty of proper monitoring of the agent inherited in the delegating of responsibility. From a corporate governance perspective this means that the owners of stock elect a board of directors that in turn chose a CEO who is responsible for the day-to-day operations of the company. Since the owners of stock are unable to continually monitor the CEO (due to technical difficulties and the fact that this would mean that the very purpose of delegating responsibility would disappear) there is insecurity if the management looks after the interests of the owners in the same manner as if the owners would have managed the company themselves.¹⁰⁹

4.6.4 Agency costs

If both the principal and agent act in a way that maximizes their personal utility there is always a risk that the agent will not act in the best interests of the principal. The costs incurred in minimizing this risk are called agency costs. A method to minimize the risk is through detailed and specific contracts, but the cost of creating a contract so precise that it covers all possible future scenarios would be almost infinite.¹¹⁰ Other alternatives for lowering the agency costs are through incentives and monitoring, however these come combined with both costs and effort. From a marginal utility perspective, it cannot be considered optimal to spend resources on fully eliminating the agency costs. Thus, there is rarely total congruence between the decisions of the agent and the will of the principal.¹¹¹

One of the ways of ensuring goal congruence between the principal and the agent, and through this avoid as much as possible of the agency costs, is through management's duty of loyalty.¹¹² From a judicial perspective the duty of loyalty implies that a representative of a company must abstain from transactions where he does damage to the principal or favors himself at the expense of the principal. Simultaneously, this bars the possibility for the management of a company to favor any other interest than the company itself. "In a joint

¹⁰⁹ Bergström & Samuelsson (2001), p. 25

¹¹⁰ Bergström & Samuelsson (2001), p. 27

¹¹¹ Bergström & Samuelsson (2001), p. 28

¹¹² Bergström & Samuelsson (2001), p. 110

stock company it [loyalty] can thus never be directed at another part of interest than the company's and the holders of stock's common interest of profit. ”¹¹³.

4.6.5 Overview

The agency theory is summarized in the diagram below. Investors have certain investment criteria which lay the foundation of the investment process. Selection is based upon these criteria. In order to minimize the risk for adverse selection information asymmetry is required to be minimized. After an investment the Investor evaluates the performance of the holding in relation to the investment criteria. Here information plays a critical role as it determines what can be measured. The relationship between the investor and its holding is of a principal-agent nature.

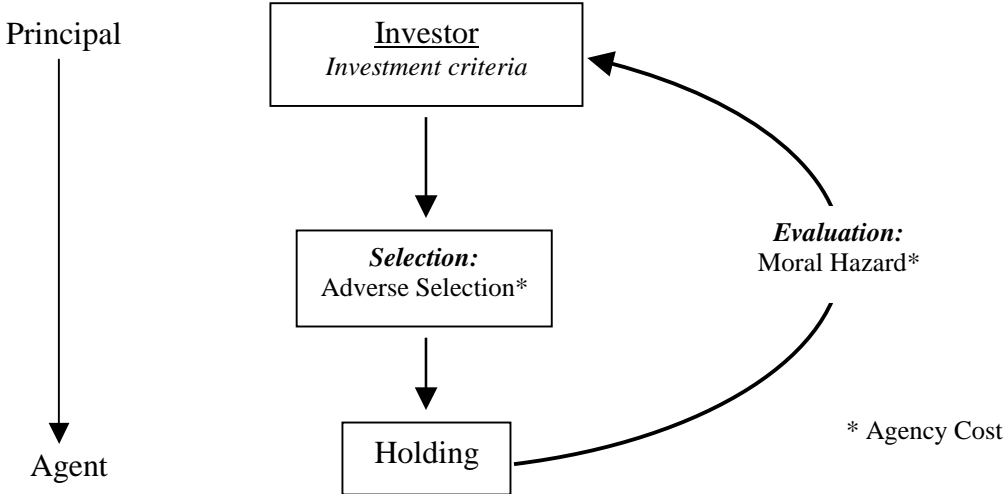


Figure 4 The Agency Theory

4.7 Exit and Voice

Regardless of how well a system is constructed or its components are selected, some of them might fail to live up to what is expected of them. For an investor, this implies that the investment performs below the standard according to whatever criteria the investor has selected as measurement. When this situation occurs, the investor has two fundamental

¹¹³ Bergström & Samuelsson (2001), p. 111

options: to sell the investment or to try to influence its future actions. These alternatives are described by Albert O. Hirschman in the theory of Exit and Voice. Voice is a political course of action, while exit is described as belonging to the economic realm.¹¹⁴ It should be noted that in its original form, the theory of exit and voice mostly concerns the relation between a company and its customers. However, the terminology is also suitable to describe the relationship between an investor and an investment. Hirschman also introduces a third term, loyalty. It is not used to describe a certain behavior, but is rather one's propensity to act in a certain manner (i.e. exit or voice).

4.7.1 Exit

In contrast to voice, exit is an economic rather than a political term. When taken into action, the market's mechanisms are used to protect or improve one's welfare or investment. It is uncomplicated, easy to use, and has a guaranteed result. It is defined by Hirschman as "...customers stop buying the firm's products or some members leave the organization"¹¹⁵ Thus, the exit option only signals that something is wrong. In the context of this thesis, the exit option implies selling the shares that the institutional investor owns in a certain corporation, if the investor's expectations are not met.

4.7.2 Voice

Voice is the alternative which belongs in the political realm; using one's influence to attempt to change the behavior of another actor. It is an attempt to change, rather than escape, a problematic situation. This can be quite a complicated and confrontational process, as it involves the articulation of one's problem rather than an anonymous exit.¹¹⁶ Hirschman defines voice as "The firm's customers or the organization's members express their dissatisfaction directly to management or to some other authority to which management is subordinate or through general protest addressed to anyone who cares to listen."¹¹⁷ In other words, the voice option not only signals that something is wrong, it also articulates what that

¹¹⁴ Hirschman (1970), p. 15

¹¹⁵ Hirschman (1970), p. 4

¹¹⁶ Hirschman (1970), p. 15

¹¹⁷ Hirschman (1970), p. 4

problem is. In the context of this thesis, the voice option is related to corporate governance: to use one's influence as owner to change the behavior of a certain corporation.

4.7.3 Loyalty

Theoretically, the presence of the exit option should reduce the probability of the use of the voice option dramatically. It is simpler to use and less costly. However, this notion fails to take the concept of loyalty into account. Loyalty, or in other words a special attachment to an organization, increases the probability of voice through the postponement of the exit option.¹¹⁸ However, in an institutional investor context loyalty should not be as influential as in the customer context used by Hirschman where aspects like brand loyalty is common. The concept of loyalty is therefore deemed as comparatively unimportant in the context of this thesis. In addition, it should be noted that there seems to be a widespread confusion¹¹⁹ as to the interpretation of the term loyalty. An alternative view is that loyalty is actually a third option and not a determinant in the choice between exit and voice. Loyalty is thus regarded as the passive option i.e. where no action is taken. Within this essay the authors have used the definition of loyalty as a determinant of voice contra exit.

4.7.4 Exit or Voice?

The choice between exit and voice is principally controlled by two determinants:¹²⁰

- The extent to which the customers (or investors) are willing to give up the certainty offered by the exit option for uncertainty and possible improvement through voice.
- The estimated influence that a customer (or investor) has on the organization.

Another factor that is bound to have influence is the number of alternatives available to the disgruntled customer or investor: if there are plenty of comparable investments, the probability of exit increases and vice versa. Moreover, the choice between exit and voice in a certain situation will often be decided by the expected outcome of the use of voice. That is, is

¹¹⁸ Hirschman (1970), p. 77

¹¹⁹ After a comprehensive search the authors have found two different interpretations of the term loyalty.

¹²⁰ Hirschman (1970), p. 77

the expected outcome of the voice option is no effect; the exit option will be used. If one believes that the voice option will have an effect, then the use of the exit option is postponed. This line of reasoning stems from the notion that once the exit option is used, then the voice option will be unavailable, while exit can be a last resort after voice has failed.¹²¹ However, voice tends to be costly when compared to exit, and is also dependant on the bargaining power of the customer or investor.¹²² Thus, when an investor's bargaining power is small (i.e. if the investor owns only a fraction of the shares in a corporation), the exit option will be attractive and vice versa.

4.7.5 Overview

If a holding does not fulfill the investment criteria of the holding company the investor can either act through voice or exit. Exit is the process whereby the investor sells its position. Voice is the tool by which an investor can try to influence its holding to alter its actions to comply with the given criteria. The decision of alternative strategy an investor chooses to adopt is dependent on its loyalty towards its holding. The more loyal the investor is, the more likely the investor will adopt a voice strategy. The relationship is described in the diagram below.

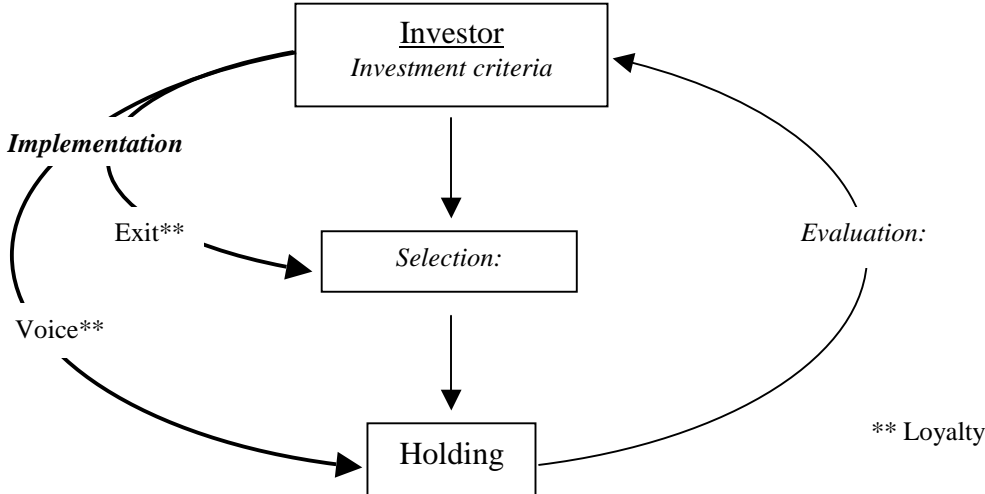


Figure 5 Exit or Voice

¹²¹ Hirschman (1970), p. 37

¹²² Hirschman (1970), p. 40

4.8 Theoretical frame of reference

The presentation of a theoretical frame of reference is not necessary within the natural sciences where theories have been proven through quantitative data. As the study is within the social sciences and qualitative data will lay the base of the thesis it may not be as clear what theories are applicable. Thus, it is of great importance that a theoretical realm of reference is presented to highlight what theories the authors have chosen to illustrate and how these are relevant to the question at hand.¹²³ The diagram illustrates the dynamics of the theoretical dilemma at hand and also forms the basis for our theoretical and analytical approach.

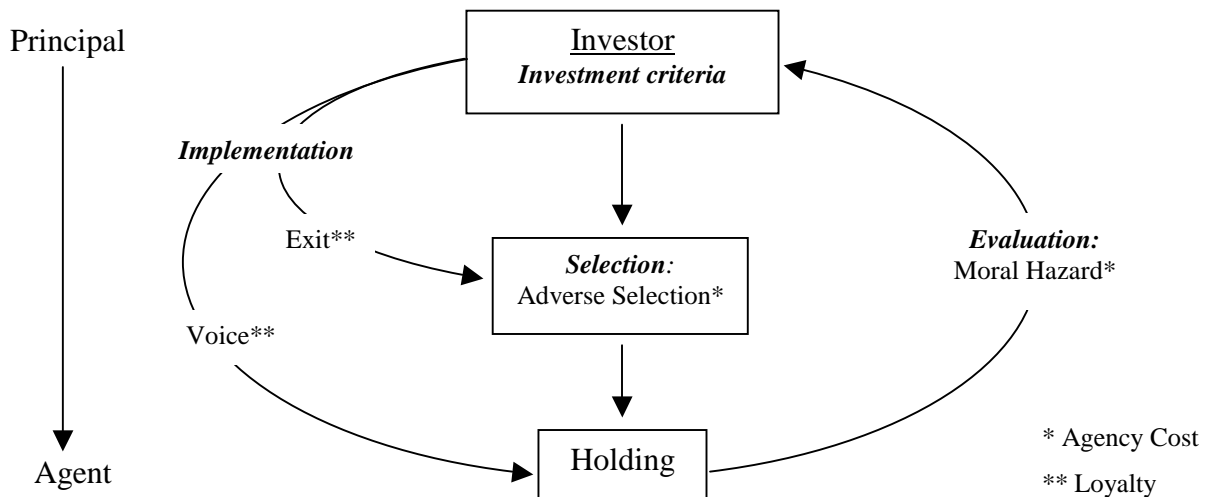


Figure 6 The Governance Cycle¹²⁴

The investment process, and thus the Governance Cycle, can rationally be divided into three central dimensions: 'criteria', 'selection and evaluation' and 'implementation'.

Criteria

Institutional investors have criteria such as risk exposure as well as varying degrees of ethical requirements which they communicate and adhere to and which shape the available investment horizon. Investors with strict and clear ethical criteria (in addition to the traditional financial criteria) expect their holdings to adhere to economic, legal and ethical

¹²³ <http://www.infovoice.se/fou/bok/10000079.htm>

¹²⁴ developed by the authors

responsibilities and thus invest according to SRI practices. Investors with vague or no ethical criteria primarily regard economic and legal issues within the investment process and can thus be expected to hold more of a shareholder value approach. For ethical criteria to be effective these have to be clear and defined. This ensures the applicability of the criteria within the investment process. Ethical criteria can either rely on international guidelines or on clearly defined values.

Selection and Evaluation

Upon selection of a stock or position investors are exposed to information asymmetry i.e. less information concerning the position than insiders¹²⁵ have. The investor is thus exposed to a risk of adverse selection whereby a position is acquired which does not 'fit' the investment criteria. The characteristics of this risk are dependant the perspective on ownership that is employed by the concerned investor. Institutions with a Shareholder Value Perspective may risk investing in firms which do not value the maximization of long-term shareholder value as their only responsibility. Institutions which follow a SRI approach risk investing organizations which maximize long-term shareholder value with little regard to ethical responsibilities. Equally, once an investment has been made there is a risk for moral hazard where the agent will does not act in the best of interest of the principal. The cost of such discrepancies as well as adverse selection is referred to as agency costs. In both instances practices and processes that focus on the acquisition of information are required to be installed to minimize the risk for agency costs. Information decreases the risk for agency costs as corporations can be identified which do not fulfill the investment criteria as well as inform investors of holdings that are in breach of the investment criteria.

Implementation

In the case where agency cost arises several different tools exists which assist investors, regardless of their perspective on ownership (i.e. Shareholder value or SRI). An owner can either exit the position or through voice/engagement use its power to push for changes. The investors loyalty towards the corporation determines which method will be used; the more loyal, the more likely the investor will prefer to exert voice over exit. Should exit be preferred, the investor will again be exposed to the risk of adverse selection whereas if voice

¹²⁵ holders of stock or individuals in close contact with the corporations

is chosen there is again a risk for moral hazard. The continuity of the process can thus be referred to as a 'cycle'.

It should moreover be noted that the Governance Cycle is of an agent-principal character and all parts within the cycle taken together ensure the agents compliance to the principals investment criteria. Should a stage within the cycle be missing or inefficient, the agent-principal relationship is not optimized as there is a risk for the agent behaving in ways which is not accepted by the principal. The cycle thus needs to be 'closed' to function properly.

4.8.1 Reflections on the frame of reference

When in the process of constructing a theoretic frame of reference, it is important to review one's work critically, as it was argued in section 3.3 . The authors believe that the theoretic frame of reference holds up to those criteria well: Through the thorough examination of relevant theories, the most important factors should be represented and be expected to contribute to an explanation of the phenomenon. In addition, the utilized concepts in the frame of reference have been systematically introduced in the theory examination, as well as related to their role in the frame of reference which should make them clear and unambiguous. Regarding the fruitfulness criteria and its ability to lead on to proper conclusions, these aspects will be more properly revealed when the constructed frame of reference is confronted and connected with the empiric data.

5 International Guidelines

5.1 Introduction

Given the vague nature of what constitutes ethical conduct, several international organizations have constructed guidelines in regard to this matter. These are guidelines for the conduct of corporations, but many institutions have chosen to incorporate one or a combination of these in their ethical criteria. It is therefore important to have a general knowledge of the implications and content of the most commonly used guidelines to be able to comprehend the extent of the ethical stance taken by the institutions within the empiric study.

5.2 The International Labour Organization

The International Labour Organization (ILO) was first established in 1919 to try to develop and adopt “international standards to cope with the problem of labor conditions involving ‘justice, hardship and privation’.”¹²⁶ Since then, many declarations and recommendations have been developed and adopted which primarily focus on workers rights issues and the establishment of sustainable working conditions. Although the recommendations can be used voluntary the ILO body will constantly encourage member states to implement the labour standards within their own laws. Furthermore, member states are obliged to report on any unratified recommendations. On ratification member states agree to implement the convention as well as allow the ILO to supervise the implementation of the principles. Although the ILO recommendations are national level policies, they may also be applied on a company level. The fundamental principles of the ILO are the following:¹²⁷

¹²⁶ <http://www.ilo.org/public/english/standards/norm/whatare/index.htm>

¹²⁷ <http://www.ilo.org/dyn/declaris/DECLARATIONWEB.INDEXPAGE>

- Freedom of association and the right to collective bargaining.
- The elimination of forced and compulsory labour.
- The abolition of child labour.
- The elimination of discrimination in the workplace.

5.3 OECD Guidelines for Multinational Enterprises

The OECD guidelines for Multinational Enterprises was established in 1976 and are voluntary and non-binding suggestions for corporations involved with or situated in countries which have adopted the standard.¹²⁸ Countries which have accepted the resolution include all of the 30 member OECD countries as well as Argentine, Brazil and Chile. They provide standards for responsible business conduct, in a variety of areas including employment and industrial relations, human rights, environment, information disclosure, competition, taxation, and science and technology.¹²⁹ These guidelines were established to promote the “shared values of governments of countries” and the “positive contributions multinationals can make to economic, environmental and social progress.”¹³⁰ In 2000 the guidelines and recommendations were revised. Aspects concerning economic, social and environmental developments were strengthened and emphasized and now include recommendations on: the abolishment of child labor, adaptation of international labor standards and higher MNC focus on environmental performance as well as means on how to combat corruption. Furthermore, the revised guidelines offer a greater tool for the “implementation procedures, setting out mechanisms for promoting transparency, accountability, and best practice”¹³¹ of the recommendations.

¹²⁸ Jonathan P. Doh and Terrence R. Guay, Globalization and CSR: How NGO’s influence labour and environmental codes of conduct, Working paper

¹²⁹ http://www.oecd.org/document/45/0,2340,en_2649_34889_1903277_119696_1_1_1,00.html

¹³⁰ http://www.oecd.org/document/45/0,2340,en_2649_34889_1903277_119696_1_1_1,00.html

¹³¹ <http://www.socialfunds.com/news/article.cgi/article301.html>

5.4 UN Global Compact

One of the most recent developments within global recommendations for social responsibility originated during the 1999 World Economic Forum. The initiative is not constructed as a regulatory instrument but serves as a “value-based platform designed to promote institutional learning.”¹³² Its aim is to “mainstream the nine principles in business activity around the world” and “catalyze actions in support of UN goals”.¹³³ As the initiative is voluntary, organizations are free to sign up. However, there is no enforcement of the guidelines the Global Compact is open for misuse of affiliation. An example of such an action is Nestlé’s acceptance in 2002 into the initiative even though they were supplying breast-milk substitutes to developing nations, “thereby harming millions, harming the health and well-being of millions of infants the world over.”¹³⁴ The UN rejected the accusations by NGO’s and referred to Nestlé’s actions as ‘a single issue’. Furthermore, BASF, a member since the start of the initiative, was recently reported to be involved in “importing and selling millions of pounds of illegal, counterfeit pesticides in the U.S. over a several year period”¹³⁵ and has since been on the black-list of many SRI consultants. Ethical groups are therefore highly skeptical of the initiative and even go as far as to call it “gravely threatening because companies can use it in many ways to enhance their reputation through image transfer, to ward off or undermine legally-binding regulations.”¹³⁶ The UN is currently developing provisions which are to protect the integrity of the initiative.¹³⁷ The nine principles of the UN Global Compact are:¹³⁸

Principle 1: Businesses should support and respect the protection of internationally proclaimed human rights within their sphere of influence

¹³² Jonathan P. Doh and Terrence R. Guay, Globalization and CSR: How NGO’s influence labour and environmental codes of conduct, Working paper

¹³³ <http://www.unglobalcompact.org/>

¹³⁴ <http://www.gifa.org/Documents/QuicksandFINAL.pdf>

¹³⁵ http://www.panna.org/resources/gpc/gpc_200112.11.3.19.dv.html

¹³⁶ <http://www.gifa.org/Documents/QuicksandFINAL.pdf>

¹³⁷ <http://www.unglobalcompact.org/>

¹³⁸ http://www.unglobalcompact.org/Portal/?NavigationTarget=/roles/portal_user/aboutTheGC/nf/nf/theNinePrinciples

Principle 2: ...make sure that they are not complicit in human rights abuses.

Principle 3: ... uphold the freedom of association and the effective recognition of the right to collective bargaining;

Principle 4: ...support the elimination of all forms of forced and compulsory labour;

Principle 5: ...support the effective abolition of child labour

Principle 6: ...eliminate discrimination in respect of employment and occupation.

Principle 7: ...support a precautionary approach to environmental challenges;

Principle 8: ...undertake initiatives to promote greater environmental responsibility

Principle 9: ...encourage the development and diffusion of environmentally friendly technologies

5.5 Summary

The ethical guidelines established by the major international organizations are similar with the possible exception of the ILO. Both the UN Global Compact and the OECD guidelines are non-binding. The ILO focuses solely on labour issues, however this should be expected given the involvement. The OECD and the UN Global Compact have wider organizational scope where the guidelines cover more areas than just those of the ILO. When examined, the guidelines of the OECD and the UN Global Compact are very similar where central areas concerned are human rights, labour issues and the environment. An interesting aspect of the guidelines for ethical conduct is whether they actually concern ethical requirements and not legal ones, especially in the western world. The ILO, for example, has an explicitly stated aim for its principles to be incorporated in the laws of the ratifying members. This aspect, however intriguing, is beyond the scope of this essay but a noteworthy point to remember.

5.6 The Consultants

5.6.1 Introduction

This section features a short presentation of the ethics consultants that are predominantly employed by the institutions in the study in, both in terms of their criteria setting process as well as in their information and evaluation process. The role played by the consultants in each

of the institutional investors' internal processes does vary between them, but they generally play an important role and thus it is relevant to present their services.

5.6.2 CoreRatings

CoreRatings is one of the leading European ethical consultants. In the Swedish market, their clients include AP3 and Banco Fonder while their large international clients are well-renowned institutions such as ABN Amro and Barclays Global Investors. CoreRatings has two main services, which are called Research and Ratings, respectively. Within Research, CoreRatings provide summary rating profiles on companies' performance in key areas of the area of social responsibility such as environmental management and employment practices. The Ratings service creates corporate social responsibility ratings that are used internally by CoreRatings as well as sold to the investor community where it is used for a detailed understanding a certain corporation's performance. The overall rating of a corporation provides an objective opinion on a company's responsibility risk rating.¹³⁹

5.6.3 GES Invest

GES Invest is the largest ethical consultant on the Swedish and Nordic markets, as well as one of the leading actors in Europe. GES Invest provides four main services: Global Ethical Standard, Risk & Opportunity, GES Active and GES Controversial. The global ethical standard is GES' basis for the SRI-analysis of a company. It is a tool that identifies companies which have been guilty of a breach in international norms of business conduct. Risk & Opportunity is a service which focuses both on the present state as well as the future possibilities of a company's methods of dealing with the environment, human rights and corporate governance. The criteria for these are based on international standards and conventions. GES Active has its focus on an active ownership process and combines SRI with improvements concerning the company's management process. The GES Controversial service is a negative criteria analysis, where business activities that are deemed as controversial are singled out; these include production and/or sales of weapons, tobacco and alcohol.¹⁴⁰

¹³⁹ www.coreratings.com

¹⁴⁰ www.ges-invest.com

6 Empirical foundation and analysis

6.1 Introduction

Empirical data has been collected through both primary and secondary sources; a thorough presentation of this process is to be found in the method chapter. This chapter will present the empirical data that has been collected, as well as the analysis of the material, utilizing the theoretical frame of reference constructed in the third chapter. The analysis of each of the investors is divided into three dimensions; ‘criteria’, ‘selection and evaluation’ and ‘implementation’. In essence, ‘criteria’ refers to which ownership perspective that an investor uses and to which levels of corporate responsibility that the investor expects its holdings to adhere to. ‘Selection and evaluation’ concerns the actions that are taken to reduce the agency costs (i.e. that arise through adverse selection and moral hazard) while implementation relates to the means by which the investor governs its holdings (i.e. exit or voice). Taken together, these dimensions describe the overall conduct of an investor in ethical issues as was presented in the Governance cycle.

6.2 AMF Pension

6.2.1 Criteria

AMF Pension “has a wide and general policy”¹⁴¹ considering the ethical conduct of a company. The company tries to avoid too narrow and specific criteria concerning what constitutes ethical conduct or as it was put forward in the interview: “We thus engage in a balanced decision making process where the overall picture serves as a ground”¹⁴². AMF

¹⁴¹ Interview with AMF

¹⁴² Interview with AMF

Pension's point of view when it comes to the use of specified ethical criteria can be summarized as “...ethics should not be a value but rather a perspective.”¹⁴³

AMF Pension’s reason for their policy - which avoids narrow and specific criteria - is that “...the area of ethics is very vague”¹⁴⁴, and because of this “[AMF Pension] does not believe in definitive values, [...] but in a judgement which integrates all factors.”¹⁴⁵ Should more specified criteria be employed, AMF Pension worries that it might lead to absurd effects: “If one applies threshold values it leads to that certain companies are included within the investment horizon one year and are excluded the other”¹⁴⁶. “Threshold values are contrary to AMF Pension’s policy of making decisions by considering all factors at hand.”¹⁴⁷

However, the overall picture-policy that AMF Pension employs consists of several factors, such as “... criminality, violence, drugs etc. and international declarations such as the ILO”¹⁴⁸. When it is considered relevant, attention may also be given to “...other factors ... such as the environment and war material”¹⁴⁹. The factors mentioned this far are negatively focused, however “positive aspects can be included within the analysis.”¹⁵⁰ In this way, “...a good environmental responsibility it can help to counterbalance a possibly negative aspect.”¹⁵¹

6.2.2 Selection and Evaluation

AMF uses several measures to ensure ethical investment. Employees who work with the selection of the investment have a responsibility of holding “a general ethical readiness”.

¹⁴³ Interview with AMF

¹⁴⁴ Interview with AMF

¹⁴⁵ Interview with AMF

¹⁴⁶ Interview with AMF

¹⁴⁷ Interview with AMF

¹⁴⁸ Interview with AMF

¹⁴⁹ Interview with AMF

¹⁵⁰ Interview with AMF

¹⁵¹ Interview with AMF

AMF does not have any employees directly working with ethical issues as they view this area to be a “general public question requiring general public values”.¹⁵² Ethics is therefore the responsibility of every individual within the institution as these “act as we deem [ethically] right”¹⁵³. “Based upon the findings a collective assessment is made whether a position can be acquired”.¹⁵⁴ Current positions are also continuously assessed according to the criteria. If the ethical analysts determine that a certain activity or course of action can be put to question, the issue will be presented to the group or the AMF management team for analysis. AMF will then contact the corporation to clarify the situation. A decision is then made whether the matter strives against the ethical criteria. If deemed unethical it can lead to that the company is excluded from the investment horizon. Thereafter, the corporation is continuously monitored to determine when it can be included within the selection process again. AMF has been in contact with ethical consultants in order to integrate them within the ethical process however with no success so far.

6.2.3 Implementation

“The media plays an important role in ethical matters as these can help to inform us on corporations who engage in unethical activities.”¹⁵⁵ AMF then tries to verify the accuracy of the information. If the information can be shown to be correct, AMF contacts the management of the corporation either through telephone conferences or letters in order to discuss the matter. “We believe voice to be a preferred way to act and that exit is only engaged in as a last alternative”¹⁵⁶. AMF does not believe in engagement in annual general meetings as it is viewed as “ineffective and slow”. If the corporation is responsive and initiates steps to remedy the situation, AMF determines the breach to be a minor misdemeanor and maintains the position. However, if the offense does not defy the corporate policy and they do not initiate steps to alter guidelines, the position is liquidated as there is a risk for future offences. “It should be noted that such situations occur very seldom.”¹⁵⁷

¹⁵² Interview with AMF

¹⁵³ Interview with AMF

¹⁵⁴ <http://www.amfpension.se/templates/Page.aspx?id=3581> Translated by author

¹⁵⁵ Interview with AMF

¹⁵⁶ Interview with AMF

¹⁵⁷ Interview with AMF

A specific example of this is Nestle and their distribution of breast-milk substitutes in Africa causing the death thousand of infants. Nestle did not alter their policies when AMF contacted them and the position was shortly thereafter sold. The H&M “child labour” scandal is an Swedish example where AMF decided that the offence was not likely to occur in the future as H&M has a clear and strict policy against child labour. A sub-supplier’s supplier was guilty of the misdemeanor and thus outside of H&M’s control. H&M was thus kept in the portfolio.

6.2.4 Conclusion

In summary, AMF Pension does not only take on the economic and legal responsibilities, but also has a program for adhering to ethical responsibilities. As a response to the difficulty in deciding what those responsibilities actually consist of, AMF Pension has chosen to focus on the limitations of the vagueness of the concept of ethics, and thus has no formal definition at all, and do not use criteria. Instead, an attempt of a holistic view is undertaken where the big picture is what matters and a negative performance in one aspect can be evened out by a positive performance in another. Regarding the philanthropic responsibilities, these are not considered by AMF Pension.

Although AMF pension claims to have an ethical investment selection process we have found it difficult to identify a substantial and well founded system which minimises the risk for adverse selection. Selection is based upon the interpretation of each and every analyst on their own findings. AMF does screen the investment horizon for both positive and negative practices however, no preference practices were identified. Adherence to unified institutional ethical criteria, in our view, can be difficult to implement within AMF as it is the responsibility of the employees as well as open to their interpretation. Furthermore, as no external reports apart from media intelligence are used there is a risk for inadequate and incorrect information upon which the analysis is based. The authors have not been able to identify measures by which this risk has been minimised. This threat is also present in the continuous examination of the corporations. As media reports are the primary source of information on ethical conduct the risk for moral hazard is substantial. Media reports are primarily released after an unethical activity has been conducted. From what we have been presented, minimal incitements or monitoring processes have been incorporated to minimize

the risk for agency costs. The passive SRI processes are therefore vulnerable to information inefficiency and thus asymmetric information.

AMF has chosen to act primarily through voice in situations where ethical criteria are not met as it is an effective tool and corporations generally change policies. Exit or divestment is viewed as a last option. Here dialogue is used to push for changes. Shareholder resolutions are considered ineffective and are thus not employed within ethical issues. SRI engagement is thus present however taunted by the information asymmetry as well as the information inefficiency. There is thus a substantial risk for a low engagement level (i.e. voice or exit) when ethical agency costs (organisations in breach of AMF Pension's ethical guidelines) occur as these may not be detected.

6.3 AP3

6.3.1 Criteria

AP3 is a state-owned organization as such that their criteria and guidelines are controlled by the law that governs the organization. This regulation states that “...environmental and ethical investment considerations are to be taken into account. These considerations may however not be detrimental to the overriding objective of high return.”¹⁵⁸ Thus, AP3 may have certain criteria but they may not affect the over-all goal of creating shareholder value.

These criteria guidelines are divided into two sub-categories: International Conventions and Ethics as risk. The first criteria category is required by regulation: “...AP3 is a state owned organization and therefore have to follow the international conventions which Sweden has signed.”¹⁵⁹ If a company “severely and continuously”¹⁶⁰ violate these AP3 is not allowed to invest in that company. AP3 regards the following to be serious crimes against the international conventions:¹⁶¹

¹⁵⁸ AP3 fact sheet and web site

¹⁵⁹ Interview with AP3

¹⁶⁰ Interview with AP3

¹⁶¹ AP3 fact sheet and web site

- Serious and systematic breaches of the human rights such as murder, torture, forced labour, deprivation of liberty, the worst cases of child labour and any other trade with children.
- Serious violations against human rights in situations of war and conflict
- Serious breaches on environmental guidelines set forth by international conventions

The second category concerns the ethical conduct of companies that AP3 has invested in. However, “...it's not about determining whether a corporation is ethical or not but rather whether these have an adequate risk management process within ethics just like within any other risk which they are exposed to.”¹⁶² In other words, it is concerned with avoiding risk and through that creating shareholder value.

The two categories presented above only concerns AP3's positions in companies in the Swedish market; however, the majority of AP3's investments are made abroad through external parties. The criteria that do apply to the Swedish investments do not apply to the international holdings. In regard to those, AP3 does not have any criteria or guidelines.

6.3.2 Selection and Evaluation

In order to implement ethical as well as environmental guidelines into AP3's investment process, an analysis is conducted during the selection process. Here AP3 looks at “the ethical and social risks companies is exposed to and how well these are dealt with”¹⁶³. AP3 has no employees involved with the analysis of ethics. The analysis function is conducted by the external consultant, Core Ratings. The consultants gather information from public sources as well as directly from the corporations and provide AP3 with a report once a year on their large Swedish holdings (approximately 70 corporations). Specifically corporations are analyzed, measured and benchmarked in terms of their risk management systems. Corporations, which are suspected or have been exposed of unethical conduct, are placed under continuous surveillance. “...corporations are excluded from the investment horizon which have severely

¹⁶² Interview with AP3

¹⁶³ Interview with AP3

and continuously breached the international conventions which Sweden has accepted.”¹⁶⁴ Furthermore AP3 has chosen “not to invest in companies which produce weapons which under normal use violate human rights conventions or the “Non Proliferation Treaty”¹⁶⁵. Ethical ownership questions and issues are dealt with by the information’s officer. Furthermore, upon demand ethical issues are raised within the weekly meetings of the corporate governance team.

6.3.3 Implementation

AP3 furthermore engages in active ownership in order to establish an active dialogue with corporations concerning ethical issues. “Within the second program corporations are not excluded. The AP3 however takes an active ownership position through the use of letters, meetings and through annual general meetings.”¹⁶⁶ Corporate governance is thus used to press for organizations to have sound risk management systems which also involve ethical policies. This is implemented in five levels: annual general meetings, board nominations, direct contact, and coordinate activities with other shareholders as well as through promoting nomination committees.¹⁶⁷ Primarily direct contact is used (approximately 3-4 times a year) through meetings with the management. If such meetings are unsuccessful AP3 moves to invoke change at the annual general meetings. Furthermore, the AP3 demand its largest holdings to have implemented and established an ethical and environmental code of conduct consisting of three elements:¹⁶⁸

- Transparency to set an environmental agenda
- Follow up and control so that the code is implemented
- Reporting such as the global reporting initiative

AP3 has no system in place whereby corporations are monitored for adhering to the International Conventions. “When AP3 is informed of a serious and repeated breach against

¹⁶⁴ Interview with AP3

¹⁶⁵ Interview with AP3

¹⁶⁶ Interview with AP3

¹⁶⁷ www.ap3.se

¹⁶⁸ www.ap3.se

these conventions the corporation is contacted”¹⁶⁹ to further investigate the matter. If the situation and no action is taken to end and prevent the violation and there “is reason to believe that such conducts will occur in the future, the position will be liquidated and excluded from the investment horizon.”¹⁷⁰

6.3.4 Conclusion

In summary, AP3 takes on the economic and legal responsibilities, but does not comply with the ethical and philanthropic duties. The criteria that AP3 uses are not related to ethical concerns. Adhering to International Conventions is a legal responsibility (i.e. AP3 does it because the law that governs the organisation requires them to do so) and the second category is viewed as risk management and thus part of the economic responsibilities.

AP3 views unethical conduct as an economic risk and therefore has chosen to incorporate ethical analysis within their selection process. In order to minimise the risk for adverse selection, which in this case would be the purchase of a high ethical risk corporation, AP3 has outsourced the function to consultants. Information asymmetry can therefore be considered low as the external “experts” are specialized within the field. Negative screening is employed and corporations which continuously and substantially breach international conventions which Sweden has signed are singled out. “AP3 does not believe in ‘black listing unethical’ corporations as this requires very strict criteria as well as being exposed to problems with the acquisition of adequate information.”¹⁷¹ AP3 does not employ positive screening mechanism nor any form of preference. SRI selection and evaluation can thus be considered as minimal however one has to bear in mind that this is congruent with their ethical criteria.

These passive measures by themselves do not minimise the moral hazard risk involved. AP3 has thus chosen to engage actively through dialogue and shareholder resolutions within their top 70 positions to promote the adoption, implement and reporting of ethical standards through voice. This enables AP3 to have higher information transparency and minimise information asymmetry within the evaluation phase. Voice is thus a preferred corporate

¹⁶⁹ www.ap3.se

¹⁷⁰ www.ap3.se

¹⁷¹ Interview with AP3

governance means where corporations are required to specify their ethical position. Where an organisation has breached the ethical criteria, AP3 has chosen to act primarily through active dialogue. Shareholder resolutions are not used as a means to bring on a change within a corporation. If an active dialogue does not lead to a change in corporate conduct and AP3 believes violations can occur in the future the position will be divested. Exit is thus a last resort.

However, all of this said it should be noted that AP3 has at this stage not set ethical requirement upon its external holdings which constitute the majority of its portfolio (approximately 55.9% at 31.12.2003)¹⁷². AP3 therefore has a substantial risk for agency cost. Its legal obligation to its agents, the state, is furthermore not fulfilled in this respect as the majority of AP3's holding is not ensured within the risk management process which they proclaim to hold.

6.4 Robur

6.4.1 Criteria

Robur has three types of criteria within SRI: ethical, social and environmental. All of these are based on the guidelines of international organizations. "A precise definition of ethics is difficult to make. This is the reason for why Robur has chosen international conventions as ethical benchmarks."¹⁷³

With regards to environmental criteria, Robur works after a 21-criteria program that specifically concerns the strategy, products, production, environmental systems and market communication of the companies. The foundation of Robur's social criteria is based on the UN declaration on Human Rights, UN Global Compact and the eight Core Conventions of the ILO. As for ethical criteria, these are based on a co-operation with the Church of Sweden. These criteria are used for negative screening and consist of weapons, alcohol, tobacco and gambling, where a maximum of 5% of turnover may be related to these activities.

¹⁷² http://www.ap3.se/portfolj_faktisk.asp

¹⁷³ Interview with Robur

6.4.2 Selection and Evaluation

Robur has three different levels of analysis which externally compiled are used in the selection and evaluation work. These are two current situation analyses, the negative and the human rights report and a forward looking analysis which is referred to as the positive analysis. The reports are then further processed internally by the ethical analyst team. The ethical analyst team consists of three full-time employees which are specialised on the Nordic region.

The Negative Analysis - a GES report which screens global corporations for engagement in weapons, alcohol, tobacco and gambling. This is then further processed within Robur's ethics analyst team.

Human Rights Report - Furthermore, a GES report screens the global market for organisations which are in breach of human rights.

The Positive Analysis - The largest of these reports where corporations are evaluated according to their actual CSR performance. This is a more proactive and forward looking analysis where organisations are evaluated for best-in-class conduct.

When a corporate analysis is conducted Robur primarily establish contact with the concerned corporation and inform these of the analysis. Regular corporate analysis is conducted primarily on the Swedish market where Robur has an active holding. Robur has regular contact with corporations under analysis. Robur examines various materials such as old reports from the basis of their values and criteria. An ethics committee is responsible for final decision regarding the social, ethical as well as environmental criteria as well as negative ethics. The analysis is then sent to the corporations so that these are able to comment the findings as well as answer any questions which may exist. This usually takes place during a meeting with the corporation. A final report is then produced which is presented to an ethics committee who decides upon further action i.e. weather to include or exclude the organisation from the investment horizon. This takes place without the involvement of the investment managers in order for these not to be able to influence the outcome of the decision. The analysis and findings are also distributed internally within Robur and can be incorporate into the general corporate analysis.

6.4.3 Implementation

Within certain holdings, Robur has a representative within the board and therefore can act to ensure a correct ethical conduct. In positions where this is not the case “there is no step-by-step manual rather a tested way of conduct”¹⁷⁴ in the way pressure is exerted. If Robur becomes aware, either through the internal and external analysis or media reports, of an active position in breach of the ethical criteria, Robur will initially contact the corporation to get a clear and direct view of the situation. Contact is established with corporations both within the Swedish as well as the global market. In cases where findings turn out to be correct Robur will demand the corporation to implement measures to ensure that such breaches do not occur in the future. Such demands will in most situations be made by the ethics and environmental department however in certain circumstances for example when other departments agree with the demands as well as when a breach is in violation of Robur’s overall ethical code, pressure is exerted by Robur as a whole.

Demands are put forth in various forms and are dependent upon the situation. Formal procedures, such as letters, are used in situations where Robur has less direct contact with corporations or in situations which are of a delicate nature. If Robur has had previous contact with the corporation, less formal contact is also preferred. Robur does not believe in engagement during annual general meetings as it is considered to be a slow process and regarded as a failure as all other means have been exhausted. “Influence is therefore enforced on various levels”¹⁷⁵. Robur believes that a negative effect of acting in such a manner is that it receives very little attention whereas other smaller institutions operate primarily through annual general meetings as this is more noticeable. If the corporation is not open to initiate steps to ratify the issue the position will be sold and excluded from the investment horizon. If however steps are taken to remedy the situation the position will be maintained as the threat of future breaches diminishes. Furthermore, Robur contacts corporations in certain situations even when no positions are held in order to impose active external influence.

¹⁷⁴ Interview with Robur

¹⁷⁵ Interview with Robur

6.4.4 Conclusion

In summary, Robur does not only take on the economic and legal responsibilities, but also has a comprehensive program for adhering to ethical, social as well as environmental responsibilities. As a response to the difficulty in defining what those responsibilities actually consist of, Robur has chosen to look at established international conventions. The criteria include weapons, alcohol, tobacco, gambling, environment as well as criteria directly based on the international guidelines of the ILO and the UN Global Compact. It should however be noted, that these criteria are not valid for all of Robur's funds, but only those that are managed by the ethics and environmental department. Regarding the philanthropic responsibilities, these are not considered by Robur.

Robur has implemented several measures to minimise the risk of adverse selection. External reports provide Robur with information concerning various ethical measures which is then processed further internally. Selection is then based upon the ethical findings. A clear passive SRI process is present within the selection process whereby corporations are continuously screened for positive as well as negative ethical performance. Proactive engagement is also present as Robur is in close contact with the corporations to evaluate their performance both direct and indirect influence is exerted. Moral hazard can be minimized as companies are required to continually report their positions. As research is sourced from both internal and external sources (i.e. GES Invest) proper monitoring can be ensured in organisation where no board position is held and therefore risk for asymmetric information is minimized. Furthermore as Robur is active in various corporate boards the risk for moral hazard and therefore agency costs can be minimised as proper corporate governance can be exerted in such positions.

The primary tool employed by Robur in situations where their ethical criteria are not met is the political choice of voice. Robur explains this to be a result of the generally positive response of corporations; these are willing to change the behaviour to suit the requirements of the investors. Furthermore Robur believes this to be an effective tool to change the attitudes to suit the requirements of the ethical criteria. Exit is only employed as a last resort where the corporations do not show interest in altering policies or ratifying situations. The estimated influence of Robur is thus viewed to be generally high. This can be explained by Robur's high influence on the Swedish stock exchange. In foreign corporations Robur has explained that

exit is employed more as these are less likely to alter policies. “A specific example was a Danish firm who did not respond to our requirements as they believed us to be too remote.”¹⁷⁶ Robur therefore includes all three elements of SRI engagement (Dialogue, shareholder resolutions as well as divestment) within their implementation process.

6.5 Folksam

6.5.1 Criteria

Folksam uses both negative and positive criteria. As for the negative ones, Folksam has “...one negative criteria and this is that we do not invest in tobacco companies or companies which have some sort of turnover within this industry. Within this we are very strict and hold a 0% tolerance level.”

In addition Folksam utilizes positive criteria: “...we have so called ‘influencing criteria’... where we as owners however can influence corporations in aspects concerning Human Rights and as well as Environmental aspects.” The ethical investment criteria employed by Folksam are tobacco, human rights and environment. The reason for using these criteria is that “We [Folksam] have conducted various studies which have shown that our clients view human rights as well as the environment to be the most important ethical aspects when given a choice. Clients wanted that Folksam would be active within the two areas above. We respect that and have adopted this view.” The human rights criteria is founded upon international conventions such as UN Global Compact, ILO guidelines and the OECD's guidelines, while the environmental criteria is built upon Folksam's own framework for sustainability.

6.5.2 Selection and Evaluation

The evaluation of the positive and the negative ethical criteria is done both internally and in cooperation with external consultants (GES Invest). Various internal departments within Folksam are active within this area including five ethical analysts, three members of the ethics board as well as an ethical committee. “We invest according to the model portfolio and no

¹⁷⁶ Interview with Robur

preference or screening takes place except for the negative criteria, tobacco.”¹⁷⁷ Although positive selection is utilized “the ‘positive’ firms only weigh a small part within this model portfolio and therefore are hardly noticeable in terms of a percentage”¹⁷⁸. All positions are screened twice yearly for possible changes in corporate activity which may impede Folksam's ethical standards. If a violation of the negative criteria is detected the position is disposed immediately or soon as the market allows it but no longer than six months after the breach has been detected. Within Folksam's positive criteria, no organisations have been excluded.¹⁷⁹

6.5.3 Implementation

The GES report is also used to bring to notice breaches in Folksam's human rights and environmental criteria. If a violation is detected the situation will be investigated through direct contact in the form of a letter with the corporation. The gravity of the situation will be assessed as well as whether the violation has been remedied. If no improvements are made by the corporation Folksam will take an active position, urging the organisation to change its policies. “Our ambition is to have a constructive dialogue with corporations, through various means, in order to affect it positively.”¹⁸⁰ This is done through a variety of tools including letters, facsimile, electronic mail, telephone as well as personal meetings with top executives.¹⁸¹ The findings will then help the ethical committee to assess whether the position will be maintained. “If corporations do not implement policies and we believe that such breaches will continue to occur Folksam will sell the position within 6 months.”¹⁸²

6.5.4 Conclusion

In summary, Folksam has a comprehensive program for adhering to the ethical responsibilities with clear criteria of what they expect from their investment in terms of

¹⁷⁷ Interview with Folksam

¹⁷⁸ Interview with Folksam

¹⁷⁹ www.folksam.se

¹⁸⁰ Interview with Folksam

¹⁸¹ www.folksam.se

¹⁸² Interview with Folksam

ethical conduct. The criteria include tobacco, human rights and environment. However, Folksam does not consider the philanthropic responsibilities.

Folksam has devised a clear and structured process in the selection process to comply with its ethical criteria. Both internal and external analysts screen the market for organisations which are suited for investment. The risk for adverse selection can therefore be reduced considerably as information asymmetry is minimised through the internal processes but also the external consultants. The findings of the internal and external analysis determine the investment horizon. Folksam has thus a clear passive investment structure where corporations are screened according to negative criteria (tobacco) as well as structured influencing criteria (human rights and environment). A positive selection process is also included however “the ‘positive’ firms only weigh a small part within this model portfolio and therefore are hardly noticeable in terms of a percentage”.¹⁸³ The risk for moral hazard is minimized as the level of asymmetric information is low. The authors have however not identified any means by which Folksam indicates ethical requirements to organizations and informs them of the constant monitoring. There could be a risk that organizations do not understand what is required by their owners and thus lead to moral hazard and possibly agency costs.

Folksam has very strict codes with respect to its negative criteria tobacco. Exit is the preferred choice and can be explained by the low level of influence: “As we cannot influence corporations to depart of areas of turnover we have the 0% tolerance within tobacco.”¹⁸⁴ Within Folksam’s ‘positive’ criteria however voice is preferred: “Areas where we as owners however can influence corporations are in aspects concerning Human Rights and as well as Environmental aspects “¹⁸⁵, and can again be explained by the level of influence: “In most cases however we are quite successful at pursuing corporations to implement policies which ensure that such situations do not arise in the future.”¹⁸⁶ However, it is important to note that Folksam has a structured and methodic exit process where “if corporations do not implemented policies and we believe that such breaches will continue to occur Folksam will

¹⁸³ Interview with Folksam

¹⁸⁴ Interview with Folksam

¹⁸⁵ Interview with Folksam

¹⁸⁶ Interview with Folksam

sell the position within 6 months.”¹⁸⁷ The high level of voice engagement can be explained by the substantial position which Folksam holds on the Swedish stock exchange and this is emphasized by the general feeling that influence decreases as one moves away from Sweden. The responsiveness of the Swedish firms is explained by that it is generally viewed favorable that change originated internally (by the owners) rather than through external pressure. Corporations are evaluated and pursued by an ethical board and an ethical committee is responsible for evaluating whether the position will be maintained. Folksam’s engagement level can thus be viewed as high.

6.6 Overview

6.6.1 Criteria

AMF Pension's ethical criteria are vague and undefined: the company claim to have a balanced and overall perspective but such a policy leads to not employing strict and well-defined criteria. The ethical criteria of AP3 are, after further examination, not related to ethics at all. Instead, what the organisation present as their ethical criteria actually belong in the economic and legal realms, respectively. Considering Robur, the ethical criteria are clear and well-defined and built upon a foundation of the guidelines of international organisations. It should be noted, however, that the ethical practices of Robur are only valid for a limited number of specified funds. Folksam, like Robur, has clear and well-defined criteria for what constitutes ethical conduct and these are mostly related to international guidelines.

When examining the role of ethical criteria in the investment process, the institutional investor community can be divided into two major groups. Of those groups, one has clear and well-defined criteria, which often are related to the recommendations of established and well-renowned international organisations. Considering the institutional investors that were interviewed, Robur and Folksam belong in this category. The second group have poorly defined and vague criteria, or none at all; AP3 and AMF Pension belong to this group. The first of the identified groups takes on corporate responsibility when it comes to economic, legal and ethical issues, while the second group adhere to the economic and legal

¹⁸⁷ Interview with Folksam

responsibilities of the corporation but not to ethical ones. Neither of the groups appear to give any consideration to the philanthropic responsibilities of Carroll's framework.

This division of the institutional investor community and their ethical criteria into two distinct groups do also seem valid when the four investors for which fact sheets were created but interviews were not carried out are taken into account. Alecta's view on this matter is that a good relationship with all stakeholders is important in order to secure a corporation's future financial position and that each corporation should publicise its policy and/or guidelines for social, environmental and ethical concerns. In this manner, Alecta puts the corporation's ethical responsibilities on each organisation's board and therefore there is no use of specified ethical criteria within Alecta's investment process.¹⁸⁸ SEB Fonder holds the view that each corporation should have an environmental and ethical policy which should be adapted to the field in which the corporation is active. In addition, SEB Fonder has a specified ethical fund which uses criteria based on international norms within human rights and environment, among other areas. However, this particular fund has General Electric as its largest holding and Exxon Mobil as number five.¹⁸⁹ KPA aims to balance the use of positive and negative criteria, where positive criteria are criteria that KPA wants to support while negative criteria are criteria that KPA wants to avoid. Their positive criteria are focused on human rights and environmental issues, based on the guidelines of international organisations while their negative criteria focus on excluding fossil fuels, weapons, alcohol, gambling and tobacco.¹⁹⁰ Banco Fonder has ethical criteria that are based on the guidelines and norms of international organisations such as the OECD and the UN. The central areas are human rights, labour rights, environment and corruption. In addition, certain industries are excluded such as weapon-related, tobacco and alcohol.¹⁹¹ Of these institutional investors, SEB Fonder and Alecta belong in the second group while KPA and Banco Fonder belong in the first one.

¹⁸⁸ www.alecta.se

¹⁸⁹ www.seb.se

¹⁹⁰ www.kpa.se

¹⁹¹ www.banco.se

6.6.2 Enforcement

Enforcement concerns Selection and Evaluation, as well as Implementation. From the interviews conducted two distinctive groups can be identified. The first group has clear and structured procedures which regulate the ethical aspect of the investment process, from selection, evaluation to the implementation. Of the interviewed institutions both Robur and Folksam belong to this group. Through the use of both internal and external sources the risk for information asymmetry can be minimised. This limits the extent of agency costs incurred and further provides an information platform from which to evaluate any form of implementation such as voice or exit. Other institutions which belong to this category include KPA and Banco, both of which conduct internal analysis and receive external ethical reports (GES Invest and CoreRatings respectively) which lay the basis for investment decisions.¹⁹² While KPA focuses on excluding corporations which fall within their negative criteria and encourages corporations to adopt its positive criteria, Banco establishes an overall picture on how well an organisation handles social and environmental risks within their industry and invests accordingly. Banco has published a detailed explanation of its ethical investment as well as ownership process on its web-page for transparency. Furthermore, Banco's fund managers are legally committed to adhere to the ethical recommendations of the ethical analysts.¹⁹³ Positions are automatically assessed on a daily basis to further ensure compliance to ethical decisions. All institutions which fall within this realm have taken several measures to minimize the risk for adverse selection as well as moral hazard through the use of both internal as well as external information sources and analysis. Information asymmetry can thus be minimised. Furthermore, these institutions have structured engagement processes as well as divestment regulations which are used when corporations are not adhering to the defined ethical criteria. Internal layers such as ethical committees as well as ethical boards are present to ensure consistency within the selection, evaluation and implementation process.

Within the second group of institutions ethical investment processes are less clearly defined or are absent completely. The ethical policies of AMF are a proper example. Although AMF asserts that ethics is included within their investment process no clear and structured system was identified by which the risk for ethical agency costs are minimized. However, as soon as

¹⁹² www.kpa.se

¹⁹³ www.banco.se

a breach comes to AMF Pension's attention the process becomes more structured and clear criteria are set: corporations need to ensure that such offences do not occur in the future or else AMF will exit the position. Yet, as criteria are not transparent it can be difficult to maintain consistency within the implementation phase.

AP3 on the other hand has clear implementation processes with little information asymmetry and thus low agency cost within its own holdings. The external holdings, representing the largest share, however do not require ethical, social and environmental considerations.

SEB and Alecta both recommend that corporations are to have set ethical standards yet no processes are presented by which the institutions ensure that such requirements are met.¹⁹⁴ Whereas Alecta claims this to be the responsibility of the board, SEB believes that it is the corporation itself which is responsible for the implementation of ethical standards. Although one could argue that an implementation policy exists the policy actually quite opposes its overall ethical view that ethics is the responsibility of the corporation.

¹⁹⁴ www.seb.se, www.alecta.se

7 Conclusion

7.1 Introduction

In order to properly present the findings and conclusions of the study, its aim and questions from section 2.2 are revisited. It was stated that the aim of the thesis was:

“to construct a theoretical framework which serves as a basis to identify and describe the ethical criteria and enforcement means of Institutional Investors.

Empiric data will then be used to develop and refine the theoretical framework and to create an understanding of the ethical conduct of the Institutional Investors.“

The study also set out to answer two questions, which were:

- Which are the ethical investment criteria of institutional investors?
- By what means do institutional investors enforce their ethical investment criteria?

7.2 The Governance Cycle

A theoretical framework was constructed in section 4.8 . This framework was then utilized as a foundation for the analysis of the collected empiric material. Finally the theoretical frame of reference is employed in the discussion of the findings where the framework is modified accordingly.

7.2.1 Relation of the empiric material to the theoretical framework

The Institutional Investors have been analysed with the theoretical frame of reference as a structure of analysis. By focusing on specific areas the ethical codes and practices could be derived and critically assessed using the frame. In the analysis, two groups were identified which both have their distinct approaches to ethicality. The different approaches of the groups can be visualized through the governance cycle and thereby differences at hand can be brought to light.

7.2.1.1 Shareholder value approach

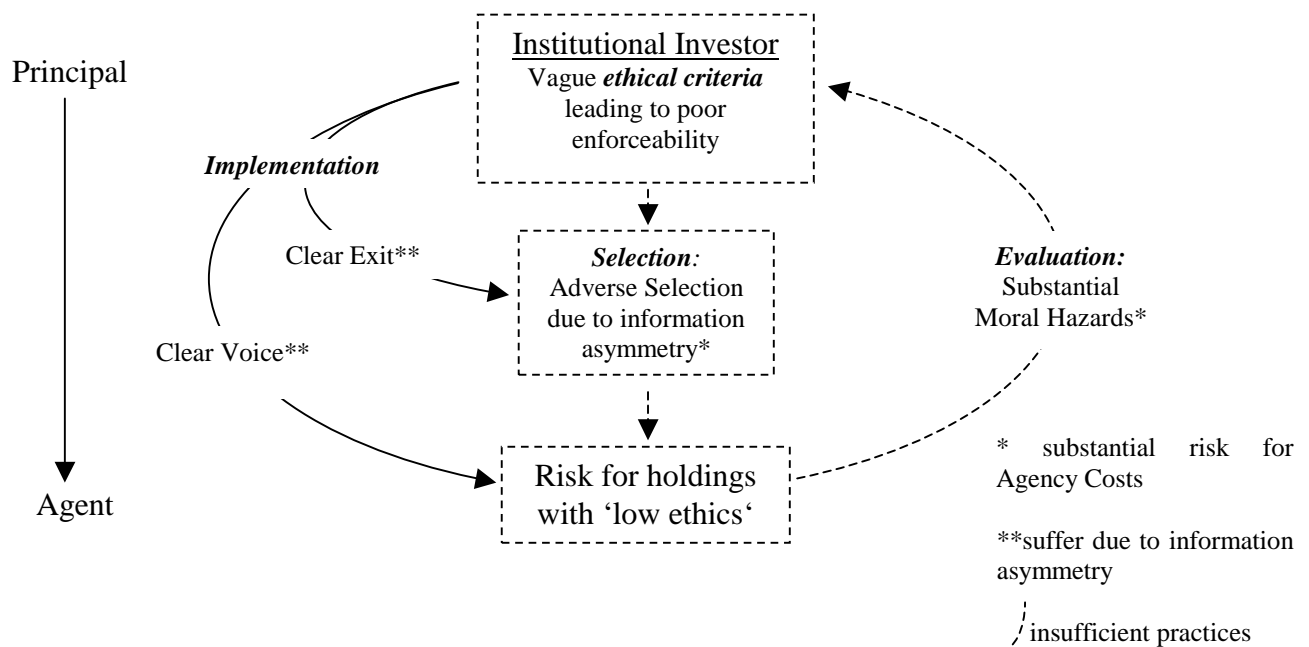


Figure 7 The incomplete Governance Cycle

The institutional investors which fall into this category are AMF Pension, AP3, SEB Fonder and Alecta. As can be seen from the diagram above these institutions all share a similar pattern. The criteria which lay the foundation of the investment approach are within this group of institutions range from being undefined, vague or imprecise, and set the ground for the phases to come. Within the selection and evaluation phase institutions need to ensure that asymmetric information is minimised as only this can ensure that the agency costs incurred are minimized. Agency costs are costs incurred due to adverse selection or moral hazards and are thus, within ethicality, directly linked to corporate conduct which strives against the

institutional ethical code. Institutions thus need adequate sources of information as well as internal structures which process and evaluate the data thoroughly. Furthermore processes and internal bodies are required that clearly define and systematically addresses issues to develop contingency and commitment. The group showed little signs of adequate processes and structures that would provide such stability. In many cases, information on ethical conduct was drawn from the media, when agency costs had already been incurred. In another example there is a risk that unethical corporate conduct could have been accepted by the institution due to the lenient nature of the ethical criteria. The risk for information asymmetry can thus be regarded as considerable, increasing the risk for agency costs. Surprisingly however all but one of the institutions which fall within this group have clear and structured processes in dealing with breaches in ethical conduct. Voice is used as a primary tool for engagement and influence is generally regarded as high. Exit is a last resort and will only be utilised if corporations are not willing to cooperate on the demands. Yet, enforcement can be regarded as low due to the risk for asymmetric information: unethical practices are in most cases brought to light through the media. Thus both ethical criteria and information handling processes need to be of a sufficient standard in order for enforcement policies and procedures to be relevant. When ethical policies are vague later stages within the governance cycle will suffer as selection, evaluation and implementation practices will be of equal character.

The interesting point to note is that for investment to be considered ethical, all stages within the cycle are required to be streamlined for this purpose. If one views ethical criteria to be the foundation upon which all later stages rest these needs to be clear and precise so that enforcement means do not disburse or follow unpredictable and uncontrollable paths. Furthermore the selection, evaluation and implementation stages, all successive to the previous, need not only to be clear and predefined in order to predict the flow of the process but also require adequate information input so that the practices do not evaporate into oblivion. Only by having installed a comprehensive programme and structured processes can ethical investment practices thus be ensured. This is not the case within this group.

7.2.1.2 SRI approach

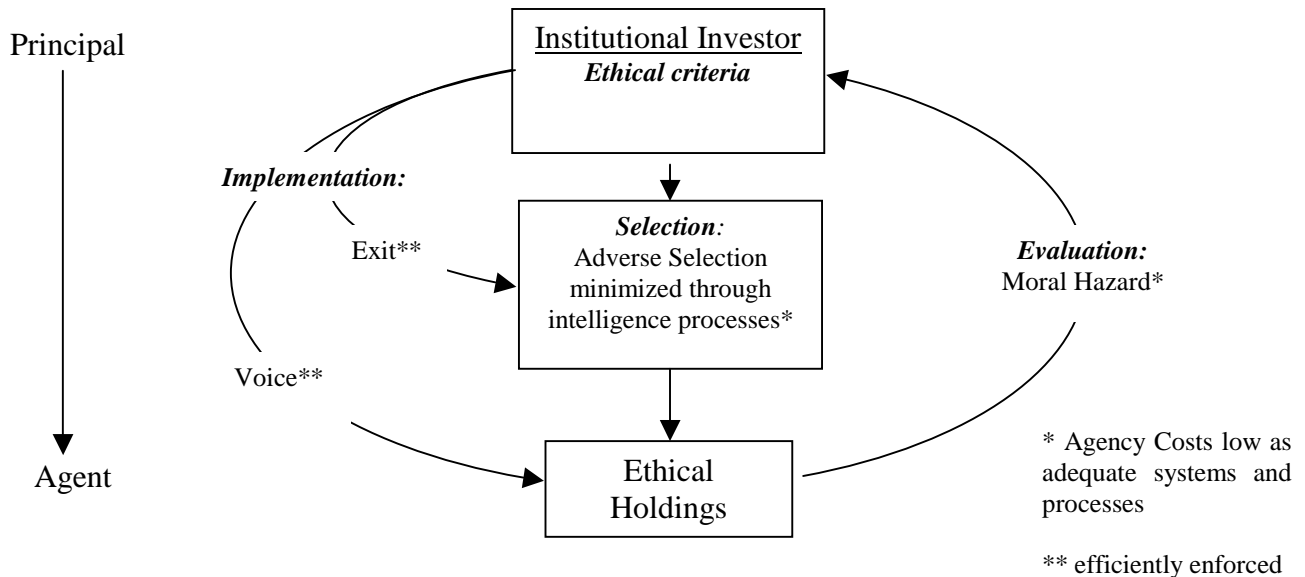


Figure 8 The ethical Governance Cycle

The institutional investors that fall into this group are Folksam, Robur, KPA and Banco Fonder. As can be seen from the diagram above the institutions which fall within this group have a complete process, incorporating all elements of the governance cycle. Ethical criteria are clearly defined and founded in the guidelines of international organisation providing a solid base upon which selection can take place. Adverse selection is minimised through the use of external consultants as well as elaborate internal processes which aim at minimizing information asymmetry. Furthermore, processes are established which continually monitor holdings. In some instances the extensive direct contact employed may lead to indirect ethical engagement as corporations continually have to testify to their socially responsible, moral hazards as well as agency costs can thus be minimised. Engagement practices are conducted primarily via voice as it is considered the most effective. As with the previous group, exit is a last resort.

The institutions which fall within this group have thus ensured clear and structured ethical criteria which serve as a solid foundation to the subsequent stages. Ethical selection, evaluation as well as implementation are thus not hindered by obstacles and follow a

predetermined and predictable path. The intelligence framework provides sufficient informational input to ensure the consistency of the system. The group thus has a complete programme which allows for ‘ethical’ investment practices while incurring minimal agency costs.

7.3 Discussion

When examining the criteria and the selection & evaluation as well as implementation processes, there seem to be two major groups. This market-level situation can be visualized as follows:

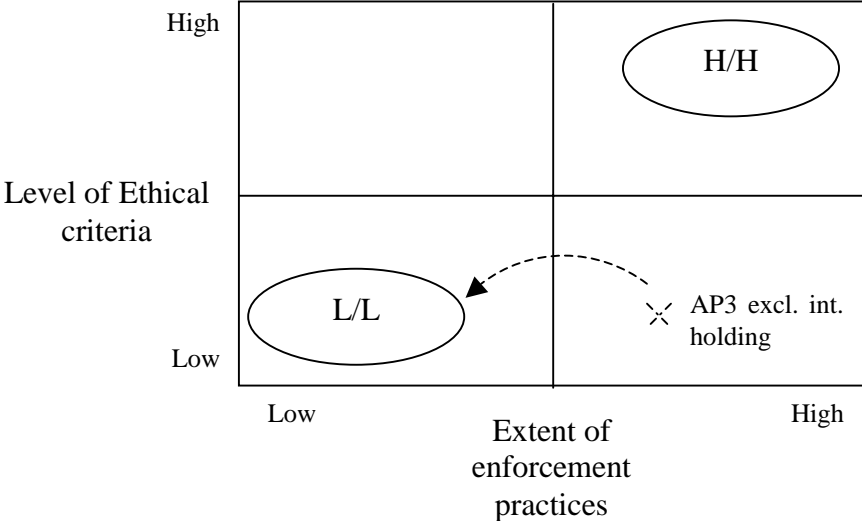


Figure 9 The SRI Market for Institutional Investors

Two dimensions are dominant within ethical investment: the ethical criteria and the extent of enforcement practices. The level of ethical criteria refers to the adopted ethical investment governance policies which institutions have. Institutions which have unclear, vague or imprecise criteria are thus classified as having ‘low levels of ethical criteria’. Institutions with comprehensive and well founded policies are regarded as having a ‘high level of ethical criteria’. The enforcement practices can be classified equally where institutions with developed and indisputable processes are considered as having a ‘high extent of enforcement practices’ and vice versa. It should be explicitly noted that the classification in ‘low’ and ‘high’ levels does not imply that ‘high’ is better than ‘low’. It is, however, distinctively different.

Within the H/H group Folksam, Robur, KPA and Banco Fonder are all represented and can be regarded as having an SRI approach. Here institutions have clear and well-defined criteria, often based on international guidelines and which are implemented through structured processes that ensure adequate acquisition and handling of intelligence. The governance cycle is 'closed' and all areas are catered for. "Within the [H/H group], clear and structured processes are in place such as are defined within the SRI theory i.e. engagement, screening and preference..."¹⁹⁵

Within the L/L group institutions such as AP3, AMF Pension, SEB Fonder and Alecta are represented. This group can be regarded as having more of a shareholder value approach. Vague criteria, if any are implemented through simple and incomplete ethical governance structures. Here, the governance cycle is 'open' as weaknesses exist within. "There are institutions which have not decided how they are to handle for example group policy or ethical criteria as well as how the institutions are to act in accordance to the criteria and policy. Here large variations do exist within the market as there is no universal 'doctrine' as to what processes are to be in place."¹⁹⁶

It is interesting to note that no institutions were found with either comprehensive ethical criteria but undeveloped ethical practices and vice versa. Although AP3 could be considered as having sound enforcement practices but vague ethical criteria, the fact that its external holdings are not required to follow the criteria shifts enforcement back to being low. Requiring external holdings to have ethical criteria as well as implementation practices is as much part of enforcement as necessitating the harmonisation of internal processes. However, the possibility exists that an investor has a high/low or a low/high combination but this should only be for a short period of time when a 'shareholder value perspective investor' transforms itself into an 'SRI-perspective investor' and all internal processes are not yet fully developed. The authors expect this positioning to be short as no benefit is gained from those combinations. High criteria and low enforcement opens up the risk for criticism against the investor. Low criteria and high enforcement would be costly without generating corresponding revenue: as low criteria will not attract the 'ethical' segment of the market. Investors with these combinations will be 'stuck in the middle'.

¹⁹⁵ Interview with GES

¹⁹⁶ Interview with GES

Moreover, the split market can be related to Michael Porter's well-known generic strategies: Low-Cost and Differentiation.¹⁹⁷ The H/H group uses SRI as a means to differentiate themselves towards a segment of base investors (i.e. fund buyers) who value ethical investments, while the L/L group follow a low-cost strategy in this aspect. Their vague criteria might either have arisen as institutions want to reach the basic threshold value required by the market or it may be a first attempt of institutions to adopt ethical investment processes. It should be noted once again that this finding is based upon interviews with four institutional investors and fact sheets on four more. The analysis is thus not to be considered statistically reliable but rather aims at creating a theoretical understanding of the market and in turn helped to refine the theoretical frame of reference. The fundamental distinction of the market which was identified within this study is shared by the ethical consultant: "Obviously there exist institutions which have dealt with the issues a longer time and have dared to adopt more structured and complex processes. However one of the factors is also that such institutions have clients which require such products. This development is thus a logical evolutionary process. So this distinction is a fair representation of the market."¹⁹⁸

7.4 Concluding Remarks

During the course of the work on this thesis, the authors have been continuously perplexed by the broad use of the concept of ethics and SRI. Perhaps the reason for this is that the notion of SRI is a fairly recent phenomenon.¹⁹⁹ This point is accentuated in the GES Interview, where it is put forward that "Many of these institutions are currently within the ethical investment maturity phase. The market is very young in many ways." and "...there is no consensus about what is to be valued and not, what is ethical and what is not as different groups, clients and groups have different views concerning the field."²⁰⁰ As a result of this situation, arguments

¹⁹⁷ See among many other Grant (2002), p. 246

¹⁹⁸ Interview with GES

¹⁹⁹ "Across Europe, however, Eurosif says there is no single definition of SRI, with each country's culture, financial market structure and legal framework influencing its approach to SRI, and therefore influencing the level of investment. Eurosif expects these cultural attitudes to SRI to converge over time." Investment & Pensions Europe, www.IPE.com/article.asp?article=15542

²⁰⁰ Interview with GES

such as the one between Folksam and Banco Fonder will continue to be commonplace, until a formalized definition is agreed upon. For a consumer, this has to be quite a confusing situation when not even the players on the market are able to agree upon what an ethical fund actually is. The authors would welcome an initiative for a standardization of the label of ethical investments and SRI, similar to what has been employed within the consumer goods market (i.e. the KRAV-label for goods).

7.5 Reflections on the framework

After refining the theoretic frame of reference it is of importance to critically review it according to the criteria that were presented in section 3.3 . The empirical part of the study confirmed that the most important factors are represented (i.e. criteria, selection & evaluation and implementation) and that the constructed frame of reference does indeed describe the phenomenon well. However, further research is needed to improve the frame of reference. Another important aspect is if the constructed frame of reference is fruitful, i.e. if it helps to increase the understanding of the matter at hand. The authors claim it is the case as the framework lead up to an explanation of the market-level situation that could be related to Porter's generic strategies.

7.6 Suggestions for future research

This thesis has constructed a theoretical frame of reference for the analysis of the ethical conduct of an investor. The frame of reference would benefit from further research, both of qualitative and quantitative variety. This study has focused on the Swedish market, which is why a study that takes an international perspective, either focusing on the practises within a single country or a comparative study, would be interesting in the view of the authors. Moreover, one of the findings of this study has been that the concept of ethics is quite broadly used within the institutional investor community and there is a lack of an accepted definition of what defines SRI and ethical investment. An attempt to create such a 'label' is perhaps a starting-point for a future study. Another area where the views are diverging within the investor community as well as the academic world is whether there exists a positive correlation between SRI and long-term return. A study that once and for all solves this matter would be in place. There is also the issue of the effects on the behaviour of the business

community that the growth of SRI has resulted in; a study that takes on the investment rather than the investor perspective would be highly interesting.

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Appendix A: The Debate

Sternberg's four stakeholder flaws

Sternberg, a key proponent of the Shareholder value perspective, argues that the stakeholder theory has four fundamental flaws:

1) *It imposes a socialistic structure in a clearly defined hierarchy.* Proponents of the shareholder value perspective, such as Sternberg, believe social responsibility to have two underlying structural errors. Firstly fundamental social and moral goals cannot and should not be imposed on business as this cannot be exercised by them. Thus such goals have to be pursued by individuals and/or through legislative changes. Such changes will however according to her view, foster 'socially responsible acts' as true social responsibility resides within the realms of voluntary action i.e. of doing more than the law requires. Furthermore, social responsibility entails imposing one individual's beliefs and values upon others. Within a free economy individuals are free to choose between products as well as organizations to work for. Thus social responsibility in its wider sense inhibits the freedom of individuals. Sternberg believes that social responsibility is the responsibility of the individual and not of the business. Individuals are free to decide and thus "if enough people devote their services and donate their funds to non-business ends, then the non-business ends will benefit".²⁰¹

2) *It claims that business is accountable to all its stakeholders.* As everything is or can potentially be a stakeholder the business would thus be accountable to everything making it impossible to run the business. Mahoney, another proponent of the Shareholder value perspective, elaborates on this point by saying that "identifying the various groups of people

²⁰¹ Sternberg (1994), p. 257

who are affected in one way or another by how a business behaves is capable of almost indefinite expansion”²⁰². In this view business can thus only be accountable to its shareholders. Business is not capable of addressing all of the stakeholders and suit their requirements. “A concept that excludes nothing is useless; since it refers equally to everything it cannot distinguish one thing from another.”²⁰³

3) *If the business would be accountable to all it in effect would be accountable to none as responsibility would be very diffused.* As the stakeholder theory is too broad as it “includes the media, competitors and terrorists, and could well encompass future generations and trees” it becomes obsolete especially with the increasing diffusion of the internet and the globalization of business.²⁰⁴ Goyder takes the same approach by claiming that it provides “an accountability so broad as to be valueless”.²⁰⁵ Maximizing long term value is thus the prime concern and all activities which do not directly add to this can only be justified if they contribute to it. Business should therefore not serve the public good as it is the ‘prime contributor’ to it.²⁰⁶ Equally the role of business is not to produce goods or serves as these are merely a means of achieving long term maximization of shareholder value.

4) *it claims that business should balance the interest of these however provides no measure as to how to do this:* “Since stakeholder theory offers no substantive business purpose, it proves no guidance at all as to how competing interests are to be ranked or reconciled. And it consequently provides no effective standard against which business can be judged.”²⁰⁷ When examining the contemporary stakeholder and SRI theory it is hard to find it a sensible model of business in general or most corporate objectives. Furthermore, the stakeholder aim is to balance the benefits of all stakeholders is unworkable for several reasons. First, the theory offers no guidance as to how the appropriate individuals or groups should be selected. The stakeholders of an organization, in the widest sense, are everyone and everything and reasonably, a limitation must be found but the theory leaves this question open. Mahoney

²⁰² Vinten (2001), p. 38

²⁰³ Sternberg (1998), p.33

²⁰⁴ Sternberg (1998), p. 94 f.

²⁰⁵ Vinten, (2001), p. 38

²⁰⁶ Sternberg (1994), p. 36

²⁰⁷ Sternberg (1994), p. 51

furthermore stresses that the theory does not provide any guideline as how to weigh the different stakeholders claims against each other.²⁰⁸ Secondly, the theory does not explain what counts as a benefit or how the managers of a corporation should find this out. The most fundamental problem is the third one, namely how the balance between different stakeholders should be struck. Since the interests of different stakeholder groups diverge, what benefits one group might harm another. Stakeholder theory gives no guidance of how to rank the interests of the various stakeholder groups.²⁰⁹

Stakeholder defense against Sternberg

Proponents of the stakeholder and SRI perspective claim that the legal and economic realm in which businesses operate is often too narrow for sustainability and that organizations thus have an obligation ‘above the law’ i.e. ethical and philanthropic responsibilities, or shared understandings in the social contract discourse. To illustrate this Vinten provides an example of the UK Law of Tort and how moral responsibility was undermined by the legal framework in the UK. In the case of Overseas Tankship (UK) Ltd v Morts Dock and Engineering Co. Ltd (The Wagon Mound) (1961) the defendant released furnace oil into the harbor water which drifted to the plaintiff’s wharf. The oil ignited by welding works and caused extensive damage to the wharf. The court ruled in favor of the defendant as although liability was established the damages were deemed to be “not reasonably foreseeable”, too remote and as the wharf had ignited the oil, *novus actus interveniens* – a new act intervening.²¹⁰ Where a direct consequence of negligence can be established law has no difficulty in determining liability. Society, in the SRI view, is thus not capable of establishing realms which enshrines sustainability within business conduct and argue that organizations are thus required to take an active stance towards stakeholder interests which “go beyond the minimum obligations of regulation and corporate governance”²¹¹. This is an unmistakable and direct opposition to Sternberg’s first proposition.

²⁰⁸ Vinten (2001), p. 38

²⁰⁹ Sternberg (1998), p. 97

²¹⁰ Keenan & Riches (1995), p. 11

²¹¹ Johnson & Scholes (1999), p. 217

SRI proponents furthermore criticize the shareholders theorists' interpretation of the theory. Proponents of the shareholder value perspective have taken the term 'stakeholder' to be descriptive rather than a normative approach and have thereby misinterpreted its meaning. Crainer believes that by taking a descriptive stance Sternberg, amongst others, has been able to incorporate everything and everybody as a stakeholder thus discrediting the applicability of the theory due to the sheer numbers involved.²¹² The definition of stakeholders should however be viewed as normative description where only a "number of stakeholders have a right to determine what happens within an organization".²¹³ This in turn clearly opposes Sternberg's second and third proposition.

Vinten goes on to say that time, in essence, has passed Sternberg as stakeholder model, such as the Balanced Scorecard as well as including other non-financial criteria within performance evaluations, have been developed and successful implemented.²¹⁴ Furthermore several papers, such as Fredrick, Davis and Post's (1988) six stage model, Carroll's (1989) Management Questions and Wheeler and Sillanpaa's (1997) Stakeholder Analysis Blueprint,²¹⁵ have been issued during the last quarter century which suggest means and models of how to incorporate a stakeholder balance perspective into business plans. This is a clear counter-argument against Sternberg's fourth proposition.

²¹² This directly opposes Milton Friedman's definition: "A stakeholder in an organization is any group or individual who can affect or is affected by the achievement of the organization's objectives." <http://itrs.scu.edu/mcalkins/spring99/09/stakeholder.htm>

²¹³ <http://www.fba.nus.edu.sg/rsearch/pqrc/PQRCNW/5ICIT/Powerpoint/01-11.ppt>

²¹⁴ Vinten (2001), p. 43

²¹⁵ Vinten (2001), p. 41